Enron and Andersen: Heed the Questions and Warnings They Raise for Your Company's Own Compliance Program

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Enron has captured public and media attention in a way that has made business misconduct an everyday topic of discussion. But what are the lessons for compliance professionals from this highly public case study? The shock of this immense scandal should cause members of boards of directors, managers and compliance professionals to ask whether their compliance and corporate ethics programs could prevent--or at least detect at an early stage--the next Enron. Drawing from the reports on what happened at Enron, here are some of the questions, based on the U.S. Sentencing Guidelines template, that should guide this careful corporate evaluation.

USSG's Item 1-- Standards and Procedures

- Is your code of conduct binding--i.e., is it the law of your company? Or is it just high-sounding words?
- Do your professional advisers--lawyers and accountants--have to follow your code in advising what conduct is acceptable for your company?
- Have you determined what your corporate culture is--by surveys, focus groups, and interviews--to be sure that your compliance program matches reality?
- Has your risk assessment matched the real risks in your business? Are you listening to the warning signals, such as those from the government? For example do you cover earnings management?
- Does your program have procedures that are designed as a check on the misuse of power anywhere in the company? For example, if you waived a conflict of interest, would you have real Chinese Walls separating those with the conflict from any role in company decisionmaking?

Enron had a code of conduct, but apparently the ethical standards were not applied in judging potential business transactions. Company vice president Sherron Watkins alleged that the Enron culture was "arrogant" and "intimidating." The troublesome partnerships were supposed to be monitored carefully, but allegedly were not. There do not appear to be any signs of an organized approach to earnings
management compliance.

**USSG's Item 2--**
**Compliance Infrastructure**

- Does your compliance officer have the "clout" to be able to resist a high-powered chief financial officer or company president intent on meeting the earnings numbers?
- Does your board of directors include an audit committee composed exclusively of outside directors? Does the compliance program report to that independent committee?
- Is your audit committee prepared for the compliance task? Are the members truly independent, without other ties to management?
- Is the audit committee empowered? Does it have access to independent resources, such as separate outside counsel? Do members have the necessary background, training, and tools to monitor compliance?
- Do the outside auditors, who report to the audit committee, have sufficient independence?
- Is the compliance officer required to report on a direct and unfiltered basis to the audit committee, including meetings in executive session? Must that officer report promptly any allegation regarding a senior officer, and do so before such matters are acted on (including any decision not to act)?
- Is the compliance officer formally elected by the board, as an executive officer, with his or her removal requiring board approval? Has an employment contract for the compliance officer been considered?
- Do any cuts in the budget of the compliance program or transfers of key personnel require approval of the audit committee?
- Is there a compliance presence, such as a compliance liaison, in every business unit (such as the finance department) with significant compliance risk?

*Enron's audit committee apparently was not attuned to compliance program needs and appears to have depended on information from the very managers, lawyers, and accountants involved in the partnership process. The partnerships were apparently run by very high-powered executives and managers in Enron, who tried to get at least one person who resisted them fired. The audit committee was apparently not made aware when managers or lawyers raised questions about the senior managers' involvement in the partnerships.*

**USSG's Item 3--**
**Delegating Responsibility And Assessing Leaders**

- Were the types of people

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responsible for the Enron partnerships people who would be promoted in your company? Would a manager who suggested an arrangement to enrich himself in dealings with the company be permitted to have management responsibilities?

- Does the company's assessment and promotion system screen out those with a possible propensity to break the company's ethical standards?
- What signals are the company's rewards systems sending? Are earnings results all that matter for compensation, recognition, and promotions? Are the accountants and finance people rewarded for being "creative" (one of many earnings management "red flags")?

*Enron appears to have been focused on growing earnings and increasing the share price, and rewarding those who achieved this objective with little attention to the means used.***

**USSG's Item 4--Communicating Effectively**

- Is compliance and ethics training more than boring lectures and weak, text-based programs that do not connect emotionally with employees? Is it powerful enough to have an impact in a high-intensity culture?
- Are you verifying that employees have actually taken the training? Does the training reach deep into the company?
- Do all employees understand the system for raising questions and reporting concerns and why they should use it? Do they know that retaliation is prohibited?
- Do all employees understand that conflicts of interest are prohibited, why conflicts are wrong, and what the dangers are?
- Has the program addressed the training and background needs of the board and audit committee? Are they trained in the high-risk areas?
- Does the audit committee have a current list of red flags for spotting earnings management issues?
- Do the board members know what *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Chanc. 1996), requires of them and what makes a compliance program effective? Do they understand the personal risks if they fail to act on allegations of misconduct?
- Is the audit committee supplied with the tools and resources it needs to manage an effective compliance program?
- Do you reach all at-risk employees on the types of subjects that led to trouble for Enron and Arthur Andersen:
  a. Earnings management/accounting and securities fraud--this can involve surprisingly large numbers of people.
  b. Conflicts of interest--too often overlooked are the serious legal and reputation risks.
  c. Insider trading ("pump and dump"), such as selling when allegations of serious misconduct emerge.
d. Cover-up, responding to problems, investigations, destroying evidence.

e. Code of conduct/whistleblower systems--does everyone have the message?

From Sherron Watkins's description of the culture, it does not appear that a compliance and ethics message reached employees and especially not the senior managers. The board and the compliance program do not appear to have addressed the types of risks that destroyed the company--conflicts, earnings management and securities law issues, the failure to escalate compliance concerns, and how to react to government investigations. The audit committee does not appear to have been given background on the risks in these key areas, or on what steps were needed to address these risks.

USSG's Item 5--
Steps to Prevent Violations

• Does your internal audit organization help keep the outside auditors on their toes? Have you avoided combining the internal and external audit functions?
• Are your outside auditors sufficiently independent, or do consulting and other contracts compromise that independence? Should you rotate the outside auditors? Should the audit committee have access to outside experts to help in assessing such questions?
• Have you assigned the law department an official monitoring role, to assure that the shareholders' interests, and not those of management, are protected, and to assure that the company's activities conform to the code of conduct, and not just legal minimums?
• Where there is high risk, such as the Enron partnerships with senior executives on both sides of the negotiating table, do you have systems to assure especially tight monitoring, and that the audit committee is kept close to the facts?
• Are you using surveys and focus groups to surface troublesome trends and signals about the culture?
• Do you use annual questionnaires requiring managers to report on all conflicts?
• Is there a strong alternative reporting system, such as a well-publicized helpline, to protect employee anonymity and make it easy for employees to raise questions?
• Do you avoid giving employees impractical advice on reporting misconduct, like telling them to call the CEO to report misconduct?
• Are detailed reports on the help-line and investigations carefully monitored by the audit committee, on an unfiltered basis?

Enron outsourced its internal audit function to Andersen, which also engaged in a lucrative consulting practice with the company. The legal department and outside counsel appear to have ignored the company's own ethical standards regarding dealings with the partnerships. The partnerships were apparently not closely supervised. Although Sherron Watkins described the culture in very negative terms, it does not appear that anyone was measuring this to help assess the compliance risks. There also does not appear to have been an anonymous 800 reporting line; instead employees were told to call the
CEO or write a letter. There does not appear to have been a reporting system that would escalate serious issues to the audit committee, and managers apparently were not reluctant to attempt retaliation against those who resisted them.

USSG's Item 6--
Discipline

- Is discipline for anyone threatening retaliation severe, especially if it is a high-level manager? If a manager demanded an employee be fired for trying to do the right thing or challenging misconduct, would that type of threat bring swift disciplinary action against the manager?
- Would your company discipline a senior manager who was responsible for results in an area rife with misconduct for failing to detect the misconduct even though the manager claimed not to know what had been going on?

No disciplinary steps appear to have been taken against anyone for threatening another employee for resisting misconduct. This was true both for the lawyer who took a tough negotiation stand in dealing with the partnerships, and for Sherron Watkins. The former CEO states that he did not know what was going on with the partnerships, but there is no indication the company would consider any form of discipline for this.

USSG’s Item 7--
Responding Effectively

- Do you have standards for conducting investigations that would prohibit someone from conducting an investigation when they have already been involved in the matter being investigated?
- Would those standards and procedures prohibit telling investigators not to do things that are necessary in the investigators' professional judgment to conduct an investigation?
- Do you have systems in place to assure that records are retained from the moment you learn of an investigation? Would your system freeze all records disposal, including electronic records? Would you seize records promptly so they cannot be destroyed?

The general counsel of Enron retained the same firm to investigate the partnerships that had been involved in advising on them. He allegedly instructed this firm not to "second guess" the very accounting that was at issue, and not to examine all of the transactions. Upon word of the SEC investigations, employees in Andersen and Enron allegedly shredded documents. At Andersen, an e-mail reminder of the firm's existing records retention and disposal policy was used as an explanation for the records disposal activities in the Houston office.

Third Parties

- Do you require outside professional firms you retain, e.g., accounting and law firms, to have compliance programs?
• Have you trained your professional services providers on your code of conduct, so they apply the code's standards when reviewing any issues at your company?

It does not appear that Andersen had a Sentencing Guidelines type of compliance program, which would have encouraged employees to escalate ethical concerns and prohibited destruction of potential evidence. It also appears that neither outside counsel nor Andersen applied Enron's ethical standards in considering the permissibility of the partnerships and other transactions. In fact, outside counsel's opinion in response to the Watkins letter allegedly stated that the partnerships would look bad if subjected to a Wall Street Journal exposé--i.e., they failed the standard ethics "newspaper test."

Documentation

• If you are doing these things, can you prove it? For example, can you document your employees' compliance training?
• Do you have the code of conduct from your outside accounting and law firms? Is it at least as thorough and rigorous as your company's?
• Have you audited your compliance files to be sure they are complete?

At this point, there is not much that any Enron or Andersen compliance files could do for them, as it appears that they did not have the necessary program steps in place. But if your company does take the steps to have an effective and empowered program you need to be able to prove what you have done.

Some may say that the real solution to the Enron problem is to have ethical leaders. This advice is 100 percent correct, but it is also just about 100 percent useless. Compliance practitioners do not select CEOs and even if we did, there is no system known to humankind to assure that only good people are in an organization. So until Plato's dream of philosopher-kings (or philosopher-CEOs) comes to pass, we must focus on the practical steps we can each take. There are many such steps, and there is no better time to start than now, before we read an Enron-type story about our own company in the Wall Street Journal.