**ENRON’S TENTH ANNIVERSARY: CONCLUSION—OR IS IT?**

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***Grumpy Old Accountants, November 2011***

In previous essays we have discussed the context in which Enron found itself during the 1990s, an environment friendly to managers who chose aggressive accounting maneuvers; we have described the crimes themselves; we have looked at the gargantuan transformation of the auditing profession; and we have examined what Arthur Andersen did not do in its Enron audit and how it neglected professional skepticism. We conclude this series by looking at what it means.

One of the better essays on the topic is by John Coffee, law professor at Columbia. In “[What Caused Enron: A Capsule Social and Economic History of the 1990s](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=373581),” Coffee postulates three causes of Enron: (1) the misaligned incentives story, (2) the gatekeeper story, and (3) the herding story. The misaligned incentives explanation focuses on the dramatic rise in stock options that gave managers enormous incentives to massage earnings reports in order to increase their compensation. The gatekeeper story focuses on a decrease in legal exposure for gatekeepers and an increase in possible consulting fees. The herding story claims that fund managers think alike and nobody is willing to break from the pack even if they sense danger.

Still, Coffee’s explanations are insufficient. A bigger problem lies in Washington. We begin with Coffee’s three causes and then move to other more important causes of the problem, which if left unattended will unfortunately lead to more Enrons and more Andersens.

**The Manager Problem**

Initial reactions to Enron and WorldCom led some to claim that there existed a few “bad apples” and that the vast majority of managers would never do what Lay and Skilling did to Enron and what Ebbers and Sullivan did to WorldCom. These statements were naïve or self-serving. As the GAO [report on restatements made clear](http://www.gao.gov/new.items/d06678.pdf), during the period from January 1, 2002 to September 30, 2005, there were 1,084 companies that restated their accounting results. While some people might interpret this as a few “bad apples,” such as CEOs and CFOS, we think it shows a perverse disregard for the discipline of financial reporting. Apparently, truth is no longer a virtue to corporate managers.

Much of the problem is due to compensation schemes—schemes that encourage managers to manipulate accounting reports and thereby gain more compensation (including perquisites). While we loathe having the public sector regulate compensation, we also believe that present-day compensation of managers is outrageous inasmuch as it begs the question of how much value the firm receives from these overpaid managers. Worse, it invites managers to cheat.

**The Gatekeeper Problem**

With the many accounting scandals arising during the early years of the 21st century, most observers stopped singing the “bad apples” tune and started criticizing the gatekeepers for a poor job. Usually by gatekeepers they meant auditors and credit rating agencies—and they are correct on both indictments.

Indeed, the transformation of the auditing profession has been one of the causes of the decline of integrity in accounting reports. And all of the reforms of the profession fall flat because none of them addresses the central problem—the patron system in which the auditor is paid by the firm it audits. This structure is pernicious because it necessarily aligns the interests of auditors with that of managers. To address the underauditing problem, one must address the patron system itself.

Credit rating agencies have an isomorphic structure—they too are paid by the firms whose debts they evaluate. As long as they are paid by managers, they will be the servants of management. To address the gatekeeping problem, one must correct the structural defects of the institution.

Boards of directors are likewise ineffective in fighting managers, often because they are as independent of managers as bees are detached from honey. Directors too often side with management or remain indifferent rather than aligning themselves with shareholders.

Analysts are also a problem because many are employed by the banks that negotiate various deals for managers. Until they break the shackles of their banks, they cannot provide truly independent analyses. And firewalls are a joke; they are as ineffective as window fans on a space shuttle.

Besides the structural change already mentioned, society needs to find ways of improving the economic incentives of these actors. We must decrease the incentives to align gatekeepers with managers and to increase the incentives to align them with shareholders. So far we are treating this cancer as if it were a cold.

**The Investment Fund Manager Problem**

Investment fund managers have a tremendous pull to do what the others are doing. If they invest in something differently, they will have gains when they are correct; but when wrong, they not only suffer stock declines, but they lose much reputational value and investors drop out and go to other investment funds. With small benefits when correctly different from the herd and huge losses when incorrectly different, these investment fund managers move in a herd and are slow to address accounting problems.

We hope someday to find braver fund managers who also deeply understand accounting and finance so that they are right more often than not. Further, we hope someday to find smarter investors who do not penalize a fund manager when he makes ten correct decisions different from others but one mistake. Investors need to appreciate diversification and tally gains and losses on a portfolio basis.

**The Regulator Problem**

John Coffee provided a good analysis of three of the causes of the fraud at Enron and the ineffective audit by Arthur Andersen. But he still left out some important pieces to this puzzle—the problem of the regulators such as the SEC and the problem of Congress and the White House, who apparently are not in favor of rigorous enforcement of the securities acts.

The manager problem also exists because the government does precious little to penalize managers. Except for some outliers in terms of large civil fines or prison sentences, most managers either escape any punishment or suffer at most small and inconsequential civil penalties. It is as if the SEC does not comprehend its purpose or care for investors any more.

Much of the problem is that too many commissioners are pro-business, meaning they are pro-managers. Their motto seemingly has become let the CEOs pillage their companies. SEC Chairmen Arthur Levitt and William H. Donaldson tried to make the SEC more investor-friendly, but Chairs Harvey Pitt, Christopher Cox, and Mary L. Schapiro have been disasters.

Enron occurred on Harvey Pitt’s watch and his response is found in “[How to Prevent Future Enrons](http://www.sec.gov/news/speech/spch530.htm).” He did not criticize the managers or the auditors; instead, Mr. Pitt felt that accounting needed to be modernized and that financial statements might be impenetrable—whatever that means. But he did not want to criticize his former clients.

The bank crisis occurred on the watch of Christopher Cox. He did nothing to prevent the meltdown of the subprime mortgage industry and nothing to help investors afterwards. But nobody should have been surprised, for he was anti-investor beforehand, having sponsored many bills to thwart the efforts of FASB to improve financial reporting for business combinations and stock options, as well as sponsoring litigation reform so fraudsters and their auditors could run amok with smaller consequences.

Mary Schapiro likewise is not investor-friendly. She inherited the bank scandals from Cox, but seems content to let the scoundrels off with small penalties. For example, Citigroup lied to investors about a $1 billion CDO and the SEC is willing to let Citi off the hook for a mere $95 million penalty (total fine $285 million). Fortunately, [Judge Rakoff is questioning](http://www.nypost.com/f/print/news/business/not_so_fast_mary_3swYT8jetx2WNtcFf4HdZP) the justice of the deal, wondering why Citi should get off with its fine when Goldman incurred a penalty of $535 million for a similar transaction. Indeed, one wonders why the SEC has changed strategy and is willing to charge these criminals with negligence instead of fraud (see “[At SEC, Strategy Changes Course](http://professional.wsj.com/article/SB10001424052970203405504576601251693560910.html?mod=WSJ_hp_LEFTWhatsNewsCollection&mg=reno-secaucus-wsj)”).

If you want to deter accounting fraud, the regulators have to ferret out accounting fraud and impose civil and criminal penalties. If the SEC does not do this, managers have incentives to cheat.

**The Government Problem**

The biggest problem, however, is that of the federal government. The White House and the Congress have the power and the authority to do something to minimize accounting and securities fraud, but they do nothing substantively.

In 1995 Congress passed the Private Securities Litigation Reform Act, which had the purposes of making it more difficult for plaintiffs to file a class action suit against business enterprises, corporate managers, and public auditors and curbing the awards when plaintiffs won. In 1998 Congress passed the Securities Litigation Uniform Standards Act which requires class action lawsuits brought because of accounting issues to be filed in federal court. With these two acts Congress made it much harder for plaintiffs to sue wayward managers, directors, and auditors and it capped the awards. The consequence was a dramatic increase in the number of accounting frauds and an increase in the amount of the frauds. Congress would be wise to repeal these two acts and reduce accounting scandals.

Congress passed the Sarbanes-Oxley Act in response to Enron and WorldCom, and it passed Dodd-Frank in response to the bank crisis. While they have some benefits, overall they are unnecessary because the 1933 and 1934 securities acts already define many managerial actions as fraud. Sarbanes-Oxley and Dodd-Frank were more political than real; Congress wanted to appear in control of the situation rather than actually dealing with the problem. If Congress really wanted reform, at a minimum it would haul in the SEC commissioners and ask where are the legal proceedings against corporate miscreants. If Congress desired more, it could have examined the structural problem in present day auditing and credit rating agencies—it could have removed the conflicts of interest inherent in the managers-pay-the-evaluators system with something truly independent.

Finally, we are aghast that Congress won’t increase the budget of the SEC. To fight crime, you need cops on the scene and in the lab. As the SEC has the white collar cops to deal with reprobate managers, Congress should give them the funds to do their jobs. Then haul the commissioners in and be sure they are fighting for the interests of investors.

**Summary**

The history of Enron and Arthur Andersen tells a simple story. Some managers cheat investors and gatekeepers, the SEC, and even Congress and the White House align themselves more with the bad guys than the investment community. Can this problem be fixed?

We are not so naïve to think society can eliminate accounting crimes; the human heart is too greedy. But, we can reduce the frequency of these crimes and we can reduce their severity by focusing on the incentives of would-be criminals. Society can reduce the incentives to cheat by increasing the probabilities of getting caught and by increasing the penalties when caught. We haven’t done much so far to address the underlying problems, so the crimes continue. Until then, let’s expose the problem and continue our appeals to Congress and the White House and maybe, just maybe, somebody will care for investors and creditors.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*