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Enron's Lessons

Former Enron exec Lynn Brewer on the value of veracity

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ENRON's LESSONS

LynnBrewer

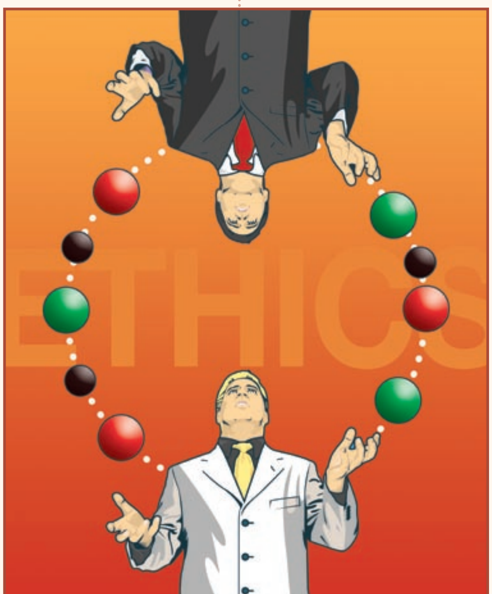
Putting a price on integrity isn't easy. But it's pretty clear that the world is looking beyond the balance sheet. In fact, ROI means 'return on integrity' as much as 'return on investment.' Has your organization heeded Enron's lessons? How about your stockholders? How do they define ROI?

How many business leaders believe they have learned the lessons taught by Enron? That the Enron story is simply one of failed corporate governance – the oversight necessary to maintain the compliance and ethics of an organization? What if I told you that the U.S. Securities and Exchange Commission (SEC) currently receives some 40,000 whistle-blowing reports every month – compared to 6,400 per month the year Enron imploded? What if I were to tell you that, right now, 100 of the FORTUNE 500 companies could possibly be cooking their books? Would it make you wonder whether business leaders should take a second look at the issue of integrity?

Redefining integrity

We have been misguided into believing integrity equates to ethics and that if you have solid corporate governance policies, the integrity of the organization is sound. Although certainly compliance, ethics and corporate governance are part of an organization's integrity, we must expand our approach. If, for instance, we were to approach organizational integrity the way a structural engineer examines a building, we would realize the issue has far less to do with policies and procedures and more to do with overall soundness of the business and its ability to withstand market forces.

Integrity, originating from the word "integer" (a whole number), in its simplest form means "soundness, wholeness and incorruptibility." When we realize hundreds of companies have demonstrated that they operate with the same level of integrity as Enron, we begin to understand stakeholders' needs to have a way of separating the wheat from the chaff – the Enrons from the others. And equally important, companies need to have a way of differentiating themselves as something other than the next Enron. As they achieve this, companies gain shareholder confidence while shareholders gain the financial benefit of a greater ROI.



What if I were to tell you that, right now, 100 of the Fortune 500 companies could possibly be cooking their books?

Measuring integrity

There are several arguments swirling around the importance of integrity. However, despite those companies seeking to "do the right thing," there is no standard means by which we can gain any assurance that a company has integrity, much less a quantifiable measure of the specific level of integrity. The company may be fully compliant with Sarbanes-Oxley requirements, yet the competency of the leadership may be questionable, compensation excessive and the culture of the organization dysfunctional – none of which violate the law, but all of which may ultimately destroy the value of the company.

By understanding the factors that affect the quality of financial reporting, business leaders can begin to demonstrate the level of integrity under which they operate. For instance, how does the CEO communicate with shareholders? With the intent of putting a spin on the truth – obscuring the facts – or with the intent of demonstrating full transparency?

Of course, most people believe annual letters to shareholders are prepared by investor relations and/or public relations professionals, and thus pay little or no attention to them. However, we need only look at the case of Enron to realize the importance of the information contained in these letters and the damage caused to investors from their failure to fully examine their contents.

In Enron's 2000 Letter to Shareholders, CEO Jeffrey Skilling stated the company had hit a record "$1.3 billion in net income," yet the audited financials were clear – Enron had reached only $978.5 million in net income. There were no footnotes, no further discussion of the discrepancy, and yet every reference by the media or analysts from that point forward stated Enron was a $1.3 billion company – no questions asked.

Financial recognition or overcompensation?

Moving to the issue of compensation, clearly the packages at Enron were excessive, but Enron is not alone in its excessive pay. While executives who increase the long-term value of a company's assets for investors should be recognized and rewarded, we also must understand that rewarding an executive, or any employee for that matter, with a package based upon false reality or performance that can be manipulated can tarnish a company's integrity. Additionally, leaders must recognize the cultural destruction that can occur for leaders who fail to recognize the disparity between their own compensation packages and the compensation of those they seek to lead – particularly if leaders are out of touch with the culture of the organization.

Meanwhile, CalPERS and TIAA-CREF, two of the largest institutional investors, have both created policies for fairly and justly compensating their executives. As excess compensation is seen as a lack of good corporate governance, institutional investors have said they will "punish" companies with excessive compensation packages by withholding their investment dollars. Given that the SEC has issued its own guide to executive compensation for investors, it is likely that this issue will remain a hot topic for many years.

When examining the dual issues of compliance and ethics, we must recognize that they have far more to do with business intelligence than simply doing the right thing. To detect violations of laws and policies, and thus reduce the risk of exposure, the company must have a confidential and anonymous reporting solution. While Sarbanes-Oxley requires such a system for employees of publicly traded companies, the SEC has suggested the system not be limited to employees only. To maintain the confidence of the reporter and the integrity of the system, companies must outsource their reporting solution. The system must be available to all stakeholders via a secure Internet site, telephone and/or mail. Beyond that, the reporting solution should meet the criteria established and defined for all business intelligence systems.

Addressing the financial impact of confidential and anonymous reporting, the Association of Certified Fraud Examiners recently published its 2004 study, *Third Report to the Nation on Occupational Fraud Abuse*. It reports that "the median loss among organizations with anonymous reporting mechanisms was $56,000, while it was more than

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“Investors need transparency if they are to be able to make informed decisions to benefit the economy as a whole by making sure that capital goes to companies who deserve it.” **– Frits Bolkestein, European Commission’s Internal Market Commissioner**

twice as high for those that didn’t have established reporting procedures.” The study concludes, “Among cases that were detected by a tip, 60 percent of tips came from employees, 20 percent came from customers, 16 percent were from vendors and 13 percent were from anonymous sources.”

Despite the new legal requirement for a confidential and anonymous reporting system, it is obvious, based upon the alarming rate at which employees are reporting directly to the SEC, that employees don’t trust the integrity of the systems put in place by their companies. Clearly, through a review of these reports, companies can first understand the integrity of the organization as it relates to compliance and ethics, and then determine whether corporate governance policies need to be revised. Beyond that, the new law prohibits retaliation against reporters and requires “treatment” of the problems, which may clearly expose companies to additional liabilities if they fail to analyze the reports being made.

With the passage of Sarbanes-Oxley, many companies have been forced to undertake a review of their corporate governance policies. As organizations, such as Institutional Shareholder Services and The Corporate Library, are measuring this aspect of corporate integrity, many companies today are seeing a real impact to their shareholder value as investment decisions are being made based upon these ratings.

Of course, many leaders falsely believe corporate governance is a fad. Yet, according to a July 2004 study by *The Ethical Corporation* magazine, 85 percent of senior finance professionals say the issue of governance will remain on their firms’ agendas for at least the next 18 months. The referenced survey defined business governance as a three-pronged approach: corporate governance, corporate performance management and corporate social responsibility. In fact, 60 percent of respondents said they were making “real and significant changes to business processes” with this new emphasis on corporate governance.

When it comes to reporting “non-financial” information like corporate governance policies, we realize it is now becoming mandatory to report corporate social responsibility policies in many countries. The European Commission’s Internal Market Commissioner Frits Bolkestein made it clear: The reason this information is now required is because “investors need transparency if they are to be able to make informed decisions to benefit the economy as a whole by making sure that capital goes to companies who deserve it.”

As we move to understanding the value of integrity and the impact non-financial information can have on shareholder value, companies should also look to the importance of stakeholder perceptions. Interestingly enough, according to the 2003 LRN and Wirthlin Worldwide study, 80 percent of respondents from the general public said their perceptions of a company’s compliance and ethical behavior had a direct influence on their purchasing decisions.

Rather than maintaining a myopic view of our organizations, we should look to employees, customers, vendors and shareholders to provide the insights that business leaders may fail to recognize. The board of directors may understand the business from management’s perspective, but do board members understand the perspective of investors and customers?

Finally, companies need to address their business intelligence. The Integrity Institute measures a company’s ability to understand its own integrity through the factors listed above, as well as its risk analysis and business intelligence systems. A “forward-looking” formulation that is predictive is used to assess operational risk, as well as assess the company’s business intelligence systems.

For instance, to demonstrate integrity (soundness, wholeness and incorruptibility), the company’s business intelligence systems must meet all of the following criteria to be certifiable:

- Functions and technologies across the organization must be integrated.
- BI systems must be adaptable and understandable to technical and non-technical business users alike so that data is available to anyone who needs the information and in a format that is relevant to them.
- Data must be complete and comprehensive in an end-to-end platform, meaning all components of every system must be integrated.
- The systems must be capable of performing analytic insight into the future rather than a review of the past through historical query and reporting.
- Accurate and uncompromised data can be validated – even when multiple systems, disparate data sources and applications are integrated.
- Uncompromised storage capabilities must be secure and allow for quick and accurate retrieval of information.

After examining the above non-financial factors, the information needs to be validated against the financial information – such as the likelihood that the company's earnings may have been manipulated. This validation is usually performed using a variation of the Beneish Model.

Although many companies have used a number of approaches to measure the level of integrity within their organizations, including the balanced scorecard, many leaders today are still struggling to communicate the value of their integrity to investors. At least 94 percent of executives, according to the 2003 LRN study, believe that ethical companies are generally more efficient and better run, naturally lending themselves to greater ROI.

When executives are unable to communicate the level of integrity that they maintain, companies are subject to the perceptions of institutional investors. According to a McKinsey Investor Opinion Survey of 200 institutional investors, 89 percent said they would pay more for the shares of a well-governed company than for those of a poorly governed company with comparable financial information. The Integrity Institute's certification of corporate integrity, similar to the Underwriters Laboratories certification of consumer product safety, is just one of the many ways that companies can communicate they are not another Enron.

Of course, to make a strong case for the benefits of measuring and certifying corporate integrity, one must understand the financial benefit, as well as the impact to such things as the cost of goods, cost of capital and shareholder value.

Beyond the balance sheet

As investors begin to look beyond the balance sheet as the basis for investment decisions, we find they are expanding the definition of ROI – moving from a simple return on investment to adding a return on integrity. That's not to say the balance sheet and the financial analysis will not remain important aspects of investment decisions; rather, institutional investors are beginning to recognize the role that non-financial information plays in the process. In fact, according to a survey conducted by the Cap Gemini Ernst & Young Center for Business Innovation, "Roughly a third of investors' buying and selling decisions depend at least in part on non-financial information." Perhaps this is why, according to a recent Deloitte survey, "nearly three-quarters (73 percent) of executives and board directors are under increasing pressure to measure non-financial performance indicators."

While study after study shows that there is a "clear negative correlation between levels of corruption (as perceived by investors) and levels of investment," some business leaders still believe that "this too shall pass," thereby failing to meet the demands of shareholders simply because they think that their companies are not "corrupt." However, there are those leaders who are not so naïve. Take Jeffrey Immelt, CEO of General Electric, as an example. In his 2002 Letter to Shareholders, he states: "One concern that keeps me up at night is that, among the 300,000-plus GE employees worldwide, there are a handful who choose to ignore our code of ethics. I would be naïve to assume that a few bad apples don't exist in our midst." And yet, as he clearly points out, GE spends billions each year to "protect one our most valuable assets – our reputation." GE's recognition of the value of integrity is perhaps one of the reasons that the company earned the honor of being named "The World's Most Respected Company" in PriceWaterhouseCoopers' 2003 survey of 1,000 global CEOs. The survey also placed GE first in integrity.

Those who seek to emulate Jeff Immelt or GE would be wise to heed the warning of Adam Hanft of *Inc.* magazine. "We are now entering a cycle where ethical accountability will shape the way companies will be judged and valued. This isn't ethics as an ornament, as the accessory of the moment, but as a new systemic force and reality."

Clearly, the real force behind this new reality will be the judgment of institutional investors as they make their investment decisions, based in large part on the perceived value they believe that companies place on integrity and the soundness of their organizations.

John C. Bogle, founder of The Vanguard Group, points out that a mere 100 of the largest managers of pension funds and mutual funds now represent the ownership of one-half of all U.S. equities. And the dollar amount held by just six of these managers is $1.4 trillion. While such thought leaders as Bogle and Berkshire-Hathaway Chairman Warren Buffett realize that the sustainability and success of our capital markets require long-term returns and long-term investors, one of every 10 equity funds turned its portfolio over at an annual rate of more than 200 percent, while four of every 10 funds at a rate of more than 100 percent. But who can blame these investors? There is too much uncertainty about the integrity of companies, so rather than get stuck holding shares in another Enron, these investors are simply moving their money from one slot machine to another, hoping to hit the big payoff without losing too much money. This roulette mentality only serves to exacerbate the "misvaluation," volatility and instability of our markets.

As we look at the issues raised when measuring integrity, we should look at the negative impact that excessive executive compensation can have on investor confidence. With the enforcement of shareholder rights by large institutional investors, excessive executive compensation is now actually considered to be of negative value in assessing integrity. As a result, companies that award excessive compensation over the interests of shareholders will be penalized. As these large institutional investors demonstrated in the cases of Disney and American Airlines, they don't think excessive packages are always deserved and don't necessarily align management's interests with those of the shareholders.

While the issue of executive compensation will be an ongoing debate, excessive packages are indicative of poor board oversight, as witnessed in the case of Dick Grasso, former chairman of The New York Stock Exchange. When we measure the value of board quality in terms of corporate performance, we find, according to a *BusinessWeek* study, companies with the most highly rated boards averaged 51.7 percent in shareholder returns, while the worst boards dragged their companies down to an average 12.9 percent return over the same period of time.

Focusing on the issue of corporate governance as it correlates to shareholder value, we find companies that score higher in their governance rating are the ones that provide greater shareholder returns. In fact, Institutional Shareholder Services, which has a corporate governance quotient (CGQ), found the top 10 CGQ-rated companies outperformed the companies rated in the bottom 10 by 18.7 percent return on investment and 23.8 percent return on equity.

Meanwhile, researchers have found that companies that demonstrate weaker shareholder rights earned significantly lower returns, were valued lower, had poorer operating performance, and engaged in greater capital expenditure and takeover activity. "Corporate Governance and Equity Prices," a paper prepared by economists Paul Gompers, Joy Ishii and Andrew Metrick, revealed that "a portfolio strategy based on purchasing shares in companies with the strongest investor protections and selling short those firms with the greatest management power earned an abnormal return of 8.5 percent a year."

While corporate governance is important, it is only a small portion of the overall factors that are examined when assessing integrity. In fact, the Cap Gemini Ernst & Young Center for Business Innovation used a value creation index that, based upon publicly available data, found analysts relied heavily on a broad range of 12 intangible factors. The index was used to measure a company's performance on these intangible factors. The results demonstrated that "at least half of a traditional company's value is based on nine of the 12 intangible drivers." A high index rating correlated to a higher market value, and a relatively small change was found to produce significant changes in market value.

Meanwhile, the University of Michigan Ross School of Business has perhaps the most interesting data when it comes to the value of integrity. Companies that are perceived to have higher organizational virtues (such as forgiveness, trust, integrity, optimism and compassion) proved to have a higher level of profits.

The conclusion we can draw from all of this data is that the criteria upon which investment decisions are made, which may ultimately affect the long-term sustainability of companies, are changing. Perhaps that's why the Dow Jones Sustainability Index, which invests in companies that integrate economic, environmental and social issues into their strategies, outperformed the mainstream market in 2003. Or why Italy's STAR exchange – which has strict corporate governance requirements and require that the compensation of management and directors must reflect a company's performance – outperformed its counterparts on the less-restrictive Borsa exchange.

As investors realize the risks and benefits of investing in companies that don't understand the full importance of the value of integrity, the likely rise and fall of companies in the future will not be based upon accounting scandals but on the company's ability to measure and certify its integrity. ■

BIO **Lynn Brewer** is a former Enron executive and author of *Confessions of an Enron Executive: A Whistleblower's Story*. In her nearly three years at Enron, she was responsible for risk management in Energy Operations, the e-commerce initiatives for Enron's water subsidiary and competitive intelligence for Enron Broadband Services. Today, she is the founding chairman of The Integrity Institute, Inc., a public policy institute that assesses and certifies corporate integrity at the request of organizations for the benefit of their stakeholders.