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**In This Issue:**

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(Or, What We Can  
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# BUSINESS & THE LAW

## EARLY LESSONS FROM THE POWERS REPORT (Or, What We Can Learn from Enron)

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Although the investigations of Enron have only begun, with audit committee season in full swing, and with the staffing of board committees to follow shortly, we want to provide some preliminary thoughts on what Enron's failure might mean to public companies. While much of what we recommend is based upon the concerns expressed in recent reports regarding Enron, many of these lessons build upon similar corporate failures, such as those of Phar-Mor, Cendant, Waste Management and Sunbeam.

The scale and depth of what went wrong at Enron is so massive that it is easy for most public companies to distinguish themselves and conclude that it could never happen to them. However, several of the underlying problems that existed at Enron could exist at almost any business. The Powers Report — the report of the Special Committee of Enron's Board of Directors chaired by Dean Powers of the University of Texas Law School — describes a number of these problems, most specifically the difficult issues resulting from related party transactions. In addition, the Report and other reports and releases, including two SEC releases,<sup>1</sup> also address other underlying problems, such as accounting practices, off-balance sheet financing, auditor independence and incentive-based compensation.

### Related Party Transactions

Probably the most troubling aspect of Enron's collapse was the prevalence of significant related party transactions involving high-ranking officers of the company. The Report dramatically illustrates the dual dangers of these transactions. First, and most obviously, the officers involved in these transactions are tempted to enrich themselves at the expense of the company. Second, the transactions may provide short-term accounting benefits to the company that would not be available in arms-length transactions with third parties.<sup>2</sup> Senior officers who are expected to monitor and control related party transactions may be motivated to ignore problems because of the short-term financial benefits to the company or because they may view a transaction as fair compensation to the affected employee.

SEC rules and good corporate governance practices attempt to address these dangers through disclosure requirements and independent director review. In Enron's case, both of these failed because Enron's lawyers and accountants, and its independent directors, did not exercise the vigilance necessary in light of the significance of the transactions. In particular, the Report criticized the Enron Board and Audit Committee for their lack of oversight. It further criticized the Audit Committee for failing to obtain a better understanding of the accounting and economic aspects of the transactions. In its responsive releases, the SEC also focused on the oversight responsibilities of boards and audit committees.<sup>3</sup> Accordingly, given the potential risks involved with related party transactions and the current sensitivity of the SEC and the financial markets to such transactions, we believe that this year all boards should undertake a close review of their procedures for dealing with related party transactions.

Enron's related party transactions were highly unusual in both size and form. Related

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party transactions more commonly include such ordinary transactions as leasing a building or buying products or services from an executive or a business controlled by his or her family. It has been our long-standing advice that public companies should have written policies governing these types of transactions, either as part of their general business ethics policies or as separate free-standing policies. In addition, in light of Enron and the scrutiny that is likely to be applied in the near term to related party transactions, where policies do not require board or audit committee approval (some just require CFO or general counsel approval), they should be modified to require that approval for significant transactions. It is clear to us that not all transactions warrant board or audit committee review — consider an officer's purchase of a company car at the end of its planned use; so defining what is significant will be important. At a minimum it should encompass transactions that could be financially material to a company. It may be desirable, however, to include transactions that do not meet that threshold but involve either a company's high-ranking executive officers or otherwise are of a nature that could be embarrassing if publicly disclosed. We further recommend that where the approval authority is vested in the audit committee, the audit committee refer the most significant transactions, particularly those involving high-ranking executive officers, to the full board for approval.

Enron also demonstrates that scrutiny of related party transactions should extend beyond transactions with the company's "named" executive officers. In order to avoid proxy statement disclosure, Enron structured one very significant, and very disastrous, related party transaction with an officer just below the reach of the executive officers required to be named in the compensation table.<sup>4</sup> The SEC suggested in its January Release extending the scope of related party transaction disclosures to include disclosures of transactions involving parties beyond those traditionally thought of as related parties.<sup>5</sup> While we do not believe that additional disclosure requirements are needed in this area, board and audit committee scrutiny should encompass a broader group of individuals than in the past, probably extending to all senior officers.

For less significant transactions, or as part of the procedures approved by the board for more significant transactions, some review responsibilities may be delegated to

management. According to the Report, this procedure was employed at Enron, with several management officials having general responsibilities in connection with the review and approval of specific related party transactions. Perhaps because the transactions improved Enron's reported financial results, and in reading the Report in the best light for the individuals who were involved, each of these individuals narrowly interpreted his responsibilities and relied heavily on the fact that others also had responsibilities with respect to the transactions. This resulted in a level of review that was not nearly as thorough as the Enron Board had expected. Accordingly, in any situation where review responsibilities are delegated to management, a board should clearly delineate those responsibilities and, where appropriate, require the reviewing officer to confirm that he or she performed the required review. Except in unusual or complex situations, we do not think outside auditor review of a specific transaction is necessary.

### Other Significant Issues

**Accounting Practices.** Enron's accounting practices were characterized in the Report as "beyond aggressive" and were certainly a major factor leading to its collapse. In response, the SEC, in its December Release, reminded management and audit committees that the selection and application of accounting principles must be appropriately reasoned. It also indicated that audit committees should review the selection, application and disclosure of "critical accounting policies."<sup>6</sup>

In connection with an audit committee's review of accounting practices generally, the Report also demonstrates the need to probe more deeply into unusual transactions that occur late in a reporting period and generate positive accounting results. As noted in the Report, there is nothing fundamentally wrong with late period transactions if the transactions have economic substance. However, in Enron's case many of the late period asset sales appeared to be sham transactions, with Enron repurchasing the assets it previously sold shortly after the end of the reporting period. In addition, a pattern of such transactions, even if economically supportable, should raise concerns regarding the validity of reported earnings.

The SEC has announced that it will adopt rules that will require specific disclosures regarding critical accounting policies and separately recommended that all companies

include a plain English description of such policies as part of their MD&A discussion in their Form 10-K's. Accordingly, management of each public company should identify and describe their most critical accounting policies. If management does not believe that it has any, we still urge public companies to consider describing the three or four most significant policies lest they stand out in the SEC's review process. Audit committees should carefully review these policies and their application with management.

**Off-Balance Sheet Financing.** The Report criticized the Enron Audit Committee and, to a lesser extent, the entire Board for their failure to develop a more thorough understanding of Enron's off-balance sheet financing, particularly given the significance of these arrangements to the company's reported earnings and the related party nature of these arrangements. The SEC also has indicated concerns over these arrangements, particularly the level of disclosure provided by reporting companies with respect to these arrangements.

Given the current concerns over off-balance sheet arrangements, we believe that this year audit committees should focus particular attention on these arrangements, which include, for example, customer receivable securitizations. This may be accomplished by requesting and reviewing a written report of management and the outside auditors that provides a thorough description of off-balance sheet arrangements. The significance and types of such arrangements should be considered by audit committees in determining whether to look more closely at, or to obtain outside assistance to develop a better understanding of, the arrangements. In addition, audit committees should be more skeptical of off-balance sheet financing arrangements that are uncommon in their company's industry. For example, the audit committee of a retailer should not be surprised to see that the retailer has securitized its customer receivables. However, if the audit committee of a non-capital intensive enterprise suddenly begins to see numerous off-balance sheet financings, close scrutiny is warranted.

**Auditor Independence.** Concerns over the independence of outside auditing firms arose well before the Enron scandal. The two principal concerns are (i) the provision of non-audit related services by audit firms, and (ii) the presence of former employees of the outside auditor on the internal accounting staff of the audit client. The Enron collapse further inflamed the concerns

over auditor independence, as Arthur Andersen provided significant non-audit related services to Enron and numerous former Andersen accountants worked as employees of Enron.

The provision of non-audit related services by outside auditors has generated significant debate. There are a number of proposals for rules or regulations that would prohibit outside auditors from providing such services to audit clients. And to some extent the Big Five are addressing this debate by divesting their consulting practices. However, audit committees should carefully monitor the non-audit work being performed by their auditors, and companies should be aware of the potential for shareholder proposals relating to such matters. For example, the SEC recently refused to allow Disney to exclude a shareholder proposal to prohibit the company from using its outside auditor for non-audit services.

With respect to hiring former employees of an outside auditor, such practices have been justified due to the efficiencies that result from the new employee's familiarity with the company. However, this familiarity between in-house staff and the outside auditors can lead to problems, the best example being Phar-Mor, where the independent auditing firm allowed the inside accountants to have too much input in the audit process thereby enabling them to hide inventory shortages. We agree with Marty Lipton's widely discussed recommendation that companies consider restrictions on hiring employees of their outside auditor. While we do not believe that it is necessary to eliminate all hiring of employees of the outside auditor as some have suggested, we believe that at least several key participants in the financial reporting process should have no prior relationship with the outside auditor. We do not see sufficient urgency in this area to necessitate changing existing staff; we would simply suggest recruiting from other sources on a prospective basis.

**Incentive Compensation.** While most of the concerns arising from Enron's collapse relate to the work of audit committees, they also have raised questions for compensation committees. In a recent report, Frederic W. Cook & Co., Inc., an executive compensation consulting firm, questioned whether executive compensation systems that are heavily tied to financial performance, such as the system at Enron, may contribute to an atmosphere that compromises the integrity of financial reporting.<sup>7</sup> The Cook Report questions whether extremely high levels

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of performance-based compensation may provide potential rewards so great that managers are encouraged to take unreasonable risks. Enron's compensation system was highly performance-based, and it is rumored that in some departments the bottom performing 15% were terminated annually. Compensation committees should not overlook these concerns in their consideration of performance-based compensation.

## Potential Regulatory Response

As described above, the Enron collapse has been viewed as a failure in a number of areas, including accounting practices, corporate governance practices and disclosure practices. Given the magnitude of Enron's collapse, there will be significant regulatory responses in each of these areas, with the most significant responses likely to be in the area of accounting practices. SEC Chairman Harvey Pitt and other commentators already have suggested revisions to the system of reviewing the work of independent auditors, such as the adoption of a self-regulatory organization that would be subject to SEC supervision. In addition, the process used by FASB to issue new accounting standards, which is viewed as being slow and subject to inappropriate influence, is likely to be reconsidered.

In the area of corporate governance, the SEC has asked the New York Stock Exchange and Nasdaq to review their corporate governance standards, including a review of rules relating to officer and director qualifications and the codes of conduct of public companies. The NYSE already has established a Special Committee on Corporate Accountability and Listing Standards to conduct that review. One possibility is that the NYSE and Nasdaq may begin to require continuing education programs for directors and officers, which is something that we consider extremely burdensome and unnecessary.

Finally, with respect to disclosure practices, the SEC, consistent with its January Release, has declared that it intends to amend the rule governing the content of MD&A's. The amended rule would require plain English disclosures about the critical accounting policies of the company, including the judgments and uncertainties affecting the application of those policies and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. In addition, the SEC already has provided guidance suggesting expanded MD&A

disclosures with respect to liquidity, contingencies, off-balance sheet arrangements and related party transactions. Accordingly, all reporting companies will be required to devote significant attention to their disclosure over the next several months.

We would be pleased to discuss any or all of these issues with you further and to provide you with copies of the materials that have been referenced herein.◆

<sup>1</sup> In response to the Enron collapse, the SEC has issued several releases articulating its concerns and prospective guidance. In Release No. 34-45149, issued in December 2001 (the "December Release"), the SEC addressed the need for audit committee review of critical accounting policies as well as the need for transparent disclosures of such policies to investors. In Release No. 34-45321, issued in January 2002 (the "January Release"), the SEC provided guidance with respect to existing disclosure requirements for related party transactions, off-balance sheet financing and certain trading activities.

<sup>2</sup> For example, since independent parties would not provide economic hedges for its merchant investments, Enron engaged in hedging transactions with related entities that in theory allowed Enron to accomplish its temporary accounting objectives of not reporting any decline in the value of the investments. Since the hedges lacked economic substance, the temporary accounting results were unsustainable and eventually required the reporting of significant losses that surprised the marketplace.

<sup>3</sup> In the January Release, the SEC suggested that audit committees review related party transactions in their discussions with management and auditors, including a review of their terms and internal corporate and Board actions involving such transactions, prior to recommending that the financial statements reflecting those transactions be included in a company's SEC filings.

<sup>4</sup> According to the Report, to avoid disclosure of certain purported hedging transactions as related party transactions, Michael J. Kopper was inserted as manager of the related entity in lieu of Enron's CFO, Andrew Fastow. Any material transactions involving Fastow, a named executive officer, would require disclosure under Item 404 of Regulation S-K; however, transactions with Kopper, a subordinate of Fastow, did not require such disclosure.

<sup>5</sup> In the January Release, the SEC indicated that companies also should consider disclosure of transactions involving parties that fall outside the definition of a related party, but with whom the company has a relationship that enables it to negotiate terms that would not be available with a third party.

<sup>6</sup> Critical accounting policies include those policies that are both most important to the portrayal of a company's financial condition and results and require management's most difficult, subjective or complex judgments, often as the result of the need to make estimates about the effect of matters that are inherently uncertain.

<sup>7</sup> The February 6, 2002 report, entitled "The Implications of 'Enron' for Executive Compensation," was issued by Frederic W. Cook & Co., Inc. This report, along with a number of excellent law firm memoranda relating to the issues discussed in this memorandum can be found at [www.thecorporatecounsel.net/accounting/index.htm](http://www.thecorporatecounsel.net/accounting/index.htm).