



AUDIT COMMITTEE THINKING POST-ENRON

**Prepared By
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**KPMG Directors Roundtable
Dallas, Texas**



ENRON OF YESTERDAY

- **Share Price Went From \$30 to \$90 Between 1998 and 2000 While Revenues Increased From \$31 Billion to Above \$100 Billion**
- **7th Largest Company in the Fortune 500**
- **Board of Directors Ranked As One of the Nation's Five Best Boards (*Chief Executive Magazine – October, 2000*)**
- **“I can honestly say I’ve never felt better about the company, its business model, its prospects, and probably most importantly, our incredibly deep talent pool.”**
Ken Lay (August 14, 2001)

ENRON OF TODAY

- **Largest Bankruptcy in U.S. History (Dec., 2001)**
- **\$17 Billion Loss in Stockholder Value**
- **Thousands of Enron Employees Put Out of Work and Lose Millions in Retirement Savings**

- **Multiple Class Action Lawsuits for Damages**
 - **Officers**
 - **Directors**
 - **Auditing Firm**
 - **Law Firms**
 - **Investment Banking Firms**
- **Criminal Indictments**
 - **Auditing Firm**
 - **?**
 - **?**

How Did This Happen?

- **“This was a massive failure in the governance system”**

*Robert E. Litan
Brookings Institute
New York Times
December 16, 2001*

“Enron Board Comes Under A Storm Of Criticism” *New York Times* Headline, Dec. 16, 2001

- **Board/Audit Committee Failed to Adequately Understand, Review, Approve and Monitor Special-Purpose Entities (Off-Balance Sheet Transactions)**
- **Enron’s Relationship With External Auditor Too Cozy**

- **Audit Committee Flawed**
 - **3 Members of the Audit Committee Not Totally Independent (Conflict of Interest)**
 - **3 of 6 Members of Audit Committee Lived Abroad**
 - **Audit Committee Met Less Than The Compensation Committee Met**
 - **Waived Enron's Conflict of Interest Policy to Allow Certain Special-Purpose Entity Transactions With Insiders**

Perspective Of The Chairman Of The Enron Special Investigative Committee

“How could [Enron’s tragic consequences] have happened? ... [It is] the result of failures at many levels ... inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limit. ... **The Board of Directors failed in its duty to provide leadership and oversight.**”

Dean William C. Powers, Jr.
Dean University of Texas School of Law
February 7, 2002

Perspective Of The Enron Audit Committee Chairman

“Throughout my tenure as Chairman of the Enron Board’s Audit Committee, I have been committed to ensuring that it is an effective and actively functioning body. Over the last few years, **we began a number of initiations to ensure that we remained a “best practices” Audit Committee. ... I respectfully submit that we did our job. ... We did all of this, and more. Sadly, despite all that we tried to do, in the face of all the assurances that we received, we had no cause for suspicion until it was too late.**”

Robert Jaedicke

Former Dean Stanford School of Business

February 7, 2002

Enron's Impact on Corporate Governance

“... appalling was the performance of Enron’s board of directors. By not keeping Enron from barreling down the wrong track to a rendezvous with catastrophe, the board has given a black eye to efforts by other American firms to improve corporate governance in recent years.”

Knowledge @ Wharton
Wharton Business School
March, 2002

Government Reactions

- **Congressional Investigative Hearings Initiated**
- **SEC Investigations Initiated**
- **50-plus Pieces of Federal Legislation Introduced to Address Perceived Corporate Governance, Public Disclosure and Auditing Failures in Enron**
- **President Bush Announced Ten Point Plan To Address Enron Issues**
- **SEC Proposes New Public Disclosure Requirements In The Aftermath Of Enron**

Corporate Board Reactions

- **Boards Are Asking Questions About The Adequacy Of Their Own Conduct In Light Of Enron**
 - **Could Our Board/Audit Committee Be Subjected to the Same Criticisms Levied Against Enron's Board/Audit Committee?**
 - **In The Aftermath of Enron, Is There Anything That We Should Do Differently?**

- **Boards Are Considering Policies to Strengthen External Auditor Independence**
 - Rotation of External Auditor on a Regularly Scheduled Basis (e.g. 5 years)
 - Restrictions on the Retention of the External Auditor for Non-audit Services
 - Restrictions on Hiring Employees From the External Auditor

- **Boards Are Considering Policies to Strengthen Audit Committees**
 - Stricter Independence Requirements for Audit Committee Members
 - Continuing Education to Enhance Financial Literacy of Audit Committee Members
 - Retention of Separate Legal Counsel and Accounting Expertise for the Audit Committee

- **Boards/Audit Committees Are Asking Whether They Need to “Enron” Their Due Diligence When Interfacing With Management, External Auditor, Internal Auditor And Legal Counsel**
 - **Special- Purpose Entities.** Inquire About “Special Purpose Entities” and Other Complex Financing Transactions and Related Accounting Treatment
 - **Critical Accounting Policies.** Inquire About The Company’s Most Critical Accounting Policies Especially Those That Involve Considerable Subjective Decision Making

- **Third-Party Criticisms.** Inquire Whether There Have Been Any Articles, Analysts' Reports or Other Credible Third-party Sources That Are Critical of the Company's Accounting Policies or Financial Disclosures
- **Disclosure Adequacy.** Inquire Whether the Company's Financial Statements and Disclosures Comport With the Disclosure Requirements of the Federal Securities Laws Notwithstanding Their Conformity With Accounting Principles and Practices

- **Corporate Misconduct.** Inquire Whether There Have Been Any Allegations of Director or Officer Misconduct or Corporate Misconduct by the Company (Whether Made by Employees or Third Parties)
- **Policy Waivers.** Inquire Whether There Have Been Any Violation or Waiver of the Company's Conflict of Interest or Internal Control Policies

- **Risk Developments.** Inquire Whether There Are Any Claims, Government Investigations or Other Legal Matters That Might Significantly Affect the Financial Statements or Risk Management
- **Auditor Disputes.** Inquire Whether Any Major Disagreements Have Occurred Between Management And the Auditors Over Accounting Policies or Financial Disclosures
- **Legal Counsel Disputes.** Inquire Whether Any Major Disagreements Have Occurred Between Legal Counsel and Management Over the Form or Any Public Disclosures or Other Legal Matters

MEANWHILE BACK AT THE AUDIT COMMITTEE MEETING THE ADVICE REMAINS THE SAME POST-ENRON

- 1. Keep Focused on the Fundamentals of Fiduciary Care – Adhere to the Business Judgment Rule’s Three-Step **Process** for Decision Making**

Point to Remember: In Litigation, the Judicial Focus Will Be on Whether the **Process** by Which the Board Made Its Decisions was Reasonable Under the Circumstances.

First: Become Fully Informed

- **Prepare For Meetings (Read “Board Packet” and Other Pertinent Materials)**
- **Review Information With a Healthy Dose of Skepticism**
- **Ask Probing Questions (Devil’s Advocate)**
- **Be Vigilant**

- **Seek the Advice of Independent Experts (e.g. Legal Counsel, Accountants and Consultants) Where Appropriate**
- **Have “High Understanding” of the Company’s Business and Accounting Policies**
- **Keep Abreast of Developments to Maintain Financial Literacy**

Second: Consider the Issues in a Prudent Manner

- **Attend and Actively Participate in Meetings**
- **Meet As Often As the Circumstances Dictate**
- **Do Not Be “Hurried”**
- **Engage in Appropriate Deliberation with Fellow Directors (“Free and Open Discussions”)**

Third: Act In Good Faith

- Be Free of Conflicts of Interest
- Believe That the Actions Taken Are in the Best Interest of the Company
- Conduct Yourself in a Manner That Demonstrates You Have Exercised Independent Judgment (Arms-length From Management – No “Rubber Stamp”)

REMEMBER: DIRECTORS ARE JUDGED BY THE CARE TAKEN IN THEIR DECISION MAKING PROCESS

2. Properly Rely On Management And Experts

2.1 The Duty of Care Does Not Require That Directors Be or Become Experts in Matters Presented to Them for Action.

2.2 Section 141(e) of Delaware General Corporation Law Provides That A Director Is Fully Protected in Relying in **Good Faith Upon Information, Opinions, Reports, or Statements of :**

- (i) Officers and Employees,**
- (ii) Board Committees, and**

(ii) Experts who have been selected with reasonable care As to Matters That the Board Believes Are Within the Expert's Professional Competence

2.3 Good Faith Means That the Director Does Not or Should Not, in the Proper Exercise of His or Her Office, Know of Facts That Would Lead Him or Her to Believe That the Report Is Inaccurate, Incomplete or Flawed

2.4 Section 141(e) Does Not Mean That a Board Can Blindly Rely on Management or Experts or Delegate Away Its Duties to the Point That It Interferes With the Exercise of Its Independent Judgment

3. Properly Record Actions Taken

3.1 The Content of Minutes Can Often Be Pivotal Evidence in Litigation Challenging Director Conduct.

3.2 When Properly Prepared, Minutes Can Effectively Demonstrate That Directors Carried Out Their Fiduciary Duties.