

Presentation Notes

NACD conference: “Lessons To Be Learned From the Rise and Fall of High Profile Corporate Entities: The Scandals and How to Identify Red Flags In Revenue Reporting and Financial Statements.”

14 September 2004

My remarks:

...Thank you Mickey for those welcoming remarks.

I wish to echo your thoughtful comments about the loss of our good friend, Vince. Indeed, the Houston chapter of the NACD would not exist were it not for Vince’s leadership.

I am reminded of conversations I had a few years ago with Hal Shear prior to the founding of the Houston chapter. Hal had the idea of forming a Houston chapter. Hal said that his experience with starting other NACD chapters around the country showed that the success of a new chapter was largely a function of the quality of the first leader. In the Houston chapter, we had a terrific leader in Vince and we owe to him much gratitude for being our first leader. All of us have a deep sense of loss with his passing.

To get your mental wheels turning this morning, I will now say a few words about how we can be sensitized to red flags that can signal impending breakdowns in corporate governance and financial performance.

This will serve as a preface to our main speakers this morning, my good friends and colleagues Professors Bala Dharan and Nancy Rapaport. Bala and Nancy have some terrific thoughts to share with you.

Although much of our conversation this morning will center on the lessons we can learn from Enron, there are of course an abundant supply of other corporate scandals that we can draw upon as raw material such as such as WorldCom, Tyco, Global Crossing, and Adelphia, and Hollinger.

I have written about Enron and other scandals in a recent piece entitled “*The Fragility of Organizational Trust: Lessons from the Rise and Fall of Enron*,” which was co-authored by my colleague in the Jones School here at Rice.

Mine is a behavioral science perspective, while you will hear Bala comment later on the accounting perspective and Nancy on the legal perspective.

In an odd way, like Bala and Nancy, I owe a great deal to Enron. It was a boon to my media visibility! I did over 25 media interviews on Enron and did three interviews on the national “Nightly Business Report” on Public Broadcasting Television. Because I had more than 30 former students working at Enron, reporters saw me as having some insight into the corporate culture of Enron.

I was quite familiar with Enron although I am reticent to call myself an expert. But, one hallmark of being an academic is that we never hesitate to offer our opinion even if our expertise is limited!

And, if I would have taught my 30 + former students better, perhaps Enron would not have ended up in the mess it did. My only consolation is that I did not teach any of the *top executives* of Enron, who were responsible for most of the misdeeds!

Furthermore, before I get too pompous and imply that I was smart enough to see Enron’s problems long before they emerged in the public domain, I must acknowledge that I, like many others, thought Enron was a juggernaut that would go forever.

Sure, I knew about the “rank and yank” employee performance policies and other oddities in the ways that Enron managed its employees.

But, did that stop me from personally buying Enron stock? No!

In all my wisdom, I bought Enron stock at \$60 per share!

But, at least I sold it at \$40 per share, which makes me smarter than some...

So, let us talk about red flags this morning and how we can recognize them and, hopefully, avoid corporate calamities.

From my behavioral science viewpoint, here are some thoughts to set the stage for Bala and Nancy's remarks...

1. One of the odd facts about the collapse of Enron was that it was a case, not of too little trust in corporate executives. Rather, it was a case of *excessive trust* in top managers.

This is one red flag that should make all directors nervous – when there is unwavering trust in top executives, we should take care to scrutinize a bit more closely. Nobody is perfect, after all, so although some degree of trust in top executives is of course desirable, too much trust gives them too much power. And, power can corrupt, as it did with Enron.

2. Another red flag as to do with “conflicts of commitment.” This is a term that is familiar to all of us and refers to situations when an executive has too many outside obligations to adequately discharge his/her responsibilities inside a corporation. Ken Lay had in my view a conflict of commitment due to all his political activities, which made it more difficult for him to “mind the store” at Enron. This created the leeway that Skilling and Fastow needed to launch their inappropriate financial and accounting structures.

Speaking of financial and accounting structures, I will now turn over to Bala and Nancy. After their remarks, we look forward to the questions and opinions of our audience members...