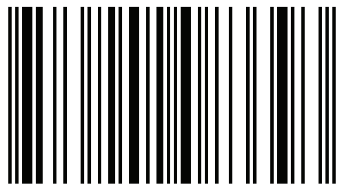
Enron: How Public and Private Governance Works In Different Contexts?

We know that Corporate Governance is the central and dynamic aspect of business. The term ‘governance’ derives from the Latin gubernare, meaning ‘to steer’, usually applying to the steering of a ship, which implies that corporate governance involves the function of direction rather than control. We have many ways of defining corporate governance, from narrow definitions that focus on companies and their shareholders, to broader definitions that incorporate the accountability of companies to many other groups of people, or ‘stakeholders’. In my paper, I discuss a the definition of the Corporate Governance in Emerging Markets, but for the purposes of this introduction I use a general definition that corporate governance concerns the way in which companies are directed and controlled.

Laurea Triennale in Economia e Management (Università di Roma Tor Vergata 2010) 95/110, Laurea Magistrale in Lingua Inglese in Business and Administration (Università di Roma Tor Vergata 2013) 108/110, Master II Livello in Ingegneria per le PA (Università di Roma Tor Vergata 2016), PhD in Economia e Finanza (Università di Roma La Sapienza)



978-620-2-08339-3

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Paper for the 6Th International Conference in Corporate Governance in Amsterdam 2018

edizioni accademiche italiane

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Imprint
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Cover image: www.ingimage.com

Publisher:
Edizioni Accademiche Italiane
is a trademark of
International Book Market Service Ltd., member of OmniScriptum Publishing Group
17 Meldrum Street, Beau Bassin 71504, Mauritius

Printed at: see last page
ISBN: 978-620-2-08339-3

Zugl. / Approved by: paper Corporate Finance

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We know that Corporate Governance is the central and dynamic aspect of business. The term 'governance' derives from the Latin gubernare, meaning 'to steer', usually applying to the steering of a ship, which implies that corporate governance involves the function of direction rather than control. We have many ways of defining corporate governance, from narrow definitions that focus on companies and their shareholders, to broader definitions that incorporate the accountability of companies to many other groups of people, or 'stakeholders'. In my paper, I discuss a the definition of the Corporate Governance in Emerging Markets, but for the purposes of this introduction I use a general definition that corporate governance concerns the way in which companies are directed and controlled.

The importance of corporate governance for corporate success as well as for social welfare cannot be ignored. Recent stories of massive corporate collapses resulting from weak systems of corporate governance have highlighted the need to improve and reform corporate governance at an international level. In the case of Enron and other similar cases, countries around the world have reacted quickly by pre-empting similar events domestically. As a speedy response to these corporate failures, the USA issued the Law of the Sarbanes–Oxley Act in July 2002, while in January 2003 the Higgs Report and the Smith Report were published in the UK, again in response to recent corporate governance failures. The impact of their recommendations are discussed throughout this paper. I also spend time discussing the difference between the rules-based approach to corporate governance adopted by the USA and the comply or explain approach chosen by the UK. Our main aim is to consider why such initiatives are being pursued and why continuing reform of the corporate governance system in the UK and elsewhere is necessary. In this introduction, I set the argument by placing the evolution of corporate governance in its historical and theoretical context, focusing mainly on the UK case. I now outline the paper in more detail.

Corporate Governance: What It Is? What Are Its Framework and Mechanism?

There is no single, accepted definition of corporate governance. There are differences in definition according to which country we are considering. The main focus of this paper is the agenda for corporate governance reform, mainly from a UK perspective. However, I use the US case of Enron and I demonstrate the need to improve corporate governance mechanisms. However, even within the confines of one country's system, such as the UK, arriving at 'a' definition of corporate governance is no easy task. Corporate governance as a discipline in its own right is relatively new. I consider that the subject may be treated in a narrow or a broad manner, depending on the viewpoint of the policy maker, practitioner, researcher or theorist. It seems that existing definitions of corporate governance fall on to a spectrum, with 'narrow' views at one end and more inclusive, 'broad' views placed at the other. One approach toward corporate governance adopts a narrow view, where corporate governance is restricted to the relationship between a company and its shareholders. This is the traditional finance paradigm, expressed in 'agency theory'. At the other end of the spectrum, corporate governance may be seen as a web of relationships, not only between a company and its owners (shareholders) but also between a company and a broad range of other 'stakeholders': employees, customers, suppliers, bondholders, to name but a few. Such a view tends to be expressed in 'stakeholder theory'. This is a more inclusive and broad way of treating the subject of corporate governance and one which is gradually attracting greater attention, as issues of accountability and corporate social responsibility are brought to the forefront of policy and practice in the UK and elsewhere.

In general the definitions of corporate governance found in the literature tend to share certain characteristics, one of which is the notion of accountability. In fact narrow definitions are oriented around corporate accountability to shareholders. Some narrower, shareholder in Emerging Markets oriented definitions of corporate governance focus specifically on the ability of a country's legal system to protect minority shareholder rights. However, such definitions are mainly applicable to emerging countries comparisons of corporate governance, and at present we are focusing on corporate governance within the UK.

Broader definitions of corporate governance stress a broader level of account ability to shareholders and other stakeholders. I can say that the corporate governance definition, encompassing accountability to a broader group of people than just the shareholders, was also supported strongly by institutional investors. This demonstrates an interest within the financial community in a broader, EM approach to corporate governance. The broadest definitions consider that companies are accountable to the whole of society, future generations and the natural world. I have agreed on our own, relatively broad, definition of corporate governance for the purposes of this paper, based on our research and our views concerning corporate governance issues in EM. I suggest that corporate governance is the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity.

Throughout this paper I attempt to show that theoretical frameworks that suggest companies in EM should be accountable only to their shareholders are not necessarily inconsistent with theoretical frameworks that champion stakeholder accountability. The reason underlying this argument is that shareholders' interests can only be satisfied by taking account of stakeholder interests, as companies that are accountable to all of their stakeholders are over the long term more successful and more prosperous. My definition of corporate governance therefore rests on the perception that companies can maximize value creation over the long term, by discharging their accountability to all of their stakeholders and by optimizing their system of corporate governance. This view is supported by the emerging markets practical cases. Indeed, my own empirical research has provided substantial support for the view that corporate financial performance is positively related to corporate governance in EM. I have found substantial evidence to suggest a growing perception among institutional investors in the City of London that there is a corporate governance dividend as well as a dividend attached to stakeholder accountability. In conclusion, I have found from my research that one reason 'good' corporate governance, as well as corporate social responsibility, are linked significantly to good corporate financial performance.

Overall, this perception is growing among the professional community and academic research is beginning to provide empirical evidence in support of this view of corporate governance, accountability and corporate profitability. However, this is the

‘business case’ for corporate governance and, more generally, for corporate social responsibility. Should companies improve corporate governance and discharge accountability to all of their stakeholders purely because it is ethical? In the real world, it is unlikely that businessmen and investors will be interested in acting ethically unless there are positive financial returns to be made from so doing. As there appears to be a strong business case underlying corporate governance reform and stakeholder accountability, then the corporate and financial communities are more likely to embrace these approaches. Having provided an introduction to corporate governance and a sample of the many approaches to defining the subject, I now move on to discussing a number of theoretical frameworks that are used to analyse corporate governance issues in EM.

Corporate Governance in Emerging Countries

A number of different theoretical frameworks have evolved to explain and analyze corporate governance in Emerging Countries. Each of these frameworks approaches corporate governance in a slightly different way, using different terminology, and views corporate governance from a different perspective, arising from a different discipline.

I want to introduce the "stakeholder theory", arise from a more social-orientated perspective on corporate governance. Although there are marked differences between the various frameworks, as they each attempt to analyze the same problems but from different perspectives. Here I want to define some of the most commonly used theoretical frameworks in accounting and finance-related disciplines and to specify some of the commonalities and differences between these competing paradigms. I examine agency theory, transaction cost theory and stakeholder theory.

Agency Theory in Developed Countries

The introduction of limited liability and the opening up of corporate ownership to the general public through share ownership had a dramatic impact on the way in which companies were controlled. The market system in the UK and the USA, is organized in such a way that the owners, who are principally the shareholders of listed companies, delegate the running of the company to the company management.

There is a 'divorce' of ownership and control that has led to the notorious 'agency problem'. I discuss the extent to which there was a dispersion of shareholding, which consequently led to a separation of ownership and control in the USA. It is showed that a similar structure of ownership and control operated in the UK. The agency problem defines the managers of the company as the 'agents' and the shareholder as the 'principal' (in their analysis there is one shareholder versus the 'managers').

In other words, the shareholder, who is the owner or 'principal' of the company, delegates day-to-day decision making in the company to the directors, who are the shareholder's 'agents'. The problem that arises as a result of this system of corporate ownership is that the agents do not necessarily make decisions in the best interests of

the principal. One of the principal assumptions of agency theory is that the goals of the principal and agent conflict. In finance theory, a basic assumption is that the primary objective for companies is shareholder wealth maximization. In practice this is not necessarily the case. It is likely that company managers prefer to pursue their own personal objectives, such as aiming to gain the highest bonuses possible. Managers are likely to display a tendency towards 'egoism' This can result in a tendency to focus on project and company investments that provide high short-run profits rather than the maximization of long-term shareholder wealth through investment, in projects that are long term in nature. Hence British industry has been notorious for 'short-termism'. Short-termism has been defined as a tendency to foreshorten the time horizon applied to investment decisions, or raise the discount rate above that appropriate to the firm's opportunity cost of capital. It is considered to characterize countries that are classified generally as 'outsider dominated where this means that the economy is not only dominated by large firms controlled directly by their managers but also indirectly through the actions of outsiders, such as institutional investors. I discuss this categorization of corporate governance systems in more detail.

Further, short-term pressure on companies has arisen from the institutional investment community, who have been more interested in gaining quick profits from portfolio investment than in the long-term survival and growth of their investee companies. They have been accused of 'churning' shares in order to make high returns on investment, regardless of the effects of their actions on managers, who as a consequence have been under pressure to focus on short-term performance.

In this corporate governance environment, managers are tempted to supplement their salaries with as many perquisites (such as holidays through the company, office equipment and the like) as possible—again leading to a reduction in shareholder value. The reduction in the shareholder's welfare is known as the 'residual loss' in agency theory terminology. Overall, I can see that the ownership structure in the UK (and in other countries with similar market systems) leads to a significant problem of divergent objectives. This 'agency problem' presents shareholders with a need to control company management.

An important question is therefore, 'how can shareholders exercise control over company management?'

Another important and basic assumption of agency theory is that it is expensive and difficult for the principal to verify what the agent is doing. There are a number of ways in which shareholders' and managers' interests may be aligned, but these are costly. Agency costs arise from attempts by the shareholder to 'monitor' company management. Monitoring by the shareholder is expensive, as it involves initiating activities such as shareholder engagement (expensive on resources and time-consuming). Incentive schemes and contracts are examples of monitoring techniques. The literature shows that solutions to agency problems involve establishing a 'nexus' of optimal contracts (both explicit and implicit) between management and the company's shareholders. These include remuneration contracts for management and debt contracts. These contracts seek to align the interests of the management with those of the shareholder. Although agency costs arise from establishing these contracts, costs are also incurred from the agents' side. Managers are keen to demonstrate to the shareholder that they are accountable and that they are following the shareholder wealth maximization objective. They may provide extra information about risk management in their annual reports, for example, which will add costs to the accounting process. They may expend additional resources in arranging meetings with primary shareholders. The costs associated with such initiatives are referred to as ex-ante bonding costs. The total agency cost arising from the agency problem has been summarized as comprising of: the sum of the principal's monitoring expenditures; the agent's bonding expenditures; and any remaining residual loss (see Hill and Jones, 1992). One of the main reasons that the desired actions of principal and agent diverge is their different attitude toward risk. This is referred to as the problem of 'risk sharing', as managers and shareholders prefer different courses of action because of their different attitudes toward risk.

We now introduce briefly the direct ways in which shareholders can 'monitor' company management and help to resolve agency conflicts. First, as owners of the company, shareholders have a right to influence the way in which the company is run, through voting at AGMs. The shareholder's voting right is an important part of his or her financial asset. An area of the finance literature is devoted to investigating the use of voting rights by shareholders, particularly institutional investors.

Shareholders can influence the composition of the board of directors in their investee companies (the companies in which they invest) through voting at AGMs. There is also a range of other issues on which shareholders may vote. Voting by shareholders constitutes 'shareholder activism'. Although the voting right is seen to constitute part of a shareholder's financial asset, institutional investors do not necessarily consider it to be a benefit, but rather an albatross around their necks. One pension fund director we interviewed commented that:

There is a weakness in the present system of corporate governance in that responsibility for ownership rests with people who don't want it and are not seeking it. I'm investing in shares because they give us a good return and it is coincidental really that they bring with them this responsibility. I am not saying we don't want this responsibility. I am just saying it is difficult to handle that sort of thing.

However, the same interviewee also suggested that one important result from the most recent code of corporate governance practice in the UK (the Combined Code, 1998) was that fund managers are taking more interest in corporate governance and in particular are voting at AGMs. Connected to shareholder voting rights is the takeover mechanism, which represents another means of controlling company management.

I emphasize the importance of the stock market as a means of disciplining company management through the takeover mechanism.

If shareholders are dissatisfied with a company's management structure they can vote in favour of a takeover. Clearly, the threat of takeover is per se a disciplining force on managers, as they are unlikely to want to lose their jobs. Directors' contracts represent one means by which they can gain some security, although lengthy contracts are becoming less popular as corporate governance reform continues.

Transaction Costs Theory in Emerging Markets

I can define that transaction cost theory is, '. . . an interdisciplinary alliance of law, economics, and organization . . .' (Williamson, 1996)

This discipline was initiated by Cyert and March's (1963) A Behavioural Theory of the Firm, a work that has become one of the cornerstones of industrial economics and finance theory. Theirs was an attempt to view the firm not as an impersonal economic unit in a world of perfect markets and equilibria but rather as an organization comprising people with differing views and objectives.

Transaction cost theory is based on the fact that firms have become so large that they, in effect, substitute for the market in determining the allocation of resources. Indeed, companies are so large and so complex that price movements outside companies direct production and the markets co-ordinate transactions. Within companies, such market transactions are removed and management co-ordinates and controls production (Coase, 1937). The organization of a company (e.g., the extent of vertical integration) seems to determine the boundaries beyond which the company can determine price and production. In other words, it is the way in which the company is organized that determines its control over transactions.

Clearly, it is in the interests of company management to internalize transactions as much as possible. The main reason for this is that such internalization removes risks and uncertainties about future product prices and quality. It allows companies to remove risks of dealing with suppliers to some extent (e.g., by owning both breweries and public houses, a beer company removes the problems of negotiating prices between supplier and retailer). Any way of removing such information asymmetries is advantageous to company management and leads to reduction in business risk for a company. There are non-trivial and prohibitive costs in carrying out transactions in the marketplace, and it is therefore cheaper for companies to do it for themselves through vertical integration. The same analysis applies equally well to the case of oil companies in their various stages of production, from oil exploration, to refining and eventual retail distribution. Traditional economics considers all economic agents to be rational and profit maximization to be the primary objective of business. Conversely, transaction cost economics attempts to incorporate human behaviour in a

more realistic way. In this paradigm, managers and other economic agents practise ‘bounded rationality’.

Simon (1957) defined bounded rationality as behaviour that was intentionally rational but only limitedly so. Transaction cost economics also makes the assumption of ‘opportunism’. This means that managers are opportunistic by nature. The theory assumes that some individuals are opportunistic, some of the time. The result of assuming bounded rationality and opportunism is that companies must:

> . . . organize transactions so as to economize on bounded rationality while simultaneously
> safeguarding the transactions in question against the hazards of opportunism.
> (Williamson, 1996, p. 48)

Opportunism has been defined as ‘self-interest seeking with guile’ and as ’the active tendency of the human agent to take advantage, in any circumstances, of all available means to further his own privileges’ (Crozier, 1964, p. 265). Given the problems of bounded rationality and opportunism, managers organize transactions in their best interests, and this activity needs to be controlled. Such opportunistic behavior could have dire consequences on corporate finance as it would discourage potential investors from investing in companies. Immediately, we can see similarities here between agency theory and transaction cost economics, as both theories present a rationale for management to be controlled by shareholders.

I now examine the ways in which transaction cost theory and agency theory are similar.

Transaction cost theory versus agency theory

Difficulties in disentangling agency theory and transaction cost economics have been acknowledged in the literature (see, e.g., Gilson and Mnookin, 1985). Williamson

Stakeholder theory

Stakeholder theory has developed gradually since the 1970s. One of the first expositions of stakeholder theory, couched in the management discipline, was presented by Freeman (1984), who proposed a general theory of the firm, incorporating corporate accountability to a broad range of stakeholders. Since then, there has been an abundance of writing based on stakeholder theory, across a wide array of disciplines (see, e.g., Donaldson and Preston, 1995). The role of companies in society has received increasing attention over time, with their impacts on employees, the environment, local communities, as well as their shareholders, becoming the focus of debate. Social and environmental lobby groups have gathered information on business activities and have targeted companies that have treated their stakeholders in an unethical manner.

Stakeholder theory may be viewed as a conceptual cocktail, concocted from a variety of disciplines and producing a blend of appealing sociological and organizational flavours. Indeed, stakeholder 'theory' is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational social science (Wheeler et al., 2002). A basis for stakeholder theory is that companies are so large, and their impact on society so pervasive that they should discharge an accountability to many more sectors of society than solely their shareholders. There are many ways of defining stakeholder theory and 'stakeholders', depending on the user's disciplinary perspective.

One commonality characterizing all definitions of stakeholders is to acknowledge their involvement in an 'exchange' relationship (Pearch, 1982; Freeman, 1984; Hill and Jones, 1992). Not only are stakeholders affected by companies but they in turn affect companies in some way. They hold a 'stake' rather than simply a 'share' in companies. Stakeholders include shareholders, employees, suppliers, customers, creditors, communities in the vicinity of the company's operations and the general

public. The most extreme proponents of stakeholder theory suggest that the environment, animal species and future generations should be included as stakeholders. The stakeholder relationship has been described as one of exchange, where the stakeholder groups supply companies with ‘contributions’ and expect their own interests to be satisfied via ‘inducements’ (March and Simon, 1958). Using this analytical framework, the general public may be viewed as corporate stakeholders because they are taxpayers, thereby providing companies with a national infrastructure in which to operate. In exchange they expect companies as ‘corporate citizens’ to enhance, not degrade, their quality of life (Hill and Jones, 1992). Indeed, every stakeholder represents part of the nexus of implicit and explicit contracts that constitutes a company. However, many writers refer to ‘stakeholders’ simply as those who have a legitimate stake in the company, in the broadest sense (Farrar and Hannigan, 1998).

In the UK the Corporate Report (ASSC, 1975) was a radical accounting proposal for its time, which suggested that companies should be made accountable for their impact on a wide group of stakeholders. The way that the Corporate Report hoped to achieve this was by encouraging companies to disclose voluntarily a range of statements aimed for stakeholder use, in addition to the traditional profit and loss account, and balance sheet. The additional statements included a statement of value added, an employment report, a statement of money exchanges with government, a statement of transactions and foreign currency, a statement of future prospects and a statement of corporate objectives. This was the first time that such an approach to financial reporting was considered seriously by a professional UK accounting body. The report excited substantial controversy, although its impact was negligible at the time. One reason for the apparent dismissal of the Corporate Report was the change of government, with the Conservative Party coming to power in 1979 and advocating a more free market approach than the Labour Party. In more recent years, however, a stakeholder approach to accounting and finance has become more acceptable, particularly in light of the change of government from Conservative to Labour in 1997 and the growing emphasis on an ‘inclusive’ society. Indeed, Wheeler and Sillanpa¨ a¨ (1997) explained the importance of developing a stakeholder society and highlighted the need for companies to be accountable to a wide range of stakeholders. Their book was endorsed by Tony Blair, the UK Prime Minister, as the ‘right’ approach to industrial activity. Linked to stakeholder theory is the idea of corporate

social responsibility, which is explored in my research. This is becoming a major issue for companies in the current political and social climate. Companies are being actively encouraged by social and environmental lobby groups to improve their attitudes toward stakeholders and to act in a socially responsible manner. One motivation for encouraging corporate social responsibility derives from a belief that companies have a purely moral responsibility to act in an ethical manner. This 'pure ethics' view assumes that companies should behave in a socially responsible way, satisfying the interests of all of their stakeholders, because this is 'good'. This is intuitively appealing. Quinn and Jones (1995) defined this approach as 'noninstrumental ethics', arguing that company managers have no special rules that allow them to ignore their moral obligations as human beings and that, whether ethical behaviour is profitable or not, it must be adhered to. They provided strong analytical arguments that agency theory could only be applied effectively if four moral principles were adhered to: avoiding harm to others; respecting the autonomy of others; avoiding lying; and honouring agreements. Indeed, they claimed that the principal–agent model could only hold if it was embedded in the setting of these four moral principles. Why should the 'moral obligation' to 'keep a promise' to maximize shareholder wealth be any more important, or supersede, basic human principles, such as avoiding harm to others? In other words*:*

How can one be morally bound to an agreement to ignore one's other moral obligations?

This argument formed the basis of their exposition of 'agent morality', where agents must first attend to their basic moral duties as human beings, as they have no special dispensation from moral obligations. Only after meeting these moral obligations could they attend to their obligation to maximize shareholder wealth.

Company law, however, makes a purely ethics-motivated approach to business impractical, as companies have a legal and fiduciary obligation to shareholder wealth maximization.

Similarly, institutional investors have a legal, fiduciary obligation to maximize the returns of their clients. These legal obligations mean that the business case for corporate social responsibility is the only realistic approach for company management. The legal system has been shown to be a significant barrier to the non instrumental ethics case for business in the US (Quinn and Jones, 1995). The basic philosophy of separate legal personality of companies, as famously encapsulated in the Salomon versus A. Salomon & Co. Ltd decision (see Farrar and Hannigan, 1998), is incompatible with a framework that makes directors personally accountable for their behaviour. Even the latest review of company law in the UK, which has attempted in its various drafts to stress the needs for business to be accountable to stakeholders, has ultimately resigned corporate social responsibility to a back seat, based on the 'materiality' of social, environmental and ethical risks to the business. In other words, companies should only take account of these factors, in so far as they affect the bottom line. We discuss the implications of the Modernising Company Law (2002) review for corporate social responsibility and socially responsible investment, within the context of corporate governance, in Chapter 9. It is almost impossible to pursue ethical business unless it is demonstrated to be Defining corporate governance.

A 'pure ethics' motive attracts derision from many members of both the professional and academic community, who view it as completely impractical and unrealistic. For example, one of our academic colleagues, who will remain nameless, dismisses a pure ethics approach as the 'pink fluffy bunny' view of corporate governance.

profitable, not only because of the attitudes of managers and shareholders but also because of our legal system and corporate governance structures. It would take more than a change in attitude to reconstitute company law in the UK and elsewhere. I now discuss the extent to which stakeholder theory and agency theory may be considered together, rather than be viewed as mutually exclusive.

Stakeholder versus agency theory

Is it possible that companies can maximize shareholder wealth, in an agency theory framework, at the same time as satisfying a broad range of stakeholder needs? In other words, 'is there any consistency between stakeholder theory and agency theory?' The importance of this question, and related questions, cannot be overstated, given the pervasive impact that businesses have on society in our consumerled, multinational-driven world. Yet the answer remains elusive. New frameworks for business which depict a 'sustainable organization' culture within a corporate community and which also recognize the interdependencies and synergies between the company, its stakeholders, value-based networks6 and society are emerging from the academic literature. Such an approach to business seeks to maximize value creation, through simultaneous maximization of economic, social and ecological welfare. Some academic work has provided empirical evidence that stakeholder management leads to improved shareholder value (Hillman and Keim, 2001).

However, stakeholder theory has long been vilified as the anathema of shareholder based agency theory (e.g., Sternberg, 1998). We revisit this perspective, embodied in the work of Milton Friedman, in Chapter 9. From this viewpoint, the only moral obligation facing managers is to maximize shareholder return, as this results (in an efficient market) in the 'best' allocation of social resources (see, e.g., Drucker, 1982; Jensen, 1991). The continual friction between these two theoretical frameworks was discussed by Shankman (1999), who pointed out that agency theory has for a long time represented the dominant paradigm for business and that the conflict between agency and stakeholder theories of the firm can be characterized as:

> . . . an ongoing struggle between economic views of the firm which are decidedly silent on the moral implications of the modern corporation, and ethicists who place the need for understanding ethical implications in a central role in the field of business ethics.
>
> (Shankman, 1999, p. 319)

Indeed, on a theoretical basis, there are significant differences between the two Corporate Governance and Accountability used the term Value Based Networks (VBNs) to refer to new communities that are being created from a desire (or need) to create and increase value.

Hillman and Keim (2001) used an index to measure stakeholder performance for companies, known as the Kinder, Lydenburg, Domini Index. This Index was compiled by an independent rating service that focuses exclusively on ranking approximately 800 companies according to nine areas of social performance. Theoretical paradigms, which at first sight render the two theories irreconcilable. For example, Shankman (1999) described stakeholder theory, but not agency theory, as normative in orientation, showing that the whole theoretical and philosophical underpinnings of the two theories were at variance. Nevertheless, there is a growing perception among theorists and practitioners that these two paradigms may be compatible (Wheeler et al., 2002) and that an altered approach to their theoretical derivation may allow them to be treated within one framework. For example, Shankman (1999) argued that agency theory may be subsumed within a general stakeholder model of companies, as:

(i) stakeholder theory is the necessary outcome of agency theory and is thus a more appropriate way to conceptualize theories of the firm;
(ii) agency theory, when properly modified, is at best a narrow form of stakeholder theory;
(iii) the assumptions about human behaviour and motivation implicit in agency theory are contradictory; and
(iv) all theories of the firm must uphold an implicit moral minimum that includes certain fundamental rights and principles and assumptions of human behavior that may very well require other traditional theories of the firm to be modified or even reconceived.
Similarities between the theoretical standpoints are evident on close examination.

For example, it is the manager group of stakeholders who are in a position of ultimate control, as they have decision-making powers allowing them to allocate the

company's resources in a manner most consistent with the claims of other stakeholder groups (Hill and Jones, 1992). This means that it is company management who are ultimately responsible for satisfying stakeholders' needs and expectations. Using agency theory terminology, given their unique position of responsibility and accountability, managers' interests need to be aligned not only with shareholders' interests but also with the interests of all other stakeholder groups. As stated in Hill and Jones (1992):

> . . . there is a parallel between the general class of stakeholder–agent relationships and
> the principal–agent relationships articulated by agency theory. Both stakeholder–agent
> and principal–agent relationships involve an implicit or explicit contract, the purpose of
> which is to try and reconcile divergent interests. In addition, both relationships are policed
> by governance structure.
> (Hill and Jones, 1992, p. 134)

Balancing the needs and interests of different stakeholder groups is notoriously difficult. This should not however be used as an excuse for making no effort to achieve such a balance. Hill and Jones (1992) also pointed out that many of the concepts and language of agency theory could be applied equally well to stakeholder–agency relationships. Overall, they argued that principal–agent relationships, as defined by agency theory, could be viewed as a subset of the more general class of stakeholder–agent relationships. Indeed, in developing 'stakeholder–agency theory' they sought to develop a modification of agency theory aimed at accommodating theories of power arising from a stakeholder perspective.

They argued that stakeholder-derived and agency theory perspectives on organizational phenomena, which have been viewed as mutually exclusive interpretations, may indeed be interpreted in one model, by making a series of assumptions about market efficiency.

The moral discourse for company management implied by agency theory and stakeholder theory is vastly different. As Quinn and Jones (1995) explained, adopting one perspective (that of agency) leads to a discourse based on self-interest, whereas adoption of the other leads to a discourse of 'duty' and social responsibility. Unless these two perspectives can be merged in some way, the managerial discourse cannot be expected to combine fully the extremes of profit-seeking self-interest and moral responsibility to society.

As discussed above, the only realistic compromise solution to this problem is to adopt the business case, rather than the pure ethics case. The business case for managers to adopt a stakeholder-oriented approach is based on the notion that 'good ethics' is 'good business' and that employing ethics as a strategic management tool increases the present value of the firm (Blanchard and Peale, 1988; Kotter and Heskett, 1992; Quinn and Jones, 1995). This is, according to Quinn and Jones (1995), an example of 'instrumental ethics' whereby managers choose an approach of corporate social responsibility in order to maximize shareholder wealth. As argued earlier, this is really the only approach to ethics that makes sense in the modern world, given the extant legal and regulatory environment confronting businesses.

Unless corporate social responsibility and accountability enhance shareholder wealth, neither company management nor large institutional investors, nor small scale shareholders would ever endorse it as a realistic approach to corporate activity.

It is more realistic to accept that ethics have to be profitable in order to be acceptable to businesses. But why should this not be the case? People are generally ethical, therefore ethical behaviour should be rewarded in a free market and unethical behavior punished in an Adam Smith environment (see, e.g., Boatright, 1999).8 This was certainly the case with Enron when managerial, unethical behaviour became public knowledge.

Corporate Governance and Accountability, Boatright (1999) explains that Adam Smith's invisible hand may, in an ethical environment, distribute wealth to socially responsible, ethical companies and distribute wealth away from unethical companies, through the free market mechanism.

There are, however, problems with the instrumental ethics case, or business case, for corporate social responsibility, as it is difficult to see how a company is being truly 'moral' if it is only pursuing ethicality for reasons of self-interest. See Quinn and Jones, 1995, for an indepth discussion of this dilemma. For example, they comment that, 'Discussions about stock price movements, instrumental ethics, and shareholder wealth maximization obscure the true moral argument' (p. 28). They also make the point that ethics is 'hard to fake'. It seems increasingly likely that creating value for stakeholders by businesses focusing attention on maximizing value for local communities, employees and environmental impacts (to name but a few) may be synonymous with creating financial value for shareholders. Ignoring the needs of stakeholders can lead to lower financial performance and even corporate failure. Corporate social, ethical and environmental performance are being viewed increasingly by investors as indicators of management quality and proxies for performance in other areas of the business. A company that is well managed is likely to have a good environmental management system and high levels of stakeholder dialogue and engagement. Indeed, the efforts made by many companies to increase the quality and quantity of cross-stakeholder dialogue is impressive. Camelot plc is a salient example of a company attempting to demonstrate an eagerness to embrace stakeholder dialogue and active engagement with diverse stakeholder groups.

However, this may be due to the company's heightened vulnerability in the area of ethics, given its core business of gambling. Nevertheless, any company with bad stakeholder relations could be characterized by poor management and consequently poor financial performance. This is one scenario—and one that is being accepted more widely in practice. There is, however, a large element of scepticism concerning the genuine improvements in stakeholder accountability arising from the increase in dialogue.

An essential aspect of this debate is the extent to which satisfying the needs of a divergent group of stakeholders can also lead to satisfaction of the ultimate objective of shareholder wealth maximization. I attempt to demonstrate that in the long term there is little inconsistency between the ultimate objective of agency theory and the practice of a stakeholder approach. I consider that it is only by taking account of stakeholder as well as shareholder interests that companies can achieve long-term profit maximization and, ultimately, shareholder wealth maximization. This belief is principally based on a growing body of literature and empirical evidence that

suggests that corporate accountability which takes into account a broad range of social, ethical and environmental factors is conducive to financial performance. We attempt to show at different points in this text that businesses can be ethical and profitable, by considering the growing wealth of literature endorsing a positive relationship between corporate social responsibility and corporate financial performance.

Possible Questions

1 What would be your own, preferred definition of 'corporate governance'?

2 Which theoretical framework discussed do you believe presents the

most appropriate explicit framework for corporate governance, and why?

3 Do you think that agency theory and stakeholder theory are striving toward the same goal?

4 Read the discussion on the instrumental and non-instrumental ethics case for corporate social responsibility. Do you think either of these approaches is viable in today's business environment?

Enron: a case study in corporate "Governance Failure"

Aim and objectives

In this paper I want to present a case study of the Enron saga, in order to highlight the consequences that arise from the failure of corporate governance mechanisms. The specific objectives of this chapter are to: g appreciate the importance of effective corporate governance and the consequences of weak corporate governance; g consider the factors that led to the collapse of Enron; g explain why the case of Enron has encouraged corporate governance reform worldwide.

Introduction

In the previous chapter we defined corporate governance and introduced a number of theoretical frameworks that have been used to analyse corporate governance issues. We now provide a detailed case study of the collapse of Enron, in order to enhance the reader's appreciation of why corporate governance is essential to successful business and social welfare. The Enron saga presents a poignant illustration of what happens when corporate governance is weak and when the checks and balances are ineffective. The case also illustrates the problems of controlling human nature. However good corporate governance is from a cosmetic point of view and however good a company's apparent financial performance, if there is unethical behaviour at the highest level, little if anything, can avoid eventual disaster.

The collapse of Enron

In 2001 Enron became a household name—and probably in most households in most countries around the world! On 2 December 2001 Enron, one of the 10 largest companies in the USA, filed for Chapter 11 bankruptcy (a type of court protection giving the company management time to make arrangements with their creditors). In the following months, more and more evidence emerged of corporate governance weaknesses and fraudulent activity. Countries across the world have been unsettled

and disturbed by the shock of this event and are now examining their own corporate governance systems in micro-detail, looking for similar weaknesses and potential Enrons. 'Enronitis' has spread across the globe like a lethal virus, infecting every company and every shareholding institution, worrying even the smallest shareholder and unnerving the financial markets. In this case study we examine the downfall of Enron in detail, looking at the reasons for the collapse and commenting on the corporate governance problems that were rife within the company. Corporate governance failure and corporate collapse can happen in the strongest company. Investors, employees and creditors can be seduced by a company's reputation and success and can throw caution to the wind. If economic agents were rational, as they should be according to economic and finance theory, this sort of blindness could never happen. But it does. Investors do not always behave rationally, and human behaviour and psychology are factors that are difficult to incorporate in a finance model or an economic theory. Polly Peck and Coloroll were cases of irrational behaviour in the UK in the 1980s, when investors missed vital information in the accounts of these companies, pertaining to huge contingent liabilities. As soon as this information became public knowledge, both companies collapsed (Smith, 1996b).

I first consider the way in which Enron built up its glittering reputation and the success that it encountered before crashing in such a monumental fashion.

Laying the foundations

Enron was a Houston-based energy company founded by a brilliant entrepreneur, Kenneth Lay. The company was created in 1985 by a merger of two American gas pipeline companies. In a period of 16 years the company was transformed from a relatively small concern, involved in gas pipelines, and oil and gas exploration, to the world's largest energy trading company (The Economist, 28 November 2002). Deregulation of the energy market in the USA allowed utilities to choose their energy supplier. The 1980s saw deregulation of the market for natural gas in the USA, and deregulation of the wholesale electricity market followed in 1992 (The Economist, 26 February 1998). Deregulation had a far-reaching impact, allowing energy providers to diversify into other areas of the industry and become more competitive.

Deregulation of energy in the UK had a similar effect, forcing providers to compete on price in order to attract supply contracts. One of the effects of deregulation was to create a market in energy trading, similar to a futures and options trading floor, where deals were struck between suppliers and clients on a continual basis.

Glittering success

Enron's success was phenomenal. By 1998 Enron had eight divisions including Enron Energy Services (EES) and Enron Capital & Trade (ECT). In 1994 ECT sold $10 million of electricity. By 1997 the company was selling $4 billion, which constituted almost a fifth of the North American wholesale market. Yet it only produced a small proportion of this itself. In 1998 Enron held $23 billion in assets (see The Economist, 26 February 1998 for these and other figures). In January 1998, Enron sold a 7% share of EES to two pension funds for $130 million. From 1990 Enron's total return to shareholders ran far in advance of the index. In July 1998 Enron announced a $2.3 billion takeover of Wessex Water in the UK. Indeed, Rebecca Mark, then in charge of Enron's new water business, commented that they intended to be one of the two or three dominant players in the business (The Economist, 30 July 1998). In 1999 Enron's sales reached $40.1 billion. By 2000 the company's revenues reached over $100 billion (The Economist, 8 February 2001). In February 2001 the company's stock market value was $60 billion (The Economist, 29 November 2001). Enron became famous for its dexterity in handling risk management derivatives, as well as for its abilities in the area of commodity trading derivatives.

Indeed, the company was proud of having 'invented' weather derivatives in 1997 (The Economist, 15 June 2000). Another area where Enron was praised for its innovation and success was in Internet-based business. At the end of 1999, Enron launched its Internet-based trading platform, Enron Online. The venture was massively successful with 5,000 trades taking place online every day valuing about $3 billion (The Economist, 28 June 2001). However, the chief executive of Enron, Jeffrey Skilling, dismissed this success by saying that the Internet business was just a better form of telephone, which was the way the company did business successfully before.

Toward the end of its life, Enron had transformed itself from an energy company to a predominantly financial and energy trading company, trading financial derivatives as well as energy contracts and effectively running a gas pipeline on the side (The Economist, 29 November 2001). Success was so great at Enron that the words over the door as visitors entered the Houston headquarters were changed in 2001 from:

'The world's leading energy company'
to:
'The world's leading company'
Perhaps a quote from Dante would have been better:
'Lasciate ogni speranza voi ch'entrate!'

This sort of self-confidence and pride is a clear example of counting chickens before they are hatched.

The translation of this is 'Abandon all hope ye who enter here!' It is the last sentence of the inscription over the entrance to Hell in the Divina Commedia, 'Inferno' canto 3, 1.

Early worries

An article in The Economist (26 February 1998) raised queries as to the permanency of Enron's success. Causes for concern were, first, the different speeds of deregulation in different states in America and, therefore, the ability to achieve free competition in all of the states relatively quickly. Second, there were growing concerns that Enron may not have been well enough equipped to deal with the smaller customers it was taking on. Another main concern, expressed in many newspapers and professional literature, was that the company's management team were arrogant, overambitious and even sycophantic. Some even suggested that Kenneth Lay was like a cult leader with staff and employees fawning over his every word and following him slavishly (The Economist, 1 June 2000). This is not a healthy way to do business and indicates an ethical and moral problem at the head of the company.

Such cases of unethical behaviour are associated with bad corporate governance and should be taken as warning signs. A prophetic, ironic and almost visionary comment begs quotation:

Arrogance . . . is Enron's great failing . . . And how does Mr. Lay respond to this charge? . . .
Mr. Lay speaks glowingly of the heyday of Drexel and of its star trader Michael Milken, whom he counts as a friend: they were accused of arrogance . . . but they were just being 'very innovative and very aggressive'. The comparison is not especially well chosen, for it is worth recalling what then happened: Mr. Milken ended up in jail for pushing the law too far, and the arrogant Drexel collapsed in a heap of bad debts and ignominy. For all its arrogance, Enron is hardly likely to share that fate: but hubris can lead to nemesis, even so.
(The Economist, 1 June 2000, emphasis added)

This quotation proved to be a poignant forecast of later events at Enron, as well as prophetic in terms of the reasons for the company's downfall.

Signs of distress

In 1997 Enron wrote off $537 million, mainly in order to settle a contract dispute over North Sea Gas. The company also became notorious for relying too heavily on non-recurring items, such as asset sales, to reach its target of 15% annual growth in earnings. The company purchased Portland General Electric, a utility company in Oregon that held access to the California market. By buying into the Californian retail electricity market when the State deregulated electricity, the company seemed to be expanding too far. Furthermore, they had little success in penetrating the market and were only able to attract about 30,000 new customers in the whole State. This was not enough to merit their massive advertising campaign (The Economist, 23 April 1998). It seems that Enron's success in controlling the energy market came more from its dexterity in energy derivatives trading than its abilities in the core business. The company seems to have overstretched itself as a trader in commodities. In 2001, Dynegy, a competitor in the energy industry, was committed to a merger with Enron but backed out when Enron's accounting problems began to emerge. Indeed, not everyone was seduced by Enron's success. One investment firm, Reed Wasden, had been sceptical of Enron for a number of years. They pointed out that the company's trading margins had collapsed from 5.3% in 1998 to under 1.7% in 2001 (The Economist, 6 December 2001).

The fall . . . and fall . . . of Enron

In August 2001 the chief executive, Jeffrey Skilling, left the company following concerns about the company's management and about his outburst of 'asshole' at an analyst who dared ask him a tricky question (The Economist, 6 December 2001). By late autumn it became clear that Enron was suffering serious financial problems with discussion over a takeover or bankruptcy (The Economist, 1 November 2001). Toward the end of October 2001, Moody's credit rating agency cut Enron's rating to barely above that of junk bonds. In November 2001 Standard & Poor's downgraded Enron's debt to junk bond status. Unfortunately, Enron's debt contracts included clauses stipulating that the company would have to make additional payments to debtholders if the company was downgraded (The Economist, 6 December 2001). On one day alone, 30 October 2001, Enron's shares fell by 19% (The Economist, 1 November 2001).

Enron's brilliance in derivatives trading fuelled its demise, as the company lost $1.2 billion in capital from a failed hedging deal with a private equity fund. The company had to sell 55 million shares. A severe lack of transparency in Enron's balance sheet meant that no one was aware of this and other off-balance-sheet liabilities until it was too late. Despite such serious problems, even as late as November 2001, there was a general perception that the company was too big to fail and would weather the storm (The Economist, 1 November 2001). However, by the middle of November 2001 it was clear that the company was doomed. More than 20 class action lawsuits had already been filed. The main accusations covered fraud and material misstatement in the companies' financial reports. Kenneth Lay himself commented that the company had been overgeared, with extensive use of debt capital on the balance sheet (The Economist, 15 November 2001). Furthermore, the company was accused of insider trading. Indeed, Enron top executives sold over $1 billion of Enron shares to other investors. Even though Enron's annual reports indicated financial prosperity, it was clear that Enron's management knew a lot more than they were letting on, making hay while the sun shone. This is a clear illustration of information asymmetry and agency problems, with insider investors profiting from better information than outsiders.

On 2 December 2001, the great Enron filed for Chapter 11 bankruptcy. Kenneth Lay resigned in January 2002. In August 2002, Michael Kopper, an assistant to the former finance director of Enron, pleaded guilty to charges of wire fraud and money laundering. On 2 October 2002, Andrew Fastow, former finance director of Enron, was charged with: money laundering; securities, wire and mail fraud; and conspiracy to inflate Enron's profits and enrich himself at the company's expense (The Economist, 3 October 2002). Creative accounting at Enron and its impact on the accounting profession Transparency is an essential ingredient for a sound system of corporate governance. In Chapter 6 we examine the role of transparency in corporate governance in more detail. The USA has been dubbed the strongest capital market in the world, with the highest standards of integrity and ethicality. What went wrong? Both the audit function and the accounting function in Enron were fraudulent and opaque.

However, Enron's collapse has had repercussions on the whole of the accounting and auditing profession, not just in the USA but worldwide. Enron's accounting was

anything but transparent. Confidence in the company collapsed in 2001, when it became clear that their accounts were not only unreliable but fraudulent. Arthur Andersen, one of the Big Five, has now disappeared, partly as a result of its involvement in Enron's fraudulent accounting and auditing. However, Enron was not Andersen's first major problem. They had already paid out millions of dollars in settlements following inaccurate and weak auditing on a number of companies including Sunbeam, Waste Management and Discovery Zone (The Economist, 15 November 2001). In 2000, Andersen collected $25 million for auditing Enron's books in addition to $27 million for consulting services. This seems excessive and demonstrates a notorious problem of conflicts of interest between the auditing and consultancy arms of accounting firms. We return to this issue in more detail below.

Examples of Enron's devious accounting abound. The company recorded profits, for example, from a joint venture with Blockbuster Video that never materialized (The Economist, 7 February 2002). In 2002, Enron restated its accounts, a bad sign in itself and a process that reduced reported profits by $600 million (The Economist, 6 December 2001). Indeed, the process resulted in a cumulative profit reduction of $591 million and a rise in debt of $628 million for the financial statements from 1997 to 2000. This triggered an investigation by the Securities & Exchange Commission (SEC) into the auditing work of Andersen, Enron's auditors. The difference between the profit figures was mainly attributable to the earlier omission of three off-balance sheet entities. Such profit inflation allowed the company to increase its earnings per share figure (EPS). EPS is simply the total earnings figure divided by the number of shares. The company's exaggerated focus on its EPS was certainly a factor in its eventual decline, as Enron stated in its 2000 annual report that this main aim was to focus on EPS. This is a common strategy and one which can lead to manipulation of accounting numbers in attempts to inflate the EPS figure (The Economist, 6 December 2001). The pressure on companies in the USA and elsewhere to increase their EPS year on year has been blamed for corporate short-termism (see Chapter 1 for a discussion of short-termism, p. 17). It also provides directors with an irresistible temptation to cheat the figures! Not only did the company clearly manipulate the accounting numbers to inflate the earnings figure, but it was found to have removed substantial amounts of debt from its accounts by setting up a number of off-balance sheet entities. Such special purpose entities are non-consolidated, off-balance-sheet vehicles that have some legitimate uses, such as the financing of a research and

development partnership with another company. However, they can also be used to hide a company's liabilities from the balance sheet, in order to make the financial statements look much better than they really are (The Economist, 2 May 2002). This was certainly the case for Enron. It meant that significant liabilities did not have to be disclosed on Enron's financial statements, as they were almost attributable to another legal entity (but not quite). To anyone, this is an obvious example of fraudulent, premeditated and unethical management. Furthermore, about 28% of Enron's EPS was shown to have come from gains on sales of securitized assets to third parties connected to Enron (The Economist, 6 December 2001). All this begs the question, 'why did Enron's auditor allow this type of activity?'

They had to have been aware of it. Perhaps Andersen considered the transactions were relatively too small to be considered material. However, this is becoming less of a reasonable excuse (The Economist, 6 December 2001). In December 2001 the chief executive of Andersen, Joseph Berardino, stated that the firm had made an error of judgement over one of the off-balance-sheet entities created by Enron (The Economist, 20 December 2001). One 'special purpose' vehicle in particular, called Chewco, again created by Enron to offload liabilities for off-balance-sheet financing purposes, was cited as being a chief culprit, as it did not provide Andersen with adequate information. Clearly, had Andersen had this additional information, they would have forced Enron to consolidate Chewco into their accounts. However, such ignorance on the part of Andersen may not be adequate support for its lack of action. According to Enron, Andersen had been carrying out a detailed audit of the main structured finance vehicles, which made the auditing firm guilty of acting too slowly and inadequately (The Economist, 20 December 2001).

In January 2002, Andersen fired the partner in charge of Enron's audit, David Duncan, as he was found to have ordered the disposal of documents even after the SEC had subpoenaed the firm as part of its investigation into Enron. However, David Duncan clarified that he was not working in isolation, but was in constant contact with Andersen's headquarters. Furthermore, Enron itself ordered the shredding of vast quantities of documentation concerning the company's financial liabilities. The firm was criminally indicted by the Department of Justice for shredding documents relating to Enron. In March 2002, Andersen pleaded not guilty in a federal court to charges of obstruction of justice by document shredding (The Economist, 21 May

2002). Documents pertaining to Enron were not only shredded in Houston but also in London! Berardino resigned as chief executive of Andersen in March 2002. On 15 June 2002, Andersen was convicted of obstruction of justice. It is difficult for some to see how a company (as opposed to a person) can be found guilty of a crime, but certainly in the USA there is a perception that companies may be associated with unethical behaviour, in the same way as individuals (see The Economist, 13 June 2002, for a discussion of this issue). Such an approach makes corporate social responsibility a moral, human obligation, as companies are considered to be equivalent to people in a moral sense.

The fall of Enron was the biggest corporate collapse ever, and the downfall of Andersen the most significant death of an accounting firm ever. Conflicts of interest are a frequent problem in the audit profession. Independent appointment of the company's auditors by the company's shareholders is frequently replaced by subjective appointment by company bosses, where the auditor is all too often beholden to the company's senior management. Further, there are conflicts of interest arising from interwoven functions of audit and consultancy. Special, cosy relationships are built over time between companies and their auditors, which can again compromise independent judgement and cloud the auditing function. Such conflicts of interest impinge on the corporate governance function. Improvements in the audit function are clearly emphasized by the Enron case (The Economist, 7 February 2002). Creating a division between the auditing and consultancy arms of auditing firms may help. Indeed, a complete ban on auditing firms offering both services to the same client may be implemented. KPMG and Ernst & Young, PricewaterhouseCoopers and Deloitte Touche Tohmatsu have all decided to separate their auditing and consulting arms (The Economist, 7 February 2002). Another solution may be to instigate the rotation of auditors so that special relationships between auditors and their companies may not be allowed to develop. We discuss these possible routes to ensuring the effectiveness of the audit function.

Until now audit companies have been essentially self-regulated. They have used a process of peer review to check their procedures. The oversight bodies have been weak and lacking in regulative clout (The Economist, 7 February 2002). The Sarbanes–Oxley Act of July 2002 has taken a hard line on the regulation of auditing.

The new Act restricts the consulting work that accounting firms are allowed to carry out for their audit clients. The Smith Report (2003) has also attempted to deal with these issues, as we see in this paper.

The Financial Accounting Standards Board (FASB) in the USA has been forced to reconsider its position on off-balance-sheet financing, a subject that has troubled them for years. Especially, the FASB is reviewing its rules on how to account for special purpose entities (financing vehicles), such as those created and used by Enron. Attempts to address such issues in the past have been halted by aggressive lobbying (The Economist, 7 February 2002). Not surprisingly, one important lobbyist was Richard Causey, Enron's former chief accountant (The Economist, 2 May 2002). The FASB rule in place at the time of Enron's fall was that a company could keep a special purpose vehicle off its balance sheet, as long as an independent third party owned a controlling equity interest equivalent to at least 3%of the fair value of its assets. The FASB has, post-Enron, considered raising that number to 10% (The Economist, 2 May 2002). The Enron saga has added fuel to the process of international harmonization of accounting standards. The International Accounting Standards Board (IASB) is in the process of developing internationally acceptable standards for accounting worldwide. The strong card that the USA has traditionally played, in setting the agenda for international accounting, has been severely weakened by the shock waves from Enron. Under international accounting standards, the removal of material liabilities from Enron's balance sheet via its special purpose entities would not have been allowed, as the rules are harsher. The rules-based approach to accounting traditionally applied by the USA has also come under fire, as it provides companies with an incentive to comply with the letter but avoid the spirit of the rules. A more principles-based approach, such as that adopted in the UK, would probably encourage companies to comply more in substance than in form. Further, there are two accounting standards in the UK that protect investors from the type of creative accounting practised by Enron. First, there is the fifth accounting standard 'Reporting the Substance of Transactions'.

This ensures that quasi subsidiaries, such as Enron's special purpose entities, are presented in the group's accounts so that the commercial effects of controlling operations, not owned by the company in a technical sense, are clarified. Second, there is the twelfth accounting standard, which deals with contingent liabilities.

Companies in the UK have to disclose a description and a quantification of the effect of each and every contingent liability (see Ryland, 2002). Having suffered severely from Polly Peck and Coloroll, the UK has ensured that these potential black holes in accounting are dealt with. Surely this is encouraging for UK investors, as these two standards make a UK Enron less likely.

The Sarbanes–Oxley Act, brought in quickly in July 2002, also attempted to address accounting fraud through regulation. Chief executives and chief financial officers now have to 'swear' that to the best of their knowledge their latest annual reports and quarterly reports neither contain untrue statements, nor omit any material fact (The Economist, 15 August 2002). Such new legislation should encourage directors to act ethically and monitor their own financial accounting practices more carefully. They are now personally liable for cases of fraudulent, creative accounting. But is regulation really the answer? Is it not more worrying for shareholders to feel that the directors of companies they 'own' are so untrustworthy that they have to be tied down in this way, not having the integrity to regulate themselves?

The aftermath

There are distinct similarities between the downfall of Enron and the collapse of Long Term Capital Management, an infamous hedge fund in the USA run by Nobel Prize-winning financial economists. Both companies demonstrated financial wizardry, trading immense quantities of derivative contracts and becoming excessively confident, indeed arrogant, about their abilities to beat the market. Indeed, although Enron had substantial abilities in the hedging field, these can collapse—and did—when the market started to fall. The general decline in stock markets around the world in 2001 had a negative influence on Enron's hedging success. The collapse of Enron also bore similarities to those of Maxwell and Polly Peck in the UK, as these companies also revealed significant audit failures. The personal suffering caused by Enron's collapse has been extensive. When Enron filed for bankruptcy many employees lost their savings as well as their jobs (The Economist, 28 November 2002). The pensions of Enron's employees were invested in Enron shares, so massive loss in future income for such pensioners is another important consideration. This emphasizes the social implications of corporate collapse and weak corporate governance.

One of the main effects of Enron's collapse has been on the general confidence of the government, corporate and professional bodies, and investors in companies' activities and management integrity. The effects of Enron have been so far-reaching that the term 'Enronmania' has been coined to refer to the reaction among company bosses and investors to fear (indeed terror!) that companies with characteristics similar to Enron may share its fate (Ryland, 2002). Indeed, the whole case raises the question, 'how could such a huge and successful company have avoided scrutiny for so long and managed to fool investors and creditors?' For the Federal Reserve, the concern was 'how could a company with such huge debts avoid regulatory checks and balances?' The immediate remedy for this situation was the Sarbanes–Oxley Act, which was produced and signed by the President in July 2002. However, an ongoing cause for concern is the choice between a regulated or a more voluntary corporate governance environment. As some countries, such as the USA, adopt a regulated approach to corporate governance reform and react in a regulative manner to corporate governance problems, other countries, such as the UK, consider that a more

principles-driven and voluntary approach is more appropriate. The Higgs Report (2003) reviewed corporate governance in the UK and made proposals for improvements in boardroom practice, but avoided any attempt to introduce regulation. This is typical of the UK's more voluntary approach to corporate governance reform and is the UK's response to Enron, inter alia (see, e.g., The Economist, 31 October 2002).

We discuss the 'comply and explain approach' to corporate governance in this paper.

A reflection on the corporate governance problems in Enron Severe corporate governance problems emerge from the Enron wreckage. Unfettered power in the hand of the chief executive is an obvious problem and one that characterized Enron's management. Separation of the chairman and chief executive role is not common in the USA. This is a technique that is so successful in the UK as a means of improving the effectiveness of a company's board of directors that its application in the USA would benefit American companies and particularly American shareholders! As we see from Chapters 3 and 4, the Higgs Report (2003) has further strengthened the relevance of this initiative to corporate governance in the UK. The function of the non-executive directors in Enron was weak as they did not detect fraudulent accounting activities through their internal audit function. Indeed, the internal audit committee failed completely in policing their auditors. Serious conflicts of interest have arisen involving members of Enron's internal audit committee. For example, Wendy Gramm was the chairman of Enron's audit committee and her husband, Phil Gramm, a senator, received substantial political donations from Enron. Also, Lord Wakeham was on the audit committee at the same time as having a consulting contract with Enron (The Economist, 7 February 2002). These examples show that people in responsible positions, who should have detected unethical activities, were themselves not independent. There were numerous illustrations of unethical activity within the Enron Organization that continued to come to light long after its downfall. For example, in May 2002 it became clear from documents released by the Federal Energy Regulatory Commission that Enron's energy traders developed and used strategies, or tricks, to manipulate the markets in which California bought electric. One trick, the 'Death Star', involved arranging power sales to flow in opposite directions, so that Enron could collect fees for transporting electricity when it had not done so! (The Economist, 9 May 2002).

Overall, corporate governance in Enron was weak in almost all respects. The board of directors was composed of a number of people who have been shown to be of poor moral character and willing to conduct fraudulent activity. This was the genuine root of the company’s corporate governance failure. If the leadership is rotten how can the rest of the company succeed in the long run? Also, the nonexecutive directors were compromised by conflicts of interest. The internal audit committee did not perform its functions of internal control and of checking the external auditing function. Furthermore, the company’s accounting and financial reporting function failed miserably. Both the financial director and the chief executive were prepared to produce fraudulent accounts for the company. The corporate crimes perpetrated by members of the Enron hierarchy are unnerving. How could the company survive so long with such unethical activities being carried out at the highest level? Why did no one notice? Where they did notice problems, why did they not report the company? How could the company’s auditors allow such a travesty of justice? The questions raised by the Enron saga are far more numerous than the solutions offered. There have been a proliferation of books on the downfall of Enron, seeking to explain why events transpired as they did.2 As we have seen, the USA and the UK reacted strongly to Enron’s collapse and corporate governance has been hurled to centre stage, as a result of the terrible weaknesses at the heart of Enron’s corporate governance system. The long-term effects of Enron will hopefully be a cleaner and

Continuous updating of corporate governance codes of practice and systematic review of corporate governance checks and balances are necessary to avoid other Enrons in the future. As in the famous (or infamous) UK novel, The Clockwork Orange (by Anthony Burgess), systems of controlling juvenile delinquents only worked superficially, as they forced a change in behaviour but did not alter the individuals’ character and attitudes. The chief miscreant in the novel still wanted to behave amorally, but could not due to the treatment he had received. In a similar way, preventing unethical behavior within companies through cold, legalistic and mechanistic means cannot alter a person’s general approach. In our own research into the attitudes of institutional investors toward corporate governance issues, we found that generally fund managers and directors considered unethical behaviour could not be controlled easily. For example, one corporate governance representative in a large investment institution in the City of London commented that:

. . . if people want to be fraudulent there is nothing in the current system to stop them— and if they are clever and fraudulent then they will get away with it for even longer and probably get rich on it. Clearly, corporate governance checks and balances can only serve to detect, not cure, unethical practices.

Summary

In this chapter we have used the case of Enron's downfall to illustrate the importance of 'good' corporate governance. The case study has shown that not only does weak corporate governance affect the company it also affects society as a whole. The system of checks and balances that supports corporate governance needs to function effectively. The Enron case highlights the essential functions of non-executive directors, audit and disclosure, as well as ethicality of management. Indeed, we make the point that all the checks and balances within the corporate governance system have the ultimate aim of controlling and monitoring company management. The corporate governance mechanisms cannot prevent unethical activity by top management, but they can at least act as a means of detecting such activity before it is too late. When an apple is rotten there is no cure, but at least the rotten apple can be removed before the contagion spreads and infects the whole basket. This is really what effective corporate governance is about. We aim to explore the various checks and balances, and mechanisms by which good corporate governance ensures successful business and social welfare maximization in the rest of this book.

Questions for reflection and discussion

1 Read a selection of newspaper articles and academic writings on the collapse of Enron. Do you think that the Enron management behaved in an unethical manner? If so, do you think that a better system of corporate governance checks and balances would have detected their unethical behaviour before it was too late and avoided the company's collapse?

2 Do you think that the role of non-executive directors, auditors, the internal audit committee and the board of directors are all equally important as mechanisms of 'good' corporate governance? If not, which mechanism do you consider is the most important?

3 To what extent do you agree that 'When an apple is rotten there is no cure, but at least the rotten apple can be removed before the contagion spreads and infects the whole basket.

4 Summarize the corporate governance problems in Enron. Do you think they are all of equal importance? If not, which corporate governance problem do you feel contributed the most to the company's downfall?

5 The response to Enron (and other recent corporate collapses) from the UK and from the USA are extremely different. Which approach do you prefer? Which do you think will be more effective in the long run?

6 To what extent do you think a UK Enron is likely to occur?

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