# Enron & Corporate Governance

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**Abstract**

With the emergence of capitalism, companies increasingly appreciated the necessity of external funding for continued growth and expansion. A number of high profile corporate collapses, betraying investor's trust on published reports, arose in the 1980s. The effects of these collapses were felt throughout the world, mortifying the global community. With adaptable decision making, and improved accountability to markets, potential investors are more willing to invest in companies. This paper aims to examine the theoretical principles and limitations of the code of ethics that arose from the largest scandal in corporate America, Enron. The contrast between Enron's moral mantra and the behaviour of some of their executives is discussed.

**Keywords:** market accountability; global governance; corporate scandal.

## Introduction

Entering the capitalist era, companies began to appreciate the need to attract external funding in order to grow and expand. Investors wanted to have the necessary information to make sound economic decisions, and to be assured that the company is well managed and would continue to be profitable indefinitely (Mallin, 2007).

A number of high profile corporate collapses, betraying investor's trust on published reports, arose in the 1980s. The effects of these collapses were felt throughout the world, mortifying the global community. According to Monks and Minow (1996), good governance is of national importance, promoting commercial competitiveness and boosting the global economy at the same time. With adaptable decision making, and improved accountability to markets, investors are more willing to invest in companies.

This paper aims to examine the theoretical principles and limitations of the code of ethics that arose from the largest scandal in corporate America, Enron. The contrast between Enron's moral mantra and the behaviour of some Enron executives are discussed. The well-known moral mantra of Enron was denoted by the acronym, R.I.C.E. – respect, integrity, communication, and excellence. It is not the objective of this paper to look into the details of the case, but only to focus on governance issues recommended by the code of ethics.

## Corporate Governance

The term "corporate governance" has become one of the most commonly used phases in the current business industry (Solomon, 2007). The fall of Enron had brought about international attention on corporate failures, and the preventive role played by corporate governance. Enactment of the Sarbanes Oxley Act and timely review of best practice codes are the result of corporate failures. What exactly is corporate governance?

There is no single definition of corporate governance. Some interpret corporate governance as a tool that creates an ethical environment to promote responsible trading (Premeaux, 2008). The Cadbury Report (1992) defined corporate governance as a "system by which organizations are directed and controlled" (Cadbury Report, 1992, Paragraph 2.5). Conversely, the Organization for Economic Co-operation and Development sees corporate governance as "a set of relationships between a company's directors, its shareholders and other stakeholders" (OECD, 2004, Preamble).

Despite the many interpretations, it is certain that corporate governance is only one of the many pieces in the jigsaw, which contribute to effective and sustainable corporate practice (Dawson, 2004). The following corporate governance issues will be discussed in later sections: agency theory, corporate environment, board structure, managerial hegemony, and accountability and audit.

## Agency Theory

Separation of ownership and control arose from Salomon v. Salomon & Co. Ltd. in 1897 and is an example of the notorious 'agency problem' (Farrar & Hannigan, 1998). This case gave rise to the ideology of management acting as 'agents', working in the interests of the 'principals'. Ross (1973) was the first to explore the detailed theoretical exposition of agency theory.



 
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Later developed by Solomon (2007) who described how management act in the interest of the shareholders, making decisions that would maximize shareholders wealth. This assumption, however, proved to be problematic in the enterprising environment. Management has a tendency to act in their own interests, maximising their personal objectives at the expense of the shareholders, for example, Eurotunnel's financial problems were, in part, a result of such practices (Wearing, 2005).

Management of Enron obviously exploited shareholders' trust, acting to satisfy their own ego and self-interest. Unlawful transactions with special purpose vehicles were utilized and fictitious figures were disclosed which were derived from 'market-to-market' accounting to mislead shareholders. As their misdeeds were brought to light, management was punished severely by the law and market.

Arguably, the blame for the collapse of Enron should be shared with the shareholders as well. If shareholders uphold their rights as owners and exercise direct influence on the company and board, fundamental problems could have been identified and remedied at an earlier stage. Nonetheless, shareholders were not penalised in any aspect, other than losing their initial investment. Is it fair that only management is punished for Enron's collapse? Is it justifiable that shareholders are not penalised for the role they played in the downfall of Enron? It may be argued that, in the eyes of the public at least, the price paid by both management and shareholders is fair.

## Ethical Corporate Climates

Corporate culture is defined as a company's set of common beliefs and expectations based on a common collection of values, assumptions and attitudes (Arnold & Lampe, 1999). Ethical climate refers to ethical values held by management to lead subordinates with the use of policies, practices and procedures (Dallas, 2004). These values act as guidance, influencing moral awareness in the process of making decisions.

Rest (1984) identified four components in ethical decision-making: moral awareness, moral decision-making, moral intent, and moral behavior. It was posited that with these elements, companies would be guided to make the 'right' choices.

In practice, factors, such as reward systems, compensation systems, and appraisal also have an impact on the ethical climates in a company. Empirical evidence suggests that once management is



 
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willing to conduct fraudulent activities, their actions would also encourage subordinates to engage in similar activities (Premeaux, 2008). Before long, the immoral culture would 'infect' the whole company, retaining only employees with poor moral character.

Enron's 'R.I.C.E.' principles fooled the public for many years (Markham, 2006). Resulting from Enron's actions, it may be argued that, their values should more appropriately be risk-taking, individualism, contempt and exploitation. Outsiders were kept in the dark regarding Enron's corporate culture, they had no idea concerning how the company was governed, other than that they had 'innovatively' created value for shareholders. In fact, even financial institutes accepted Enron's business proposals without asking questions (Elkind & Mclean, 2003).

In addition, Enron put in place the harshest employee-ranking system in corporate America, replacing 15% of its workforce annually. Those who contributed to the appreciation of stock price were rewarded handsomely, while those who were unwilling to fabricate 'profitable' deals were laid off (Elkind & Mclean, 2003). With this system, employees were forced to use unscrupulous methods to survive in the highly-competitive environment. In short, Enron is characterised by "individual and collective greed born in an atmosphere of market euphoria and arrogance" (Thomas, 2002, pp 41). Without an ethical environment, management would act irrationally and immorally. Selfishness would brew into a monster that would 'murder' a company of any size and industry.

## Role of Boards in Corporate Governance

Empirical evidence showed that well-governed companies tend to be more successful (Conger, Finegold & Lawler, 2000). Well-functioning and effective boards protect the interests of shareholders without undermining the operations and strategies of the companies.

## Board Structure

In an Anglo-Saxon environment, companies such as Enron operate a unitary board. Its structure is characterised by one single board comprising both executive and non-executive directors (Mallin, 2007). The board makes decisions in a unified manner, and work towards a common goal. In theory, board members are appointed by shareholders during the Annual General Meeting. However, in



 
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practice, the duty of nominating members is delegated to management, who often “select directors they ‘can count on’ rather than individuals who constructively examine important issues” (Salmon, 2000: 10). Would an independence-deprived board be able to function properly? This does not seem to be the case at Enron.

An investigation was conducted on the impact of ineffective non-executive directors, and published in the Higgs Report. From an agency theory perspective, it is believed that the presence of non-executive directors on the board would reduce conflict of interest between shareholders and management (Solomon, 2007). However, duties of non-executive directors were completely breached in the cases of Enron. It has been suggested that, in practice, boards do not consult nor criticise management’s decisions, as they are unwilling to strain the relationship with management.

**Managerial Hegemony**

While boards do not see themselves as pawns of management, they acknowledge an increasing number of restrictions imposed to hinder them from discharging their duties effectively (Lorsch & Maclver, 1989). According to Mace (1971), ineffective performances of boards suggest that they were incapable of adequately representing any interest. Consequently, the role of the board in reducing the effect of agency problems is made ineffective to some extent. The wide gap between what the board is supposed to do, and what they are actually allowed to do in practice has caused a breach in the fundamental reasons for creating a board in the first place.

Managerial hegemony could also occur when separation between duties of the chairman and Chief Executive Officer – “CEO” is blurred. Conflict of interest is detrimental to the role of boards as watchdogs for shareholders (Lorsch & Salmon, 2000). Combined Code of ethics (2008) recommends that there “must be a clear division of responsibilities at the head of the company between the running of the board and the executive” (Paragraph A.2). Corporate failures, such as Polly Peck and Parmalat, had caused the professional body to believe that separation of duties should resolve the issue on conflict of interest. Is that really the case?

In the case of Enron, duties of the chairman and CEO were dominated by Ken Lay (Fusaro & Miller, 2002). As a charismatic character in the company, he could influence the board to perform ‘rubber-stamping’, approving all proposals without being subject to questioning. His influence was so great



 
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that the board ignored all warning signs of fundamental problems, depriving any chance of taking remedial actions (Hamilton & Micklethwait, 2006). It appears that the cause of failure of Enron's board is consistent with the professional recommendations. Nevertheless, separating duties would not have wholly removed any conflict of interest, only mitigated it. If the CEO dominates the board, it would not matter whether there is a separation of duties. The board would still be obligated to agree with management, even if it is at the expense of shareholders.

## Accountability and Audit

Independent auditing is becoming an essential element of today's corporate governance. As ownership and control is separate, shareholders depend on independent scrutiny to ensure that management is acting in their interest (Kurihama, 2007). Checks are usually carried out by independent auditors, who, in theory, act in the interest of shareholders. This is not always true in practice as an auditor's independence is often threatened by factors such as a close relationship with management, conflicts of interest and power of auditor (Gray & Manson, 2008).

In their attempt to ensure shareholders of perceived independence, the audit committee was formed, acting as a barrier between management and the auditors. Responsibilities of the audit committee generally include "responsibility for the reliability of financial reporting, the effectiveness of the internal control structure over financial reporting, and the external and internal audit functions" (Semenza, 2002: 131).

Dye (1991) suggests that if audit fees are disclosed to shareholders, auditor's independence would improve as there are no quasi-rents to influence the company's audit opinion. Lai (2009) provided empirical evidence that disclosure of audit fees improves auditor independence. It is evident that with adequate disclosure of audit fees and improved transparency, shareholders confidence in the accuracy of an auditor's report would improve.

A study conducted by Antle *et.al.* (2006) suggested that by paying higher audit fees, auditors are more consenting to higher abnormal accruals. This was proven in the case of Arthur Andersen, who earned $25 million pertaining to audit work and $27 million pertaining to consultant work, from Enron in 2000 (Markham, 2006). Considering the financial dependence of Arthur Andersen on Enron, the motive of assisting in masking Enron's massive losses in the financial statements is



 
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apparent. It is only natural that Arthur Andersen does not want to risk losing their client, whose fees make up a major portion of their total revenue. Undue pressure had affected not only Arthur Andersen's independence in appearance, but also their independence in fact.

## Conclusion

The Enron saga had brought to light many weaknesses in the accounting, auditing, and corporate governance of various firms. Other corporate governance issues, such as director's remuneration and internal auditors, arose from the Enron case. Furthermore, principles such as stakeholder theory and corporate social responsibility were greatly influenced by the case. The impact of Enron's collapse could be felt throughout the global economy, devastating the whole financial industry. Professional bodies have subsequently sought to develop approaches to plug loopholes, impose new controls, and prevent the emergence of other, similar companies. Efforts of the professional bodies, however, have yet to materialise, and there is much work to be done to keep pace with changes in the business environment and uphold good governance.

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