LESSONS FOR THE MARKET PARTICIPANTS FROM THE RECENT US CORPORATE SCANDALS

For

CRISIL

YOUNG THOUGHT LEADER

SERIES- II

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ACKNOWLEDGEMENT

The topic “lessons for the market participants from the recent us corporate scandals” has been a very challenging and a rewarding project. Though a humble effort on my part, it would have proved to be an uphill task had it not been for the sincere cooperation and guidance of my college faculty whose valuable and timely inputs compensated for our relative inexperience. I would also like to thank CRISIL for having given me an opportunity to work on such an interesting topic.

Above all, I wish to acknowledge that such a committed effort would not have been possible without the support of my friends and family.

Harsha P.

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INTRODUCTION

The global business scenario is passing through one of the most volatile and testing times in its history. The year 2002 stands out *for having endangered the very integrity of Capitalism.* The chain of corporate scandals has wiped out billions of dollars of public money, laying-off lakhs of employees and hurting thousands of families. If investors continue to lose faith in corporations, they could choke the supply of capital, the fuel that has powered the rapid growth of industrialization. Hence, it is a wake-up call for the market participants to give a serious thought towards fixing these evils. But the first step is to realize the lessons from these US corporate disasters.

Below are some of the lessons to be learnt.

BACK TO BASICS- THE COMPANY CULTURE

The recent corporate scandals reveals that the management at a point of time or over a period of time failed to act *responsibly*. It either wasn't persistent enough, or hadn't paid proper attention towards its duties, or was simply overwhelmed by greed and overconfidence. This resulted in a loss of direction and ethical lapses eventually leading to failure. This is exactly what happened in Enron, Xerox, Arthur Andersen, & WorldCom. Their failure wasn't something that happened overnight. It was slowly being baked in the rotten corporate culture. Enron's culture bred profit taking without disclosure and gave too much of autonomy to its employees in making investments, Andersen's culture engendered conflicts of interest without safeguards, Xerox's culture encouraged bribery to win contracts, Salomon Brother's culture encouraged risk taking without accountability.

So "as you sow, so shall you reap". Rotten cultures produce rotten deeds. Every company should have and abide to a proper cultural and ethical code, which will act as a compass guiding all the policies, strategies and the actions of the organization towards sustainability and prosperity.

STICK TO ETHICS

The reason for Enron's complete melt down is that much of its credible business activities depended on a good reputation. Buyers and sellers of electricity for e.g. lost confidence that Enron would uphold its side of any deals. So even this legitimate part of the firms business sunk with the firms lost reputation. Similarly Arthur Andersen is in the business of providing assurances of quality. As an auditor its whole business is based on credibility. The firm is now scrambling to re establish its reputation.

A sound reputation is one of the most basic prerequisites of successful businesses. According to a research from university of Washington by Karpoff, the effect of white-collar crime-including financial reporting fraud- has a very detrimental effect on company's stock values. 132 cases of corporate fraud between 1978 through 1987 revealed that there is an average decrease of 60.8 mn dollars in the values of the affected company stocks. The loss was further compounded by lost future sales or higher costs. Most of the companies which recently collapsed after their financial jugglery came to light, underestimated the power of reputation and overlooked the cost of a lost reputation.

Financial frauds apart, ironically, even creative accounting may backfire because, it's the people who run corporations who are fooled by accounting fictions. The U.S. steel industry is such a basket case now partly because for decades it could make generous pension commitments to employees without counting them against earnings. And because they could pretend options were free, CEOs and boards in the 1990s probably gave out far too many of the things and ignored other, possibly better ways of linking pay to performance (restricted stock grants, for example).

In the light of the above, it would make sense for companies to worship reputation as much as profits. They should, as a policy, adopt ethical accounting practices and deter from all those activities, which may endanger their reputation.

REENGINEER THE BOARD

When we get to the root of the corporate disasters, we are most likely to end up at the board of directors. Reforms are urgently required to ensure the effective working of the board.

Boards should have a substantial majority of independent directors. An independent director should be designated as the chairman or lead director. The board should regularly review the performance of the CEO, senior management, the key committees, adequacy of the companies' compliance and reporting systems. The directors should be prevented from selling the company's stock until after they've resigned. This will encourage them to blow the whistle on the management when necessary without fear of short-term price declines that may follow. Adopting corporate governance practices strengthens the company culture thereby reasonably insuring it against failures.

OPERATE FROM GROUND REALITIES.

“ Those whom the Gods would destroy, they first make mad”. So wrote Euripides, some 2500 years ago. And it applies very well even to today’s organizations, which have time and again proved that if ‘nothing succeeds like success’; nothing *impedes* like *too much success*. A number of studies have confirmed that prolonged periods of success impede one’s ability to acknowledge impending dangers and take optimal decisions. Most of the companies, which failed, fell from the mountaintops. Enron, WorldCom, Cisco to name a few.

Enron was so blinded by a string of awards, applause and the soaring stock made it believe that nothing could go wrong. Precisely, this illusion brought about its downfall. Billions of dollars were raised to invest in the wildly hyped telecom networks by the companies, which were at the zenith on the Wall Street. Now, as little as 3 percent of new long-distance networks are being used, resulting in the collapse of many telecom majors and a loss of a whopping $2 trillion loss for the telecom investors.

There is no ‘one shot’ strategies to such corporate mistakes. Companies should realize that no company no matter how high flying is divorced from the larger economy. Close attention should be given to macroeconomic factors like oil prices, currency fluctuation, inflation, bubble bursts, competitor position, new technologies, new governmental policies etc.

Also there should be special sessions, where the executives should engage in objective criticism of their present policies and actions. In addition, companies should use, Scenario Planning where the employees can plan the course of actions and alternatives for various possible scenarios ahead. This will avoid the quick fix short-term strategies (which ultimately lead to scandals) and enable them to take the right course of actions for the various situations.

STICK TO THE KNITTING

One of the major reasons for Enron's failure was its inability to manage the risks arising out of its myriad of businesses viz., energy trading, weather derivatives, broadband capacity, metals etc, which were radically different from its core business of energy generation. Similarly, WorldCom acquired MCI, MFS and its UUNet subsidiary and Sprint. It was more concerned about new acquisitions than about making the existing ones- all 75- work together. The result was disastrous. They were not exceptions because most acquisitions go awry. Not only are the synergies to which so many executives pay lip service seldom realized, more often than not the result is catastrophic. Acquisitions even the little ones suck up an inordinate amount of top management's time, time taken away form the mainline businesses in learning the new businesses. Virtually every academic study has concluded that unchanneled diversification is a loosing proposition.

One of the smarter strategies of diversification would be to enter only those businesses that build on, draw strength from, and enlarge some central strength or competence. Or, acquire and diversify in an experimental fashion. Buy a small company or start a new business in small and manageable steps in such a way to contain risks.

TAP THE ‘IN-BUILT ALARM SYSTEM’

When we closely analyze the recent corporate scandals, it is glaringly clear that if the right people had got the right information, things would not have been so worse. CEOs normally don’t get the information they need, to make informed decisions. This is because subordinates are afraid to tell the truth. No wonder why Sherron Watkins expressed her concerns anonymously. Too often, frontline employees smell something rotten but do not or cannot, convey the message upward. So, companies need a mechanism to capture and communicate these signals to the right people. One possible approach is to appoint ‘neutral ombudsmen’ who may even be an external agency. These ombudsmen will capture and solicit employee feedback on sensitive matters and communicate it directly to the board members. They should also be given the powers to ask the rudest questions possible about the company matters. Such a system can insure the company to a great extent from corporate disasters.

EXECUTIVE COMPENSATION.

No one in the community should earn more than five times the wages of the ordinary worker.

--Plato.

No leader should earn more than 25 times the company's lowest paid employee.

--Peter Drucker

BUT…..

CEO's of large corporations last year made 411 times as much as the average factory worker.

In the past decade, as rank-and-file wages increased 36%, CEO pays climbed 340%, to $11 million.

Clearly, executive compensation has reached astronomical heights. And thankfully, the investors share the same feeling.

Ninety percent of the 33 fund managers surveyed recently said they are using corporate pay practices "at least some of the time" as one of the factors they consider when making investment decisions[1].

A growing number of mutual fund managers are taking executive pay policies into account when deciding where to invest, according to a new survey. Some investors consider it a warning sign if a company's CEO was among the 15 percent most highly paid. Perhaps these developments seem to be shaped by the reasoning below.

Pay for performance: the caveat

In the interest of fattening the year's net earnings and hyping executive bonuses, the executives are tempted to differ expenditures that won't yield an immediate profit like R&D, Advertising, maintenance etc. This is compounded due to the corporate world's obsession with EPS and the consequent obsession with the stock price, which is a factor in the evaluation of the performance linked pay. Thus the personal interests often conflict with the interest of the corporate and the shareholders.

Stock option grants- the fallout

When an executive exercises an option to buy his company's stock for substantially less than market value, that can lower the value of all the shares outstanding. The CEOs would be encouraged to indulge in short term jugglery designed to inflate the stockprice and enable them to draw high returns. This jugglery is normally in the form of window dressing and/or a nexus with the analysts as was evident from most of the recent disasters.

To avoid the above, The executive bonus plan should be based on goals for three years instead of one. It should be based on corporation's performance in comparison to that of competitors over several years. The next generation of refinements in compensation clearly will be on the basis of how successful they

[1] According to Pearl Meyer & Partners, the New York-based compensation consulting firm

are in achieving strategic goals such as larger market share and improved quality and to remove the penalties that executives suffer when they decide to allocate money for R& D and long term capital expenditure, some reformers have suggested that such expenses be considered apart from other aspects of the executive's performance.

PLUG THE *GAAPS*

"If you torture the data long enough, Nature will confess."

--Ronald Coase.

It is now clear that accounting chicanery has become a widespread epidemic in the corporate world today, which, on being visible leads to a stock crash wiping out billions of dollars of public money and subsequently leading to the corporate failure. Thus one of the first lessons for the market participants is to improve accounting standards. Below are some of the necessary changes (pioneered by S & P's Core earnings method) which will communicate relevant information to the investors to enable them to see through the complexities of the companies' business structures and get a clear picture of its performance.

The main features of the proposed changes are

Items included in core earnings	Items excluded from Core earnings
Reported earnings less Employee stock option grant expenses Restructuring charges from ongoing operations Pension costs Purchases research and development expenses = CORE EARNINGS	Items Excluded Goodwill impairment charges Gains losses from asset sales Pension gains Unrealized gains/losses from hedging activities Merger/acquisition related expenses Litigation or insurance settlements and proceeds

Along with the above changes, there is an urgent need to bring in fresh regulations to stop the abuse of Special Purpose Entities (SPEs). The current requirement for the outside ownership limit is just 3%. This rule enabled Enron to keep debt worth $2.6bn from three of its partnerships off balancesheet, since outside investors contributed threshold investment of 3% of the overall funding of the partnership. Raising the limit of investment for the outside investors to over 10% and separating the management of the SPEs from the company's are one of the possible approaches.

Also, It is important that there should be regulation, which will compel the rotation of auditors every few years to ensure a fresh look by a new firm. Also there should be more forensic auditing to dig behind the journal entries. An expanded auditor statement illuminating just where in the wide range of acceptable practices a particular company falls will give investors a better insight.

WHOSE BREAD I EAT, HIS SONG I SING

One of the prominent challenges faced by the regulators is the **conflict of interest** among various players in the corporate world. To beginwith…

<u>The Chinese Wall</u>

Some 30-odd years ago, analysts first "*jumped the Chinese wall*", that was supposed to separate analysts from investment bankers. This explains why the research provided by the analysts is often just a marketing tool to win underwriting and merger business for their firms.

So, investment bankers should be made to do their own vetting. The analysts will have to evaluate the company only after it has gone public and should be paid on the stock picking and the earnings estimate prowess. Some groups have already barred analysts from owning stocks that they cover. Regulations should make it mandatory that the reports prominently disclose a firm's specific investment banking relationship with the companies it is covering.

<u>Auditors & consulting</u>

Auditors who also do consulting work for the same organization to which they audit are not in a position to be stringent in their auditing for the fear of losing their consulting contract.

There should be a legal ban on auditing and consulting for the same company. In India, if the ICAI discovers that an auditor was giving wrong or misleading information; the punishment involved (under section 230/231 of Company's Act, 1956) is a fine of mere Rs 10,000/- and confiscation of registration. Moreover, ICAI faces a case of conflicting interest as it facilitates the training and registration of the Chartered Accountants themselves. So, monitoring of the auditing practice must be covered under SEBI or another independent tribunal. Punishments must be harsher to include criminal proceedings and the fine must be increased to 5 lakhs.

Fund management industry

Fund managers are reluctant to take an activist's stance when it comes to voting against the senior executives on matters of strategy, compensation or environmental policy. This is because they depend on the same companies for contracts to manage or administer corporate pension plans.

A legislation which will in some way discourage institutional investors from managing the funds of the companies where they have invested will certainly be desirable.

Politics:

Since large corporations fund the political parties, even the governments face a conflicts of interest in enacting the necessary legislation which may prove *tough* for these lobbying groups. This explains how Enron managed to help write energy policy in the Bush Administration, while the business roundtable and Silicon Valley combined to derail efforts to change the accounting treatment for stock options.

The corporations must be detached from the political funding process, or more transparency and accountability in the administrative decision-making process will ensure the passing of effective legislation.

CONCLUSION

The US corporate disasters have exposed the rot in the Capitalism. Now is the time for these participants to wake up and take some concrete action through commitment to ethics and stricter regulations.

Also, as the old Chinese proverb goes, *When spider webs unite, they tie down the lion.* This applies aptly to shareholders, who now have an increased responsibility to actively monitor and participate in the running of corporations.

If all the lessons are taken in the right spirit, they can be a blessing in disguise, because, it can clean the business world of all its evils and maladies and strengthen the corporate world for the greater challenges waiting ahead in the evolving global market place.

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