Corporate Scandals: Can Businesses Be Trusted

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When investors diversify their capital ventures, the consequence of one financial failure is substantially decreased. Therefore, smart investment practices combined with the protective reform of the Sarbanes-Oxley Act provides reasonable protection for investors. The recent combination of substantive, responsive, and preventative legislation indicates that there is effective corporate policy pressure in the United States. These responsive and preventative changes to securities regulations put adequate pressure on corporations to maintain ethical business practices, effectively and efficiently protecting the prudent investor.

Corporate Scandals: Can Businesses Be Trusted?

Charisa L. Player*

Some optimists will no doubt argue that companies, by and large, remain trustworthy.... However, the presence of such a watershed of fraudulent activities has brought attention to some basic problems.

Trust in companies has been destroyed in recent years, and rightly so. Companies once hailed as headed by innovative geniuses and touted as "One of the Best Companies to Work For" have folded in incredible displays of mismanagement and fraud. Some optimists will no doubt argue that companies, by and large, remain trustworthy. After all, only a small percentage of companies have had the need to restate earnings and overhaul accounting methods. However, the presence of such a watershed of fraudulent activities has brought attention to some basic problems. William T. Allen said, "Enron is not just the hundred year flood of fraud, but is in fact a warning that there are fundamental weaknesses that require immediate attention." This essay will (I) suggest that a particular sector of business is more prone to fraudulent activities, (2) analyze the role of employee ethics in the downfall of a company, and (3) examine the viability of the proposed solutions for amending these fundamental weaknesses.

* Charisa Player has won several awards for her writing, including placing in the Michael L. Rosten contest and the Disneyland Creativity Challenge. A mother of three boys, she plans to enter law school in 2005.


THE PROBLEM WITH NONTANGIBLE PRODUCTS

Businesses typically earn a profit by selling one of two things: a tangible product or service. Tangible product-based companies are fairly well structured in terms predicting expected earnings and reasonable profit expectations. Financial structure in a product-centered company revolves around the costs of production, which includes supplies, packaging, assembly, and logistics. Profits are predicted according to these costs of production, the available supply relative to expected demand, and the price that can reasonably be charged for the product. The costs of production and a limited supply keep the market stable and the profit expectations reasonable.

Service and nontangible product sales are a great deal less structured. The value of call waiting or financial advice is more difficult to measure and possible profits from sales of such intangibles are less bounded.

Corporate scandals akin to Enron are not new. After the stock market crash of 1929, Middle West Utilities was forced to declare bankruptcy after its "elaborate webs of holding companies, each helping hide the others' financial weaknesses" failed to keep the company afloat. Ivan Boesky and Michael Milken have served jail time for the savings and loan junk bond scandals of the '80s. More than a few dot-com companies came crashing down in the late '90s following unsustainable profits and growth. Enron wasn't solely concerned with energy sales. It also dabbled in the telecom business.

Companies at the forefront of recent scandals (Enron, Tyco, Adelphia, WorldCom, Global Crossing, Dynegy, Network Associates, and Qwest, to name a few) have all shared the common thread of selling telecommunications. Enron described itself as "one of the world's leading electricity, natural gas and communications companies, which markets electricity and natural gas, delivers physical commodities and financial and risk management services to companies around the world."

Economics teaches us that the cost and price of a product is based on the principles of supply and demand. A higher demand allows a higher price and greater profit potential. The fundamental weakness in telecommunications companies is the lack of supply as a significant bounding factor.

Tangible-product based organizations, when calculating possible profits, must take into consideration many costs that a service-based organization can ignore. The product must not only be researched and developed, but it also must be laboratory tested, and possibly FDA approved, requiring a large amount of capital. The company must purchase and warehouse the raw materials. The product requires manpower to transform the raw materials into the finished product. It must be packaged, inventoried, and moved to retailers. The costs of production keep the supply finite.

After the telephone deregulation in the 1980s, the phone companies were handed a ready-made infrastructure of phone wires and circuitry already in place and operating, with a previously captive customer base. With minimal hardware and software upgrades, phone companies began to offer more than just local and long distance. They began to offer additional services such as call waiting, 3-way calling, and even the occasional car phone. The only product that these telecom companies actually sell are the cell phones customers use to access the network.

Services like long distance access and cell phone plans require no inventory, no raw materials, no warehouses. The telecom companies sell services that are handled by computers. At first look, it would seem that telecom prices would be based on the supply of bandwidth the companies have to offer. However, these companies were carrying inventory, in terms of bandwidth, so large that there could never be a market of buyers large enough to fill capacity. This created a market that required little initial capital to establish an infrastructure and the appearance of unlimited profit potential.

EMPLOYEE ETHICS

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Employee Ethics

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an entire organization. An example of trickle-down corruption would be Tyco's acquisition of ADT Security Services and the resulting change of protocol. Salespeople were told to target "the scummiest neighborhoods possible... neighborhoods where there were problems." Tyco did this to boost their numbers. They were not interested in keeping these contracts on a long-term basis, nor were they interested in the customers' well-being. In the interest of the appearance of immediate growth they signed contracts with customers of very poor credit.9

There have been several studies done on the implicit nature of employee trust. Employees, for the most part, trust management for no other reason than the fact that management is in a position of authority. Stanley Milgram, a behavioral psychology professor at Yale University, has said, "A substantial proportion of people do what they're told to do, irrespective of the content of the act and without limitations of conscience, so long as they perceive that the command comes from a legitimate authority."10 Milgram also reported his findings that 65 percent of his subjects would inflict pain on other human beings if told to do so by someone they perceived to be an authority figure.11 A 2001 survey of CFOs also found that 17 percent of CFOs at public companies feel pressure to misrepresent financial results.12 Employees at Enron who spotted accounting irregularities were highly motivated by the executives to do as they were told and to not question the financial reporting they were asked to do.13 It would appear that the pressure to follow an authority figure is strong, even when unethical behavior is involved.

This is not to say employees are automatons. The Lutheran Brotherhood, an insurance group, conducted a survey that showed 38 percent of their respondents would talk to their supervisors about an ethical dilemma that they were facing in the company, 23 percent said they would either do nothing, quit, or were unsure what they would do; 40 percent said they would try to find a way to resolve the conflict without losing their jobs.14 Despite these findings, however scientific the surveys purport to be, asking a hypothetical question yields different results than if the respondents were actually faced with the dilemma and their jobs were truly on the line and at odds with their morals.

While much of the responsibility for the sudden earnings restatements and accounting overhauls can be laid at the feet of the CFO, ethical troubles pervaded these telecom companies and were present not only at the top.

THE VIABILITY OF PROPOSED SOLUTIONS

Several recent articles have attempted to quantify the issues that caused the culture that would create Enron. Marianne Jennings, in particular, suggests seven factors which lead to the "Yeehaw" culture that created the recent scandals.15 These factors include the pressure to maintain the unsustainable numbers and performance, an employee culture of fear and silence, the young 'uns and the bigger-than-life CEO, a weak board, a culture of conflicts in interest, a culture of innovation like no other spurred on by the tech boom, and a culture of social responsibility.

Business ethics played a major role in these scandals.16

The great criticism of English theories of utility was that they allow the possibility of "moral corruption" to set in. If ethical behaviour is justified in terms of its beneficial effects, surely it can be adjusted or amended in the light of those effects. If an overwhelming financial benefit follows from flouting an ethical principle, obeying the principle ceases to be a "best policy" and becomes a burden. The best policy becomes to ditch the ethics.17

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10 Ibid.
11 Ibid., 391.
12 See http://www.stanleymilgram.com/quotes.html for more information on Stanley Milgram's social research findings.
17 Ibid., 410.
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Ethics are a touchy issue and not easily defined, except as a list of things one can and cannot do (as in Sarbanes-Oxley). There is a clear difference between social ethics and business ethics: business ethics focuses on the ultimate goal to pursue money, social ethics is more focused on the pursuit of happiness. One of the professors at a meeting for the Society for Business Ethics was heard to say, "Let's face it. We are all in colleges of business because we wanted more money. We sold out years ago." In a matter unrelated to the pursuit of money, 82 percent of executives confess that they cheat at the game of golf. Ironically, 99 percent of those same CEOs profess to be honest in business.

Despite these admissions Enron's accounting, at first, was perfectly within legal boundaries. When the Special Purpose Entities (SPEs) became unsustainable, business ethics dictated that social ethics must be trumped in the pursuit of money. Business schools are being singled out as a potential beginning to the pervasive nature of business ethics: "The notions from the rest of campus on moral relativism and there being no absolute truth have invaded business ethics discussions as well as courses in management and marketing. The prevailing ethical theory of stakeholderism is not an ethical theory at all but a convenient tool of analysis that permits the justification and rationalization of any business decision so long as the business is acting in the best interest of some stakeholder group. Teaching a value system with shifting accountability could not be more subversive." There is some proof to support the assertion that there is a change in the values of graduates brought about by business school training.

To prevent these sorts of company collapses and widespread fraud, several layers of fixes, patterned after models described in The Federalist Papers, have been suggested: internal fixes such as an employee hotline, employment of an ethics officer, use of a code of ethics with ethics training, curbing social responsibility, and hiring employees over the age of forty. The quasi-internal fixes deal with the board, separation of the chairman and CEO positions, and the use of independent auditors. One of the fundamental principles behind these proposals is the sum wisdom of the employees of a company far exceeds the wisdom of those on the board.

These fixes are impractical and unlikely. They call for a dramatic and costly restructuring that is not likely to occur within a company already in financial difficulty. An employee hotline may be set up by these companies to maintain an open corridor for whistle-blowers and those with concerns; however, unless the employee is able to maintain strict anonymity, it is likely this would backfire, causing more fear and silence in the resulting meetings between the managers and those who have complaints to discuss their concerns.

Many of these companies already had a code of ethics for their employees to sign and maintain. However, ingenuity leads to loopholes. Kenneth Lay signed a code of ethics waiver to allow an employee to participate in the management of several SPEs set up to absorb company debt and artificially manufacture equity. Unless the code of ethics is completely universal within a corporation and carries stiff internal penalties for violations, it will have no teeth.

Removing conflicts of interest by curbing social responsibilities, such as charitable contributions, is unlikely to help the company's ethics and appearance of trustworthiness, and it is not likely that companies will hire more experienced and therefore more costly employees based only on the hope these would offset ethical issues that may arise.

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19 Ibid., 261.

20 Ibid., 230.

21 Ibid., 231.
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23 Ibid., 504.
Other fixes have come in the form of government SEC reform. There is no doubt that Sarbanes–Oxley has stipulated draconic measures against those who violate the specific duties set forth. However, behavioral economists have questioned the SEC's ability to regulate, given that the SEC may suffer more from behavioral economic biases than investors. Choi and Pritchard suggest that until these biases are addressed the SEC will not be able to adequately perform its duties.26

The largest acts of reform (such as passing Congressional laws like Sarbanes–Oxley, the Insider Trading Sanctions Act, and the Insider Trading and Securities Fraud Enforcement Act) came about only when the SEC was moved into action by large corporate scandal.27 It is the SEC's duty to prevent these breaches of trust; these scandals call into question the effectiveness of the SEC. Because scandals become a threat to the existence of the SEC, they are quickly addressed, usually by a law mandating an increased disclosure of some sort. Proposals that suggest new market self-regulation would be a better solution than SEC oversight are consistently dismissed.28 Unfortunately, once a law is passed—there is question as to why Sarbanes–Oxley passed as quickly as it did, without time to thoroughly consider the ramifications—it usually takes on a life of its own, becoming extremely difficult to revoke.29 "The market corrects its mistakes; regulators frequently resist doing so."30

While the SEC may have the investor's best interests at heart, it is wise to remember that overregulation will lead only to a depression in companies' ability to operate. It remains to be seen what the effects of Sarbanes–Oxley will be. More legislation is not the answer and will only create more problems than it proposes to fix.

26 Apparently, the Behavioral Economic Theory, which is yet to be defined, won the Nobel Prize for Economics recently. I will admit that "Behavioral Economics and the SEC" is a fascinating read that delicately sledgehammers the point that the SEC is inadequate to fulfill its duties. Stanford Law Review 56 (2003): 4.
28 Ibid., 5.
29 Ibid., 39.
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