Chapter 10

Ethical Decision Making: Corporate Governance, Accounting, and Finance

Did you ever expect a corporation to have a conscience, when it has no soul to be damned and no body to be kicked?

Edward Thurlow (1731–1806), Lord Chancellor of England

Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years, it is futile to blame men. It is the institution that malfunctions.

Peter Drucker

Earnings can be as pliable as putty when a charlatan heads the company reporting them.

Warren Buffet
Chapter Objectives

After reading this chapter, you will be able to:

1. Describe the environment for corporate governance prior and subsequent to the Sarbanes-Oxley Act.
2. Explain the role of accountants and other professionals as “gatekeepers.”
3. Describe how conflicts of interest can arise for business professionals.
4. Outline the requirements of the Sarbanes-Oxley Act.
5. Describe the COSO framework.
6. Define the “control environment” and the means by which ethics and culture can impact it.
7. Discuss the legal obligations of a member of a board of directors.
8. Explore the obligations of an ethical member of a board of directors.
9. Highlight conflicts of interest in financial markets and discuss the ways in which they may be alleviated.
10. Describe conflicts of interest in governance created by excessive executive compensation.
11. Define insider trading and evaluate its potential for unethical behavior.
1. Ethical Decision Making: Corporate Governance, Accounting, and Finance

Chapter 10

Ethical Decision Making: Corporate Governance, Accounting, and Finance

Many of the companies mentioned in the opening pages of this book were involved in financial corruption. Recall those company names—whether from this text or from the headlines of the national press—such as Enron, WorldCom, Tyco, Adelphia, Cendant, Rite Aid, Sunbeam, Waste Management, HealthSouth, Global Crossing, Arthur Andersen, Ernst & Young, ImClone, KPMG, J.P. Morgan, Merrill Lynch, Morgan Stanley, Citigroup, Salomon Smith Barney, Marsh & McLennan, Credit Suisse First Boston, and even the New York Stock Exchange itself. In the past few years, each of these companies, organizations, accounting firms, and investment firms has been implicated in some ethically questionable activity that has resulted in fines or criminal convictions. Most of the unethical behavior involved some aspect of finance, from manipulating special purpose entities in order to evidence growth, to cooking the books, to instituting questionable tax dodges, to allowing investment decisions to warp the objectivity of investment research and advice. Ethics in the governance and financial arenas has been perhaps the most visible issue in business ethics during the first years of the new millennium. Accounting and investment firms that were looked upon as the guardians of integrity in financial dealings have now been exposed in violation of the fiduciary responsibilities entrusted to them by their stakeholders. Many analysts contend that this corruption is evidence of a complete failure in corporate governance structures; could better governance and oversight have prevented these ethical disgraces?

Consider the following:

The jury is still out on the costs to corporations of Sarbanes-Oxley compliance, but it’s a safe guess that it’s already in the billions of dollars and millions of person-hours. No one doing Sarbanes-Oxley work adds value to any company. They design nothing, make nothing, and sell nothing. They make no improvements to management, marketing, or morale. They meet no demands, satisfy no necessities, create no opportunities. They simply report.¹

If Sarbanes-Oxley has these challenges, are there alternatives to address wrongdoing in corporate governance? Is Sarbanes-Oxley the best alternative? What other suggestions might you offer?

• What else might you need to know to determine how to prevent mismanagement of this type?
• What ethical issues are involved?
• Who are the stakeholders in financial mismanagement?
• Whose rights are protected by Sarbanes-Oxley’s implementation? What are the consequences of Sarbanes-Oxley’s implementation? Is it the fairest option? Is it regulating companies to act in the way a virtuous company would act?
• What alternatives have you compiled?
• How do the alternatives compare; how do the alternatives affect the stakeholders?

Decision Point

But Is Regulation the Answer?

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This chapter will address the cultural elements that led to the Enron Corporation debacle, as well as others during the end of the 20th and beginning of the 21st centuries. Though the Sarbanes-Oxley Act is one response to these corporate governance failures, others exist, such as adherence to the elements of the control environment framework advocated by the Committee of Sponsoring Organizations of the Treadway Commission. (See the Decision Point on the previous page and the above Reality Check to consider other alternatives.) Perhaps, however, many of these challenges could be avoided by having more accountable and responsible boards of directors. The chapter will outline board member roles and responsibilities and discuss specifically pervasive issues such as conflicts of interest, insider trading, and leveraged buyouts and mergers. We will explore the impact that corporate institutions have on the social fabric and how corporate issues connect with the global environment in the first decades of the 21st century.

Professional Duties and Conflicts of Interest

The watershed event that brought the ethics of finance to prominence at the beginning of the 21st century was the collapse of Enron and its accounting firm Arthur Andersen. William Thomas’s essay “The Rise and Fall of Enron” details the steps that led to the downfall of those companies, including using complex special purpose entities to access capital or hedge risk. The Enron case “has wreaked more havoc on the accounting industry than any other case in U.S. history,” including the demise of Arthur Andersen. Of course, ethical responsibilities of accountants were not unheard of prior to Enron, but the events that led to Enron’s demise brought into focus the necessity of the independence of auditors and the responsibilities of accountants like never before.

Accounting is one of several professions that serve very important functions within the economic system itself. Remember that even Milton Friedman, a staunch defender of free market economics, believes that markets can function only when certain conditions are met. It is universally recognized that markets must function within the law; they must assume full information; and they must be free from fraud and deception. Ensuring that these conditions are met is an important internal function for market-based economic systems. Several important business professions, for example, attorneys, auditors, accountants, and financial analysts, function in just this way. Just as the game of baseball requires umpires
who act with integrity and fairness, business and economic markets require these professionals to operate in a similar manner.

Such professions can be thought of as “gatekeepers” or “watchdogs” in that their role is to ensure that those who enter into the marketplace are playing by the rules and conforming to the very conditions that ensure the market functions as it is supposed to function. Recall from Chapter 3 the critical importance of role identities in determining ethical duties of professionals. These roles offer us a source of rules from which we can determine universal values to apply under deontological and Kantian analysis. We accept responsibilities based on our roles. Therefore, in striving to define the rules that we should apply, we see that the ethical obligations of accountants originate in part from their roles as accountants.

These professions can also be understood as intermediaries, acting between the various parties in the market, and they are bound to ethical duties in this role as well. All the participants in the market, especially investors, boards, management, and bankers, rely on these gatekeepers. Auditors verify a company’s financial statements so that investors’ decisions are free from fraud and deception. Analysts evaluate a company’s financial prospects or creditworthiness, so that banks and investors can make informed decisions. Attorneys ensure that decisions and transactions conform to the law. Indeed, even boards of directors can be understood in this way. Boards function as intermediaries between a company’s stockholders and its executives and should guarantee that executives act on behalf of the stockholders’ interests.

The most important ethical issue facing professional gatekeepers and intermediaries in business contexts involves conflicts of interest. A conflict of interest exists where a person holds a position of trust that requires that she or he exercise judgment on behalf of others, but where her or his personal interests and/or obligations conflict with those of others. For instance, a friend knows that you are heading to a flea market and asks if you would keep your eyes open for any beautiful quilts you might see. She asks you to purchase one for her if you see a “great buy.” You are going to the flea market for the purpose of buying your mother a birthday present. You happen to see a beautiful quilt at a fabulous price. In fact, your mother would adore the quilt. You find yourself in a conflict of interest—your friend trusted you to search the flea market on her behalf. Your personal interests are now in conflict with the duty you agreed to accept on behalf of your friend.

Conflicts of interest can also arise when a person’s ethical obligations in her or his professional duties clash with personal interests. Thus, for example, in the most egregious case, a financial planner who accepts kickbacks from a brokerage firm to steer clients into certain investments fails in her or his professional responsibility by putting personal financial interests ahead of client interest. Such professionals are said to have fiduciary duties—a professional and ethical obligation—to their clients, duties that override their own personal interests. (For another example of a conflict of interest, see the Decision Point on page 425.)

Unfortunately, and awkwardly, many of these professional intermediaries are paid by the businesses over which they keep watch, and perhaps are also employed by yet another business. For example, David Duncan was the principal accounting professional employed by Arthur Andersen, though he was hired by and assigned to work at Enron. As the Arthur Andersen case so clearly demonstrated, this situation
can create real conflicts between a professional’s responsibility and his or her financial interests. Certified public accountants (CPAs) have a professional responsibility to the public. But they work for clients whose financial interests are not always served by full, accurate, and independent disclosure of financial information. Even more dangerously, they work daily with and are hired by a management team that itself might have interests that conflict with the interests of the firm represented by the board of directors. Thus, real and complex conflicts can exist between professional duties and a professional’s self-interest. We will revisit conflicts in the accounting profession later in the chapter.

In one sense, the ethical issues regarding such professional responsibilities are clear. Because professional gatekeeper duties are necessary conditions for economic legitimacy, they should trump other responsibilities an employee might have. David Duncan’s responsibilities as an auditor should have overridden his

FIGURE 10.1 Conflicts of Interest in Public CPA Activity
role as an Andersen employee. But knowing one’s duties and fulfilling those duties are two separate issues.

This common situation has many ethical implications. If we recognize that the gatekeeper function is necessary for the very functioning of economic markets, and if we also recognize that it can be difficult for individuals to fulfill their gatekeeper duties, then society has a responsibility to make changes to minimize these conflicts. For example, as long as auditors are paid by the clients on whom they are supposed to report, there will always be an apparent conflict of interest between their duties as auditors and their personal financial interests. This conflict is a good reason to make structural changes in how public accounting operates. Perhaps boards rather than management ought to hire and work with auditors since the auditors are more likely reporting on the management activities rather than those of the board. Perhaps public accounting somehow ought to be paid by public fees. Perhaps legal protection or sanctions ought to be created to shield professionals from conflicts of interests. These changes would remove both the apparent and the actual conflicts of interest created by the multiple roles—and therefore multiple responsibilities—of these professionals. From the perspective of social ethics, certain structural changes would be an appropriate response to the accounting scandals of recent years.

Consider the case of what is referred to as “soft money” within the securities industry. According to critics, a common practice in the securities industry amounts to little more than institutionalized kickbacks. “Soft money” payments occur when financial advisors receive payments from a brokerage firm to pay for research and analyst services that, in theory, should be used to benefit the clients of those advisors. Such payments can benefit clients if the advisor uses them to improve the advice offered to the client. Conflicts of interest can arise when the money is used for the personal benefit of the advisor. In 1998, the Securities and Exchange Commission released a report that showed extensive abuse of soft money. Examples included payments used for office rent and equipment, personal travel and vacations, memberships at private clubs, and automobile expenses. If you learned that your financial advisor received such benefits from a brokerage, could you continue to trust the financial advisor’s integrity or professional judgment?

- What facts do you need to know to better judge this situation?
- What values are at stake in this situation? Who gets harmed if a financial advisor accepts payments from a brokerage? What are the consequences?
- For whom does a financial advisor work? To whom does she have a professional duty? What are the sources of these obligations?
- Does accepting these soft money payments violate any individual’s rights? What would be the consequence if this practice were allowed and became commonplace?
- Can you think of any public policies that might prevent such situations? Is this a matter for legal solutions and punishments?
Perhaps the most devastating aspect of the Enron case was the resulting deterioration of trust that the public has in the market and in corporate America. Decision makers at Enron ignored their fiduciary duties to shareholders, employees, and the public in favor of personal gain, a direct conflict of interest leading not only to extraordinary personal ruin but also to its own demise: Enron filed for bankruptcy in December 2001. In an effort to prevent these conflicts in the future, Congress enacted legislation to mandate independent directors and a host of other changes discussed below.

However, critics contend that these rules alone will not rid society of the problems that led to this tragedy. Instead, they argue, extraordinary executive compensation and conflicts within the accounting industry itself have created an environment where the watchdogs have little ability to prevent harm. Executive compensation packages based on stock options create huge incentives to artificially inflate stock value. (You might wish to review the reading on executive compensation in Chapter 3 to consider this issue in more detail.) Changes within the accounting industry stemming from the consolidation of major firms and avid “cross-selling” of services such as consulting and auditing within single firms have virtually institutionalized conflicts of interest.

Answers to these inherent challenges are not easy to identify. Imagine that an executive is paid based on how much she or he impacts the share price and will be ousted if that impact is not significantly positive. A large boost in share price—even for the short term—serves as an effective defense to hostile takeovers and boosts a firm’s equity leverage for external expansion. In addition, with stock options as a major component of executive compensation structures, a higher share price is an extremely compelling quest to those in leadership roles. That same executive, however, has a fiduciary duty to do what is best for the stakeholders in the long term, an obligation that is often at odds with that executive’s personal interests. Not the best environment for perfect decision making, or even for basically decent decision making.

The Sarbanes-Oxley Act of 2002

The string of corporate scandals since the beginning of the millennium has taken its toll on investor confidence. The more it is clear that deceit, chicanery, evasiveness, and cutting corners go on in the markets and in the corporate environment, the less trustworthy those engaged in financial services become. Because reliance on corporate boards to police themselves did not seem to be working, Congress passed the Public Accounting Reform and Investor Protection Act of 2002, commonly known as the Sarbanes-Oxley Act, which is enforced by the Securities and Exchange Commission (SEC). The act applies to over 15,000 publicly held companies in the United States and some foreign issuers. In addition, a number of states have enacted legislation similar to Sarbanes-Oxley that apply to private firms, and some private for-profits and nonprofits have begun to hold themselves to Sarbanes-Oxley standards even though they are not necessarily subject to its requirements.
Sarbanes-Oxley strived to respond to the scandals by regulating safeguards against unethical behavior. Because one cannot necessarily predict each and every lapse of judgment, no regulatory “fix” is perfect. However, the act is intended to provide protection where oversight did not previously exist. Some might argue that protection against poor judgment is not possible in the business environment but Sarbanes-Oxley seeks instead to provide oversight in terms of direct lines of accountability and responsibility. The following provisions have the most significant impact on corporate governance and boards:

- **Section 201**: Services outside the scope of auditors (prohibits various forms of professional services that are determined to be consulting rather than auditing).
- **Section 301**: Public company audit committees (requires independence), mandating majority of independents on any board (and all on audit committee) and total absence of current or prior business relationships.
- **Section 307**: Rules of professional responsibility for attorneys (requires lawyers to report concerns of wrongdoing if not addressed).
- **Section 404**: Management assessment of internal controls (requires that management file an internal control report with its annual report each year in order to delineate how management has established and maintained effective internal controls over financial reporting).
- **Section 406**: Codes of ethics for senior financial officers (required).
- **Section 407**: Disclosure of audit committee financial expert (requires that they actually have an expert).

Sarbanes-Oxley includes requirements for certification of the documents by officers. When a firm’s executives and auditors are required to literally sign off on these statements, certifying their veracity, fairness, and completeness, they are more likely to personally ensure their truth. The Reality Check above explores other possible positive consequences of Sarbanes-Oxley.

One of the most significant criticisms of the act is that it imposes extraordinary financial costs on the firms; and the costs are apparently even higher than anticipated. A 2005 survey of firms with average revenues of $4 billion conducted by Financial Executives International reports that section 404 compliance averaged

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**Reality Check A Perfect Ten**

Governance Metrics International produces an annual ranking of global companies based on their governance standards. In its 2004 results of 2,588 companies, GMI reported that 26 firms received a score of 10 points, its highest rating. As a group, these companies outperformed the Standard & Poor’s 500 Index by 10 percent over the last five years. “This suggests a correlation between corporate governance practices and portfolio returns when measured across a number of variables across a multiyear period,” said GMI’s CEO. In addition, he notes, U.S. companies’ overall ratings increased based, in part, he posits, on the impact of Sarbanes-Oxley.

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The European Union’s 8th Directive, effective in 2005 (though member states have two years to integrate it into law), covers many of the same issues as Sarbanes-Oxley but applies these requirements and restrictions to companies traded on European Union exchanges. The directive mandates external quality assurances through audit committee requirements and greater auditing transparency. The directive also provides for cooperation with the regulators in other countries, closing a gap that previously existed. However, contrary to Sarbanes-Oxley, the directive does not contain a whistleblower protection section, does not require similar reporting to shareholders, and has less detailed requirements compared to Sarbanes-Oxley’s section 404.

The Internal Control Environment

Sarbanes-Oxley and the European Union’s 8th Directive are external mechanisms that seek to ensure ethical corporate governance, but there are internal mechanisms as well. One way to ensure appropriate controls within the organization is to utilize a framework advocated by the Committee of Sponsoring Organizations (COSO). COSO is a voluntary collaboration designed to improve financial reporting through a combination of controls and governance standards called the Internal Control—Integrated Framework. It was established in 1985 by five of the major professional accounting and finance associations, originally to study fraudulent financial reporting and later to develop standards for publicly held companies. COSO describes “control” as encompassing “those elements of an organization that, taken together, support people in the achievement of the organization’s objectives.”³ The elements that comprise the control structure will be familiar as they are also the essential elements of culture discussed in Chapter 5. They include:

- **Control environment**—the tone or culture of a firm: “the control environment sets the tone of an organization, influencing the control consciousness of its people.”
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- **Risk assessment**—risks that may hinder the achievement of corporate objectives.
- **Control activities**—policies and procedures that support the control environment.
- **Information and communications**—directed at supporting the control environment through fair and truthful transmission of information.
- **Ongoing monitoring**—to provide assessment capabilities and to uncover vulnerabilities.

**Control environment** refers to cultural issues such as integrity, ethical values, competence, philosophy, operating style. Many of these terms should be reminiscent of issues addressed in Chapter 4 during our discussion of corporate culture. COSO is one of the first efforts to address corporate culture in a quasi-regulatory framework in recognition of its significant impact on the satisfaction of organizational objectives. Control environment can also refer to more concrete elements (that can better be addressed in an audit) such as the division of authority, reporting structures, roles and responsibilities, the presence of a code of conduct, and a reporting structure.

The COSO standards for internal controls moved audit, compliance, and governance from a *numbers orientation* to concern for the *organizational environment* (see Figure 9.1). In recognition of the interplay between the COSO control environment and the Sarbanes-Oxley requirements with the discussion of culture in Chapter 5, it is critical to influence the *culture* in which the control environment develops in order to impact both sectors of this environment described above. In fact, these shifts impact not only executives and boards; internal audit and compliance professionals also are becoming more accountable for financial stewardship, resulting in greater transparency, greater accountability, and a greater emphasis on effort to prevent misconduct. In fact, all the controls one could implement have little value if

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**TABLE 10.1  COSO Definition of Internal Control**

**Internal control** is a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

**Key Concepts**

- Internal control is a *process*. It is a means to an end, not an end in itself.
- Internal control is affected by *people*. It’s not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only *reasonable assurance*, not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of *objectives* in one or more separate but overlapping categories.

Source: Committee of Sponsoring Organizations, “Key Concepts,” http://www.coso.org/key.htm. Copyright © 1985–2005 by the Committee of Sponsoring Organizations of the Treadway Commission. Reproduced by permission from the AICPA acting as the authorized copyright administrator for COSO.
there is no unified corporate culture to support it or mission to guide it. As philosopher Ron Duska noted in the Mitchell Forum on Ethical Leadership in Financial Services, “If you don’t have focus and you don’t know what you’re about, as Aristotle says, you have no limits. You do what you have to do to make a profit.”

More recently, COSO developed a new system, Enterprise Risk Management—Integrated Framework, to serve as a framework for management to evaluate and improve their firms’ prevention, detection, and management of risk. This system expands on the prior framework in that it intentionally includes “objective setting” as one of its interrelated components, recognizing that both the culture and the propensity toward risk are determined by the firm’s overarching mission and objectives. Enterprise risk management, therefore, assists an organization or its governing body in resolving ethical dilemmas based on the firm’s mission, its culture, and its appetite and tolerance for risk.

Going beyond the Law: Being an Ethical Board Member

As discussed above, perhaps the most effective way to avoid the corporate failures of recent years would be to impose high expectations of accountability on boards of directors. After all, it is the board’s fiduciary duty to guard the best interests of the firm itself. However, much of what Enron’s board did that caused its downfall was actually well within the law. For instance, it is legal to vote to permit an exception to a firm’s conflicts of interest policy. It may not necessarily be ethical or best for its stakeholders, but it is legal nonetheless. So what does it take to be an ethical board member, to govern a corporation in an ethical manner, and why is governance so critical? The law offers some guidance on minimum standards for board member behavior.

Legal Duties of Board Members

The law imposes three clear duties on board members, the duties of care, good faith, and loyalty. The **duty of care** involves the exercise of reasonable care by a board member to ensure that the corporate executives with whom she or he works carry out their management responsibilities and comply with the law in the best interests of the corporation. Directors are permitted to rely on information and opinions only if they are prepared or presented by corporate officers, employees, a board committee, or other professionals the director believes to be reliable and competent in the matters presented. Board members are also directed to use their “business judgment as prudent caretakers”: the director is expected to be disinterested and reasonably informed, and to rationally believe the decisions made are in the firm’s best interest. The bottom line is that a director does not need to be an expert or actually run the company!

The **duty of good faith** is one of obedience, which requires board members to be faithful to the organization’s mission. In other words, they are not permitted to act in a way that is inconsistent with the central goals of the organization. Their decisions must always be in line with organizational purposes and direction, strive towards corporate objectives, and avoid taking the organization in any other direction.
The **duty of loyalty** requires faithfulness; a board member must give undivided allegiance when making decisions affecting the organization. This means that conflicts of interest are always to be resolved in favor of the corporation. A board member may never use information obtained through her or his position as a board member for personal gain, but instead must act in the best interests of the organization.

Board member conflicts of interest present issues of significant challenges, however, precisely because of the alignment of their personal interests with those of the corporation. Don’t board members usually have some financial interest in the future of the firm, even if it is only through their position and reputation as a board member? Consider whether a board member should own stock. If the board member does own stock, then her or his interests may be closely aligned with other stockholders, removing a possible conflict there. However, if the board member does not hold stock, perhaps he or she is best positioned to consider the long-term interests of the firm in lieu of a sometimes enormous windfall that could occur as the result of a board decision. In the end, a healthy board balance is usually sought. Consider the impact that the composition and training of a board might have on board decision making as you review the following Reality Check.

The **Federal Sentencing Guidelines** (FSG), promulgated by the United States Sentencing Commission and (since a 2005 Supreme Court decision) discretionary in nature, do offer boards some specifics regarding ways to mitigate eventual fines and sentences in carrying out these duties by paying attention to ethics and compliance. In particular, the board must work with executives to analyze the incentives for ethical behavior. It must also be truly knowledgeable about the content and operation of the ethics program. “Knowledgeable” would involve a clear understanding of the process by which the program evolved, its objectives, its process and next steps, rather than simply the mere contents of a training session. The FSG also suggest that the board exercise “reasonable oversight” with respect to the implementation and effectiveness of the ethics/compliance program by ensuring that the program has adequate resources, appropriate level of authority, and direct access to the board. In order to ensure satisfaction of the FSG and the objectives of the ethics and compliance program, the FSG discuss periodic assessment of risk of criminal conduct and of the program’s effectiveness. In order to assess their success, boards should evaluate their training and development materials, their governance structure and position descriptions, their individual evaluation processes, their methods for bringing individuals onto the board or removing them, and all board policies, procedures, and processes, including a code of conduct and conflicts policies. Though the above FSG recommendations seem intuitive to some extent, see the following Reality Check for the actual numbers of firms that implement training on these issues for their boards of directors.

### Beyond the Law, There Is Ethics

The law answers only a few questions with regard to boards of directors. Certainly Sarbanes-Oxley has strived to answer several more, but a number of issues remain open to board discretionary decision making. One question we would expect the law to answer, but that instead remains somewhat unclear, is whom the board
represents. Who are its primary stakeholders? By law, the board of course has a fiduciary duty to the owners of the corporation—the stockholders. However, many scholars, jurists, and commentators are not comfortable with this limited approach to board responsibility and instead contend that the board is the guardian of the firm’s social responsibility as well.

Bill George, former chairman and CEO of Medtronic and a recognized expert on governance, contends that there are 10 basic tenets that boards should follow to ensure appropriate and ethical governance:

1. **Standards:** There should be publicly available principles of governance for the board created by the independent directors.
2. **Independence:** Boards should ensure their independence by requiring that the majority of their members be independent.
3. **Selection:** Board members should be selected based not only on their experience or the role they hold in other firms but also for their value structures.
4. **Selection, number 2:** The board’s governance and nominating committees should be staffed by independent directors to ensure the continuity of independence.
5. **Executive sessions:** The independent directors should meet regularly in executive sessions to preserve the authenticity and credibility of their communications.
6. **Committees:** The board must have separate audit and finance committees that are staffed by board members with extensive expertise in these arenas.
7. **Leadership:** If the CEO and the chair of the board are one and the same, it is critical that the board select an alternative lead director as a check and balance.
8. **Compensation committee outside expert:** The board should seek external guidance on executive compensation.
9. **Board culture:** The board should not only have the opportunity but be encouraged to develop a culture including relationships where challenges are welcomed and difference can be embraced.

**Board Ethics Training?** A 2003 Conference Board report found that 81 percent of firms represented at their conferences had conducted ethics and compliance training, perhaps a good sign. However, only 27 percent of these same firms had held similar training sessions or other opportunities for learning for members of their boards of directors.

**Board Diversity?** A 2006 report by Catalyst found that women held 14.7 percent of board seats in the Fortune 500 in 2005. Though some might contend that this is the result of the fact that women did not enter the executive suites in significant numbers until the latter part of the 20th century, Catalyst’s report points out that, at current growth rates, women in board rooms will not reach parity with men for another 70 years. Women of color are progressing at an even slower pace, holding only 3.4 percent of board seats in the Fortune 500.

**Reality Check** *Do As I Say, Not As I Do* . . .
10. Responsibility: Boards should recognize their responsibility to provide oversight and to control management through appropriate governance processes.\(^8\)

Some executives may ask whether the board even has the legal right to question the ethics of its executives and others. If a board is aware of a practice that it deems to be unethical but that is completely within the realm of the law, on what basis can the board require the executive to cease the practice? The board can prohibit actions to protect the long-term sustainability of the firm. Notwithstanding the form of the unethical behavior, unethical acts can negatively impact stakeholders such as consumers or employees who can, in turn, negatively impact the firm, which could eventually lead to a firm’s demise. (And good governance can have the opposite effect—see the Reality Check that follows!) It is in fact the board’s fiduciary duty to protect the firm and, by prohibiting unethical acts, it is doing just that.

As author Malcolm Salter warned, perhaps one of the most important lessons form Enron was that “corporate executives can be convicted in a court of law for a pattern of deception that may or may not be illegal.”\(^9\) The critical distinction Salter identifies in the Enron jury decision is that “at the end of the day, we are a principles-based society rather than a rules-based society, even though rules and referees are important.” Therefore, though our rules and processes offer guidance in terms of corporate decision making from a teleological, utilitarian perspective, if corporate executives breach common principles of decency and respect for human dignity, society will exact a punishment, nonetheless. Accordingly, a board has an obligation to hold its executives to this higher standard of ethics rather than simply following the legal rules.

Fortune journalists Ram Charan and Julie Schlosser\(^10\) suggest that board members have additional responsibilities beyond the law to explore and to investigate the organizations that they represent, and they suggest that an open conversation is the best method for understanding, not just what board members know, but also what they do not know. They suggest that board members often ignore even the most basic questions such as how the firm actually makes its money and whether customers and clients truly do pay for products and services. That is rather basic, but the truth is that the financial flow can explain a lot about what moves the firm. Board members should also be critical in their inquiries about corporate vulnerabilities—what could drag the firm down and what could competitors do to help it along that path? You do not know where to make the incision (or even just apply a Band-Aid) unless you know where the patient is hurting. Ensuring that information about vulnerabilities is constantly and consistently transmitted to the executives and the board creates effective prevention. Board members need to understand where the company is heading and whether it is realistic that it will get there. This is less likely if it is not living within its means or if it is paying out too much of its sustainable growth dollars to its chief executives in compensation.

Failing in any of these areas creates pressures on the firm and on the board to take up the slack, to manage problems that do not have to exist, to be forced to make decisions that might not have had to be made if only the information systems were working as they should. It is the board members’ ultimate duty to provide oversight, which is impossible without knowing the answers to the above questions.
Conflicts of Interest in Accounting and the Financial Markets

Conflicts of interest, while common in many situations among both directors and officers as discussed above, also extend beyond the board room and executive suite throughout the financial arena. In fact, trust is an integral issue for all involved in the finance industry. After all, what more can an auditor, an accountant, or an analyst offer than her or his integrity and trustworthiness? There is no real, tangible product to sell, nor is there the ability to “try before you buy.” Therefore, treating clients fairly and building a reputation for fair dealing may be a finance professional’s greatest assets. Conflicts—real or perceived—can erode trust, and often exist as a result of varying interests of stakeholders. As discussed earlier in this chapter, public accountants are accountable to their stakeholders—the stockholders and investment communities who rely on their reports—and therefore should always serve in the role of independent contractor to the firms whom they audit. In that regard, companies would love to be able to direct what that outside accountant says because people believe the “independent” nature of the audit. On the other hand, if accountants were merely rubber stamps for the word of the corporation, they would no longer be believed or considered “independent.”

If you were to look in a standard business textbook, you might find the following definition of accounting: “the process by which any business keeps track of its financial activities by recording its debits and credits and balancing its accounts.” Accounting offers us a system of rules and principles that govern the format and content of financial statements. Accounting, by its very nature, is a system of principles applied to present the financial position of a business and the results of its operations and cash flows. It is hoped that adherence to these principles will result in fair and accurate reporting of this information. Now, would you consider an accountant to be a watchdog or a bloodhound? Does an accountant stand guard or instead seek out problematic reporting? The answer to this question may depend on whether the accountant is employed internally by a firm or works as outside counsel.

Linking public accounting activities to those conducted by investment banks and securities analysts creates tremendous conflicts between one component’s duty...
to audit and certify information with the other’s responsibility to provide guidance on future prospects of an investment. Perhaps the leading example of the unethical effects of conflicts of interest is manifested in the shocking fact that 10 of the top investment firms in the country had to pay fines for actions that involved conflicts of interest between research and investment banking. Companies that engaged in investment banking pressured their research analysts to give high ratings to companies whose stocks they were issuing, whether those ratings were deserved or not. William H. Donaldson, the chairman of the SEC, spelled out the problem on the occasion of a global settlement between those companies and the SEC, NASAA, NASD, and NYSE of approximately $1.5 billion for such breaches.

The ethical issues and potential for conflicts surrounding accounting practices go far beyond merely combining services. They may include underreporting income, falsifying documents, allowing or taking questionable deductions, illegally evading income taxes, and engaging in fraud. In order to prevent accountants from being put in these types of conflicts, the American Institute of CPAs publishes professional rules. In addition, accounting practices are governed by generally accepted accounting principles (GAAP) established by the Financial Accounting Standards Board that stipulate the methods by which accountants gather and report information. However, the International Accounting Standards Committee, working with the U.S. SEC, is in the process of creating “convergence” between the International Financial Reporting Standards and the GAAP, with compliance required by 2009. 11 It is not an insignificant task; indeed, it poses daunting challenges. Beyond the prospect of the standards simply being translated appropriately and effectively, the standards themselves can be complex, modifying the standards becomes infinitely more complicated, small global firms may realize a greater burden than larger multinationals, and differences in knowledge bases between countries may pose strong barriers. Accountants are also governed by the American Institute of Certified Public Accountants’ (AICPA) Code of Professional Conduct. The code relies on the judgment of accounting professionals in carrying out their duties rather than stipulating specific rules.

But can these standards keep pace with readily changing accounting activities in newly emerging firms such as what occurred with the evolution of the dot.coms of a decade or more ago? Fortune magazine devoted an entire cover story at the time to the accounting “sleight of hand” in which dot.coms were engaging to “pull revenues out of thin air.” 12 Similar to the slow speed at which the courts caught up to emerging technology such as employee monitoring, accountants need to be on the lookout for the evolutionary tendencies of these sleight of hands.

In any case, would standards be enough? The answers to ethical dilemmas are not always so easily found within the deontological rules and regulations governing the industry. Scholar Kevin Bahr identifies a number of causes for conflicts in the financial markets that may or may not be resolved through simple rule-making:

1. The financial relationship between public accounting firms and their audit clients: Since audits are paid for by audited clients, there is an inherent conflict found simply in that financial arrangement.
2. **Conflicts between services offered by public accounting firms:** Since many public accounting firms offer consulting services to their clients, there are conflicts in the independence of the firm’s opinions and incentives to generate additional consulting fees.

3. **The lack of independence and expertise of audit committees.**

4. **Self-regulation of the accounting profession:** Since the accounting industry has historically self-regulated, oversight has been lax, if any.

5. **Lack of shareholder activism:** Given the diversity of ownership in the market based on individual investors, collective efforts to manage and oversee the board are practically nonexistent.

6. **Short-term executive greed versus long-term shareholder wealth:** Executive compensation packages do not create appropriate incentive systems for ethical executive and board decision making. “Enron paid about $681 million in cash and stock to its 140 senior managers, including at least $67.4 million to former chairman and chief executive Kenneth Lay, in the year prior to December 2, 2001, when the company filed for bankruptcy. Not bad for a company that saw its stock decline from $80 in January of 2001 to less that $1 when filing for bankruptcy.”

7. **Executive compensation schemes:** Stock options and their accounting treatment remain an issue for the accounting profession and the investment community since, though meant to be an incentive to management and certainly a form of compensation, they are not treated as an expense on the income statement. They also tend to place the incentives, again, on short-term growth rather than long-term sustainability.

8. **Compensation schemes for security analysts:** Investment banking analysts have an interest in sales; this is how they generate the commissions or fees that support their salaries. However, the sale is not always the best possible transaction for the client, generating potential conflicts.

Similarly, scholar Eugene White contends that, in part based on the above challenges, markets are relatively ineffective and the only possible answer is additional regulation. Though Bahr argues that there may be means by which to resolve the conflicts, such as due notice and separation of research and auditing activities, White instead maintains that these conflicts cannot in fact be eliminated. “Financial firms may hide relevant information and disclosure may reveal too much proprietary information.” There remains no perfect solution; instead the investment community has no choice but to rely in part on the ethical decision making of the agent who acts within the market, constrained to some extent by regulation.

**Executive Compensation**

Few areas of corporate governance and finance have received as much public scrutiny in recent years as executive compensation. A *Fortune* cover exclaimed: “Inside the Great CEO Pay Heist,” and the article inside detailed how many top corporate executives now receive “gargantuan pay packages unlike any
In the words of *Fortune’s* headline: “Executive compensation has become highway robbery—we all know that.”

In 1960, the after-tax average pay for corporate chief executive officers (CEO) was 12 times the average pay earned by factory workers. By 1974, that factor had risen to 35 times the average, but by 2000, it had risen to a high of 525 times the average pay received by factory workers! (See Figure 10.2.) The most recent figure reports an estimated ratio of 411 times a worker’s average pay for 2005. Importantly, these numbers address only the average pay; the differences would be more dramatic if we compared the top salary for CEOs and minimum-wage workers. In two of the more well-publicized cases of the past decade, Sandy Weill, the CEO of Travelers Insurance, received over $230 million in compensation for 1997 and Michael Eisner of Walt Disney received $589 million in 1998. These numbers continue to rise. In 2005, total direct compensation for CEOs rose by 16 percent to reach a median figure of $6.05 million, not including pensions, deferred compensation, and other perks.16 Let’s take another look at the salary of former New York Stock Exchange Chairman Richard Grasso’s salary, which we discussed in Chapter 2.

*Forbes* reported that the CEOs of 800 major corporations received an average 23 percent pay raise in 1997 while the average U.S. worker received around 3 percent. The median total compensation for these 800 CEOs was reported as $2.3 million. Half of this amount was in salary and bonuses, and 10 percent came from such things as life insurance premiums, pension plans and individual retirement accounts, country club memberships, and automobile allowances. Slightly less than half came from stock options.

It is relevant to note in Figure 10.2 that CEO pay and the S&P 500 Index seem to follow similar trajectories. One might expect something along these lines since “pay for performance” is often based on stock price as one element of measurable performance. However, notice that actual corporate profits, not to mention worker pay, have not increased at the same rate as CEO pay. So, though CEOs have seen an increase, the corporations themselves—and the workers who contribute to their successes—have not reaped equivalent benefits. This lack of balance in the distribution of value has led to the perception of unfairness with regard to executive compensation, as we will discuss below. (See the following Decision Point for a review of the fairness of Richard Grasso’s compensation during his work with the New York Stock Exchange.)

More recently, compensation packages paid to the top executives of Exxon-Mobil drew harsh public criticism amid rising gas prices and soaring profits. Exxon-Mobil CEO Lee Raymond received total compensation of $28 million, including $18 million in stock in 2003 and $38 million, of which $28 million was in Exxon-Mobile stock, in 2004. In 2005, the year in which he retired, Raymond received $51 million in salary. The interest alone on this three-year salary would, at a modest 5 percent rate of return, forever produce $5.85 million annually. Apparently this was not sufficient for Raymond’s needs because he also received an additional retirement package with a combined worth of $400 million. When he succeeded Raymond, new CEO Rex Tillerson’s salary increased 33 percent to a total of $13 million including $8.75 million in stock. The combined compensation seen before.” In the words of *Fortune’s* headline: “Executive compensation has become highway robbery—we all know that.”

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just for these two executives in 2004 and 2005 was in excess of $500 million. During the same period, Exxon-Mobil also achieved record profits, earning more than $25 billion in 2004 and $36 billion in 2005.

The relationship between profits and executive compensation, however, is not always as direct as this. In 1998, Forbes also reported that there was little correlation between CEO pay and performance. Comparing CEO compensation to stock performance over a five-year period, Forbes described 15 CEOs who earned over $15 million while their company’s stock lagged well behind the market average of 23 percent. One CEO, Robert Elkins of Integrated Health Systems, received over $43 million during this five-year period while his company’s stock valued declined by 36 percent. Another report, based on data for 1996, showed that the top executives of firms that laid off more than 3,000 workers in the previous 10 years had a higher average CEO to average worker pay ratio than those that did not.

FIGURE 10.2  Average CEO to Average Worker Pay Ratio, 1990–2005


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year received an average 67 percent increase in their total compensation package for the year. In 1996, the average gap between CEO pay and the wages for the lowest-paid worker for the top 12 job-cutting companies was 178 to 1. Finally, Pfizer’s stock price decreased by more than 40 percent since 2001 when McKinnell became CEO though he has received $79 million in pay during that same period and has a guaranteed pension of $83 million when he retires.

These gaps continue to increase. For the decade ending in 2000, the U.S. minimum wage increased 36 percent, from $3.80 per hour to $5.15 per hour. The median household income in the United States increased 43 percent, from $29,943 to $42,680. The average annual salary for a tenured New York City teacher increased 20 percent, from $41,000 to $49,030. During this same decade the total compensation for the Citicorp CEO increased 12,444 percent from $1.2 million to $150 million dollars annually. General Electric CEO Jack Welch’s salary increased 2,496 percent, from $4.8 million to $125 million.

Skyrocketing executive compensation packages raise numerous ethical questions. Greed and avarice are the most apt descriptive terms for the moral character of such people from a virtue ethics perspective. Fundamental questions of distributive justice and fairness arise when these salaries are compared to the pay of average workers or to the billions of human beings who live in abject poverty on a global level.
But serious ethical challenges are raised against these practices even from within the business perspective. The reading by Jeffery Moriarty in Chapter 3 details the shortcomings of attempted justifications for such excessive pay packages. Both *Fortune* and *Forbes* magazines have been vocal critics of excessive compensation while remaining staunch defenders of corporate interests and the free market. Beyond issues of personal morality and economic fairness, however, excessive executive compensation practices also speak to significant ethical issues of corporate governance and finance.

In theory, lofty compensation packages are thought to serve corporate interests in two ways. They provide an incentive for executive performance, and they serve as rewards for accomplishments. (See the Reality Check above.) In terms of ethical theory, they have a utilitarian function when they act as incentives for executives to produce greater overall results, and they are a matter of ethical principle when they compensate individuals on the basis of what they have earned and deserve.

In practice, reasonable doubts exist about both of these rationales. First, as suggested by Moriarty’s essay and the *Forbes* story mentioned previously, there is much less correlation between pay and performance than one would expect. At least in terms of stock performance, executives seem to reap large rewards regardless of business success. Of course, it might be argued that in difficult financial times, an executive faces greater challenges and therefore perhaps deserves his salary more than in good times. But the corollary of this is that in good financial times, as when Exxon-Mobil earns a $30 billion profit, the executives have less to do with the success.

More to the point of governance, there are several reasons why excessive compensation may evidence a failure of corporate boards to fulfill their fiduciary duties. First, as mentioned before, is the fact that in many cases there is no correlation between executive compensation and performance. Second, there is also little evidence that the types of compensation packages described above are actually needed as incentives for performance. The fiduciary duty of boards ought to involve approving high enough salaries to provide adequate incentive, but not more than what is needed. Surely there is a diminishing rate of return on incentives beyond a
certain level. Does a $40 million annual salary provide twice the incentive of $20 million, 4 times the incentive of $10 million, and 40 times the return of a $1 million salary?

Another crucial governance issue is the disincentives that compensation packages, and in particular the heavy reliance on stock options, provide. When executive compensation is tied to stock price, executives have a strong incentive to focus on short-term stock value rather than long-term corporate interests. One of the fastest ways to increase stock price is through layoffs of employees. This may not always be in the best interests of the firms, and there is something perverse about basing the salary of an executive on how successful they can be in putting people out of work.

Further, a good case can be made that stock options have also been partially to blame for the corruption involving managed earnings. Two academic studies concluded that there is a strong link between high levels of executive compensation and the likelihood of misstating or falsely reporting financial results. When huge amounts of compensation depend on quarterly earning reports, there is a strong incentive to manipulate those reports in order to achieve the money.

Excessive executive compensation can also involve a variety of conflicts of interests and cronyism. The board’s duties should include ensuring that executives are fairly and not excessively paid. They also have a responsibility to evaluate the executive’s performance. However, all too often, the executive being evaluated and paid also serves as chair of the board of directors. The board is often comprised of members hand-selected by the senior executives. In addition, the compensation board members receive is determined by the chief executive officer, creating yet another conflict of interest. (See Figure 10.4.)

**FIGURE 10.4** Duties of the Board and Senior Executives That May Give Rise to Conflicts of Interest

<table>
<thead>
<tr>
<th>Board</th>
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<tr>
<td><strong>Duties of Board Members</strong></td>
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<tr>
<td>• Ensure executives are fairly and not excessively paid</td>
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<td>• Evaluate the executive’s performance</td>
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<th>Senior Executives</th>
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<tr>
<td><strong>Duties of Senior Executives</strong></td>
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<tr>
<td>• CEO often serves as chair of the board of directors</td>
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<tr>
<td>• Often hand-selects members of board of directors</td>
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<tr>
<td>• Compensation received by board members is determined by the chief executive officer</td>
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</table>
The cronyism does not end at the boardroom door. One of the larger concerns to have arisen in recent years has been the cross-fertilization of boards. The concern spawned a Web site called www.theyrule.net, which allows searching for links between any two given companies. A search for a connection, for instance, between Coca-Cola and PepsiCo uncovers within seconds the fact that PepsiCo board member Robert Allen sits on the Bristol-Myers Squibb board alongside Coca-Cola board member James D. Robinson III. Though sitting on a board together does not necessarily mean Pepsi’s board member will gain access to Coke’s secret recipe, it does lend itself to the appearance of impropriety and give rise to a question of conflicts.

In another case involving lesser-known companies, three individuals served on the boards of three companies, with each serving as CEO and chairman of one of the companies, Brocade, Verisign, and Juniper. Unfortunately, the companies were found to have backdated stock options, and each firm found itself subject to either Securities and Exchange Commission inquiries or criminal or civil legal proceedings. Cronyism or basic occurrences of overlapping board members might occur, of course, simply because particular individuals are in high demand as a result of their expertise. However, where the overlap results in a failure of oversight and effective governance—the primary legal and ethical responsibility of board members—the implications can be significant to all stakeholders involved.

Insider Trading

No discussion of the ethics of corporate governance and finance would be complete without consideration of the practice of **insider trading** by board members, executives, and other insiders. The issue became front page news in the 1980s when Ivan Boesky was sent to prison for the crime of insider trading. Though it certainly has not left the business pages in the intervening years, it once again gained iconic status when Ken Lay and his colleagues at Enron were accused of insider trading when they allegedly dumped their Enron stock, knowing of the inevitable downturn in the stock’s worth, while encouraging others to hold on to it.

The definition of insider trading is trading by shareholders who hold private inside information that would materially impact the value of the stock and that allows them to benefit from buying or selling stock. Illegal insider trading also occurs when corporate insiders provide “tips” to family members, friends, or others and those parties buy or sell the company’s stock based on that information. “Private information” would include privileged information that has not yet been released to the public. That information is deemed material if it could possibly have a financial impact on a company’s short- or long-term performance or if it would be important to a prudent investor in making an investment decision.

The Securities and Exchange Commission defines insider information in the following way:
“Insider trading” refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include “tipping” such information, securities trading by the person “tipped” and securities trading by those who misappropriate such information. Examples of insider trading cases that have been brought by the Commission are cases against: corporate officers, directors, and employees who traded the corporation’s securities after learning of significant, confidential corporate developments; friends, business associates, family members, and other “tippees” of such officers, directors, and employees, who traded the securities after receiving such information; employees of law, banking, brokerage and printing firms who were given such information in order to provide services to the corporation whose securities they traded; government employees who learned of such information because of their employment by the government; and other persons who misappropriated, and took advantage of, confidential information from their employers. 21

Because insider trading undermines investor confidence in the fairness and integrity of the securities markets, the commission has treated the detection and prosecution of insider trading violations as one of its enforcement priorities. 22

Accordingly, if an executive gets rid of a stock he knows is going to greatly decrease in worth because of bad news in the company that no one knows except a few insiders, he takes advantage of those who bought the stock from him without full disclosure.

Insider trading may also be based on a claim of unethical misappropriation of proprietary knowledge, that is, knowledge only those in the firm should have, knowledge owned by the firm and not to be used by abusing one’s fiduciary responsibilities to the firm. The law surrounding insider trading therefore creates a responsibility to protect confidential information, proprietary information, and intellectual property. That responsibility also exists based on the fiduciary duty of “insiders” such as executives. Misappropriation of this information undermines the trust necessary to the proper functioning of a firm and is unfair to others who buy the stock. Though one might make the argument that, in the long run, insider trading is not so bad since the inside information will be discovered shortly and the market will correct itself, this contention does not take account of the hurt to those who completed the original transactions in a state of ignorance.

Insider trading is considered patently unfair and unethical since it precludes fair pricing based on equal access to public information. If market participants know that one party may have an advantage over another via information that is not available to all players, pure price competition will not be possible and the faith upon which the market is based will be lost.

On the other hand, trading on inside information is not without its ethical defense. If someone has worked very hard to obtain a certain position in a firm and, by virtue of being in that position, the individual is privy to inside information, isn’t it just for that person to take advantage of the information since she or he has worked so hard to obtain the position? Is it really wrong? Unethical?
Decision Point

Where does a private investor find information relevant to stock purchases? Barring issues of insider trading, do all investors actually have equivalent access to information about companies?

- What are the ethical issues involved in access to corporate information?
- Where do private investors go to access information about stock purchases? On whose opinion do they rely? Does everyone have access to these same opinions? If not, what determines access to information in an open market? Instead, is there equal opportunity to have access to information?
- Who are the stakeholders involved in the issue of access? Who relies on information relevant to stock purchases? Who has an interest in equal access to information?
- What alternatives are available when considering access to information? How can we perhaps best ensure equal access?
- How do the alternatives compare, and how do the alternatives affect the stakeholders?

Consider an issue that might be closer to home. If your brother has always been successful in whatever he does in the business world, is it unethical to purchase stock in the company he just acquired? Others don’t know quite how successful he has been, so are you trading on inside information? Would you tell others? What about officers in one company investing in the stocks of their client companies? No legal rules exist other than traditional SEC rules on insider trading, but isn’t there something about this that simply doesn’t feel “right?” Consider the ethical issues surrounding access to information in the Decision Point above.

Some people do seem to have access to more information than others, and their access does not always seem to be fair. Let’s take a look at what landed Martha Stewart in jail. Stewart was good friends with Sam Waksal, who was the founder and CEO of a company called ImClone. Waksal had developed a promising new cancer drug and had just sold an interest in the drug to Bristol Myers for $2 billion. Unfortunately, though everyone thought the drug would soon be approved, Waksal learned that the Food and Drug Administration had determined that the data were not sufficient to allow the drug to move to the next phase of the process. When this news became public, ImClone’s stock price was going to fall significantly.

On learning the news (December 26, 2001), Waksal contacted his daughter and instructed her to sell her shares in ImClone. He then compounded his violations by transferring 79,000 of his shares (worth almost $5 million) to his daughter and asking her to sell those shares, too. Though the Securities and Exchange Commission would likely uncover these trades, given the decrease in share price, it was not something he seemed to consider. “Do I know that, when I think about it? Absolutely,” says Waksal. “Did I think about it at the time? Obviously not. I just acted irresponsibly.”23 Waksal eventually was sentenced to more than seven years in prison for these actions.
In evaluating the causes of the Enron debacle and its implications for change, scholar Lisa Newton analyzes the possible responses we could utilize as a society. Contemplate her arguments that some responses will not work and consider whether you agree or disagree:

**More regulation:** “The people who are making the money eat regulations for breakfast. You can’t pass regulations fast enough to get in their way.” Regulations are bad business, she states; they do not have sufficient foresight; and virtual and global business leaves us with little to grasp in terms of regulation.

**Business ethics courses:** Newton contends that they are ineffective in guiding future action, and they do not sufficiently impact motivations.

**Changes in corporate cultures:** “What the company’s officers do, when they act for good or (more likely) evil, does not proceed from the corporate culture, as if the corporate culture caused their actions. . . . What people do, habitually, just is their character, which they create by doing those things. What a corporation does, through its officers, just is its culture, created by that behavior. To say that if we change the culture we’ll change the behavior is a conceptual mistake—trivial or meaningless.”

Does anything work? “Back to those other eras: this is not the first time that, up to our waists in the muck of corporate dishonesty, we have contemplated regulations and ethics classes and using large rough weapons on the corporate culture. And nothing we did in the past worked.”

Instead, Newton posits, “capitalism was always known not to contain its own limits; the limits were to be imposed by the democratic system, whose representatives were the popularly elected watchdogs of the economy.” Business crime comes not from “systemic capitalist contradictions” or sin; instead it arises from a failure of the instruments of democracy, which have been weakened by three decades of market fundamentalism, privatization ideology and resentment of government. Capitalism is not too strong; democracy is too weak. We have not grown too hubristic as producers and consumers [as if the market were, when working right, capable of governing itself]; we have grown too timid as citizens, acquiescing to deregulation and privatization (airlines, accounting firms, banks, media conglomerates, you name it) and a growing tyranny of money over politics.

Newton then explains that “we need, as Theodore Roosevelt well knew (20 years before his cousin presided over the aftermath of the 1929 disaster), democratic oversight of the market, or it will run amok. As it has.

Her conclusion? “Ultimately, our whining and hand-wringing about corporate culture, or executive incentives, or other technicalities of the way businesses run themselves, is useless. Business was never supposed to run itself, at least not for long. We the people were supposed to be taking responsibility for its operations as a whole. We have evaded this responsibility for almost a quarter of a century now, and that’s long enough. It is time to remember that we have a public responsibility hat as well as a private enterprise hat, to put it on and put the country back in order.”

(continued)
Is taking public responsibility the answer to ethical lapses in business?

• What else might you need to know in order to effectively evaluate Professor Newton’s conclusion?
• What ethical issues are involved in the challenges she addresses?
• Who are the stakeholders?
• What do you think about her evaluation of the alternatives above?
• How do the alternatives compare? How do the alternatives affect the stakeholders?

Elements adapted by the authors with permission of Dr. Lisa Newton. For a more in-depth analysis, see also Reading 10-1.

How does Stewart fit into this picture? The public trial revealed that Stewart’s broker ordered a former Merrill Lynch & Co. assistant to tell her that Waksal was selling his stock, presumably so that she would also sell her stock. Stewart subsequently sold almost 4,000 shares on December 27, 2001, one day after Waksal sold his shares and one day prior to the public statement about the drug’s failed approval.

Stewart successfully avoided prison for several years, and on November 7, 2003, she explained that she was scared of prison but “I don’t think I will be going to prison.” Nevertheless she was convicted on all counts except securities fraud and sentenced to a five-month prison term, five months of home confinement, and a $30,000 fine, the minimum the court could impose under the Federal Sentencing Guidelines.

During the trial, the public heard the testimony of Stewart’s friend, Mariana Pasternak, who reported that Stewart told her several days after the ImClone sale that she knew about Waksal’s stock sales and that Stewart said, “Isn’t it nice to have brokers who tell you those things?” So, to return to the issue with which we began this tale, it appears that some investors do seem to have access to information not necessarily accessible to all individual investors. Though Stewart, Waksal, and others involved in this story were caught and charged with criminal behavior, many believe they were identified and later charged because they were in the public eye. If others are not in the public eye and also engage in this behavior, can the SEC truly police all inappropriate transactions? Is there a sufficient deterrent effect to discourage insider trading in our markets today? If not, what else can or should be done? Or, to the contrary, is this simply the nature of markets, and those who have found access to information should use it to the best of their abilities? What might be the consequences of this latter, perhaps more Darwinian, approach to insider trading, and whose rights might be violated if we allow it?
Opening Decision Point Revisited

What should the board of directors of Hershey Foods have done in connection with Hershey’s possible sale?

In evaluating the key facts relevant to your decision, are you persuaded by the concerns of the residents? Do you agree with the source of their concerns, the presumed consequences of the sale? Could alternate consequences occur? In other words, the residents claim that the sale will result in these negative circumstances. Do you agree? Does the board have any ethical obligations to the residents of Hershey, Pennsylvania? What other ethical obligations might the board have? To whom does it owe a responsibility; who are its stakeholders?

Can you imagine any possible alternatives to serve the Trust’s interests, the board’s obligations, the residents’ concerns, and any other issues you anticipate the stakeholders will raise? How will each of your alternatives impact each of the stakeholders you have identified? How will you reach this decision?

RESOLUTION

The Trust received two significant offers for Hershey. The first was from Chicago-based Wrigley Chewing Gum and the second was a joint offer from Nestlé and Cadbury. Though both included plans to keep all factories open and running, the community continued its vociferous protests and the Trust rejected both offers.

The chairman and CEO of the Hershey Trust, Robert Vowler, explained, however, that the Trust’s decision was based solely on the failure to receive satisfactory offers rather than being in response to any protest. He explained that the Trust’s original purpose was to diversify the Trust’s assets to protect its beneficiary and the Wrigley offer would not have achieved this goal. The Nestlé/Cadbury offer was evidently too low.

Following is the press release the Hershey Company issued on the day of the Trust’s decision:

**Hershey Foods Reaffirms Its Strength**

HERSHEY, Pa., Sep 18, 2002. The Board of Directors, management and employees of Hershey Foods Corporation today reaffirmed their commitment to the long-term, value-enhancing strategy embarked upon earlier this year. The company affirmed the termination of the sale process and also stated that its Board of Directors has not been approached by the Milton Hershey School Trust regarding repurchasing stock from the Trust, nor does it have any intention of renewing the stock repurchase proposal previously rejected by the Trust prior to the commencement of the sale process.

Richard H. Lenny, Chairman, President and Chief Executive Officer, said, “There has been significant disruption to our company, employees and the communities in which we live and work over the past few months. However, Hershey Foods remains a competitively advantaged market leader in an attractive category. We also have a truly outstanding workforce, one that consistently has maintained focus and shown courage in the face of significant uncertainty about our future as an independent company. Our mission, as always, is to bring our energy and attention to the task of building our brands and capitalizing on the immense strengths that were so clearly evident to potential acquirers.”

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Questions, Projects, and Exercises

1. You have been asked by the board of a large corporation to develop a board assessment and effectiveness mechanism, which could be a survey, interviews, an appraisal system, or other technique that will allow you to report back to the board on both individual and group effectiveness. What would you recommend?

2. You have been asked to join the board of a large corporation. What are some of the first questions that you should ask and what are the answers that you are seeking?

3. Scholars have made strong arguments for required representation on boards by stakeholders beyond stockholders such as employees, community members, and others, depending on the industry. What might be some of the benefits and costs of such a process?

4. You are an executive at a large nonprofit. Some of your board members suggest that perhaps the company should voluntarily comply with Sarbanes-Oxley. What are some of the reasons the company might consider doing so or not doing so?

5. You are on the compensation committee of your board and have been asked to propose a compensation structure to be offered to the next CEO. Explore some of the following Web sites on executive compensation and then propose a structure or process for determining CEO compensation at your corporation.

   http://www.aflcio.org/corporateamerica/paywatch/ceou/database.cfm
   http://www.ecomponline.com/
   http://www.rileyguide.com/execpay.html
   http://www.sec.gov/investor/pubs/execomp0803.htm
   http://www.tgci.com/magazine/97fall/exec.asp

6. What are the strongest, most persuasive arguments in favor of a board’s consideration of its social responsibility when reaching decisions?

7. A press release has a significant negative impact on your firm’s stock price, reducing its value by more than 50 percent in a single day of trading! You gather from conversations in the hallway that the company’s fundamentals remain strong, aside from this one-time event. You see this as a great opportunity to buy stock. Is it appropriate to act on this and to purchase company stock? Does it make a difference whether you buy 100 shares or 1,000 shares? Is it OK to discuss the “dilemma” with family members and friends? What should you do if you do mention it to family and friends but then later feel uncomfortable about it?

8. Modify slightly the facts of the previous question. Assume that you are also privy to the annual forecast of earnings, which assures you that the fundamentals remain strong. Stock analysts and investors are also provided this same information. Do your answers change at all?

9. In connection with the two previous questions, assume instead that you think something significant is about to be made public because all officers have consistently stayed late, a special board meeting has been called, you and your boss have been advised to be on call throughout the weekend, and various rumors have been floating throughout the company. You are not aware of the specifics, but you can reasonably conclude that it’s potentially good or bad news. You decide to call a friend in the accounting department...
who has been staying late to find out what she knows. In this situation, do your answers about what you might do change? Is it appropriate to partake in the “rumor mill”? Is it appropriate to discuss and confide your observations with family and friends? Is it appropriate to buy or sell company stock based upon these observations (you may rationalize that it is only speculation and you do not know the facts)?

Key Terms

After reading this chapter, you should have a clear understanding of the following Key Terms. The page numbers refer to the point at which they were discussed in the chapter. For a more complete definition, please see the Glossary.

Committee of Sponsoring Organizations (COSO), p. 428
corporate governance, p. 421
control environment, p. 429
control activities, p. 429
control of conflict of interest, p. 423
duty of care, p. 430
duty of loyalty, p. 431
duty of good faith, p. 430
Enron Corporation, p. 427
European Union 8th Directive, p. 428
Federal Sentencing Guidelines, p. 431
fiduciary duties, p. 423
gatekeeper, p. 424
insider trading, p. 442
internal control, p. 449
Sarbanes-Oxley Act, p. 422

Endnotes

5. Criteria of Control, Board Guidance on Control.


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Readings

Reading 10-1: “Enron: The Parable,” by Lisa Newton, p. 451
Reading 10-2: “WorldCom” by Dennis Moberg and Edward Romar, with “WorldCom Update” by Edward Romar and Martin Calkins, p. 457
Reading 10-3: “Will the SEC Ever Get Serious about Making Corporate Insiders Pay for Fraud?” Mark Pincus Blog, p. 467
Reading 10-4: “Three Women’s Moral Courage: Why We Care,” by Rushworth Kidder, p. 468

Reading 10-1

“Enron: The Parable”

Lisa H. Newton  Director, Program in Applied Ethics, Fairfield University

1. Pipes to Riches in Wonderland

Beginnings: Enron had its humble beginnings as a natural gas company. When Kenneth L. Lay became chairman and COO of Houston Natural Gas in June 1984, the company owned pipelines, and it transported natural gas to customers. Utilities of all sorts had always been highly regulated, and the industry wasn’t very interesting. But Ken Lay’s vision had its origin in President Ronald Reagan’s deregulation agenda, which Lay had helped to further, and drew its operating practices from the mergers and acquisitions habits of the 1980s business community. He set out to grow the company into the biggest and most profitable energy company in the world, which, eventually, he almost did, at least on paper. He snapped up a small pipeline company in Florida, then merged with InterNorth, Inc. in July 1985, to give him 40,000 miles of pipeline. Such size required a catchier name, so in 1986 Enron was born. (He’d thought of “Enteron” first, but changed it to “Enron” when he found out that enteron is another word for the digestive tract.)

Largely due to the lobbying efforts of Lay and others who shared his vision of unfettered utilities, most of the regulations came off the production and sale of energy in the last years of the 1980s. By 1989, Enron was trading natural gas on the commodities market. The next year Lay hired Jeffrey K. Skilling, a Harvard MBA, away from his consulting job at McKinsey & Co., to head up the new energy-trading operations. Skilling transformed the operation from a simple transportation service to an immense trading center, a “gas bank” purchasing large amounts of natural gas from the producers and reselling it to customers here and abroad on long-term contracts. After that, market innovation and company growth outpaced each other through the decade. The company began trading online, increasing by orders of magnitude the speed with which its deals could be completed.

Deals: And what deals they were! If you could name it, you could buy and sell it. It wasn’t just that Enron had turned natural gas into a commodity, a move that rapidly expanded to energy futures contracts. By the end, Enron was selling broadband, water, and weather derivatives—hedges against bad weather that might affect business operations.

But the major innovations were financial. Federal regulators permitted Enron to use “mark-to-market” accounting, a way of evaluating future income that works reasonably.
well in securities trading. In Enron’s case, it allowed the company to calculate projected income as present profit, a practice that can be taken to extremes; in 1999, for instance, the company claimed a $65 million profit “based on its projections of natural-gas sales from a South American pipeline project. The pipeline had yet to be built.”

It should be noted that Enron was not the only company turning itself from a company that dealt with things to a company that made financial deals. All through the deregulatory 1990s, law firms and banks were selling their clients “structured” deals, setting up new companies and partnerships to move assets or debts off the books and preferably off the continent. It’s just that Enron became more dependent on these deals than the others, because it set such high earnings targets (to keep the investors happy) and because there was by now so little of the original enterprise to rely on. These deals are not always lucky. By the Fall of 2000, two of the Enron investment vehicles called the Raptors were failing; Enron solved the problem by having the two solvent Raptors pick up the debt of the two insolvent ones. Another rescue had to be engineered in March 2001. This time $700 million of Enron stock had to be transferred in from another partnership. At this point Arthur Andersen protested strongly. Enron’s threat to take its business elsewhere worked once more to keep its auditors cooperative.

Throughout these years, Enron wasn’t paying taxes. Enron had paid no income taxes in four of the last five years, making good use of about 900 subsidiaries in tax-haven countries to cover its revenues (this according to an analysis of its financial reports to its shareholders). It even collected $382 million in tax refunds. The subsidiaries chose prime vacation spots for their services: there were 692 in the Cayman Islands, 119 in the Turks and Caicos Islands, 43 on Mauritius, 8 in Bermuda, 6 in Barbados, 4 in Puerto Rico, 2 in Hong Kong, 2 in Panama, and one each in Aruba, the British Virgin Islands, Guam, Guernsey, and Singapore. In the year 2000, the company got $278 million in refunds. (Stock options, with which they were very generous, do not have to be reported to the shareholders as an expense, but are deducted from company income for tax purposes.) Even Robert Hermann, the company’s general tax counsel, wondered about this apparent exemption from the U.S. Internal Revenue requirements; by his own account, he asked Skilling at a 2000 meeting why it was that the company seemed to be doing so well, but paid so little in taxes! The answer, of course, was in his own division. Enron’s skill in locating its partnerships offshore and keeping cash flow small had made the tax division a significant “profit center” for the company, saving $1 billion over the previous five years.

**Strategy:** The impression left by all of the above is that Enron was in constant motion, always innovating, always daring, always out in front of some field, but also doing rather little to earn a living. Shortly into its meteoric course into the hearts and purses of investors, Enron’s financial activities well outstripped its pipelines and its natural gas trade in the amount of money generated. And the financial activities’ profits were, as the world would soon find out, bogus. Why were they playing this game? What were they thinking?

They were trying to please Wall Street. In order to secure a “buy” recommendation from investment analysts, a company must report ever higher earnings every quarter, and in these days of deregulation, there are many fewer restrictions on how it does it. That doesn’t sound like Adam Smith’s description of a business enterprise, but it is an accurate description of the kinds of pressures placed on any business today by the investment community. Now that aggressively managed funds have largely taken the place of the wealthy individual at the stock counters (or computers), every publicly traded firm must expect to be held accountable for pleasing numbers four times a year. (In order to keep the corporate executives’ minds focused on this accounting, they are paid largely in stock options—another reason for issuing lots of stock options—which will make them millionaires and
more if the stock goes up, nothing if it goes down.) If the price of a company’s stock should nonetheless go down for any reason, it can expect to be rejected by stock analysts (so the price will decline even more) downgraded by credit raters (seriously impacting its ability to do business), and sued by Bill Lerach, who brings class-action suits against companies whose stocks go south. Accountability is not entirely bad, but the focus on quarterly earnings can create distortions in the best run companies. In the case of Enron, whose stock had to maintain its price or expose the entire pyramid of interlocked obligations to horrible collapse, it dictated the multiplication of the special purpose entities and secret loans. The basic business was long forgotten. (In the end, Enron was selling pipelines in order to raise quarterly earnings.) When the business itself takes a back seat, and only the numbers count, distortion is bound to follow. In Enron’s case, it followed immediately; the tangled web of deception required earnings, which it had not, or at least the illusion of earnings, which it could produce, so Enron became a master illusionist.

2. Where Are We Going and Why Am I in This Handbasket?

Enron’s singular rise and fall resulted from a confluence of several factors.

The New Economy: When Enron approached its peak in mid-2000, the country had had 20 years of deregulation, beginning in the administration of President Ronald Reagan, continued in the administration of George H. W. Bush, not reversed in the centrist administrations of William J. Clinton, and taking off at a wild gallop when George W. Bush entered the White House. Even as the new century opened and the Bush Recession set in, the “most admired” CEO in America was Jack Welch of General Electric, whose personal greed and self-indulgence, in combination with callousness toward his employees, was legendary. It is significant that in the face of the truly baffling financial deals that Enron undertook, almost no one asked publicly where all the money was supposed to come from if some of their bets didn’t work out. Blind trust replaced the healthy suspicion on which the conduct of business depends. Dazzled, investors, regulators, and auditors watched in admiration as the swiftly moving shells in Enron’s game twinkled across the business world. The general public sat mesmerized, as at a fireworks display; criticism of the corporations was silenced across the land.¹

The New Culture: The Enron “culture” has received a good deal of attention—perhaps too much. There is broad agreement on its nature: ambition, greed, and contempt for everyone who wasn’t part of the cheering section. Nothing mattered except getting rich, very rich, and the company was led by people (see next point) who were completely convinced that rich was what they deserved to be. Convinced of their natural superiority, Enron’s day-to-day managers sent clear signals to ignore the law, the rules, the accounting practices, and all other manifestations of the lesser breeds without the New Economy. Their highest virtue was that they could break the rules and get away with it—in the face of the incredulity of their own more experienced colleagues. They could pull off deals that would enrich the shareholders, enrich themselves, and keep the company strong. Questions were not permitted. Those who stood in the way of the top people were quickly silenced, transferred, fired. When banks hesitated to invest in the new funds, they were given to understand that their continued opportunity to do business with Enron required that they overcome their hesitations. When Arthur Andersen auditors objected to keeping those new funds off the books, they were warned that Enron might take its lucrative consulting business to another auditing firm. Even at the end, in August 2001, when Chung Wu, a broker at UBS PaineWebber from
Houston, e-mailed his clients to consider selling their Enron shares, given the difficulties that the company was experiencing, his employer rapidly reversed his recommendation—and fired him. There is no indication, anywhere, that any other banks, or other auditors, would have put up more resistance to the glamorous and admired schemes of the mighty Enron, ranked in March 2000 as the sixth largest energy company in the world (seventh in the Fortune 500). (That rank, of course, was part of the history of misrepresentation at Enron. It was never profitable—even its energy trading in California brought in only .5 percent on sales.)

What is less clear is the origin and support for this “culture.” Cultures do not make themselves. Logically, a “culture,” in the sense intended, is no more than the cumulative accustomed acts of all the people who claim it as their own. Yet while the key players in the Enron debacle surely embodied the culture, they came aboard too late to have created it. More likely, they were recruited because they already fit it—they were entirely prepared to engage in the single-minded effort to raise earnings and keep them high, only on condition that they too could become rich, and had the ability and imagination both to create the financial instruments that made Enron’s earnings possible and to sell the ideas to the appropriate clients. It is significant that the “culture” claimed for Enron happens to be identical with the national culture where money is concerned: admiration for the rich, tolerance for innovative rule-breakers, and an unshakeable conviction that government has no right to stand in the way of any person’s efforts to get fabulously wealthy.

The New Accounting:

When the van crashes into the retaining wall at 120 mph, at least three causal factors are present: the driver who lost control (was he paying attention?) the engine that brought the van to that speed (was it operating properly?), and the brakes that failed. In this particular crash, the drivers were the managers of Enron, who were apparently zipping along without a roadmap with little regard to the safety of the passengers (let alone the pedestrians), the engine was the unrestrained culture of greed and confidence in the business community that permeated the nation as a whole, and the brakes were the bankers and auditors who were supposed to be making good business judgments about the soundness of Enron’s decision making. In this case, “market discipline”—that is, the need to satisfy customers or go out of business—had put a fatal wound in the brakes, all of whom needed, or felt they needed, Enron as a customer.

Endgame: . . . It wasn’t exactly a whistle that Enron Vice President Sherron S. Watkins blew. Hers was not (initially) a principled stance. She wanted the career and the money as much as anyone, but confronted with reality, she decided to tell Ken Lay about it instead of pretending it wasn’t there. That alone makes her exceptional. She had gotten a temporary assignment to look into the LJM partnerships, including the Raptors, and was horrified by what she saw. On August 15, the day after Skilling resigned, Watkins wrote a long anonymous letter to Lay suggesting that Skilling knew what he was running away from. The letter spoke of the danger that “we will implode in a wave of accounting scandals,” when the problems with Condor and Raptor came out. There would be “suspicions of accounting improprieties,” because of Enron’s “aggressive accounting.” In this memo, she coolly estimates the appropriate course of action according to the “probability of discovery” of the improper accounting for these SPEs; she concludes that the probability of discovery is high; therefore the company should “quantify [the losses], develop damage containment plans and disclose.” She followed up with a memo suggesting damage containment activity. That sounds more like your cell-phone ringing than a whistle to stop play.

Then September 11, 2001, arrived, the terrorist attack with fuel-laden 747 aircraft, the collapse of the twin towers of the World Trade Center. The radical drop in the stock market in the week following that attack brought Enron stock down to $28.08, eight dollars from that disaster point where its obligations to the Raptors would become so great that
the company would not have enough available shares to meet them. “For every dollar the stock dropped below $20, Enron would be facing $124 million in losses,” according to an internal Enron document. Enron was hanging on by its fingernails.

On September 26, when the stock fell to $25 per share, Lay had an Internet “chat” with Enron employees. They had watched their 401(k) plans, stuffed with Enron stock, plunge to that level from $90 a year ago. Lay assured the employees that he, personally, was buying more Enron stock, which he characterized as an “incredible bargain,” and he urged them to do the same. As the end of the third quarter became imminent, the habits acquired in previous years reasserted themselves. Enron worked out one more “prepay” deal for $350 million on September 28; Enron and Qwest arranged a purchase of networks for another $112 million, a deal that made very little business sense. With all that cash to pump up earnings, third-quarter losses still had to be admitted, and somehow spun to the Wall Street analysts on whose approval the company depended. On October 8, Lay addressed the company’s outside board of directors with the same bad news. But how bad was it? When the meeting was over, in which the demise of the Raptors had been cheerfully described as a one-time setback, the directors left thinking the company was basically in good shape. There were claims of future profitability, even as the company was on the ropes.

Enron’s October 16 news release on its third-quarter problems had much the same message; the losses were one-time, nonrecurring, and the company’s future was rosy. An accounting error, he told a reporter on the phone, resulted in a $1.2 billion loss in equity. Where had all that money gone? It seems that Enron had counted a Raptors’ acknowledgement of $1.2 billion transferred from Enron to the SPEs as “shareholder equity.” On October 18, when The Wall Street Journal found out about that assignment, it wrote a sharp article calling for better explanations. When Lay addressed investment fund managers later that day, trying to get them to hold their stock, or even buy more, he responded to their concerns, and the questions triggered by the article, by attacking the press and promising, over and over, that the loss was a one-time thing, that there were no more write-offs hiding in the books.

Not quite satisfied with that explanation, on October 22 the SEC launched an investigation into Enron. By the end of the day the stock stood at $20.65. On October 28, Lay announced the formation of a special investigative committee, headed up by the Dean of the University of Texas Law School, William Powers, who hired William R. McLucas, former SEC enforcement chief and currently with the law firm of Wilmer, Cutler & Pickering to do the actual investigating. McLucas hired some accountants from Deloitte & Touche to look into the books. They found all those hidden debts and all those cover-ups and all those overstatements of profits, and there was no longer any chance of keeping them hidden. When McLucas issued his report, the company was essentially finished.

There was one more attempt to save the company, by selling it to its smaller rival Dynegy. But, Dynegy had seen enough. On November 26, the deal officially died. Six days later, on December 2, 2001, Enron filed for bankruptcy.

Just in summary, to keep the moral point in focus: who ended up with the money? On October 22, the day that the stock plunged to $20.65, Lay convened the Enron employees, several thousand strong, and commiserated with them about the loss of their investments. He promised, even as he knew that bankruptcy was inevitable, that Enron would get it all back for them. That day he took a $4 million cash advance from the company. Over the next three days he took $19 million more, repaying $6 million by transferring Enron stock, which by then he was very glad to unload. In the end, Ken Lay sold $37,683,887 in stock just before the crash came; Jeff Skilling cashed out $14,480,755. Andrew Fastow had made $45 million, at least as far as anyone has been able to determine. Employees were in “lockdown,” not permitted to sell their stock, between October 29 (about the time the employees would have
figured that it would never go up again) and November 12, when it stood at $9.98. Effectively they were barred from selling until the bankruptcy, when it was worth nothing. Employees in their 50s and 60s saw retirement funds go from millions of dollars to nothing, and there was nothing they could do about it. Many of those who lost were involved in the trading scams, one way or another, but many others, who had done nothing to deserve it and everything not to deserve it, were mortally hurt.

* * *

4. The Shredding of Arthur Andersen

Accounting firm Arthur Andersen has to take some of the responsibility for that hurt. Andersen had signed off on all of the deals that Enron had made, sometimes under pressure, but it had signed off. Moreover, despite doubts and periodic whimpering about the risk of it all, Andersen had profited from its participation; Enron was one of its biggest clients. Now the firm stood to lose badly.

It wasn’t just the money. When the accounting profession had assumed the role of corporate honesty guarantors, the company’s founder, Arthur Andersen himself, had been one of the most powerful arguers, and arguments, for trusting the profession with the job of telling the truth to the public. A man of unquestionable integrity, he had argued that the moral integrity of accountants could be counted on to protect the investors from the tendencies of businesses to cut corners. Through its 88-year history, Arthur Andersen especially, among the large accounting firms, had stood for that integrity. Everything rested on that reputation, and once lost, it would not be recovered. Extraordinary pressures had descended upon Arthur Andersen and its competitors during the 1980s and 1990s. Accounting firms discovered, in the rapid growth of technology-based industry, that they could sell their technology consulting services to the very firms they had been auditing for very attractive prices. Both stood to gain: the accounting firm suddenly had a new and major source of income, and the hiring firm had, beside the value of the consulting services, an interesting source of influence with the watchdog supposedly scrutinizing it. As the Enron case illustrates, that influence could be very great indeed. But there was a downside to the new mixture of revenues. Recall the discussion of “the New Culture.” Accounting had always been a gray and lumpishly unattractive profession, guaranteeing a safe income and a good retirement, but nothing glamorous. Now suddenly the Big Five had moved from the wallflower auditing culture to the swinging consultant culture, and all their people began to demand big bucks—really big bucks—to enjoy the lifestyles practiced by the investment bankers and their audit clients. Andersen had done very well; its consulting arm brought in barrels of money, divided among all the partners and associates, and everyone was happy.

But not for long. Greed, as Plato pointed out so long ago, is essentially unlimited. If I am enjoying a comfortable existence now, I immediately see that with more money I could enjoy a luxurious existence, and I want it, also immediately. Andersen’s consultants were not happy sharing their huge earnings with the old-fashioned stick-in-the-mud rain-on-your-parade auditors. In a brutal divorce, they separated themselves as a unit from the company, and formed a new company (Accenture) to earn their money far away from all the poor relations. But by now the auditors had got used to that larger income, and they put pressure on the senior partners to get it back for them. So they started recruiting consulting clients all over again, built the business quickly, and secured Enron as their largest client, one they could not afford to lose. (According to Forbes, Enron was paying Andersen, by the end, $1 million a week in auditing and consulting fees.)
5. The Ultimate Failure of the System

The events narrated here meant the end of Enron. They might mean the end of business as we know it. There seems to be general, if muted, agreement, that the Enron case has shown us a terrible, possibly lethal, weakness in our business system. When wrongdoing is this extensive, long-lived, and shockingly serious, we know well that whether it be the Roman Catholic Diocese of Boston or the high-flying New Economy businesses, the problem goes beyond the “few bad apples.” Unlike the Roman Catholic Diocese of Boston, the regulatory institutions of the U.S. government cannot cure souls, but they can change the institutions, the laws and the practices and the expectations governing the practice of business. Does Enron demonstrate that the current practices of the business world lead straight to the impoverishment of the citizens and, most likely, the ultimate demise of capitalism itself? Quite possibly.

Notes

1. “. . . the euphoria that characterized investing in the late 1990’s is gone; that wide-eyed acceptance of every word corporate executives uttered, of every financial statement they released, of every outlandish projection an analyst made has been replaced by a sense that trust must once again be earned, that skepticism is a worthy trait, that the advice of analysts can be costly.” Gretchen Morgenson, “Rebound from Ruin, if Not from Distrust,” The New York Times Section 3, Money & Business, Sunday, September 8, 2002.

2. Gretchen Mergenson, “How 287 Turned into 7: Lessons in Fuzzy Math,” New York Times January 20, 2002, Money & Business 1, 12. “Another half-truth concerned Enron’s appearance last year at No. 7 on the Fortune 500 list of largest American companies. The company’s $101 billion in revenue placed it between the powerhouses Citigroup and I.B.M. on the list. But rising to that level occurred only because energy trading companies can record as revenue the total amount of their transactions, rather than the profits made on each trade as is typical at brokerage firms. If viewed this way, Enron’s revenue would have been $6.3 billion last year, pushing it to the bottom half of the list, at No. 287, wedged between Automatic Data Processing and Campbell Soup.”

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Reading 10-2

WorldCom

Dennis Moberg and Edward Romar

2002 saw an unprecedented number of corporate scandals: Enron, Tyco, Global Crossing. In many ways, WorldCom is just another case of failed corporate governance, accounting abuses, and outright greed. But none of these other companies had senior executives as colorful and likable as Bernie Ebbers. A Canadian by birth, the six-foot, three-inch former basketball coach and Sunday School teacher emerged from the collapse of WorldCom not only broke but with a personal net worth as a negative nine-digit number.1 No palace in a gated community, no stable of racehorses, or multimillion-dollar yacht to show for the...
telecommunications giant he created. Only debts and red ink—results some consider inevitable given his unflagging enthusiasm and entrepreneurial flair. There is no question that he did some pretty bad stuff, but he really wasn’t like the corporate villains of his day: Andy Fastow of Enron, Dennis Koslowski of Tyco, or Gary Winnick of Global Crossing.

Personally, Bernie is a hard guy not to like. In 1998 when Bernie was in the midst of acquiring the telecommunications firm MCI, Reverend Jesse Jackson, speaking at an all-black college near WorldCom’s Mississippi headquarters, asked how Ebbers could afford $35 billion for MCI but hadn’t donated funds to local black students. Businessman LeRoy Walker, Jr., was in the audience at Jackson’s speech, and afterwards set him straight. Ebbers had given over $1 million plus loads of information technology to that black college. “Bernie Ebbers,” Walker reportedly told Jackson, “is my mentor.” Rev. Jackson was won over, but who wouldn’t be by this erstwhile milkman and bar bouncer who serves meals to the homeless at Frank’s Famous Biscuits in downtown Jackson, Mississippi, and wears jeans, cowboy boots, and a funky turquoise watch to work.

It was 1983 in a coffee shop in Hattiesburg, Mississippi, that Mr. Ebbers first helped create the business concept that would become WorldCom. “Who could have thought that a small business in itty bitty Mississippi would one day rival AT&T?” asked an editorial in Jackson, Mississippi’s Clarion-Ledger newspaper. Bernie’s fall and the company’s was abrupt. In June, 1999 with WorldCom’s shares trading at $64, he was a billionaire, and WorldCom was the darling of the New Economy. By early May of 2002, Ebbers resigned his post as CEO, declaring that he was “1,000 percent convinced in my heart that this is a temporary thing.” Two months later, in spite of Bernie’s unflagging optimism, WorldCom declared itself the largest bankruptcy in American history.

This case describes three major issues in the fall of WorldCom, the corporate strategy of growth through acquisition, the use of loans to senior executives, and threats to corporate governance created by chumminess and lack of arm’s length dealing. The case concludes with a brief description of the hero of the case—whistle blower Cynthia Cooper.

The Growth through Acquisition Merry-Go-Round

From its humble beginnings as an obscure long distance telephone company WorldCom, through the execution of an aggressive acquisition strategy, evolved into the second largest long distance telephone company in the United States and one of the largest companies handling worldwide Internet data traffic. According to the WorldCom website, at its high point the company:

• Provided mission-critical communications services for tens of thousands of businesses around the world.
• Carried more international voice traffic than any other company.
• Carried a significant amount of the world’s Internet traffic.
• Owned and operated a global IP (Internet Protocol) backbone that provided connectivity in more than 2,600 cities, and in more than 100 countries.
• Owned and operated 75 data centers . . . on five continents.” [Data centers provide hosting and allocation services to businesses for their mission critical business computer applications.]

WorldCom achieved its position as a significant player in the telecommunications industry through the successful completion of 65 acquisitions. Between 1991 and 1997, WorldCom spent almost $60 billion in the acquisition of many of these companies and accumulated $41 billion in debt. Two of these acquisitions were particularly significant. The
MFS Communications acquisition enabled WorldCom to obtain UUNet, a major supplier of Internet services to business, and MCI Communications gave WorldCom one of the largest providers of business and consumer telephone service. By 1997, WorldCom’s stock had risen from pennies per share to over $60 a share. Through what appeared to be a prescient and successful business strategy at the height of the Internet boom, WorldCom became a darling of Wall Street. In the heady days of the technology bubble, Wall Street took notice of WorldCom and its then visionary CEO, Bernie Ebbers. This was a company “on the move,” and Wall Street investment banks, analysts and brokers began to discover WorldCom’s value and make “strong buy recommendations” to investors. As this process began to unfold, the analysts’ recommendations, coupled with the continued rise of the stock on the stock market, made WorldCom stock desirable and the market’s view of the stock was that it could only go up. As the stock value went up, it was easier for WorldCom to use stock as the vehicle to continue to purchase additional companies. The acquisition of MFS Communications and MCI Communications were, perhaps, the most significant in the long list of WorldCom acquisitions. With the acquisition of MFS Communications and its UUNet unit, “WorldCom (s)uddenly had an investment story to offer about the value of combining long distance, local service and data communications.” In late 1997, British Telecommunications Corporation made a $19 billion bid for MCI. Very quickly, Ebbers made a counter offer of $30 billion in WorldCom stock. In addition, Ebbers agreed to assume $5 billion in MCI debt, making the deal $35 billion or 1.8 times the value of the British Telecom offer. MCI took WorldCom’s offer making WorldCom a truly significant global telecommunications company.

All this would be just another story of a successful growth strategy if it wasn’t for one significant business reality—mergers and acquisitions, especially large ones, present significant managerial challenges in at least two areas. First, management must deal with the challenge of integrating new and old organizations into a single smooth functioning business. This is a time-consuming process that involves thoughtful planning and a considerable amount of senior managerial attention if the acquisition process is to increase the value of the firm to both shareholders and stakeholders. With 65 acquisitions in six years and several of them large ones, WorldCom management had a great deal on its plate. The second challenge is the requirement to account for the financial aspects of the acquisition. The complete financial integration of the acquired company must be accomplished, including an accounting of asset, debts, good will, and a host of other financially important factors. This must be accomplished through the application of generally accepted accounting practices (GAAP).

WorldCom’s efforts to integrate MCI illustrate several areas senior managers did not address well. In the first place, Ebbers appeared to be an indifferent executive who “paid scant attention to the details of operations.” For example, customer service deteriorated. One business customer’s service was discontinued incorrectly, and when the customer contacted customer service, he was told he was not a customer. Ultimately, the WorldCom representative told him that if he was a customer, he had called the wrong office because the office he called only handled MCI accounts. This poor customer stumbled “across a problem stemming from WorldCom’s acquisition binge: For all its talent in buying competitors, the company was not up to the task of merging them. Dozens of conflicting computer systems remained, local systems were repetitive and failed to work together properly, and billing systems were not coordinated.”

Poor integration of acquired companies also resulted in numerous organizational problems. Among them were:

1. Senior managers made little effort to develop a cooperative mindset among the various units of WorldCom.
2. Interunit struggles were allowed to undermine the development of a unified service delivery network.
3. WorldCom closed 3 important MCI technical service centers that contributed to network maintenance only to open 12 different centers that, in the words of one engineer, were duplicate and inefficient.

4. Competitive local exchange carriers (clercs) were another managerial nightmare. WorldCom purchased a large number of these to provide local service. According to one executive, “(t)he WorldCom model was a vast wasteland of clerks, and all capacity was expensive and very underutilized . . . There was far too much redundancy, and we paid far too much to get it.”

Regarding financial reporting, WorldCom used a liberal interpretation of accounting rules when preparing financial statements. In an effort to make it appear that profits were increasing, WorldCom would write down in one quarter millions of dollars in assets it acquired while, at the same time, it “included in this charge against earnings the cost of company expenses expected in the future. The result was bigger losses in the current quarter but smaller ones in future quarters, so that its profit picture would seem to be improving.”

The acquisition of MCI gave WorldCom another accounting opportunity. While reducing the book value of some MCI assets by several billion dollars, the company increased the value of “good will,” that is, intangible assets, a brand name, for example, by the same amount. This enabled WorldCom each year to charge a smaller amount against earnings by spreading these large expenses over decades rather than years. The net result was WorldCom’s ability to cut annual expenses, acknowledge all MCI revenue and boost profits from the acquisition.

WorldCom managers also tweaked their assumptions about accounts receivables, the amount of money customers owe the company. For a considerable time period, management chose to ignore credit department lists of customers who had not paid their bills and were unlikely to do so. In this area, managerial assumptions play two important roles in receivables accounting. In the first place, they contribute to the amount of funds reserved to cover bad debts. The lower the assumption of noncollectable bills, the smaller the reserve fund required. The result is higher earnings. Secondly, if a company sells receivables to a third party, which WorldCom did, then the assumptions contribute to the amount of receivables available for sale.

So long as there were acquisition targets available, the merry-go-round kept turning, and WorldCom could continue these practices. The stock price was high and accounting practices allowed the company to maximize the financial advantages of the acquisitions while minimizing the negative aspects. WorldCom and Wall Street could ignore the consolidation issues because the new acquisitions allowed management to focus on the behavior so welcome by everyone, the continued rise in the share price. All this was put in jeopardy when, in 2000, the government refused to allow WorldCom’s acquisition of Sprint. The denial stopped the carousel and put an end to the acquisition-without-consolidation strategy and left management a stark choice between focusing on creating value from the previous acquisitions with the possible loss of share value, or trying to find other creative ways to sustain and increase the share price.

In July 2002, WorldCom filed for bankruptcy protection after several disclosures regarding accounting irregularities. Among them was the admission of improperly accounting for operating expenses as capital expenses in violation of generally accepted accounting practices (GAAP). WorldCom has admitted to a $9 billion adjustment for the period from 1999 through the first quarter of 2002.

Sweetheart Loans to Senior Executives

Bernie Ebbers’s passion for his corporate creation loaded him up on common stock. Through generous stock options and purchases Ebbers’s WorldCom holdings grew and grew, and he typically financed these purchases with his existing holdings as collateral.
This was not a problem until the value of WorldCom stock declined, and Bernie faced margin calls (a demand to put up more collateral for outstanding loans) on some of his purchases. At that point he faced a difficult dilemma. Because his personal assets were insufficient to meet the substantial amount required to meet the call, he could either sell some of his common shares to finance the margin calls or request a loan from the company to cover the calls. Yet, when the board learned of his problem, it refused to let him sell his shares on the grounds that it would depress the stock price and signal a lack of confidence about WorldCom’s future.

Had he pressed the matter and sold his stock, he would have escaped the bankruptcy financially whole, but Ebbers honestly thought WorldCom would recover. Thus, it was enthusiasm and not greed that trapped Mr. Ebbers. The executives associated with other corporate scandals sold at the top. In fact, other WorldCom executives did much, much better than Ebbers. Bernie borrowed against his stock. That course of action makes sense if you believe the stock will go up, but it’s the road to ruin if the stock goes down. Unlike the others, he intended to make himself rich taking the rest of the shareholders with him. In his entire career, Mr. Ebbers sold company shares only half a dozen times. Detractors may find him irascible and arrogant, but defenders describe him as a principled man.

The policy of boards of directors authorizing loans for senior executives raises eyebrows. The sheer magnitude of the loans to Ebbers was breathtaking. The $341 million loan the board granted Mr. Ebbers is the largest amount any publicly traded company has lent to one of its officers in recent memory. Beyond that, some question whether such loans are ethical. “A large loan to a senior executive epitomizes concerns about conflict of interest and breach of fiduciary duty,” said former SEC enforcement official Seth Taube. Nevertheless, 27 percent of major publicly traded companies had loans outstanding for executive officers in 2000 up from 17 percent in 1998 (most commonly for stock purchase but also home buying and relocation). Moreover, there is the claim that executive loans are commonly sweetheart deals involving interest rates that constitute a poor rate of return on company assets. WorldCom charged Ebbers slightly more than 2 percent interest, a rate considerably below that available to “average” borrowers and also below the company’s marginal rate of return. Considering such factors, one compensation analyst claims that such lending “should not be part of the general pay scheme of perks for executives . . . I just think it’s the wrong thing to do.”

What’s a Nod or Wink among Friends?

In the autumn of 1998, Securities and Exchange Commission’s Arthur Levitt, Jr. uttered the prescient criticism, “Auditors and analysts are participants in a game of nods and winks.” It should come as no surprise that it was Arthur Andersen that endorsed many of the accounting irregularities that contributed to WorldCom’s demise. Beyond that, however, were a host of incredibly chummy relationships between WorldCom’s management and Wall Street analysts.

Since the Glass-Steagall Act was repealed in 1999, financial institutions have been free to offer an almost limitless range of financial services to its commercial and investment clients. Citigroup, the result of the merger of Citibank and Travelers Insurance Company, which owned the investment bank and brokerage firm Salomon Smith Barney, was an early beneficiary of investment deregulation. Citibank regularly dispensed cheap loans and lines of credit as a means of attracting and rewarding corporate clients for highly lucrative work in mergers and acquisitions. Since WorldCom was so active in that mode, their senior managers were the target of a great deal of influence peddling by their banker, Citibank. For example,
Travelers Insurance, a Citigroup unit, lent $134 million to a timber company Bernie Ebbers was heavily invested in. Eight months later, WorldCom chose Salomon Smith Barney, Citigroup’s brokerage unit to be the lead underwriter of $5 billion of its bond issue.

The entanglements, however, went both ways. Since the loan to Ebbers was collateralized by his equity holdings, Citigroup had reason to prop up WorldCom stock. No one was better at that than Jack Grubman, Salomon Smith Barney’s telecommunications analyst. Grubman first met Bernie Ebbers in the early 1990s when he was heading up the precursor to WorldCom, LDDS Communications. The two hit it off socially, and Grubman started hyping the company. Investors were handsomely rewarded for following Grubman’s buy recommendations until stock reached its high, and Grubman rose financially and by reputation. In fact, *Institutional Investing* magazine gave Jack a Number 1 ranking in 1999, and *BusinessWeek* labeled him “one of the most powerful players on Wall Street.”

The investor community has always been ambivalent about the relationship between analysts and the companies they analyze. As long as analyst recommendations are correct, close relations have a positive insider quality, but when their recommendations turn south, corruption is suspected. Certainly Grubman did everything he could to tout his personal relationship with Bernie Ebbers. He bragged about attending Bernie’s wedding in 1999. He attended board meeting at WorldCom’s headquarters. Analysts at competing firms were annoyed with this chumminess. While the other analysts strained to glimpse any tidbit of information from the company’s conference call, Grubman would monopolize the conversation with comments about “dinner last night.”

It is not known who picked up the tab for such dinners, but Grubman certainly rewarded executives for their close relationship with him. Both Ebbers and WorldCom CFO Scott Sullivan were granted privileged allocations in IPO (Initial Public Offering) auctions. While the Securities and Exchange Commission allows underwriters like Salomon Smith Barney to distribute its allotment of new securities as it sees fit among its customers, this sort of favoritism has angered many small investors. Banks defend this practice by contending that providing high net worth individuals with favored access to hot IPOs is just good business. Alternatively, they allege that greasing the palms of distinguished investors creates a marketing “buzz” around an IPO, helping deserving small companies trying to go public get the market attention they deserve. For the record, Mr. Ebbers personally made $11 million in trading profits over a four-year period on shares from initial public offerings he received from Salomon Smith Barney. In contrast, Mr. Sullivan lost $13,000 from IPOs, indicating that they were apparently not “sure things.”

There is little question but that friendly relations between Grubman and WorldCom helped investors from 1995 to 1999. Many trusted Grubman’s insider status and followed his rosy recommendations to financial success. In a 2000 profile in *BusinessWeek*, he seemed to mock the ethical norm against conflict of interest: “what used to be a conflict is now a synergy,” he said at the time. “Someone like me . . . would have been looked at disdainfully by the buy side 15 years ago. Now they know that I’m in the flow of what’s going on.” Yet, when the stock started cratering later that year, Grubman’s enthusiasm for WorldCom persisted. Indeed, he maintained the highest rating on WorldCom until March 18, 2002 when he finally raised its risk rating. At that time, the stock had fallen almost 90 percent from its high two years before. Grubman’s *mea culpa* was to clients on April 22 read, “In retrospect the depth and length of the decline in enterprise spending has been stronger and more damaging to WorldCom than we even anticipated.” An official statement from Salomon Smith Barney two weeks later seemed to contradict the notion that Grubman’s analysis was conflicted, “Mr. Grubman was not alone in his enthusiasm for the future prospects of the company. His coverage was based purely on information yielded during his analysis and was not based on personal relationships.” Right.
On August 15, 2002, Jack Grubman resigned from Salomon where he had made as much as $20 million/year. His resignation letter read in part, “I understand the disappointment and anger felt by investors as a result of [the company’s] collapse, I am nevertheless proud of the work I and the analysts who work with me did.” On December 19, 2002, Jack Grubman was fined $15 million and was banned for securities transactions for life by the Securities and Exchange Commission for such conflicts of interest.

The media vilification that accompanies one’s fall from power unearthed one interesting detail about Grubman’s character—he repeatedly lied about his personal background. A graduate of Boston University, Mr. Grubman claimed a degree from MIT. Moreover, he claimed to have grown up in colorful South Boston, while his roots were actually in Boston’s comparatively bland Oxford Circle neighborhood. What makes a person fib about his personal history is an open question. As it turns out, this is probably the least of Jack Grubman’s present worries. New York State Controller H. Carl McCall sued Citicorp, Arthur Andersen, Jack Grubman, and others for conflict of interest. According to Mr. McCall, “this is another case of corporate coziness costing investors billions of dollars and raising troubling questions about the integrity of the information investors receive.”

The Hero of the Case

No integrity questions can be raised about Cynthia Cooper, whose careful detective work as an internal auditor at WorldCom exposed some of the accounting irregularities apparently intended to deceive investors. Originally charged with responsibilities in operational audit, Cynthia and her colleagues grew suspicious of a number of peculiar financial transactions and went outside their assigned responsibilities to investigate. What they found was a series of clever manipulations intended to bury almost $4 billion in misallocated expenses and phony accounting entries.

A native of Clinton, Mississippi, where WorldCom’s headquarters was located, Ms. Cooper’s detective work was conducted in secret, often late at night to avoid suspicion. The thing that first aroused her curiosity came in March, 2002 when a senior line manager complained to her that her boss, CFO Scott Sullivan, had usurped a $400 million reserve account he had set aside as a hedge against anticipated revenue losses. That didn’t seem kosher, so Cooper inquired of the firm’s accounting firm, Arthur Andersen. They brushed her off, and Ms. Cooper decided to press the matter with the board’s audit committee. That put her in direct conflict with her boss, Sullivan, who ultimately backed down. The next day, however, he warned her to stay out of such matters.

Undeterred and emboldened by the knowledge that Andersen had been discredited by the Enron case and that the SEC was investigating WorldCom, Cynthia decided to continue her investigation. Along the way, she learned of a WorldCom financial analyst who was fired a year earlier for failing to go along with accounting chicanery. Ultimately, she and her team uncovered a $2 billion accounting entry for capital expenditures that had never been authorized. It appeared that the company was attempting to represent operating costs as capital expenditures in order to make the company look more profitable. To gather further evidence, Cynthia’s team began an unauthorized search through WorldCom’s computerized accounting information system. What they found was evidence that fraud was being committed. When Sullivan heard of the ongoing audit, he asked Cooper to delay her work until the third quarter. She bravely declined. She went to the board’s audit committee and in June, Scott Sullivan and two others were terminated. What Ms. Cooper had discovered was the largest accounting fraud in U. S. history.

As single-minded as Cynthia Cooper appeared during this entire affair, it was an incredibly trying ordeal. Her parents and friends noticed that she was under considerable stress.
and was losing weight. According to The Wall Street Journal, she and her colleagues worried “that their findings would be devastating to the company [and] whether their revelations would result in layoffs and obsessed about whether they were jumping to unwarranted conclusions that their colleagues at WorldCom were committing fraud. Plus, they feared that they would somehow end up being blamed for the mess.”

It is unclear at this writing whether Bernie Ebbers will be brought to bear for the accounting irregularities that brought down his second in command. Jack Grubman’s final legal fate is also unclear. While the ethical quality of enthusiasm and sociability are debatable, the virtue of courage is universally acclaimed, and Cynthia Cooper apparently has it. Thus, it was not surprising that on December 21, 2002, Cynthia Cooper was recognized as one of three “Persons of the Year” by Time magazine.

WorldCom Update

Edward Romar and Martin Calkins

In December 2005, two years after this case was written, the telecommunications industry consolidated further. Verizon Communications acquired MCI/WorldCom and SBC Communications acquired AT&T Corporation, which had been in business since the 19th century. The acquisition of MCI/WorldCom was the direct result of the behavior of WorldCom’s senior managers as documented above. While it can be argued that the demise of AT&T Corp. was not wholly attributable to WorldCom’s behavior, AT&T Corp.’s decimation certainly was facilitated by the events surrounding WorldCom, since WorldCom was the benchmark long distance telephone and Internet communications service provider. Indeed, the ripple effect of WorldCom’s demise goes far beyond one company and several senior managers. It had a profound effect on an entire industry.

This postscript will update the WorldCom story by focusing on what happened to the company after it declared bankruptcy and before it was acquired by Verizon. The postscript also will relate subsequent important events in the telecommunications industry, the effect of WorldCom’s problems on its competitors and labor market, and the impact WorldCom had on the lives of the key players associated with the fraud and its exposure.

From Benchmark to Bankrupt

Between July 2002 when WorldCom declared bankruptcy and April 2004 when it emerged from bankruptcy as MCI, company officials worked feverishly to restate the financials and reorganize the company. The new CEO Michael Capellas (formerly CEO of Compaq Computer) and the newly appointed CFO Robert Blakely faced the daunting task of settling the company’s outstanding debt of around $35 billion and performing a rigorous financial audit of the company. This was a monumental task, at one point utilizing an army of over 500 WorldCom employees, over 200 employees of the company’s outside auditor, KPMG, and a supplemental workforce of almost 600 people from Deloitte & Touch. As Joseph McCafferty notes, “(a)t the peak of the audit, in late 2003, WorldCom had about 1,500 people working on the restatement, under the combined management of Blakely and five controllers . . . (t)he total cost to complete it: a mind-blowing $365 million” (McCafferty, 2004).
In addition to revealing sloppy and fraudulent bookkeeping, the post-bankruptcy audit found two important new pieces of information that only served to increase the amount of fraud at WorldCom. First, “WorldCom had overvalued several acquisitions by a total of $5.8 billion.” In addition, Sullivan and Ebbers “had claimed a pretax profit for 2000 of $7.6 billion.” In reality, WorldCom lost “$48.9 billion (including a $47 billion write-down of impaired assets).” Consequently, instead of a $10 billion profit for the years 2000 and 2001, WorldCom had a combined loss for the years 2000 through 2002 (the year it declared bankruptcy) of $73.7 billion. If the $5.8 billion of overvalued assets is added to this figure, the total fraud at WorldCom amounted to a staggering $79.5 billion.

Although the newly audited financial statements exposed the impact of the WorldCom fraud on the company’s shareholders, creditors, and other stakeholders, other information made public since 2002 revealed the effects of the fraud on the company’s competitors and the telecommunications industry as a whole. These show that the fall of WorldCom altered the fortunes of a number of telecommunications industry participants, none more so than AT&T Corporation.

The CNBC news show, “The Big Lie: Inside the Rise and Fraud of WorldCom,” exposed the extent of the WorldCom fraud on several key participants, including the then-chairmen of AT&T and Sprint (Faber, 2003). The so-called “big lie” was promoted through a spreadsheet developed by Tom Stluka, a capacity planner at WorldCom, that modeled in Excel format the amount of traffic WorldCom could expect in a best-case scenario of Internet growth. In essence, “Stluka’s model suggested that in the best of all possible worlds Internet traffic would double every 100 days.” In working with the model, Stluka simply assigned variables with various parameters to “whatever we think is appropriate.”

This was innocent enough, had it remained an exercise. A problem emerged when the exercise was extended and integrated into corporate strategy, when it was adopted and implemented by WorldCom and then by the telecommunications industry. Within a year, “other companies were touting it” and the model was given credibility it should not have been accorded. As Stluka explains, “there were a lot of people who were saying 10X growth, doubling every three to four months, doubling every 100 days, 1,000 percent, that kind of thing.” But it wasn’t true. “I don’t recall traffic . . . in fact growing at that rate . . . still, WorldCom’s lie had become an immutable law.” Optimistic scenarios with little foundation in reality began to spread and pervade the industry. They became emblematic of the “smoke and mirrors” behavior not only at WorldCom prior to its collapse, but the industry as a whole.

Fictitious numbers drove not just WorldCom, but also other companies as they reacted to WorldCom’s optimistic projections. According to Michael Armstrong, then chairman and CEO of AT&T, “For some period of time, I can recall that we were back-filling that expectation with laying cable, something like 2,200 miles of cable an hour.” He adds: “Think of all the companies that went out of business that assumed that that was real.”

The fallout from the WorldCom debacle was significant. Verizon obtained the freshly minted MCI for $7.6 billion, but not the $35 billion of debt MCI had when it declared bankruptcy. Although WorldCom was one of the largest telecommunications companies with nearly $160 billion in assets, shareholder suits obtained $6.1 billion from a variety of sources including investment banks, former board members and auditors of WorldCom. If this sum were evenly distributed among the firm’s 2.968 billion common shares, the payoff would (have been) well under $1 a share for a stock that peaked at $49.91 on Jan. 2000.

There are more losers in the aftermath of the WorldCom wreck. The reemerged MCI was left with about 55,000 employees, down from 88,000 at its peak. Since March 2001, however, “about 300,000 telecommunications workers have lost their jobs. The sector’s total employment—1.032 million—is at an eight year low.” The carnage does not stop there.
Telecommunications equipment manufacturers such as Lucent Technologies, Nortell Networks, and Corning, while benefiting initially from WorldCom’s groundless predictions, suffered in the end with layoffs and depressed share prices. Perhaps most significant, in December 2005, the venerable AT&T Corporation ceased to exist as an independent company.

The Impact on Individuals

The WorldCom fiasco had a permanent effect on the lives of its key players as well. Cynthia Cooper, who spearheaded the uncovering of the fraud, went on to become one of Time Magazine’s 2002 Persons of the Year. She also received a number of awards, including the 2003 Accounting Exemplar Award, given to an individual who has made notable contributions to professionalism and ethics in accounting practice or education. At present, she travels extensively, speaking to students and professionals about the importance of strong ethical and moral leadership in business. Even so, as Dennis Moberg points out, “After Ebbers and Sullivan left the company, “. . . Cooper was treated less positively than her virtuous acts warranted. In an interview with her on 11 May 2005, she indicated that, for two years following their departure, her salary was frozen, her auditing position authority was circumscribed, and her budget was cut.”

As far as the protagonists are concerned, in April 2002, CEO Bernie Ebbers resigned and two months later, CFO Scott Sullivan was fired. Shortly thereafter, in August 2002, Sullivan and former Controller David Myers were arrested and charged with securities fraud. In November 2002, former Compaq chief Michael Capellas was named CEO of WorldCom and in April 2003, Robert Blakely was named the company’s CFO.

In March 2004, Sullivan pleaded guilty to criminal charges. At that time, too, Ebbers was formally charged with one count of conspiracy to commit securities fraud, one count of securities fraud, and seven counts of fraud related to false filings with the Security and Exchange Commission. Two months later, in May of 2004, Citigroup settled class action litigation for $1.64 billion after-tax brought on behalf of purchasers of WorldCom securities. In like manner, JPMorgan Chase & Co. agreed to pay $2 billion to settle claims by investors that it should have known WorldCom’s books were fraudulent when it helped sell $5 billion in company bonds.

On March 15, 2005, Ebbers was found guilty of all charges and on July 13th of that year, sentenced to 25 years in prison, which was possibly a life sentence for the 63-year-old. He was expected to report to a federal prison on October 12, but remained free while his lawyers appealed his conviction.

At the time of his conviction, Ebbers’s lawyers claimed the judge in the case gave the jury inappropriate instructions about Ebbers’s knowledge of WorldCom’s accounting fraud. By January of 2006, Reid Weingarten, Ebbers’s lawyer, was claiming that the previous trial was manipulated against Ebbers because three high level WorldCom executives were barred from testifying on Ebbers’s behalf. At that time, too, Judge Jose Cabranes of the US Second Circuit Court of Appeals commented, “There are many violent criminals who don’t get 25 years in prison. Twenty years does seem an awfully long time.”

Weingarten went on to assert that the government “should have charged the three former WorldCom employees that could have helped exonerate Ebbers or let them go.” He charged, too, that “the jury was wrongly instructed that it could convict Ebbers on the basis of so-called “conscious avoidance” of knowledge of the fraud at WorldCom.” Perhaps most compellingly, Weingarten called into question the fairness of Ebbers’s sentence that was five times as long as that given to ex-WorldCom financial chief Scott Sullivan.

Weingarten’s claims are not without merit. In August 2005, former CFO Sullivan was sentenced to five years in prison for his role in engineering the $11 billion accounting...
fraud. His relatively light sentence was part of a bargain wherein he agreed to plead guilty to the charges filed against him and to cooperate with prosecutors as they built a case against Ebbers. In doing so, Sullivan became the prosecution’s main witness against Ebbers and the only person to testify that he discussed the WorldCom fraud directly with Ebbers. Others involved in the scandal were also treated less harshly than Ebbers. In September 2005, judgments were rendered approving settlement and dismissing action against David Myers and a number of others associated with WorldCom.

Despite Weingarten’s claims, on July 28, 2006, the courts rejected Ebbers’s contention that his trial was “fundamentally flawed” and concluded that his sentence was “harsh but not unreasonable.” In doing so, the courts upheld Ebbers’s conviction and prison sentence and cleared the way for the start of his 25-year prison term. It also ended, what is to date, the largest corporate fraud in history.

Notes

1. This is only true if he is liable for the loans he was given by WorldCom. If he avoids those somehow, his net worth may be plus $8.4 million according to The Wall Street Journal (see S. Pulliam & J. Sandberg, “Worldcom Seeks SEC Accord As Report Claims Wider Fraud,” November 5, 2002, p. A-1).

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Reading 10-3

Will the SEC Ever Get Serious about Making Corporate Insiders Pay for Fraud?

Mark Pincus, on Mark Pincus Blog

Tuesday, March 29, 2005

We are all watching yet another venerable old company (AIG) blow up over corporate accounting fraud and investor misrepresentation. Same old story, investors lose billions, often everything, while corporate insiders say “I’m sorry.” Then the SEC tries to go after a small few with expensive criminal proceedings that rarely yield much. In this case, the chairman, Maurice Greenberg, has decided to “retire” and to walk away with $2.8 billion, in addition to the millions he’s already sold. Maybe there’ll be a whistleblower. Maybe, in five years, he’ll face trial after an Enron-style bottom-up investigation. This white collar crime has become the norm and the SEC is useless in correcting it.

Here’s the easy solution—MAKE THEM PAY! It would be so simple. Just create a rule that says that any insider who sold during a time of accounting fraud (or any restatement) has
to disgorge all profits. This would immediately make every insider liable for the billions they made without bothering proving any knowledge of wrongdoing. The rationale is that they didn’t deserve the profit, that they were selling a “lemon.” California has this for cars, why can’t the SEC have it for stocks? Instead, we punish all companies (especially small ones) with Sarbanes-Oxley, one of the dumbest laws our country has ever produced. It makes about as much sense as asking people to swear on the Bible before testifying.

Last year, over 400 public companies restated earnings. Think about the billions that would have been recaptured for the injured investors. Think about AOL where the insiders walked with billions, virtually unscathed, while the poor saps who owned stock in Time-Warner were left with a billions dollar tab to the SEC over fraudulent accounting. How about Gary Winnick who sold $600m at Global Crossing before it blew up? He chose to give back $30m to former employees. With this rule, he would have returned the whole boot. John Moores sold $600m too in his company, Peregrine Systems, before it too went bankrupt for fraudulent filings. Maybe these guys Didn’t know about it. WHO CARES? Just make them give back the ill-gotten gains, and the SEC can still go after any of these people in the current long drawn-out criminal process and nab one out of 400 or less at a huge tab to the taxpayers.

We’re all disgusted with Ken Lay and the insanity they brewed at Enron. Maybe a few of these guys will see jail time, but even then they’ll keep the loot.

So why doesn’t the SEC enact this obvious rule? I don’t know. Maybe the same Wall Street guys who run the stock exchange that regulates them have a hand here. Maybe this would go too far in causing some real pain to a group that is a massive political donor.

Btw, there is a clear precedent for this in the current $16B short swing profit rule that says that, if an insider buys and sells in a six-month period, they have to disgorge the profit. I’m sure that this was enacted after realization that the criminal laws were ineffective.

If anyone has ideas on how we push the SEC to enact real dollar regulations that will start to protect investors and not whitewash the same old game, let me know.


Mark Pincus is Chairman, Co-Founder and former CEO of Tribe Networks, Inc., a venture-backed startup to enable individuals and communities to connect and transact; Co-Founder and former Chairman and CEO of SupportSoft, Inc., a publicly traded enterprise software company, formerly known as Support.com; and former CEO of Freeloader.com, the first Web-based push service, acquired after seven months by Individual, Inc. for $38 million, among other ventures.

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**Reading 10-4**

**Three Women’s Moral Courage: Why We Care**

Rushworth Kidder

*Time* magazine’s writers duly noted similarities among the three [“People of the Year” for 2002]: Each worked from within to expose wrongdoing—financial mismanagement at Enron and WorldCom, a culture of nonresponse at the Bureau. Each worked in high-profile organizations—Enron known for its devastating corporate collapse, WorldCom for its record bankruptcy filing of $3.8 billion, and the FBI for charges that it failed to investigate leads that might have helped prevent the 9/11 attacks.
What’s more, each woman worked in relative obscurity, neither at the top nor in the limelight. Each, by filing a complaint, was seeking to reform an organization she dearly loved, not setting out to destroy something she despised. Each depended on her job for a livelihood. And each was a woman.

For their part, these three told *Time* they don’t think gender has much to do with their actions. They can’t abide the term “whistleblower.” They remain emotionally attached to their organizations: Of the three, only Watkins has since left her employer—and has taken serious flak, initially for failing to go public with her accusations, and now for capitalizing on her experiences through her share of a half-million-dollar book advance. Still, she and her co-awardees are acutely aware of the stresses that whistleblowing involves.

At bottom, however, there’s another overriding commonality: moral courage, a term strangely muted in the *Time* account. In varying degrees, each of these women understood the danger they faced, found the will to endure the risk, and based her action on clear moral principle. These three characteristics—awareness, endurance, and principle—are the defining features of moral courage.

And that helps us answer the big question surrounding *Time*’s choice: Why, this year, give an award for moral courage? What is it in our culture, the ethos of our time, our zeitgeist that makes it so important to honor the courage to be moral?

In part, of course, it’s our want of heroes, our longing for bold leadership in an age of insecurity. The tragedy of 9/11 supplied us with a few heroes in the form of firefighters. Now the pendulum has swung to a different sort of courage, where what’s endangered is not life and limb but reputation, ethical standards, and the need for principle.

And in part, it’s just the reverse: our desire for something to moderate the glut of executive swashbuckling. Weary of the excesses of corporate rapacity, we reach out for the modesty and humility of a moral leadership that carefully tracks the right numbers, establishes a culture of trust, subordinates style to substance, and tells the truth.

But there’s something else, I think, driving this thirst for moral courage. Call it the Age of Disjunction. These days there’s an unusual disconnect between words and action, theory and practice, assertion and demonstration. Increasingly, it seems, there’s an inertia that keeps goodness in a state of suspended animation while badness rolls on of its own momentum. It’s an age fixed on show and surface, a two-dimensional televisual culture that militates against depth and penetration. Result: an almost hypnotic inability to bring things to conclusion. Perhaps that’s what T. S. Eliot had in mind when, in “The Hollow Men,” he noted that “Between the motion / And the action / Falls the Shadow.”

In a fascinating moment in their *Time* interview, these women glimpsed that shadow. “In this country,” said Watkins, “we have a vacuum in leadership. . . . We value splashy leaders.”

“People who move to the top,” added Cooper, “are typically racehorses, not workhorses. And they’re very charismatic.”

“And the dark side of charisma,” replied Watkins, “is narcissism.”

That’s not your usual whistleblower talk. But it speaks to a key point about moral courage. Because it seeks truth, moral courage probes for depth. In the end, what unites these three women is their discomfort with the superficial. For them, neither the glitz of WorldCom, the bland denials of Enron, nor the veneer of old traditions at the FBI was compelling. They wanted something more profound.

So, ultimately, do we. Sobered by 9/11, rocked by corporate scandals, clouded by rumors of war, we long to unite motion and action, dissolve the shadow, and connect our ideas and our lives. That can be hard, discomforting work. That three women did it—and that some editors thought what they did was supremely important—is a sign of hope for the new year.