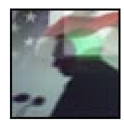
What price virtue?
By John Plender
Published: December 1 2002 21:02 | Last Updated: December 1 2002 21:02

Just one year ago today, Enron filed for protection under US bankruptcy laws. The collapse of the now notorious Houston-based energy trader proved to be the first in a succession of breathtaking corporate scandals, which emerged against the background of a deflating stock market bubble. As one unsavoury disaster has followed another, an ethical deficit has been revealed at the heart of modern capitalism.

Rarely has corporate America been held in such low regard. We now know that books were cooked at Enron, WorldCom, Qwest Communications and others. We have long known that boardroom pay in the Anglo-American world had ballooned regardless of corporate performance. Infectious greed, in the memorable phrase of Federal Reserve chairman Alan Greenspan, has enjoyed free rein.

US boardroom pay

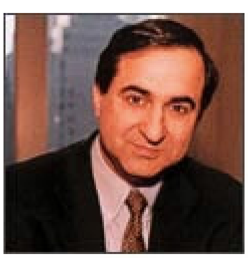


Taking stock on optionsRead

For business academics, Enron has turned into the greatest case study in unethical business practices for a generation. And ethics are undeniably back in fashion. Carly Fiorina, chief executive officer of Hewlett-Packard, has assured us that "good leadership means doing the right thing when no one's watching".

The hunt is on, too, for unsullied names to become directors of companies that have had governance shortcomings. At WorldCom, to take the highest profile case, bondholders have proposed former New York mayor Rudolph Giuliani as a suitable candidate to lend integrity to a troubled board.

Dec 12 2001:



Joseph Berardino, chief executive of Arthur Andersen, Enron’s auditor, testifies that Enron might have violated securities laws protection

Such reactions are healthy. For the moral issues raised by this chain of corporate scandals are not just a matter of concern for bishops, or for those who lost jobs, pensions and money as companies collapsed. A decline in business ethics has important economic consequences. So it makes sense to pick over the post-bubble damage and explore the ethical dimension of Enron's story.

The first and most obvious economic fall-out from corporate wrong-doing is that the legitimacy of wealth creation is eroded. With free markets under threat from protectionist politicians and anti-globalisation protesters, corporate scandals are a propaganda gift for those in the developed world who are well enough off not to worry about lower growth, and too short sighted to recognise the adverse consequences for poor countries.

But there is a more fundamental sense in which ethics affect economic activity. Quite simply, ethical conduct creates the valuable quality of trust. Trust reduces monitoring and transaction costs in companies and in the wider economy. At the most basic level - with apologies to the bishops - ethics are a low-cost substitute for internal control and external regulation.

That is why the accounting scandals at Enron and the subsequent collapse of Andersen, the energy trader's auditor, are so vitally important. Auditors are the guardians of the integrity of the capitalist system. They have a public responsibility recognised in statute in the UK, though not so specifically in US law, that transcends the employment relationship with their clients.

As the former US chief justice Warren Burger put it, the public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

Jan 10 2002:

US Justice Department initiates an investigation of Enron's collapse; Kenneth Lay resigns as the company's CEO

Joshua Ronen, a professor of accounting at New York University's Stern School of Business, points out that ethical behaviour is thus a necessary condition for investors to benefit from the auditor's product - the credibility of the auditors' attestation to financial statements. They must have the skill and competence required to detect misrepresentations or omissions in financial statements. But it is even more important, he adds, for auditors to possess the ethical trait of rendering an honest opinion.

Within this context Enron was what some economists would call a low-trust organisation. Given all the signs that directors and employees were driven by the desire to raise the stock price by fair means or foul, Andersen should have delivered a rigorous, high-cost audit. Instead, it was cosy with management and derived most of its fees from higher-margin consultancy services.

Within the company, a decent management would have incurred costs to improve internal controls and internal audit to reduce the risk of fraud, given that many of the employees lacked integrity. Instead, the executive directors coerced the employees via a fear-inducing peer review process into single-minded efforts to push up the stock price.

Feb 2002:

Jeff Skilling, Enron’s former CEO and COO, appears before Congress a second time, maintaining claims that he knew nothing about corrupt accounting practices.

The review left employees in no doubt that they would be fired if they failed to deliver the figures their bosses wanted. At the same time employees who broke the company's own ethical rules were rewarded if their misdemeanours ended up contributing to the bottom line. So Enron was, in reality, a negative-trust company in which fear destroyed value, both economic and moral, and dishonesty was encouraged in the interests of short-term profit.

This point extends far beyond accountancy and audit issues. In economic terms trust, truth telling and loyalty create externalities. Though they cannot be traded in markets, these qualities have a real value that increases the efficiency of the wider economic system. It is not a coincidence that Enron's Kenneth Lay and Jeffrey Skilling wanted everything from telecoms bandwidth to the weather to be tradeable in markets, while running a company that was deficient in non-tradeable truth and trust.

To work well, markets need both a robust legal framework and a behavioural infrastructure of accepted rules. Where laws and rules are flouted, transaction costs go up. Insider dealing provides a clear example. In markets where informed speculators are known to be extracting gains at others' expense, market makers will widen their spreads to protect themselves, causing the cost of dealing to rise.

Investors who are not insiders will demand a discount on the price of securities when they are issued. Utpal Bhattacharya and Hazem Daouk of Kelley School of Business at Indiana University have produced academic evidence. They found in a study of 103 countries that where insider dealing regulations were properly enforced, the cost of equity capital fell by about 5 per cent.

Much the same applies in corporate governance when inside shareholders extract private benefits of control at the expense of outsiders. Research by McKinsey, the consultants, for the World Bank-OECD Global Corporate Governance Forum has shown that big investors continue to pay more for shares in companies and in countries where governance is sound.

Apr 2002:

Sen Joseph Lieberman calls for new laws and dramatic changes in American business executive behaviour...

Here lies part of the explanation for the severity of the bear market that began early in 2000. For much of this year the weakness of stock prices has reflected concerns about the quality of earnings. Many investors have concluded that generally accepted accounting principles in the US are a multiple choice game in which the only consistent feature is that most managers opt for whatever produces the prettiest picture. Since Enron, however, the number of earnings restatements in the US has risen from 50 a year in the early 1990s to more than 200 a year now.

Human beings are not saints. At each new and more inflated level of a stock market bubble the robustness of executives' ethics is tested and a further batch of them succumbs to temptation and greed. So people need penalties and incentives that make good use of the self-interest motive while encouraging economically productive ethical behaviour. And one reason the Anglo-American capital market model has gone off the rails over the past decade is precisely that the sticks and carrots are badly skewed.

Jun 2002:

WorldCom discloses $3.8bn accounting fraud and fires its chief financial officer. Dennis Kozlowski, CEO of Tyco, is indicted on charges that he evaded more than $1m in income taxes...

Consider the auditors. Their appointment and pay are in the gift of management. So their independence is eroded at the outset, because robust auditing could lead to the loss of future income. There are, of course, other disciplines such as the loss of reputation if audits go wrong and the threat of costly litigation, or a potentially lethal criminal investigation by the US Justice department, which is what demolished the global brand name of Andersen.

Yet it is clear that the threat of such sanctions did not stop Andersen shedding its reputation as the toughest of the big five audit firms and becoming more pliant.

Prof Ronen argues that there will be no adequate solution until the innate conflict of interest in the auditor's relationship with management is addressed. In a forthcoming paper for the Stamford Law and Business Review, he argues for a radical realignment of interests in a system where companies would take out insurance for their financial statements. This would cover investors against losses arising from misrepresentation in accounts, while the insurers would appoint and pay the auditors. The alternative approach is to shift control over the auditor's appointment and pay to listing authorities or public sector watchdogs.

In the case of stock options, there has been a similar problem with skewed checks and balances. This arises because the huge sums managed by institutional investors in the US and UK dance to the tune of management. So few proxy votes have been cast against egregiously large option awards.

Indeed, the ethical deficit extends to fund management as well as corporate management. As Paul Myners pointed out in his report to the UK Treasury on institutional investment last year, fund managers are often more concerned to minimise their own business risk than to maximise the rewards to their beneficiaries.

Oct 2002:

Enron's former chief financial officer Andrew Fastow is charged with securities, wire and mail fraud, money laundering and conspiring to inflate Enron's profit

Poor trusteeship - note the root of the word is trust - may also explain why so little was done to correct governance shortcomings at Enron, Tyco et al, where non-executive directors' independence was compromised by consultancy contracts and the grant of stock options.

A striking feature of the re-regulation that has followed in the wake of America's corporate scandals is how little of it addresses the problem of perverse incentives. The Sarbanes- Oxley Act, for example, imposes tougher penalties on directors along with restrictions on auditors providing non-audit services. But it does much less to address the more fundamental conflict inherent in the way auditors are appointed and remunerated by management.

Nov 2002:

Fastow pleads not guilty after being indicted on 78 counts of conspiracy. Adelphia sues its former accountants, Deloitte & Touche, accusing the firm of 'fraud and other wrongful conduct'

Nor has there been much discussion about how to restore what the economist John Kay calls values-based regulation, whereby the business climate becomes an important constraint on companies such as Enron. There was a time, after all, when leading banks, institutional investors and law firms would not have connived in setting up dubious special purpose entities involving questionable accounting and acute conflicts of interest between managers and the quoted company's share-holders.

Restoring values is, of course, more difficult than passing laws and introducing regulations. Yet the ethical climate clearly matters. The first step towards bolstering the restraints on bad behaviour is to acknowledge the importance of the ethical dimension in economic activity.

John Plender's book Going Off The Rails: Global Capital and The Crisis Of Legitimacy will be published by John Wiley in January

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Taking stock on options

The explosion in the use of stock options in US boardroom pay is a classic illustration of the law of unintended consequences. It results largely from the Clinton administration's attempt in 1993 to cap directors' pay by imposing a $1m limit on its tax deductibility.

According to Pearl Meyer & Partners, the pay consultants, the average compensation mix for chief executive officers in the 1960s was two-thirds salary and one-third incentives. Today the combination is about one-third salary and two-thirds profit-based bonuses, stock options and other forms of equity.

More striking statistics about stock options concern the startling growth in income inequality between directors and employees. In September a Business Week survey showed that in 2000 CEOs of quoted companies made 531 times the amount earned by the average worker, compared with just 42 times in 1980. The extent of the disparity prompted William McDonough, president and CEO of the Federal Reserve Bank of New York, to remark that this was "terribly bad social policy and perhaps even bad morals".

The growth in option awards was facilitated by lax accounting. When the Financial Accounting Standards Board insisted in the 1990s that the cost of options should be charged in the profit-and-loss column, it was brow-beaten into a retreat by big business.

Business leaders justified lavish option awards by claiming they aligned top executives' interests with those of shareholders. Yet in practice, options gave them a powerful incentive for the company to buy more of its own stock. In many cases this resulted in a debt-financed transfer of wealth from shareholders to managers as they bought stock at bubble-inflated values.

A survey conducted last year by Towers Perrin, the consultants, found that outside directors in the US were being paid three-quarters in stock, much of it in the form of options, and only a quarter in cash. Many argue that this impairs the directors' ability to monitor management.

But criticism of these practices has been mounting, most notably from a Commission on Public Trust and Private Enterprise set up by the Conference Board, the business-led research organisation. It said recently: "The commission shares the public's anger over excessive executive compensation, especially to executives of failed or failing companies, and finds that compensation abuses have contributed to a dramatic loss of confidence in the governance of American publicly held corporations - with visible and damaging financial market effects."

The proposed best practices are pinned on more performance-based incentives to support the corporation's long-term strategic goals. This would bring the US closer to UK practice where share option awards are routinely linked to performance criteria and rarely awarded to non-executive directors.

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