

Corporate governance reforms: fact or fiction?

Steven T. Petra

Steven T. Petra is an Associate Professor at the Frank G. Zarb School of Business at Hofstra University in New York. He holds a PhD degree in accounting and is a Certified Public Accountant. His research interests include corporate governance and the role of boards of directors in improving public confidence in corporate earnings numbers. The research contained in this paper was supported by a summer research grant from the Frank G. Zarb School of Business.

Abstract

Purpose – Reforms set forth in Sarbanes-Oxley and the NYSE, AMEX, and NASD are designed to prevent the reoccurrence of corporate collapses at companies such as Enron Corp., WorldCom Inc., and Global Crossing Ltd. The purpose of this paper is to discuss the possible impact the reforms may or may not have had in controlling the abuses uncovered in recent corporate failures.

Design/methodology/approach – This paper examines the reforms to corporate governance and the rationale behind the reforms, and examines how the actual governance structures of Enron, WorldCom, and Global Crossing during the years of their accounting scandals compared to the new requirements. It also offers a discussion as to whether the new reforms would have been helpful in preventing management's manipulation of earnings.

Findings – Global Crossing's governance structure would have satisfied a majority of the reforms. Enron's and WorldCom's governance structures would have satisfied less than half of the reforms.

Practical implications – This paper highlights the need for management and shareholders alike to focus on the substance of the reforms and not merely the form of the reforms in order to make meaningful improvements to corporate governance.

Originality/value – This paper should serve as a warning to the investing public. The reforms in and of themselves should not be relied on to prevent future corporate scandals. The reforms, however, do focus the spotlight directly on corporate boardrooms where shareholders can now insist that directors' interests be separate from those of the CEO and upper management.

Keywords Corporate governance, Business ethics, United States of America, Boards of Directors

Paper type Viewpoint

Introduction

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) (United States Congress, 2002), which contains many reforms intended to protect investors by raising corporate governance standards designed to improve the accuracy and reliability of corporate disclosures. On November 4, 2003, the Securities and Exchange Commission (SEC) approved reforms to the corporate governance requirements of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) (Securities and Exchange Commission, 2003a). On December 1, 2003, the SEC approved similar reforms for the American Stock Exchange (AMEX) (Securities and Exchange Commission, 2003b). These reforms are designed to enhance the accountability, integrity, and transparency of the exchanges' listed companies.

The "meltdown" of significant companies such as Enron Corp., WorldCom, Inc., and Global Crossing Ltd has led to criticism of boards of directors and accusations that corporate boards aren't doing their jobs. "We think the [Enron] board was asleep at the switch and fell down on the job," said Senator Carl Levin a member of the Senate investigations subcommittee investigating the collapse of Enron Corp. (NYSSCPA.org News Staff, 2002). Many of the corporate governance reforms are intended to further the ability of directors serving on corporate boards to perform their functions effectively.

To what extent will these reforms prevent similar business failures from recurring? While no one can predict the future, a great scholar once said, "If we don't learn from the past, we are doomed to repeat it." This paper examines how the reforms would have affected Enron Corp., WorldCom, Inc., and Global Crossing Ltd had the reforms been in place immediately preceding these companies' collapses, during which time management was discovered to be misstating results of operations.

Enron Corp. filed for bankruptcy on December 2, 2001 and restated its financial statements for the years 1997 through 2000. WorldCom, Inc. filed for bankruptcy on July 21, 2002 and restated its financial statements for the years 1999 through 2001. Global Crossing Ltd filed for bankruptcy on January 28, 2002, and its financial statements for the years 2000 and 2001 are currently under investigation by the Enforcement Division of the SEC.

The cornerstone of the corporate governance reforms is outside independent directors. The reforms increase the role and authority of these directors, as well as tighten the definition of "independent." Additionally, the reforms require companies to focus on good corporate governance, and give shareholders more opportunity to monitor and participate in the governance of their companies. The following sections detail the reforms to corporate governance and the rationale behind the reforms, and examine how the actual governance structures of Enron Corp., WorldCom Inc. and Global Crossing Ltd during the years of their accounting scandals compared to the new requirements. They also offer a discussion as to whether the new reforms would have been helpful in preventing management's manipulation of earnings.

Reform. Listed companies must have a majority of outside independent directors

Rationale

Shareholders, by virtue of their inability to directly monitor management behavior, rely on the board of directors to perform such monitoring activities. The monitoring potential of the board is reduced or perhaps eliminated when management itself controls the actions of the board. Additionally, outside directors may lack independence through various affiliations with the firm[1]. Such directors may be inclined to support management's decisions in hopes of retaining their relationship with the firm. Accordingly, outside directors who are also independent are potentially the best monitors of management. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

Actual governance structures

Enron Corp. – maintained a board with the proportion of outside independent directors ranging from 50 percent to 55 percent.

WorldCom, Inc. – maintained a board with the proportion of outside independent directors ranging from 40 percent to 50 percent.

Global Crossing, Ltd – maintained a board with the proportion of outside independent directors ranging from 25 percent to 45 percent.

Discussion

While only Enron had a majority of outside independent directors, all three companies did have representation by outside independent directors. Despite the presence of these directors, all three companies suffered breakdowns in their corporate governance systems as a result of the failures of the outside independent directors and indeed the entire board to fulfill their oversight responsibility.

Alan Greenspan, Chairman of the Federal Reserve Board, commented, "In my experience, few directors in modern times have seen their interests as separate from those of the CEO, who effectively appointed them and, presumably, could remove them from future slates of directors submitted to shareholders" (Greenspan, 2002, 2003) This lack of director separation from the CEO has led to corporate boards being aligned with management rather than shareholders notwithstanding the presence of outside independent directors.

Reform. Listed companies are required to have a minimum three-person audit committee composed entirely of outside independent directors

Rationale

Audit committees are in the best position within the company to identify and act in instances where top management seeks to misrepresent reported financial results. An audit committee composed entirely of outside independent directors can provide independent recommendations to the company's board of directors.

Actual governance structures

Enron Corp. – the size of the audit committee ranged from five to six persons. However, the audit committee was never composed entirely of outside independent directors. The proportion ranged from 60 percent to 83 percent.

WorldCom, Inc. – the size of the audit committee remained constant at four persons. However, the audit committee was never composed entirely of outside independent directors. The proportion remained constant at 75 percent.

Global Crossing, Ltd – the size of the audit committee remained constant at three persons. However, the audit committee was never composed entirely of outside independent directors. The proportion remained constant at 67 percent.

Discussion

While none of the three companies had audit committees composed entirely of outside independent directors, all three did have audit committees composed of a majority of outside independent directors. Additionally, all three companies did have audit committees composed entirely of outside directors. All of the companies had at least one outside director on their audit committees who was not independent (i.e. a “grey” director) due to a business affiliation with the company. None of the companies had management directors serving on their audit committees.

Despite the presence of a majority of outside independent directors serving on their audit committees, these committees failed to identify and act on financial statements that contained material misstatements. “These are humans,” said Richard H. Koppes, former general counsel for the California Public Employees’ Retirement System, “you’re not going to want to rock the boat” (Lavelle, 2002). Nonetheless, Eugene O’Kelly, KPMG chairman and CEO, stated that “Independence . . . is the essence of effective audit committees [and] it is imperative that the directors who sit on today’s audit committees be independent of management in thought and action” (O’Kelly, 2003).

Barbara Franklin, former US Commerce Secretary, believes that “[audit committees] are better equipped to head off trouble” as a result of Sarbanes-Oxley. However, she adds, “if management is being dishonest, it still will be hard to get to the bottom” (Hymowitz and Lublin, 2003).

This reform would not have prevented management of Enron, WorldCom, and Global Crossing from misrepresenting their financial statements.

Reform. Each member of the audit committee must be financially literate and at least one member must be a financial expert

Rationale

The responsibilities of an audit committee include review of the internal audit department; review of the annual audit plan; review of the annual reports and the results of the audit; selection and appointment of external auditors; and review of the internal accounting controls and safeguard of corporate assets. In order to successfully serve on an audit committee, the director must be a financial expert and/or financially literate. A “financial expert” is defined as someone who has:

- an understanding of financial statements and generally accepted accounting principles;
- an ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience preparing, auditing, analyzing, or evaluating financial statements;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

Being “financially literate” is left to the judgment of the company’s board of directors. Presumably, a person who is capable of reading and understanding corporate financial statements is considered to be financially literate.

Actual governance structures

Enron Corp. – the audit committee always had at least one person who was a financial expert. However, the other members of the audit committee were not always financially literate.

WorldCom, Inc. – the audit committee did not always have a financial expert. Additionally, the members of the audit committee were not always financially literate.

Global Crossing, Ltd – the audit committee always had at least one person who was a financial expert. In addition, the other members of the audit committee were financially literate.

Discussion

In the cases of Enron and Global Crossing, the financial expert served as chairperson of the audit committee. In the case of WorldCom, a financial expert did serve on the audit committee in one of the years under examination. Despite the presence of financial experts and people who were financially literate serving on their audit committees, these committees failed to identify and act on financial statements that contained material misstatements. Although the three companies had varying degrees of financial literacy of the members of the audit committees, it is doubtful that this reform would have prevented management from misrepresenting results of operations. “What’s important is their perspective”, said Jay W. Lorsch, a professor at Harvard Business School in speaking about the qualifications of potential audit committee members (Lorsch, 2003). Charles H. King at Korn/Ferry International adds, “the active CFO is the most attractive candidate for an audit committee assignment, and they haven’t been heavily recruited.” Another source of audit committee candidates are retired audit partners from large accounting firms. Madeleine Condit a senior partner at Korn/Ferry adds, “it’s a pretty big universe – big enough that you can find someone with expertise in whatever specific industry sector you’re in” (Norton, 2003).

Reform. Audit committee members may be compensated only with director’s fees

Rationale

Audit committee members may receive their fee in cash and/or company stock or options, as well as all of the regular benefits that other directors receive. Disallowed compensation for an audit committee member includes fees paid directly or indirectly for services as a consultant or a legal or financial advisor, regardless of the amount. Disallowed compensation also includes compensation paid to such a director’s firm for such consulting or advisory services, even if the director is not the actual service provider.

Actual governance structures

Enron Corp. – director’s fees were paid in the form of cash, stock, and/or options at the discretion of the director. However, one member of the audit committee was also paid a consulting fee, which is disallowed.

WorldCom, Inc. – audit committee members were compensated only with director’s fees. Such fees were paid in the form of cash, stock, and/or options at the discretion of the director.

Global Crossing, Ltd – audit committee members were compensated only with director's fees. Such fees were paid in the form of cash and/or options at the discretion of the director.

Discussion

Two of the companies, WorldCom and Global Crossing, had policies in place that would have completely satisfied this reform. Additionally, at Enron, only one member violated the reform on an audit committee that ranged in size from five to six members. This reform would not have prevented management of Enron, WorldCom, and Global Crossing from misrepresenting their financial statements.

Reform. The audit committee must directly appoint, retain, compensate, evaluate, and terminate the company's independent auditors

Rationale

The audit committee must have the sole authority to approve all audit engagement fees and terms and must be directly responsible for oversight of the independent auditors, including resolution of disagreements between management and the independent auditor.

Actual governance structures

Enron Corp. – the audit committee had sole authority to appoint, retain, compensate, evaluate, and terminate the company's independent auditors.

WorldCom, Inc. – the audit committee had sole authority to appoint, retain, compensate, evaluate, and terminate the company's independent auditors.

Global Crossing, Ltd – the audit committee had sole authority to appoint, retain, compensate, evaluate, and terminate the company's independent auditors.

Discussion

"The requirements are very clear", said Jay W. Lorsch, professor of human relations at Harvard Business School. "The audit committee should be in charge of the relationship with the outside auditor and manage what you might call the 'financial governance system'. The requirements will make the audit committee particularly concerned with managing the relationship with the accountants. They also send a message to management that it shouldn't be involved in that relationship."

All three companies had policies in place that would have satisfied the requirements of this reform. This reform clearly would not have prevented management of Enron, WorldCom, and/or Global Crossing from misstating the company's financial statements.

Reform. Listed companies must have a compensation committee composed entirely of outside independent directors

Rationale

The responsibility of the compensation committee is to evaluate and recommend the compensation of the firm's top executive officers including the CEO. To fulfill this responsibility objectively, it is necessary that the compensation committee be composed entirely of outside independent directors.

Actual governance structures

Enron Corp. – the compensation committee was always composed entirely of outside independent directors.

WorldCom, Inc. – the compensation committee was never composed entirely of outside independent directors.

Global Crossing, Ltd – the compensation committee was always composed entirely of outside independent directors.

Discussion

Both Enron and Global Crossing had compensation committees that would have satisfied the reform. Although WorldCom did not satisfy the reform, the compensation committee was composed entirely of outside directors. Management directors did not serve on the compensation committee. One member of WorldCom's compensation committee was a party to the merger with MCI and would not be considered independent although he was not part of management. In all three companies, the compensation committees recommended large performance bonuses for their chief executive officer (CEO). These bonuses were based in large part on the attainment of targeted revenue goals in years that subsequently were determined to be grossly overstated by management.

The compensation committees failed to question the reported revenue figures upon which the CEO's performance bonuses were based, despite the fact that outside independent directors were serving on the committees. This reform clearly would not have prevented the CEOs of Enron, WorldCom, and/or Global Crossing from receiving large performance bonuses based on overstated revenue. SEC Commissioner Cynthia A. Glassman commented, "There is something wrong when managers achieve unthinkable riches, especially when the owners' investment disappears. A complete disconnect between performance and compensation is a stark red flag that something is wrong with the system." She continued by adding, "Executive compensation should not be a get rich quick scheme. Hopefully [companies hire] senior executives for the long term; and if that is the case, then the goal should be to compensate them fairly over the full term of their employment. As the shareholders' surrogate, [directors] should ask [them]selves whether the shareholders are getting their money's worth from executive pay, and whether [directors] are providing proper incentives for longer-term performance goals" (Glassman, 2003).

Reform. Listed companies must have a nominating committee composed entirely of outside independent directors

Rationale

It is the responsibility of the nominating committee to nominate individuals to serve on the company's board of directors. New director nominations is one of the board's most important functions. Placing this responsibility in the hands of an independent nominating committee increases the likelihood that chosen individuals will be more willing to act as advocates for the shareholders.

Actual governance structures

Enron Corp. – the nominating committee was never composed entirely of outside independent directors. The proportion ranged from 67 percent to 75 percent.

WorldCom, Inc. – the nominating committee was never composed entirely of outside independent directors. The proportion ranged from 50 percent to 75 percent.

Global Crossing, Ltd – the nominating committee was never composed entirely of outside independent directors. The proportion remained constant at 25 percent.

Discussion

While none of the three companies had nominating committees that would have satisfied this reform, all three had nominating committees that were composed entirely of outside directors. Management directors did not serve on any of the nominating committees. All three companies had "grey" directors (i.e. individuals who had special ties to the company such as retired executives, company consultants, and company bankers) serving on their nominating committees. However, the grey directors notwithstanding, both Enron and WorldCom did have a majority of outside independent directors serving on their compensation committees.

Despite the presence of these outside independent directors, it appears that the nominating committees failed to nominate individuals who were willing to act as advocates for the shareholders. Rather, individuals were chosen who appeared to follow the direction of the

CEO. This reform clearly would not have prevented management of Enron, WorldCom, and/or Global Crossing from placing individuals on their boards of directors who would not challenge management's decisions. SEC Commissioner Glassman stated, "A widespread sense has developed that the nomination process is not so much being run by the Board as dominated by powerful CEOs. At some companies, it appears that the CEO hires the Board instead of the Board hiring the CEO."

Reform. Shareholders must be given the opportunity to vote on all equity compensation plans

Rationale

Equity-compensation plans can help align shareholder and management interests, and equity-based awards are often very important components of employee compensation. An equity-compensation plan is a plan or other arrangement that provides for the delivery of equity securities (including options) of the listed company to any service provider as compensation for services.

Actual governance structures

Enron Corp. – shareholders had the opportunity to vote on all equity-compensation plans.

WorldCom, Inc. – shareholders had the opportunity to vote on all equity-compensation plans.

Global Crossing, Ltd – shareholders had the opportunity to vote on all equity-compensation plans.

Discussion

All three companies had policies in place that would have satisfied the requirements of this reform. This reform clearly would not have prevented the management of Enron, WorldCom, and/or Global Crossing from misstating the company's financial statements. However, this reform may have ancillary benefits for investors as noted by Dick Grasso, former Chairman and CEO of the NYSE. He stated, "Empowering America's 85 million investors by giving them greater voice in matters such as equity compensation is a critical element in increasing their confidence in the public companies they own and the equities markets in general" (Grasso, 2003).

Reform. Non-management directors of each company must meet at regularly scheduled executive sessions without management

Rationale

To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. Regular scheduling of such meetings is important not only to foster better communications among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions.

Actual governance structures

Enron Corp. – there was no provision for non-management directors to meet at regularly scheduled executive sessions without management.

WorldCom, Inc. – there was no provision for non-management directors to meet at regularly scheduled executive sessions without management.

Global Crossing, Ltd – there was no provision for non-management directors to meet at regularly scheduled executive sessions without management.

Discussion

All three companies did not have policies in place that would have satisfied the requirements of this reform. It is impossible to determine the impact this reform would have had on any of

Table I On compliance (indicates compliance with the new corporate governance reforms by Enron, WorldCom, and Global Crossing during the years of their corporate wrongdoings)

<i>Reform</i>	<i>Enron (years examined 1997-2000)</i>	<i>WorldCom (years examined 1999-2001)</i>	<i>Global Crossing (years examined 2000-2001)</i>
Majority of outside independent directors	Yes	No	No
Independent audit committee	No	No	No
Audit committee members must be financially literate and one must be a financial expert	No	No	Yes
Audit committee compensation	No	Yes	Yes
Audit committee authority	Yes	Yes	Yes
Independent compensation committee	Yes	No	Yes
Independent nominating committee	No	No	No
Equity-compensation plans	Yes	Yes	Yes
Non-management director executive sessions	No	No	No

the companies. However, this reform could have provided a forum for directors to express their concerns without fear of reprisal from management. David Nadler, chairman and CEO of Mercer Delta Consulting, cautioned, "Just because independent directors meet a couple of times a year without the CEO doesn't mean they're doing anything worthwhile" (Nadler and Nadler, 2003)

Conclusion

The corporate governance reforms are designed to do the following:

- Further the ability of honest and well-intentioned directors, officers, and employees of listed issuers to perform their functions effectively.
- Provide greater transparency regarding certain relationships that would preclude a board of directors from finding that an individual can serve as an independent director.
- Enhance investor confidence in listed companies.

Although none of the three companies examined had governance structures that would have satisfied all nine of the reforms, all had structures that would have satisfied some of them. Table I, on compliance, indicates that Global Crossing's governance structure would have satisfied five; Enron's, four; and WorldCom's, three.

Management and shareholders alike need to focus on the substance of the reforms and not merely the form in order to make meaningful improvements to corporate governance. The reforms in and of themselves should not be relied on to prevent future corporate scandals. They do, however, focus the spotlight directly on corporate boardrooms where shareholders can now insist that directors' interests be separate from those of the CEO and upper management. Only time will tell if the reforms will act to prevent management of the future Enrons, WorldComs, and Global Crossings from misstating their company's financial statements.

Federal Reserve Board Chairman Alan Greenspan said, "A change in behavior, however, may already be in train. The sharp decline in stock and bond prices after the collapse of Enron and WorldCom has chastened many of those responsible for questionable business practices. I hope that we will return to the earlier practices of firms competing for the reputation of having the most conservative and transparent set of books."

The new reforms will generally have taken effect with a company's first annual meeting occurring after January 15, 2004, but no later than October 31, 2004.

Note

1. Directors are typically placed into one of three categories: inside directors, affiliated outside directors also referred to as "grey" directors, and outside independent directors. Inside directors include corporate officers and their families. Grey directors are those who have substantial business

relationships with the company and include company retirees, the firm's investment bankers, commercial bankers that have made loans to the firm, the firm's legal counsel, consultants to the firm, officers and directors of the firm's suppliers and customers, and interlocking directors. Outside independent directors have no affiliation with the firm other than their seat on the board.

References

- Glassman, C. (2003), "Remarks on governance reforms and the role of directors before the National Association of Corporate Directors", Washington, DC, October 20, available at: www.sec.gov/news/speech/spch102003cag.htm
- Grasso, D. (2003), "Statement on SEC Approval of NYSE rules relating to shareholder approval and voting of proxies", June 30, available at: www.nyse.com/content/articles/1056810879893.html
- Greenspan, A. (2002), "Remarks by Chairman Alan Greenspan at the Stern School of Business, New York University, New York, NY", March 26, available at: www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm
- Greenspan, A. (2003), "Remarks by Chairman Alan Greenspan at the 2003 Conference on Bank Structure and Competition, Chicago, IL", May 8, available at: www.federalreserve.gov/boarddocs/speeches/2003/20030508/default.htm
- Hymowitz, C. and Lublin, J. (2003), "Corporate reform: the first year: boardrooms under renovation-scandals prompted changes, but critics say more are needed to prevent another Enron", *The Wall Street Journal*, available at: <http://global.factiva.com/en/arch/display.asp>
- Lavelle, L. (2002), "Commentary: how governance rules failed at Enron", *BusinessWeek Online*, January 21, available at: www.businessweek.com/print/magazine/content/02_03/b3766045.htm?mz
- Lorsch, J. (2003), "Making the grade: expectations on today's corporate boards", Corporate Board Member academic council supplement, *Emerging Trends in Corporate Governance*, available at: www.boardmember.com/network/acad_council03.pdf
- Nadler, D. and Nadler, M. (2003), "The hidden dangers of governance reform", *Directors & Boards*, Vol. 27 No. 3, p. 14, available at: www.directorsandboards.com/entrantz/article_of_the_week.html
- NYSSCPA.org News Staff (2002), "Corporate-Governance Bill weighed in wake of Enron collapse", New York State Society of CPAs, available at: www.nysscpa.org/home/2002/502/1week/article29.htm
- Norton, R. (2003), "How to find directors for the audit committee (and what to do if you're asked to sign on)", *Corporate Board Member*, March/April, available at: www.boardmember.com/issues/archive.pl?article_id=11377
- O'Kelly, E. (2003), "The changing roles of audit committees", *Directors Monthly*, Vol. 27 No. 11, pp. 1-4, available at: www.kpmg.com/aci/docs/directorsmonthly_nov03.pdf
- Securities and Exchange Commission (2003a), "NASD and NYSE rulemaking: relating to corporate governance", release no. 34-48745, Securities and Exchange Commission, Washington, DC, November 4, available at: www.sec.gov/rules/sro/34-48745.htm
- Securities and Exchange Commission (2003b), "Approval of AMEX proposed rule change", release no. 34-48863, Securities and Exchange Commission, Washington, DC, December 1, available at: www.amex.com/?href=/atamex/news/am_CorGov.htm
- United States Congress (2002), *Sarbanes-Oxley Act of 2002: 107th Congress of the United States of America: H.R. 3763*, Government Printing Office, Washington, DC.

Corresponding author

Steven T. Petra can be contacted at: actstp@hofstra.edu

To purchase reprints of this article please e-mail: reprints@emeraldinsight.com
Or visit our web site for further details: www.emeraldinsight.com/reprints