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RESEARCH TITLE

Does the corporate governance system solve failures problems?

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Abstract

This assignment explores the significance of corporate governance in contemporary times, with a focus on the Enron, WorldCom, and Royal Ahold scandals. It aims to identify the main factors behind these scandals and draw parallels to the Enron case. Additionally, the regulatory measures taken by the US and UK authorities to address corporate governance issues since the Enron scandal are examined, including the efficacy of measures such as role separation, performance evaluation, and board appointments in the UK. The effectiveness of the Sarbanes-Oxley Act of 2002, enacted in response to Enron, is also analyzed.

The assignment highlights the importance of corporate governance in ensuring long-term sustainability. It discusses the evolution of corporate governance systems and the efforts made to reform them in response to failures like Enron. The role of directors as monitors of management for shareholder benefit is emphasized, and the failure of non-executive directors in cases like Enron is identified as a crucial factor in corporate scandals. The assignment further analyzes the WorldCom and Royal Ahold cases, identifying key contributing factors to their failures.

In terms of regulation, the assignment explores measures implemented in the US and UK. It evaluates the effectiveness of initiatives such as role separation and board appointments in the UK. Additionally, it provides a comprehensive analysis of the Sarbanes-Oxley Act of 2002, assessing its effectiveness in addressing identified issues..

Based on the findings, the assignment offers recommendations for enhancing corporate governance practices. These recommendations may include strengthening the role of non-executive directors, improving internal audit functions, and implementing robust mechanisms for detecting unethical actions. The assignment emphasizes the continuous evaluation and enhancement of corporate governance systems to ensure the long-term safety and continuity of corporations.

Introduction:

Undoubtedly, the long-term sustainability of corporations necessitates a strict system of corporate governance, whereby the board of directors, shareholders, and top management collaborate as a unified entity to obtain the fundamental objective of ensuring the safety and continuity of the company. This involves the implementation of strategies to enhance the organization's functioning while considering the inclinations and aims of the board of directors and management team. In turn, both entities must acknowledge the expectations of the shareholders and strive to meet them.

In discussing the significance of corporate governance in contemporary times, it is pertinent to define the term itself. According to the Cadbury Code of 1992 (corporate governance is the system by which a company is directed and controlled.[1] Over the 20th century, corporate governance has undergone several changes, at many points and in many countries, both domestically and internationally. The inadequacies of the corporate governance systems in place raised efforts to reform and improve them, ultimately resulting in the adoption of a global corporate governance model. Furthermore, following the Enron scandal, state entities responded promptly to address corporate issues .[2]

In the US, Sarbanes–Oxley 2002 has made a fundamental change in market practice. Meanwhile, in the UK , smith and Higgs report was published as a response to the latest failure in 2003. Nevertheless, the first start or departure point in the UK was in 1992 with the Cadbury report, which developed the affair between the shareholders and the board of directors.

The report has since become a reference for many countries in addressing corporate issues. Nonetheless, the collapse of Enron transformed the expectations of corporate governance systems and became a cornerstone for authorities to ensure a thorough examination of the reasons behind the failure of this once-thriving enterprise. In essence, corporate governance systems examine the role of directors, who serve as monitors of management for the benefit of shareholders.[3]

Many factors were behind the Enron`failure, but one of the most important one was , the failure of non-executive directors to perform their duties. The non exective directors failed to control the function of the internal audit function, which lead to many fraudulent operations to take place inside the company .moreover, the committee did not bother to look for unethical actions that were taken within the institution ,also, the excessive control the CEO and the CFO had these factors led to the awful scandal .[4]

This assignment aims to analyze two well-known cases of corporate failure, namely WorldCom and Royal Ahold, to identify the main factors behind these scandals and draw parallels to the Enron scandal. The second part of the assignment will focus on the regulatory measures taken by the authorities in the United States and the United Kingdom to address the problem of corporate governance since the Enron scandal. This will include an examination of the efficacy of measures such as the separation of the roles of chairman and executive director ,the performance evaluation of directors, and the appointment of boards in the UK. Finally, the concluding part will provide a detailed analysis of the Sarbanes-Oxley Act of

[1] Definition of Corporate Governance , available online at http://www.applied-corporate-governance.com/definition-of-corporate-governance.html, accessed April 2, 2016.
[2] Jill Solomon & Aris Solomon , Corporate Governance and Accountability , Wiley,(2004)
[3] Bethany McLean, Peter Elkind , The Smartest Guys In The Room: The Amazing Rise And Scandalous Fall Of Enron,Portfolio,2013
[4] See note 3

2002, which was enacted in response to the Enron scandal, and its effectiveness in addressing the issues identified in the previous sections.

Royal Ahold failure:

The first example of corporate failure presented in this study is that of Ahold, which collapsed due to weak corporate governance and a failed strategy. While Ahold is not based in the United States or the United Kingdom, it is referred to as the "European Enron" due to similarities in the elements that led to its collapse. Ahold was a highly successful international retail grocery and food service company, that was managed by the Heijn family until 2001, when professional management took over. The Heijn family took all necessary steps to maintain control of Ahold, which resulted in the negation of shareholder power and the inability of the market to impose control on management. This, in turn, caused shareholders to lose almost all the return generated after Ahold's $ 66.6 billion profit in 2001. Similar to the Enron scandal, the collapse of Ahold was caused by a dominant CEO who received a long service contract and high remuneration, with poor relations with shareholders as a result. The supervisory board allowed van der Hoeven to serve as CEO and CFE simultaneously, which was considered unusual, and he was able to persuade the boards of any decision he took due to his new-found power .[5] Furthermore, due to his new position, Van der Hoeven had the power to appoint individuals who did not ask many questions and were content with overgenerous remuneration, which led to their actions being potentially detrimental to shareholders. This same issue was observed in both Enron and WorldCom corporations, where dominant CEOs had the power to control the appointment of directors and other senior executives, leading to a lack of accountability and oversight. This resulted in unethical practices that ultimately led to the collapse of these companies.

World com scandal:

The second case examined in this assignment is the collapse of WorldCom, a telecommunications company that was involved in one of the largest accounting frauds in US history.[6] The primary reason for this disaster was the excessive control exercised by CEO Ebbers and CFO Scott over the company, including the board of directors, audit committee, and compensation committee..[7] These committees became rubber stamps for the CEOs and CFOs, instead of performing their duty to prevent or curb any unacceptable conduct that may have been issued by them . However, the real problem with worldcom was the accounting misstatement that concealed the risky financial condition of the corporation ,The(report of investigation) describes the accounting trickeries that were used by ECO as " as enormous as the fraud was, it was accomplished in a relatively mundane way: more than $9 billion in false or unsupported accounting entries were made in WorldCom's financial systems to achieve desired reported financial results."[8] This is similar to the Enron case, where misrepresentation of profit reports and misappropriation of funds resulted in the corporation going bankrupt. The reasons behind this were the acquisition-focused strategy of the CEOs, using the stock of WorldCom to achieve enormous increases, as well as the desire of CEO Ebbers to build his empire.

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[5] S. Hamilton, A. Micklethwait , **Greed and Corporate Failure: The Lessons from Recent Disasters** Springer .

[6] ***Theodore F. di Stefan , (2005) WorldCom's Failure: Why Did It Happen? Available at [http://www.ecommercetimes.com/story/45542.html,](http://www.ecommercetimes.com/story/45542.html)accessed Mar.d 25, 2016 .***

6. Dick Thornburgh, 2004 A Crisis in Corporate Governance? The WorldCom Experience," available at http://www.klgates.com/files/Publication/5ca1eda3-acd7-47e1-9431-Presentation/PublicationAttachment, accessed on March 28, 2016.

[8] See note 5

It is evident that the corporate governance failures and strategic blunders that led to the collapse of two prominent companies, Ahold and WorldCom, share similarities with the Enron scandal. Ahold, a successful international retail grocery and food service company, was controlled by the Heijn family until professional management took over in 2001. However, this led to a negation of shareholder power and control, resulting in a loss of shareholder return after a 66.6 billion profit was achieved. Similarly, WorldCom, a telecommunications company, experienced one of the largest accounting frauds in US history due to the over-control of the CEO and CFO, who had unlimited power over the board of directors, compensation committee, and audit. This led to accounting misstatements and the concealment of the company's risky financial condition .[9] In both cases, the lack of objectivity in choosing board members and the dominance of CEOs over the company led to failures in corporate governance. Additionally, the lack of transparency between the board of directors and top management further contributed to this problem. The collapse of these companies could have been prevented if proper corporate governance practices had been followed, including the separation of the roles of chairman and executive director, effective evaluation of performance, and the appointment of independent and objective board members

The role of the stock exchange in shaping corporate governance.

As mentioned above corporate governance is the system by which companies are controlled and directed. Thus, the stock exchanges are playing a vital role in CG which was in the first place as encouragement of CG recommendations. However, according to the SEBI committee, the exchange rules are to maximize the shareholder wealth and take into account the interest of the stakeholders.[10]

Another way that stock exchanges can shape corporate governance is through the promotion of shareholder activism. Shareholders can use their voting rights to influence the decisions of the board of directors and hold them accountable for their actions. Stock exchanges may provide platforms or mechanisms for shareholders to exercise these rights, such as electronic voting systems or shareholder forums.[11]

Therefore, the stock can grant a platform for corporations to increase their fund as well as provide a guideline for companies in order to protect the shareholders' interest from mistakes or bad fits on the boards of directors or their representatives.[12]

In conclusion, stock exchanges play a crucial role in shaping corporate governance by promoting and enforcing best practices, establishing regulations and requirements for listed companies, and providing a platform for shareholder activism. By doing so, they can help to improve the overall health and stability of the companies they regulate, which ultimately benefits shareholders, others stakeholders, and the wider economy.

The UK Corporate Governance Code, formerly known as the Combined Code, was first introduced in 1992 and has been revised several times since then. The Code sets out principles of good corporate governance for companies to follow, and since Enron`s failure, the UK code and Sarbanes-Oxley US, both strived to tackle the problems related to the overcontrol of the people who run the company. Thus, the UK code contains some principles

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[9] See note 6

[10] Sabarnee ,Role of stock exchange in corporate governance . 2014 , available/http://corporatelawreporter.com/2014/05/21/role-stock-exchange-corporate-governance/ accessed 5April 2016 .

[11] **Llive , lins, Miller and Roth,2015 ,** Shareholder Voting and Corporate Governance Around the World, JOURNAL ARTICLE,28(8)pp 2167-2202 available at : https://www.jstor.org/stable/24466876 >

[12] Ibid.

that companies should take into account.UK corporate code.

Splitting the roles of chairman and chief executive:

For a company to be successful, good governance is fundamental, and the board plays a central role in achieving this .[13] However, it's important to ensure that power is balanced within the board so that no one individual can dominate decision-making. One way to achieve this is by separating the roles of chairman and chief executive.[14] This point was emphasized or stipulated in the UK code in sections A.2, 1. This separation of responsibilities at the top of the company ensures a balance of power and authority, leading to more effective monitoring of the company's operations. This principle is a strong indicator of good corporate governance in the UK. In contrast, in the US, the CEO often holds both the CEO and chairman roles, leading to limited board efficiency due to the CEO's ultimate decision-making power.

Another fundamental part of corporate governance is appointing a non-executive director to become a senior independent director , who is responsible for helping and supporting the members of the board of directors as well as being the link between the shareholders and the chairman when they are unable to communicate with him through normal channels. and act as a sounding board for the chairman. The SID should be available to assist other board members and be a point of contact for shareholders who are unable to communicate with the chairman through normal channels. This aspect is confirmed in Section A.4.2 of the UK Corporate Governance Code .[15]

The appointment of the board of directors under the UK corporate code:

When talking about the UK corporate code, it is worth mentioning the standards of integrity and transparency set by the code when it comes to appointing a new board of directors of companies, so that everyone is equal in opportunities when relying on the elements of experience and skills as well as the diversity, including gender, as a basis for choice to secure advanced refreshing of the board of directors ,therefore, the board ought to ensure itself that the places are set up for precise progression for appointment to the board and top management, moreover, a nomination committee will be the leader of this process for choosing the boards as well as making a recommendation to them in Section B.2.1 / B.2.2 of the UK corporate code.[16] It's also important to note that, with the appointment of a non-executive director who has the right to be reelected, the criteria of progressive refreshing must be followed.

The appointment of non-executive directors must follow the principles of progressive refreshing of the board. Therefore, in order to keep the board of directors abreast of new ideas and talents and fully prepared to take decisions that contribute to the success of the institution, any non-executive director who has served more than six years must undergo a rigorous review to ensure the balance and long-term effectiveness of the company.[17]

The evaluation of the performance of directors under The UK code.

It should be noticed that, to guarantee a perfect performance of the board, the annual assessment is the right way and it is formal and rigorous, therefore, the evaluation must contain many criteria such as skills and experience, independence, gender, and should evaluate the performance of the board as UNI. Hence, the chairman should recognize the

[13] See note 3
[14] ibid
[15] The UK corporate governance code Act 2014.
[16] ibid
[17] Ibid.

strong side of his board and deal with the weakness of the board.

The evaluation should be externally facilitated every three years at least and the senior of non-executive director must be responsible for assessing the performance of the chairman taking into account the opinion of the executive director, section B6.1, 2, 3 of the UK corporate code.[18] In addition, the transparency plays a vital role in the CG which represented of the disclosure of the information that must be given from the company and via ensuring this standard of disclosure the shareholders could monitor the corporation management" The accounting function is an essential aspect of a well-functioning corporate governance system."[19] At this point both the UK and USA adopted transparency as a principle, but, the difference was in the sanction for the company failure to disclose.

The general duty of the board of directors:

The Companies Act 2006 outlines the general duties of the board of directors, which are essential to the success of the company and must be followed to avoid situations like the Enron collapse. These duties include acting within the powers conferred by the company's constitution, promoting the success of the company for the benefit of its shareholders, exercising independent judgment, and avoiding conflicts of interest. The directors must also exercise reasonable care, skill, and diligence, and disclose any interest in a proposed transaction or arrangement with the corporation. These obligations are considered fiduciary obligations, which means that the director may be liable to the corporation for any breach of these duties. If a breach occurs, the director may be required to restore the property and account for any lost profitability. However, any breach of the duty of care, skill, or diligence ,would cost the companies a fair amount to compensate for this breach.[20]

The Sarbanes Oxley Act:

The Sarbanes Oxley Act (SOX) was enacted after Enron, WorldCom, and Tyco failed to address problems with corporate governance, financial reporting, and fraud. SOX has five main goals, which are to strengthen the independence of auditing firms, improve the quality and transparency of financial statements and corporate disclosure, enhance corporate governance, improve the objectivity of research, and strengthen the enforcement of federal securities laws. It is considered one of the most successful pieces of legislation to come out of the failures of Enron and other companies.[21]

Additionally, SOX corrected the regulatory system for public accounting and auditing.

SOX has also been provided with a guide on improving corporate governance. In addition, it enforced two main investor protection areas: (1) CEO and CFO accountability and responsibility for all financial disclosures and controls, and (2) increased professionalism and involvement of corporate audit committees."[2]

However, the SOX has addressed the shareholders' trust issue and fraud by reforming public companies and reviewing reporting standards. Nonetheless, this change has been applied broadly and deeply, with many provisions like Section 302, which requires CEOs and CFOs to certify internal controls are efficient and Write a report detailing how both the auditors and the audit committee failed to do their jobs.

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[18] See note 9.
[19] See note
[20] Alasdair Steele & Rosie Graham , Corporate Governance and Directors' Duties 2010 ,UK (England and Wales)available online / http://www.nabarro.com/downloads/corporate_governance_directors_duties_uk_handbook.pdf accessed 4 April 2016.
[21] Gregory Jackson, Understanding Corporate Governance in the United States,2010 .

In addition, SOX made an aggregate correction to the regulatory system for public accounting as well as auditing profession. Furthermore, SOX has been provided with a guide for reinforced or strong corporate governance.[22]Also, it worked in the enforcement of two main areas in investor protection," (1) CEO and CFO responsibility and accountability for all financial disclosures and related controls, and (2) increased professionalism and engagement on the part of corporate audit committees."[23]However, by reforming the public, companies and re-examining the reporting standards, the SOX addressed the shareholders' trust problem and fraud. On the other hand, this change has been taken deep and wide and is represented by many provisions, such as Section 302, which requires the CEO and CFO to certify the efficiency of internal controls as well as write a report in terms of failing both the auditors and the board audit committee in doing their jobs.[24] Also, Section 404, which indicated the importance of the internal report that public companies must make with their yearly audit and such a procedure that was required by this law led to increasing the disclosure level. Hence, monitoring public companies, and their accounting is a duty of the oversight board, which also works with the SEC. However, the accounting companies should review one to three years. Notwithstanding the board's checks, the accounting company has the responsibility for its audit .[25] Also SOX has reduced the degree of earning management through the independence of the auditors and increased the ability of the CEO and CFO.

Conclusion:

In conclusion, this assignment has provided a comprehensive analysis of the reasons behind corporate scandals and the reforms implemented by the UK and US authorities to prevent future failures. Through examining the Enron scandal and other high-profile company failures, it is evident that weak corporate governance systems and the abuse of power by boards of directors have played a significant role in such scandals. The UK corporate code and the Sarbanes-Oxley Act were introduced to address these issues and improve corporate transparency, governance, and accountability.

The UK corporate code focused on splitting the roles of chairman and chief executive, appointing independent directors, and establishing general duties that boards of directors must obey. On the other hand, the Sarbanes-Oxley Act aimed to strengthen the independence of auditing firms, improve financial statements and corporate disclosures, enhance corporate governance, improve the objectivity of research, and enforce federal securities laws, including the use of criminal penalties. It also made CEOs and CFOs responsible for the accuracy of financial statements, which has reduced the incidence of corporate fraud.

In the researcher's opinion, the Sarbanes-Oxley Act is stronger than the UK corporate code because it established stricter criminal penalties for misrepresenting information, while the UK adopted a compliance and explain approach, which only imposes civil sanctions. Overall, these reforms have been effective in addressing the weaknesses of corporate governance systems and have played a significant role in preventing future corporate scandals.

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[22] Curtis C. Verschoor ,(2012) **Has SOX Been Successful? Available onlion at http://www.accountingweb.com/practice/practice-excellence/has-sox-been-successful**

[23] Ibid.

[24] See note 9

[25] Jeremy Slaughter, Demand Media, The Impact of the Sarbanes-Oxley Act on American Businesses , available online at http://smallbusiness.chron.com/impact-sarbanes-oxley-act-american-businesses-1547.html, accessed on April 2, 2016.

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