

Roll No.

Duration : 3 Hrs.

Marks : 60

BECG 04

Notes:

1. Question 1 is compulsory and carries 30 marks.
2. Answer any two questions from the remaining three.
Each of these carry 15 marks
3. Answers to be precise, concise and legible.

Total No. of Questions : 4

Total No. of Printed Pages : 5

Read the Case given below and answer the Questions that follow

ENRON - ATTEMPTS AT CORRECTING THE WRONG

Enron brings to mind the collapse of the seventh largest company in the United States of America and the largest bankruptcy seen by the country till date. Its stock was valued at \$90 per share in 2001 and is worth almost nothing at the end of the same year. The downward spiral that began since Enron's accounting fraud was exposed affected all their shareholders and employees. Billions of dollars were lost and thousands of jobs were mislaid. Following this debacle, the US authorities have analyzed the situation and have attempted at undoing the wrong in a variety of ways. We will summarize the efforts made by the US authorities in rectifying the discrepancies in the regulations of business practices in corporate America. We will take a look at the crucial Sarbanes-Oxley Act of 2002 that was conceived and implemented following the Enron disaster and the reforms presented by the New York Stock Exchange and the NASDAQ. Finally we will take a closer look at the involvement of the board of directors of public companies to comply with corporate governance procedures after the debacle of Enron.

WHAT WENT WRONG WITH ENRON?

Enron managed to hide millions in dollars in debt and losses through unlawful accounting practices. They hid these losses under their many subsidiaries, often in foreign countries. In event of the fraud being exposed, Enron's stock crashed but few of the management members managed to bail themselves out by selling the stock when it was still at a high. The investors and employees were left high and dry to face the loss of their investment, pension and retirement amounts. There are many criminal investigations and cases registered for Enron executives. These executives have been known to receive hefty bonuses just before the collapse of Enron. Other accounting scandals like WorldCom and Xerox were brought to light further reducing public confidence in corporate investment. There are many issues that were raised with the collapse of Enron as described in the CRS Report for the Congress in 2002:

- **Auditing** - There may have been a possibility that the auditors were misled into preparing the wrong financials for the company. Often companies pay more to auditors for non-audit fees than for audit fees, which may bring the auditors to compromise their standards.

- **Accounting** - There are several questionable accounting techniques like subsidiary accounting, derivatives and third party investors used by Enron. The loopholes in the accounting system need to be rectified.
- **Pension** - More than 60% of the assets held in the 401(k) plan consisted of Enron stock, which when plummeted put stockholders and employees in huge losses and setbacks. Such grave scenarios need to be avoided in the future.
- **Corporate Governance** - The board of directors is meant to protect the interest of the shareholders. In Enron's case the CFO was allowed to create private partnerships to deal with the company which is against the best interest of the company.
- **LLP Formation** - The ease with which general partnerships can be converted to limited liability partnerships in the US by filing the requisite paperwork with the state department can lead to additional Enron-like disasters.
- **Securities Analyst** - The creditability of analysts came under question following the collapse of Enron stock in November 2001 as even the Wall Street analysts failed to predict the Enron disaster.
- **Banking** - J.P. Morgan and Citigroup have both suffered due to their involvement as investment banks and commercial banks for Enron. The reputation of banks is often at stake in events like an Enron collapse.

CORPORATE GOVERNANCE ENHANCEMENTS FOLLOWING ENRON

Having covered the major issues that require rectification following Enron, we will now take a closer look at the corporate governance regulations that were improvised in the wake of the destruction left by the former energy giant.

SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act is meant to bring accuracy and reliability of corporate disclosures by requiring certifications done to the quarterly and annual reports by the chief executive and financial officers. The Sarbanes-Oxley Act was enforced in July 2002 following a series of high profile accounting scandals. For all financial statements that were to be filed deadlines were provided to comply with the provisions highlighted in the act. There are 11 components to the Sarbanes- Oxley Act of 2002 and they are as follows along with a brief idea of the issues they address, as described by PriceWaterhouseCoopers:

1. **Public Company Accounting** - Registrations with board, auditing procedures, public accounting firms, accounting standards, funding, etc.
2. **Auditor Independence** - Conflict of interest, audit partner rotation, commission authority, etc.
3. **Corporate Responsibility** - Fair funding for investors, audit committees, financial reports, conduction of audits, etc.
4. **Enhanced Financial Disclosures** - Periodic reporting, transactions involving management and principal stockholders, code of ethics, exemptions, etc.
5. **Analyst Conflict of Interest** - Treatment and appointment of security analyst

6. Commission Resources and Authority - Authorization of appropriations, appearance and practice before the commission, etc.
7. Studies and Reports - Study of investment banks, violators and violations, enforcement actions, etc.
8. Corporate and Criminal Fraud Accountability - Criminal penalties, protection of employees, security fraud, etc.
9. White Collar Crime Penalty - Criminal fraud offenses, corporate responsibility, criminal penalties, etc.
10. Corporate Tax Return - Signing of corporate tax return by chief executives
11. Corporate Fraud and Accountability - Tampering with records, persons serving as officers or directors, increased criminal penalties, etc.

We see here that most of these issues are under the light of the Enron scandal. This act was a major move by the authorities and its enforcement and execution is causing companies a great deal of grief; however SEC has been known to give extensions for the deadlines.

NEW YORK STOCK EXCHANGE AND NASDAQ PROVISIONS

The NYSE and NASDAQ require that companies comply with the new listing standards that are approved by the US Securities and Exchange Commission (SEC). For this purpose all companies to be listed require an internal audit function and this is meant to increase governance of listed companies. The approved provisions under the corporate governance reforms by NYSE and NSADAQ though similar to the Sarbanes-Oxley Act of 2002 cover the following grounds:

- Majority directors must be independent
- Empowerment of Independent Directors
- Strengthen the Audit Committee
- Internal Audit Function
- Annual Meeting Calendars
- Codes of Conduct
- Corporate Governance Guidance
- New CEO Certification Responsibilities
- New Penalty Regime
- Prescribed Timeline

ROLE OF BOARD OF DIRECTORS

According to a special investigation report for the role of board of directors in Enron, it was found that the a few directors heavily profited from the debacle of Enron and were in compromise of the professional and ethical standards expected in corporate America.

For this reason there were reforms conducted for the board of directors of companies.

The board of directors is responsible for protecting the interest of the shareholders. When the board makes decisions they adversely affect the company and they also affect the shareholders and company employees. Here is what the board of directors must comply with following the Enron scandal and the Sarbanes-Oxley act of 2002:

- Restructure the directors and audit committees so that the requirements in the Sarbanes-Oxley Act of 2002 are met.
- Study the revised corporate governance policies and ensure that the same are met in the best possible way.
- Make certain that the role of any company player does not bring conflict of interest to the company policies and actions
- Make sure that the management performance and compensation does not compromise the interest of the company.
- Give shareholders direct input to the corporate governance measures in place in the company.
- Educate board members of the responsibility they have towards the shareholders.

It is recommended that having a majority of truly independent directors can benefit the organization and its performance in the CPA Journal of March 2004. A director may not have any material relationship with a company that compromises the independence clause. Both the NYSE and NASDAQ recommend the same measures regarding the board of directors.

We thus see that the Enron debacle was an eye opener for corporate America and brought about accounting reforms, audit committee changes, board of directors' regulations, security analyst recommendations, etc. The Sarbanes-Oxley Act of 2002 led in the implementation of changes following Enron. New York Stock Exchange and NASDAQ underwent reform for listed companies which were approved by the Securities and Exchange Commission.

Now a major public relations drive is underway to mend the reputations of disgraced banks and accounting firms. The invaluable lessons from Enron have humbled corporate America to bring reforms to improvise upon the past. Hopefully it will be able to keep such scandals from erupting again and ensure the protection of the investors and the employees that are disconnected from the management and the board of directors in large organizations. Enron, WorldCom and Xerox are the past - Sarbanes-Oxley, NYSE and NASDAQ reforms are the future.

Questions

- (a) Give an account of what went wrong at ENRON which led to its collapse. (10 marks)
- (b) What were the major changes in Corporate Governance regulations as a result of the ENRON debacle (10 marks)

- (c) Give the NASDAQ provisions as well as the role of Board of Directors as a result of the reforms in the aftermath of the ENRON collapse (Sarbanes Oxley Act of 2002). (10 marks)

Q2. Differentiate clearly between the terms "Ethics", "Morals" and "Values". What is the need for Ethics in an Organization? How is ethics nurtured and practiced in Organizations? Give examples to repudiate your claim. (15 marks)

Q3. Give the broad guidelines for duties of the Board of Directors of an Organization in terms of their powers and responsibilities. Also, give out some of the major recommendations of the Kumaramangalam Birla Committee report on Corporate Governance pertaining to the formation of the Board (15 marks)

Q4. What do you understand by the term "Corporate responsibility towards stakeholders"? How do you feel Organizations are trying to achieve this? Discuss giving examples. (15 marks)

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