

We are IntechOpen, the world's leading publisher of Open Access books Built by scientists, for scientists

6,900

Open access books available

185,000

International authors and editors

200M

Downloads

Our authors are among the

154

Countries delivered to

TOP 1%

most cited scientists

12.2%

Contributors from top 500 universities



WEB OF SCIENCE™

Selection of our books indexed in the Book Citation Index
in Web of Science™ Core Collection (BKCI)

Interested in publishing with us?
Contact book.department@intechopen.com

Numbers displayed above are based on latest data collected.
For more information visit www.intechopen.com



Corporate Governance

Alla Mostepaniuk

Additional information is available at the end of the chapter

<http://dx.doi.org/10.5772/intechopen.69704>

Abstract

The following chapter identifies the meaning and main features of corporate governance, underlines the importance of an entity, which regulates and balances the interests of shareholders, stakeholders, and managers in order to realize a corporation's long-run goals. Currently, all models of corporate governance can be divided by their characteristics into three types: Anglo-American, German, and Japanese; each of these models has some unique elements that are required by a particular country. The process of forming and development of corporate governance in transitional economies are described as well. As the accuracy of corporate government influences the wiliness of investors to sink their capital, it is crucial to understand the methods of corporate governance efficiency evaluation by international rating agencies. Moreover, the example of Enron Corporation's failure shows the exceptional role of corporate governance in protecting and ensuring the rights of shareholders and stakeholders, solving the conflict between managers seeking higher bonuses and investors' goals on stable future return and potential growth.

Chapter objectives

- To investigate the nature of conflicts of interest as a precondition of formation of corporate governance.
- To identify the meaning and main principles of corporate governance.
- To study and clarify the key players of corporate governance and their roles.
- To get acquainted with different models of corporate governance and compare their structures and principles of coordination between their elements.
- To specify the features of corporate governance within transition economies and potential limitations on its further development.
- To study the principles and techniques of evaluation the corporate governance efficiency used by international agencies.
- To investigate the failure of Enron's corporate governance.

Methodology

Historical and descriptive methods, including critical review of existing scientific literature, were used to meet the objectives of the chapter; in addition, case study on Enron's corporate governance was introduced. Based on learning the current situation of corporate governance development within advanced and transitional countries, their potential failures and constraints, the crucial contemporary issues were identified and suggested the ways to minimize or eliminate them.

Keywords: corporations, managers, shareholders, stakeholders, corporate governance, conflict of interests, the agency theory, Enron

1. Introduction

Corporations are the key players in the global economic environment; corporations are the main source of a country's economic growth, and the most attractive business deal to invest in. To maintain and increase the profitability of corporations and to enlarge the investments flows, it is crucial to ensure the total understanding of the owners', investors', and managers' interests and to find a way to balance them. All this is about corporate governance and the ways in which investors assure themselves of getting a return on the finance [1]. Corporate governance framework identifies how investors control the manager's actions, how the responsibilities are divided between owners and managers. Adequate system of corporate governance allows the suppliers of finance to relay on managers, to realize that the manager has reliable internal and external sources of information based on which he is able to make rational decisions for their mutual interests.

In general, corporate governance is a complex process that involves organizational, legal, economic, motivational, and social tools, the combination of which provides the unique working environment that allows to minimize costs by reducing the gap between managers' and owners' interests [1]. The well-organized corporate governance is not limited by managers' and owners' goals; it has to include the interests of investors, suppliers, consumers, workers, representatives of a local community, and government officers, as the financial success of a corporation depends on the satisfaction all of its chains.

However, dealing with numerous involved participations leads to a potential conflict of interest; consequently, the key objective of corporate governance is to minimize or eliminate the mentioned conflict.

2. The nature of conflicts of interest

According to the agency theory (see **Figure 1**), an agency relationship can be described as hiring a person (the agent, a manager) to perform and to make decisions on behalf of the principal(s) (owners and shareholders) [2]. The reason why the owner is not operating the business by himself is his wiliness to hire a professional, which will act in the most efficient

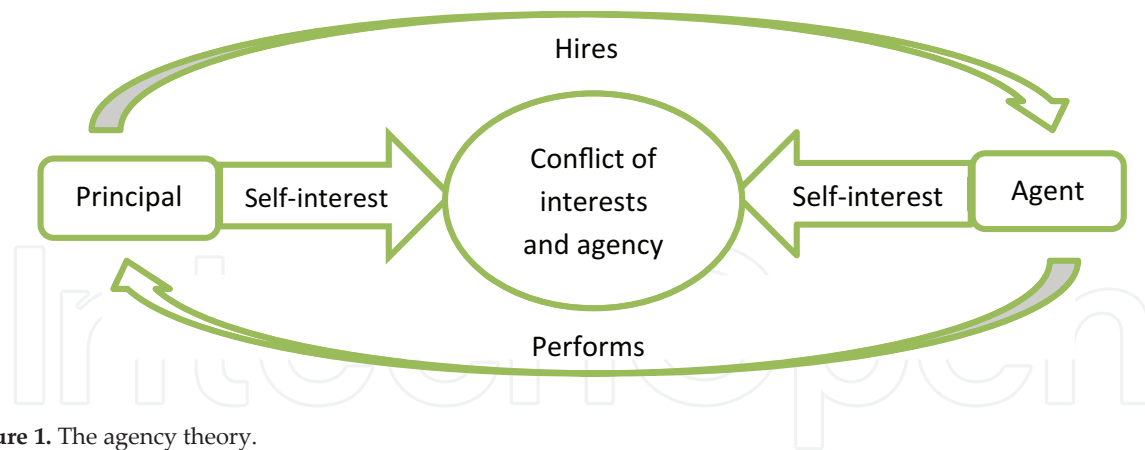


Figure 1. The agency theory.

way to improve the owner's welfare. In practice, this kind of delegation of managing tasks is rational as a manager has more sources of information. Moreover, as the owner and the manager have different information (asymmetric information), the actions made by the manager cannot be fully supported by the owner. If both participants (the owner and the manager) are aiming mostly at their self-interest, there is a possibility that the agent will not act in the best interest of the principal (according to his information).

The principal can limit the willingness of the agent to follow his goals by implementing the appropriate incentives for the agent and monitoring to prevent abnormal activities. Monitoring can be fulfilled in a form of budget constraints, compensation policies, operation rules, etc., and leads to an increase in costs. The bonding costs guarantee that the agent will not make decisions that can harm the principal; otherwise, he will compensate the loss. According to the theory, it is impossible to balance the self-interests of the principal and the agent costless; in each case, positive agency costs will occur, including monitoring, bonding, and residual loss, the last can be described as the difference between the agent's decisions and those decisions that would maximize the principal's benefits [2].

2.1. Discussion

As the agency relationships model is suitable for corporations, it demonstrates the essential need of corporate governance to cope with conflicts of interests. The conflict of interests, as a rule, arises as the goals of shareholders and managers contrast, generally, shareholders seek the stable and ensured return and long-term potential growth, while the aim of managers is to increase the financial performance in the short-time period in order to earn bonuses, which normally depend on the financial results rather than overall stability and reliability. The misuse of the bonus system can lead to either financial or reputational losses, even to "hidden" bankruptcy.

3. Key corporate actors and their roles

Since corporations have more than two involved participants (the principal and the agent), the issues on conflicts of interests, finding, and fulfillment of the mutual goals are more complicated.

There are three key players in a corporation: the board of directors, management, and shareholders. The mission of the board of directors is to select a chief executive officer (CEO), to monitor and evaluate the CEO's performance and planning process, to delegate the responsibilities, and making decisions rights to the CEO. Management directed by the CEO is responsible for setting and following a company's strategy, strategic planning, risk management, and financial reporting to the board. Shareholders supply their finance by buying a corporation's stock and receive some financial return, shareholders do not participate in day-to-day management, but they have a right to elect a representative to the board and to be informed on business decisions [3].

As a rule, corporations have obligations to stakeholders, including employees, suppliers, communities, and environments where a corporation operates, and government. Consequently, the board of directors should know who are their stakeholders, what do they know about business, and what do they expect. Generally, the representatives of management act the role of a spokesman to engage stakeholders, to inform them, to share and examine their proposals on business activities, to invite to meetings, to provide a dialog, etc. Employees are the key capital for any business; fair and proper treatment of staff is critical for any corporation; it is essential to develop and follow a policy regarding employees' regulation, compensation practices, providing social insurance, etc. Corporations should implement a mechanism for employees to inform managers about possible or occurred misconducts without fearing to be dismissed. In addition, a corporation has to be a good citizen of the local, regional, or national community where the company operates, to be responsible for environment and sustainability of the business that can bring short-run benefits as well as long-run. Being economic, social, and environmentally sustainable encourages new stakeholders to participate and helps to build a "sustainable" image of the company. Corporations, like all citizens, should obey the existing legal rules and regulations, to protect its stakeholders and ensure the further development based on a transparent way of doing business [3].

4. Principles of corporate governance

The term "corporate governance" can be defined in various ways, but still it keeps common characteristics, regarding the implementation of appropriate system of corporate governance to business; it is necessary to follow formal rules and guidance, specifically for emerging and developing economies that only start realization of innovative methods of management. For that reason, some international organizations provided the guidance on corporate governance that identifies the relationship between shareholders and stakeholders, the requirements on transparency and accessibility of information on a corporation's performance, the distribution and interdependence of responsibilities of officers at different levels of management and other issues on corporate governance [4–6].

Principle #1: Providing the foundation for a corporate governance framework

- To establish the corporate governance framework in accordance with current legal and socioeconomic systems, to ensure and encourage companies to perform transparent and in a social efficient way.

- To provide a clear division of rights and responsibilities of representatives of the public sector and to avoid double control or contradicting regulations.
- To specify the procedure and mechanism of governmental and public control, and the methods of reporting, informing, and communication to avoid confusion.

Principle #2: The rights of shareholders

- Shareholders have a right to guarantee the methods of ownership protection, transfer their shares, to be informed on the corporation's decisions and performance on a specified basis, to join and vote on the general meetings, elect and dismiss the members of the board, to share in the net profit of a corporation, etc.

Principle #3: The equal treatment of shareholders

- Minority shareholders should be protected from the leading and dominance of controlling shareholders, forcing in a direct or hidden way to vote for their personal interest rather than mutual goals.
- The voting procedure should be explained and clarified clearly to all shareholders, to prevent the misuse of the system.
- Members of the board and key officers should inform the board about any personal benefit that can be obtained from any transaction that affects the performance of a corporation.

Principle #4: The rights of stakeholders

- All stakeholders' rights should be protected by the law; stakeholders should have an access to the information that is required for their performance.
- All stakeholders and their representatives should know the procedure of communication and reporting the board regarding the potential and existing illegal or unethical decisions, rights violation, and other concerns.

Principle #5: Transparency

- Transparency and accessibility should be provided to the information on a company's financial and operational performance and results, key company's goals and interests, major and minor shareholders, voting and selecting policies, potential risks, concerns regarding stakeholders, a corporate governance framework and structure.
- It is required to run an annual audit by an independent and competent auditor to provide the external information on financial efficiency and to ensure that the existing internal reports are reliable and can be used for evaluating future benefits and estimating potential risks.

Principle #6: The responsibilities of the board

- The board should perform in the best interest of the company and shareholders; the board should fairly take into account the interests of all shareholders regardless of the size of their shares.

- The board is responsible for creating, following, and improving, if needed, the corporate strategy, long-term plans, risk policy, budgeting and financial planning, monitoring and evaluation of the company's performance, overseeing potential emerges, acquisitions, and capital expenditures.
- The board's functions are electing and replacing, guiding and monitoring the CEO activities.
- The board members should identify and eliminate the possible conflict of interest of the board members, top managers, shareholders, and stakeholders as well as issues on misuse of corporate assets.

4.1. Discussion

All the abovementioned principles are required for efficient performance of corporate governance, transparent mechanism of cooperation, and interactions of all participants of corporate governance as shareholders, managers, and stakeholders. At the same time, some issues on implementing those principles can appear in countries with developing or transitional economies, as an uncompleted and still-forming legal system of a country that consists of contradicting rules on corporate governance or even does not include any. As a rule, there are some "gray" gaps (uncertain regulation norms) in the legislation of those countries that are suitable for unfair managers to misuse the current law, that, in turn, makes difficult to develop an efficient corporate governance framework. The solution can be found only in a steady improvement of the legislation in accordance to vital needs of corporations rather than politically beneficial changes.

5. Models of corporate governance

Historical circumstances, social, legal, and economic conditions form a specific model of corporate governance in each country, and those models vary in participants, legal framework, reporting systems, etc. According to some common features, all models can be divided into three types: Anglo-American, German (Western European), and Japanese.

Anglo-American model, called sometimes as an outsider model, is characterized by heavy sparsity of the capital and a tendency to increase in outsider shareholders, which are not connected to the corporation. The model is market-oriented and aiming at the exceptional satisfaction of shareholders' interests. As in an outsider model, there are a huge number of shareholders with tiny shares, and mostly the decisions are made by the manager.

Japanese and German models can be called as insider models, as the ownership rights are distributed among insider participants, which are somehow connected to the corporation, and own relatively big shares. Consequently, the relationships between shareholders are extremely important; the main goal for the insider model is not only to maximize the shareholders' benefit but also to maximize the welfare of other stakeholders.

However, the existence of different models of corporate governance does not solve the underlying issues on ensuring financial return on investments, the conflict between long-run and short-run interests, between management and directors, between different business strategies of investors, etc.

5.1. Anglo-American model

Anglo-American model is used in the United Kingdom, the United States of America, Canada, Australia, New Zealand, etc., and characterized by the absence of dominant shareholders; the share capital is divided between numerous participants with the average share around 2–5%; consequently, no one can demand the special rights or privileges among shareholders. Additionally, the majority of shares belongs to institutional investors as mutual and pension funds; this type of shareholders plays the role of financial managers, which do not want to be presented in the board and, as a rule, do not take any responsibility for the overall efficiency. The continuous change among shareholders is common for this model, as owning a small share makes the selling process easier, comparing to the owning of a significant share. Thus, the American and English stock markets are well known for their high intensity and liquidity [7–9].

The board of directors' functions are:

1. election of board members,
2. appointment and evaluation of a CEO's activities,
3. evaluation of a current company's strategy,
4. evaluation of financial performance and distribution of its funds,
5. ensuring the legacy of corporation's activities,
6. monitoring the fulfillment of company's obligations, etc.

5.1.1. Discussion

One of the features of the model (see **Figure 2**) is the limited influence of shareholders as they own small shares; they have a right to vote for changes in a corporation's charter, to select and dismiss auditors and directors, which operate the company on behalf of shareholders (owners), to agree strategic decisions as merging and acquisition. Moreover, they do not have a right to select or dismiss a CEO and influence on operating activities of a company.

The existence of the board of directors is a key for this model of corporate governance, as the board is selected by all shareholders and represents the shareholders' interests. As a rule, the board consists of insiders and outsiders; an insider is a person who works in a corporation or connected to management of a company; an outsider is a person or an organization that is not related to a company and invited to provide specific functions; an outsider does not seek any personal benefit.

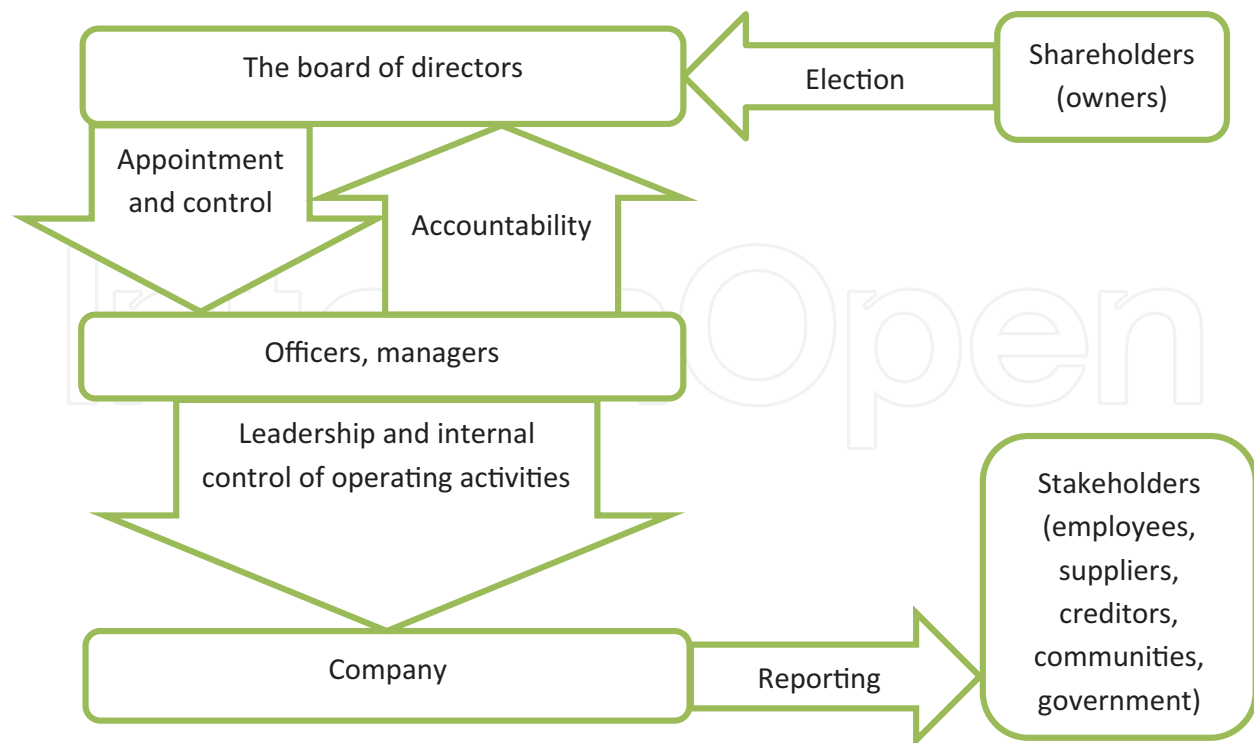


Figure 2. The structure of Anglo-American model of corporate governance.

According to the Anglo-American model, the key role in a company's management is played by the CEO, who makes all decisions on business activities; the CEO even can arrange a committee or committees if needed and appoint members, in addition, it is required to include the CEO in the board of directors.

5.2. German model

German model of corporate governance is used in Germany, Austria, and Switzerland; some elements of this model are used in the Netherlands, Belgium, and France.

The structure of the model is illustrated in **Figure 3**, and specific features of this model are:

1. a corporation's share capital is highly concentrated;
2. a tight relationship between banks and industries, which leads to integration of manufacturers with financial institutions and establishing an industrial and financial conglomerate;
3. banks participate not only by financing projects but also by selecting representatives to perform within the supervisory board;
4. including the representatives from employees and labor unions to the supervisory board;
5. clear division of managing functions into monitoring and operation;
6. existence of two boards, a managing board consisting of managers (insiders) and a supervisory board consisting of representatives of shareholders and employees (insiders and outsiders);

7. the supervisory board appoints and dismisses the members of the managing board; boards are separated; therefore, to participate in both boards at the same time is forbidden;
8. the managing board independently controls and evaluates the operating activities;
9. the size of the supervisory board is defined by the law and cannot be changed in accordance to the willingness of shareholders; and
10. the restrictions on the possible quantity of votes that can be used by a shareholder in order to limit the influence of a shareholder who owns a big share of a corporation [8, 9].

5.2.1. Discussion

According to German model of corporate governance, shareholders have more rights and responsibilities on distribution of net profit, dividend payments, confirming the decisions made by a supervision board and a managing board, election of supervision board members, and appointment of auditors.



Figure 3. German model of corporate governance.

The legal and social system of Germany modifies the model of corporate governance and emphasizes the essential need to take into account the interests of not only shareholders but also the employees; the ability to represent employees in a supervision board provides better communication and identifies mutual goals. In addition, the share capital, as a rule, is formed by financial institutions rather than by private investments, that shifts the key negotiation process from shareholders to financial institutions. The functions of shareholders, presented in Anglo-American model, are partly transferred to supervision board's functions in German model.

5.3. Japanese model

In Japanese practice of doing business, it is common to form industrial and financial conglomerates, where a big financial institution is combined with an industrial company; consequently, in the structure of corporate governance, the representative of a big financial partner (a bank) is included (see **Figure 4**). A corporation's structure is characterized by a common (industrial and financial) usage of loan and share capital, informal channels of communication and sharing information, and cross shareholdings.

Most Japanese corporations do not involve any outsider board members, as a rule; the board of directors consists of representatives of a company and main shareholders. In addition, the government plays an important role in the management as well; the government is involved in strategic planning and ensures the representation (formal or informal) of its interests in a board of directors. A corporation's goals are formed for the satisfaction of shareholders' needs accompanied with promoting governmental interests. It is crucial for a Japanese model of corporate governance to build up new business connections rather than to balance the interests of shareholders as it was for Anglo-American model [7–9].

According to Japanese model, shareholders are responsible for making divisions on

1. dividend payments,
2. distribution of net profit,
3. election of the board of directors,
4. appointment of auditors,
5. changes to the charter,
6. emerges and acquisitions, a corporation's reorganization,
7. directors' and auditors' benefits, etc.

5.3.1. Discussion

First, Japanese model of corporate governance insures the same direction of all corporations' development as representatives of the government have a right to participate in the board of directors' performance and making decisions process. Second, as corporations in Japan have

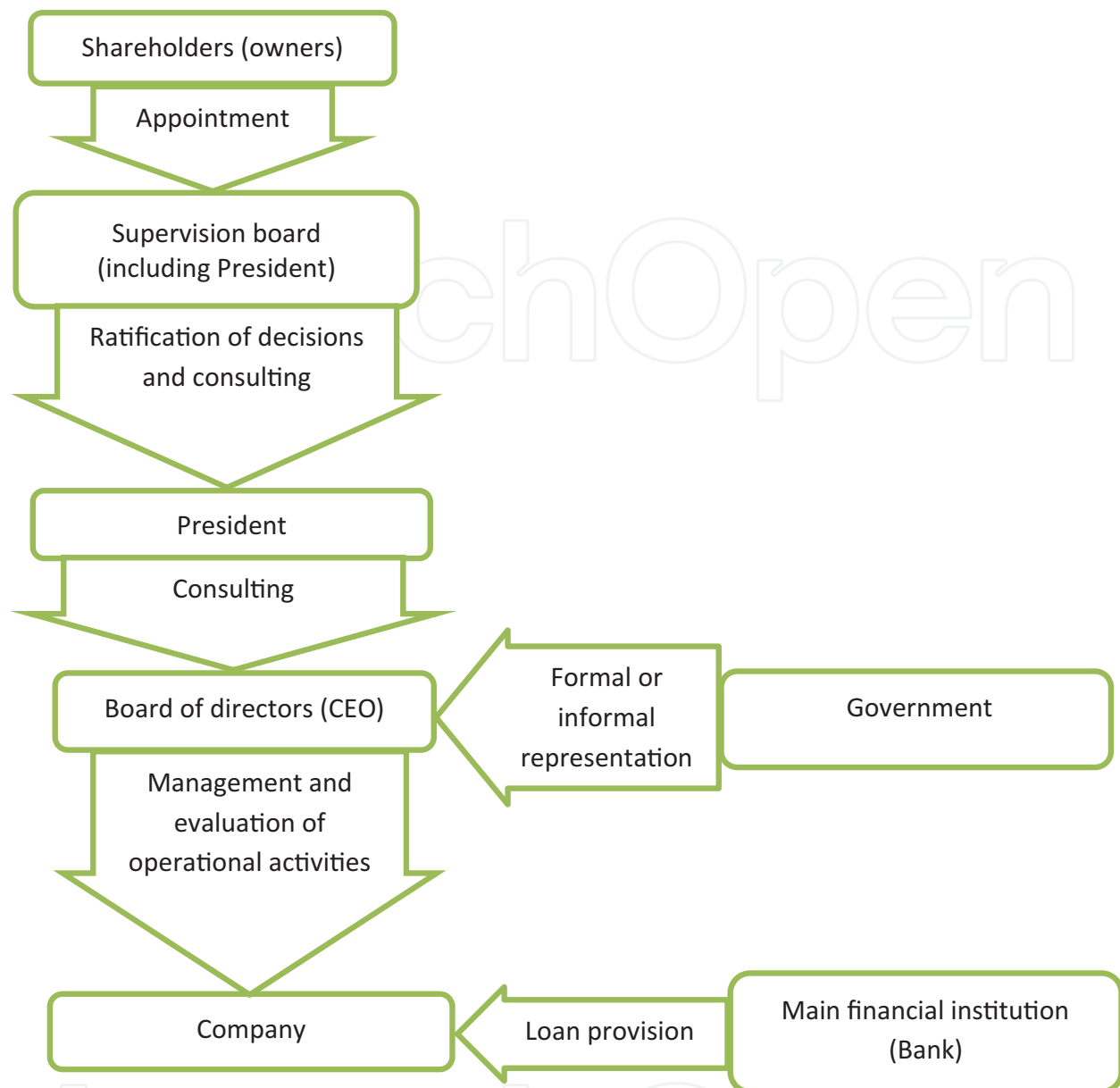


Figure 4. Japanese model of corporate governance.

a form of financial and industrial conglomeration, the representatives of the main financial institution are included to the board of directors and can participate in its performance as well. The mentioned features are the key exceptions of Japanese model in comparison to others.

6. Corporate governance in transitional economies

There is no a specific model of corporate governance within countries with transitional economies; as a rule, the mixture of features of Anglo-American and German models are used. For transitional economies, the key goal is to shift from command to market economy that requires huge investments from the private sector. At the same time, to encourage the investors and to

increase the flow of finance to the business and due to the essential need of investors to control and be guaranteed to receive the return, the adequate system of corporate governance should be implemented.

To develop and implement the proper model of corporate governance, the business sector accompanied by the government should solve vital issues of transitional economies. The first one is the absence of the trust in the financial instructions in general and to the investment procedure in particular. As with changing the system of economy, there was a modification in financial sector as well, while with transition, the elements of old and new systems contradict one another that in turn decreases the level of reliability. Weakly developed banking system is not able to play a crucial role in a corporation's performance as an investor and an overseer.

The second one is the privatization of huge public companies, where with public properties inefficient methods of management were transferred to private sector. Under those conditions, there is a complex mission to rearrange the whole understanding of the goals of a company, starting from building up a new strategy of a company till modernization of the bottom level of an organization in combination with launching key functions of corporate governance.

The third one is a changing legislation; with improving market rules, there is a transformation of old norms and regulations to new modern ones. Dealing with changing legal system requires day-to-day updates and forming the system of corporate governance in accordance to it, as one of its functions is to ensure the legislation of a company's performance. Modern models of corporate governance include stakeholders' interests, but in the command system, they were not counted as interested in a corporation's performance, thus they were out of the legislation at all.

The forth one is the lack of trust in shares and corporations with a share capital, that slows down the investment and accumulation of the share capital that is essential for all corporations. The adequate legal system can ensure the rights of shareholders and investors, but for transitional economies, the legislation is under continuous changes.

The fifth one is the superior role of the state, as previously state companies are transferred to private owners, but still the state can participate as a shareholder, and it has unrestricted influence on a corporation's performance based on the previous ownership. In such corporations, the state, as a rule, forces shareholders to make decisions that are beneficial for itself and then for other shareholders and stakeholders. At the same time, there can be even cases on violation of property rights and misuse of corporate governance functions in order to meet needs of state shareholders [8].

6.1. Discussion

The current issues on corporate governance implementation in transitional economies require the development of specific principles of building up a reliable and suitable system of corporate governance based on real transformations and incomplete legislation, as the norms appropriate for successful performance in advanced countries cannot be fully used in transitional

economies. The gap between principles of efficient corporate governance published by international organizations and suitable principles for transitional economies allows managers and shareholders to misuse them in favor with their personal interest.

7. The evaluation of corporate governance

As an investor's goal is to ensure the future return and benefits, to realize their interests, as a rule, they sink their capital in well-governed corporations, which operate in accordance with the current legislation and guarantee the fair participation of investors in the decision-making procedure, are able to eliminate the risks and balance the interests of shareholders, managers, and stakeholders. The level of corporate governance effectiveness can be measured by using the methodology of rating agencies, by evaluating the actions of key participants as well as the financial outcomes.

The first agency that implemented the rating system on corporate governance is Standard & Poor's, which evaluates the efficiency of corporate governance by studying the following actions: the misuse of a corporation's resources by the dominants for the satisfaction of personal interests, the structure of bonus systems that can encourage managers to achieve the short-run benefits instead of following long-run priorities, and inappropriate control of information that can lead to the asymmetric access to the information, accompanied by an increasing gap between interests of shareholders and stakeholders.

The rating reports provide the information on a corporation's financial and managerial performance due to the investors' need to understand and evaluate in advance the potential benefits of financing a specific corporation based on the rating criteria, which in turn form the perception of a company, its image and ability to create value, weak and strong sides of its corporate structure and functions, comparative advantages, etc., in general, the place among competitors. The availability of an objective, nonbiased, and reliable evaluation methodology allow to eliminate the asymmetry of information between shareholders, managers, and stakeholders, that, in turn, increases the probability of implementation of common interests and gaining the higher return of invested financial resources.

The corporate governance score, evaluated by the agency, provides the experts' opinion on the principles of existing structure of corporate governance and the efficiency of implementing the declared principles in comparison with other corporations. The score is calculated based on the detailed analysis of a corporation's reports and official documents and interviews with top managers. There are four key criteria of overall evaluation (for more information see **Table 1**):

1. The ownership structure, which consists of the information on the shareholders, their interrelations with stakeholders, and influence on a company's performance.
2. The legal framework, which indicates the level of legislation protection of shareholders' and stakeholders' interests. In cases with a weak legal system, regardless the wiliness of

shareholders and managers to improve the structure of corporate governance, the indicator will remain low, limiting or preventing any further elimination of risks and dealing with a conflict of interests.

- 3. Transparency in actions, which shows the level of information accessibility and openness of a decision-making procedure; a principle of regular reporting provides an overall understanding of financial results, current and potential risks, and growing possibilities, in addition, it offers the symmetric access of information to shareholders, managers, and stakeholders that ensures the rationality of managers’ decisions on the operating stage.
- 4. The structure of the board, which illustrates the level of independence of the participants separately and the board as an entity, the functions of the board and the efficiency of their implementation, the form of interactions between lenders, managers, and stakeholders, the system of compensation [10, 11].

To meet the demand of financial institutions and private investors for reliable evaluation of a corporation’s governance and the level of protection of shareholders’ rights, a well-known organization, Moody’s, provides evaluation reports on the efficiency of corporate governance. Moody’s (see **Table 1**) empathizes the crucial influence of corporate governance on financial or credit risks.

Criteria	Moody’s	Fitch	S&P
Board independence	x	x	x
Director quality and diversity	x	x	x
Internal control (audit)	x	x	x
Ethical policies and processes	x		
Directors and managers conflict of interests	x		
Interest balancing policies	x		
Shareholders’ rights (voting rights)	x		x
Governance transparency	x		x
Mechanisms or policies for transaction supervising		x	
The performance-based compensation linked to the company’s long-term growth		x	
Potentially market expectations for the company’s earnings growth		x	
Transparency of ownership structure			x
The concentration and influence of ownership and external stakeholders			x
Transparency and disclosure of information			x

Table 1. The common and specific criteria of corporate governance efficiency evaluation.

Moody's defines five key positions based on which the overall estimation on corporate governance can be completed [12]:

1. the effectiveness and independence of the board of directors;
2. the adequate compensation system for managers and directors;
3. the regular information disclosure of main financial reports to creditors and investors; implementing internal control in a form of an audit committee in order to provide reliable information on financial performance;
4. the ownership structure and characteristics regarding investors and creditors;
5. the ensuring and protection of shareholders' rights, especially minority ones, to vote, participate in the decision-making, etc.

The Fitch rating report is another case on estimation the efficiency of corporate governance; the goal of this rating system is to ensure the interests of creditors and shareholders by valuing the influence of corporate governance on possible credit risks. According to Fitch (see **Table 1**), the crucial elements of corporate governance for ensuring the interests of shareholders are the following:

1. the independence of the board of directors that includes the clear procedure of nominating directors, the wiliness and ability of managers to understand and follow a corporation's strategy;
2. interactions between different parties, minorities, and dominants in accordance with the existing policies of supervising negotiations and balancing the interests;
3. proper system of internal control, as a rule, provided by an audit committee, on potential risks and reliability of financial reports;
4. Compensation system that takes into account the current financial situation of a corporation as well as the importance of long-run stability and competitiveness rather than short-run benefits; and
5. capital structure, which demonstrates the shares owned by the executive [13].

7.1. Discussion

Based on the previous study, it is crucial to identify the common and specific criteria (see **Table 1**) that are used to evaluate the efficiency of corporate governance by different agencies, in order to improve the efficiency and to decrease the potential risks its crucial to ensure the transparency of financial and managerial performance, to disclosure regularly the information required by shareholders and creditors in order to plan their future finance and understand the overall financial situation.

The transactions and potential interdependence between shareholders and managers should be regulated by the existing legislation and internal policies regarding balancing the interests of shareholders, creditors, managers, and stakeholders, supervision of negotiations, and adopting the system of compensation in accordance to the strategic long-term goals rather than short-term benefits. An improvement in corporate governance can be considered as a comparative advantage, which attracts new investments and can be an excellent foundation for further growth of a corporation; from the point of view of creditors and shareholders, appropriate governance eliminates and minimizes possible risks and ensures the future return.

8. A corporate governance failure

The biggest scandal of twenty-first century is the case of Enron corporate governance failure. Enron Corporation was established in 1986 as a pipelines company from the merger of Houston Natural Gas and InterNorth. In the procedure of the emerge, Enron gained a huge debt and, according to the legislation, lost all rights regarding its pipelines. It was a financial disaster, and a new innovated strategy was required to survive and accumulate capital, financial inflows. The owner engaged McKinsey & Co (a young consultant named Jeffrey Skilling was assigned to the issue) to develop a new strategy and the outstanding strategy was found. According to the new strategy, a Gas Bank should be set up, which would be used by buyers and sellers of natural gas, at the same time, Enron would be involved as an intermediary, which guaranteed reliability and predictability regarding pricing and delivery for both parties. By the beginning of 1990s, Enron was transformed into a major gas trading operation and established a new division called Enron Finance Corp., which became a leader of the market for natural gas contacts dealing with more suppliers and customers comparing to its competitors [14, 15].

Skilling transformed the corporation culture to suit its new trading strategy; he decided to hire the brightest and most perspective traders; in exchange for overworking, he provided some additional services like a company gym and corporate perks, besides that, they suggested a bonus system on a merit base.

With a growth of external power of a corporation, there was a slight degradation of the internal culture; skilling launched a tough employee-ranking system, based on the values of Enron: respect, integrity, communication, and excellence; however, the key measure of a performance was the amount of profit they can produce. With the implementation of the new evaluation system, the turnover of employees grew up to 15% annually, and under those conditions, the priority moved from long-run goals to current increase in the profit and new contracts signed.

In 1996, Skilling as a chief operating officer suggested to use the gas bank model in the market for electric energy as well. In 1997, Enron acquired electric utility company Portland General Electric Corp. and named it as Enron Capital and Trade Resources, by the end of the year, the division transformed into the nation's largest wholesale buyer and seller of natural gas and electricity, by that time revenue increased from \$2 to \$7 billion with employees from 200 to 2000.

The most financially significant was a creation of Enron Online in 1999, an electronic commodities trading web site. Enron was counterparty to every transaction conducted on the platform; besides that, Enron was either a buyer or a seller in each transaction, and its credit was crucial to provide safe and reliable environment for energy industry. Enron Online shortly reached an incredible success with \$335 billion in online commodity trades in 2000. In August 2000, Enron's stock reached its maximum of \$90.56 and the company was recognized as one of the most admired and innovative in the world by Fortune and other publications [15].

Meanwhile, in the beginning of 2001, the energy prices began to fall and the world economy got in the recession, thus Enron's profitably sharply reduced, specifically the finance division, where contracts were signed regardless the possible future risks. As investments inflows are related to a company's estimated risk, representatives of Enron started to influence credit rating agencies as Moody's and Standard & Poor's on improving the credit ranking. There were other ways of reducing its financial debts as a reduction in hard assets accompanied by increasing paper profits in order to increase the return of assets and lower the debt-to-total-assets ratio, making a company more attractive for investors. Another way to hide the real financial situation was to use a limited partnership with an outsider partner ["special purpose entities" (SPEs)], the company provides hard assets and related debt to an SPE in exchange for an interest, then an SPE is able to borrow huge amounts of money from financial institutions to purchase assets or conduct other business; in this case, the debt or assets would not be shown on the company's financial documents. Thus, Enron used thousands of SPE to hide its debts and modify its financial reports as well as to maintain a share price.

As a result of accumulation of debts and failures in launched projects, the price of an Enron share fell to \$60 and continued to fall. In October 2001, Enron announced about \$591 million in losses and an additional \$628 million in liabilities. The equity market reacted immediately, and a share price became less than \$10. On November 30, the stock closed at 26 cents a share and, on December 2, Enron announced about its bankruptcy [14].

8.1. Discussion

The case of Enron raised up a question on some of the key functions of corporate governance as the adequate disclosure practice and the integrity of the independent audit. In the manner of Enron's management, the following risk factors can be seen :

- aggressive earning targets and a merit-based management bonus compensation system;
- extreme managements' interests in keeping stock price and earning targets;
- failure in accumulation of financial inflows from operations while publicly reporting earnings growth; and
- substantial associated party involvement and transactions.

Enron's case started the era of global mistrust between investors and corporations, the general belief that the American companies have the most transparent and fair way of doing business disappeared. Shortly after Enron, another American corporation WorldCom announced about

its bankruptcy, which made even bigger the gap between managers' and investors' goals and ruined the reputation of fast-growing corporations. These failures taught a good lesson for businesses; internal stimulation methods as bonus systems do not guarantee the long-term growth and stability, the participation of state and public participants (stakeholders) are crucial in appropriate corporate governance, which ensures and protects the rights of shareholders.

Author details

Alla Mostepaniuk

Address all correspondence to: a.mostepaniuk@gmail.com

Girne American University, Turkish Republic of Northern Cyprus, Kyrenia, Cyprus

References

- [1] Shleifer A, Vishny RW. A survey of corporate governance. *Journal of Finance*. 1997;**52**(2): 737-783
- [2] Jensen MC, Meckling WH. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*. 1976;**3**(4):305-360
- [3] Business Roundtable. Principles of Corporate Governance. [Internet]. 2016. Available from: <https://businessroundtable.org/sites/default/files/Principles-of-Corporate-Governance-2016.pdf> [Accessed: February 2, 2017]
- [4] Principles of Corporate Governance. [Internet]. 2004. Available from: <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> [Accessed: February 25, 2017]
- [5] Principles of Corporate Governance. [Internet]. 2015. Available from: <http://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf> [Accessed: February 25, 2017]
- [6] ASX Corporate Governance Council. Principles of Corporate Governance. [Internet]. 2014. Available from: <http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf> [Accessed: February 25, 2017]
- [7] Ungureanu M. Models and practices of corporate governance worldwide. *Centre for European Studies, Working Papers*, 2012;**4**:625-635
- [8] Shtern GU. Corporate Governance. Kharkiv: Kharkiv National Academy of Urban Economy; 2009
- [9] Wuil T. Theories and models of corporate governance. UC Davis Legal Studies Research Paper No. 213. 2010

- [10] Mattheus D. Evaluation is key to good governance. Board Leadership. [Internet]. 2014. Available from: [http://www.ey.com/Publication/vwLUAssets/EY_Artikel_2014_-_Valuation_Is_Key_To_Good_Governance/\\$FILE/EY-Artikel-2014-Valuation-Is-Key-To-Good-Governance.pdf](http://www.ey.com/Publication/vwLUAssets/EY_Artikel_2014_-_Valuation_Is_Key_To_Good_Governance/$FILE/EY-Artikel-2014-Valuation-Is-Key-To-Good-Governance.pdf) [Accessed: February 25, 2017]
- [11] Louizi A, Kammoun R. Evaluation of corporate governance systems by credit rating agencies. Journal of Management & Governance. 2016;**20**(2):363-385. DOI: 10.1007/s10997-015-9331-3
- [12] Moody's. Rating Methodologies. [Internet]. Available from: <https://www.moodys.com/researchandratings/methodology/003006001/rating-methodologies/methodology/003006001/003006001/-/-1/0/-/0/-/-/en/global/rr> [Accessed: February 25, 2017]
- [13] Maher D, Gandy B, Thomas H. Corporates Criteria Report. Evaluating Corporate Governance. [Internet]. 2007. Available from: https://www.fitchratings.co.jp/ja/images/RC_20071212_Evaluating%20Corporate%20Governance_EN.pdf [Accessed: February 25, 2017]
- [14] Enron: The Real Scandal. [Internet]. 2002. Available from: <http://www.economist.com/node/940091> [Accessed: February 25, 2017]
- [15] Thomas CW. The rise and fall of Enron. Journal of Accountancy. [Internet]. 2002. Available from: <http://www.journalofaccountancy.com/issues/2002/apr/theriseandfallofenron.html#sthash.kbbwJyNw.dpuf> [Accessed: February 25, 2017]

IntechOpen

