Sumant Chittiprolu

Ethical Lessons Learned from Corporate Scandals

Ethics is about behavior and in the face of dilemma; it is about doing the right thing. Ideally, managerial leaders and their people will act ethically as a result of their internalized virtuous core values. The Enron scandal is the most significant corporate collapse in the United States and it demonstrates the need for significant reforms in accounting and corporate governance in the United States. It is also a call for a close look at the ethical quality of the culture of business generally and of business corporations (Lessons from the Enron Scandal). The collapse of even the smallest of businesses impacts many people, and therefore even the smallest business can learn what not to do from the multibillion dollar corporation. The failure of one's business will greatly and negatively affect its employees, partners, as well as the families of each of those groups. Business owners have a duty to operate in a prudent, lawful and ethical manner. The major lessons that were illustrated by the collapse of Enron and other corporate scandals will be the morality play of the new economy. It will teach executives and the American public the most important ethics lessons of this decade.

Financial cleverness is no substitute for a good corporate strategy. Financial accounting is a backward looking, unusually complex, subject to subjective interpretation, vulnerable to several controversial accounting doctrines, and an invitation to manipulation. More important perhaps, many changes in non-financial conditions, which are never recorded on the balance sheet, may affect the value of a firm for better or for worse. For these reasons, corporate financial accounts do not provide accurate or sufficient information to corporate managers, investors, or regulators. This leads us to recommend that the SEC allow each stock exchange to set the accounting standards for all firms listed on that exchange and to promote the development of industry-specific non-financial accounts to complement the financial accounts (After Enron 53).

The most important lesson of the Enron collapse is that *every* link in the audit chain including: the audit committee and the board, the independent public auditor, the bankers and lawyers that aided and abetted the misrepresentation of Enron's financial condition, the credit-rating agencies, and the Securities and Exchange Commission failed to deter, detect, and correct the conditions that led to that collapse. Although not a part of the formal audit chain, most of the market specialists in Enron stock and the business press were also late in recognizing Enron's financial weakness (Corporate Aftershocks 12). Moreover, this is a characteristic pattern in many other bankruptcies. This leads us to recommend that most of the audit functions be assigned to the stock exchanges, the only institution with the potential to capture the third-party benefits of a good audit. Each stock exchange would set the disclosure rules for the corporations listed on that exchange and select, monitor, and compensate the independent public auditor of each firm. I also recommend new rules for the accountants, bankers, and lawyers that contribute to the misrepresentation of a corporation's financial condition, a reduced role for the credit-rating agencies, and a more focused role for the SEC.

Our tax system encourages too much debt and overly risky investments, the characteristic conditions that lead to bankruptcy. American corporations use too much debt because interest payments are a deductible expense but returns to equity are not. Until the implementation of the 2003 tax law, retained earnings and investment within the corporation were too high because the individual tax rate on long-term capital gains was much lower than on dividends. The effects of those characteristics are magnified by the fact that the combined federal and state U.S. tax rate on corporate income is now among the highest of the industrial nations. Our tax system, much like the Generally Accepted Accounting Principles (GAAP) and for much the same reasons, is extraordinarily complex, inviting attention to the many types of legal tax shelters used by Enron (Enron Lessons). Those characteristics of the current tax system lead me to recommend that the $1 million limit on the deductibility of salary and bonus be repealed and that the corporate income tax be replaced by a broad-based tax on the net cash flow of all non-financial corporations.

The corporate scandals illustrated by the Enron collapse was a serious problem, undermining trust in the accounts and the behavior of all corporations and the political support for free-market policies. Executives who are highly paid can think they are above the rules and can be tempted to cut ethical corners to retain their wealth and perquisites. Government regulations and rules need to be updated for the new economy, not relaxed and eliminated.

Sumant Chittiprolu

Works Cited

“Enron Lessons”http://www.scu.edu/ethics/publications/ethicalperspectives/enronlessons.html

Niskanen, William A., ed. *After Enron: The Major Lessons for Public Policy*. Lanham, MD: Rowman & Littlefield, 2005.

Culp, Christopher L., and William A. Niskanen, eds. *Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations.* Hoboken, NJ: John Wiley & Sons, 2003.