Corporate Scandals: Causes, Impacts, and Implications

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Abstract

Corporate scandals and fraud affect all aspects of corporate society. Researchers have conducted studies to try to determine what causes individuals to participate in corporate fraud. Studies have also been conducted regarding impacts in the business world due to scandals. This paper will consider two of the major corporate scandals of the 21st century and will discuss individual traits associated with fraudulent endeavors such as narcissism. The paper will look at the impact scandals have on society and will address the impacts which include an increase in regulations and an increased focus on ethics training. In analyzing causes and impacts of scandals, future implications can be assessed.
1. Introduction

Although scandals in the business world are not a new phenomenon, the scope and fall-out from the Enron and Arthur Andersen debacles made the issue front-page news for months. The scandals brought down two corporate giants and raised concerns in government agencies along with the business community. The well-publicized trials and large impact to their numerous employees and stockholders drew the attention of the nation. Researchers began studying the scandals to determine what could have caused established companies to commit fraudulent activities.

In response to the scandals, the government created several new regulations. One major regulatory change that went into effect required CEOs and CFOs to sign off on financial statements for their company. The regulatory change placed responsibility of the accuracy of the statements on the CEO or CFO. While some regulations were seen as effective, some researchers argue that more regulations are not the solution to eliminating financial fraud.

The business community responded by focusing on preventive measures of fraud by requiring ethics training for employees. Ethics programs had previously been in effect but not as mainstream as after the scandals of the 21st century. Along with ethics education, companies now employ compliance officers to ensure compliance with the new regulations. Overall, the impacts of the scandals perpetrated by Enron and Arthur Andersen affected the entire business world. The paper will discuss previous studies on the subject of scandals and their impacts, impacts from the scandals, and finally what implications lie ahead.

2. Previous Studies

Researches conducted into what causes individuals to initiate and participate in a corporate scandal found a relationship between narcissism, gender roles, and personal gain. A study by Rijsenbilt and Commandeur (2013) found that characteristics of narcissism led several CEOs to report false financial statements, misuse company resources, and engage in illegal and illegitimate activity.

Isaacs (2013) asserts that corporations should be charged for any illegal activities because in most cases, corporate fraud was conducted by a string of individuals working for the corporation. Bennett, Lo Cicero & Hanner (2013) found that the new era of filing suits against a corporation has led to additional hardships on prosecutors. Mishina, Dykes, Block and Pollock (2010) examine the rationalizations of decisions-makers who commit fraud. They found that the pressures of increased earnings and profitability create expectations in firms. To live up to those expectations, firms have used unethical methods anticipating that it will be temporary fix and that by the next quarter or fiscal year, earnings will have made up for the misrepresentation.
Bishop (2013) believe that ethics should be used a preventive measure. Teaching and implementing ethics programs early, instead of after a scandal, would help to prevent any future scandals. Weber & Wasieleski (2013) reviewed ethics surveys from 66 corporations in varying fields of industry to look at how compliance and ethics trainings had changed over the past two decades. All 66 corporations reported an increase in topics as well as emphasis on training for all employees, not just upper-management.

Ho and Wang (2013) contend that auditing and cheating accounting scandals will always regardless of preventative training. The relationship between lender and borrower, as well as market uncertainty, will always produce an environment suitable for corporate fraud.

To further promote business ethics, business schools have added ethics courses to their primary curriculum. Gordon (2011) compared ethics topics found in both United States and Canadian textbooks as well as teaching techniques. The study found that ethics topics are becoming separate classes taught to train professionals in fair and legal behavior. Dzuranin, Shortridge, & Smith (2013) studied a program at the Northern Illinois College of Business on its ethics training program that is taught to students at all grade classification levels. The program is designed to teach ethics throughout a business student’s college career to instill values.

Government reforms focused on prevention by creating new regulations and programs to avoid illegal activity. One program geared towards “whistle-blowing” from within the organization. Incentives are offered for corporate employees to inform regulators of any illegal activity occurring within the corporation. Nielsen, Balachandra, & Nielsen (2013) found that flaws exist in the whistle blower program regarding regulatory agencies acting on whistle blower tips. Ball (2009) argues against the implementation of more regulations, asserting that a fraudulent corporation left on its own will eventually fail and be ousted. The regulations are only impacting the individuals already conducting legitimate behavior.

3. Why Corporate Scandals Occur: narcissism & Opportunity

The amount of corporate scandals occurring in the recent decades has prompted researchers to consider possible causes. The narcissist theory argues that executives with high levels of self-confidence and narcissism are more likely to commit fraud to maintain a positive image. Some researchers have found the individuals commit fraud simply because they have the opportunity.

Narcissism is considered to be a possible reason for an individual to commit corporate fraud. Researchers Chin, Hambrick, & Trevino (2013) found that most executives make decisions based on past experiences, values, and
personalities. Rijensbilt & Commandeur (2013) compared corporate management accused of illegal business activity with traits of narcissism. Narcissists thrive on affirmation and praises from others and behave unethically to keep from falling short of their goals.

Financial frauds share the same three properties: “1) Inability to meet performance expectations, 2) Personal costs pecuniary or nonpecuniary of failing to meet expectations and 3) Being able to convince oneself that real performance will improve soon.” (Ball, 2009, pg. 286) Self-confidence has also led to some “good” firms participating in illegitimate behavior, such as the case with Arthur Andersen. The illegitimate behavior can include embezzling, misrepresented financial statements, and misuse of company resources. Over-confident managers often feel they can outsmart any regulatory agency and keep illegal activity hidden. (Mishina, Dykes, Block, & Pollock, 2010, pg. 705) The manager’s overconfidence can eventually lead to the corporation getting caught up in a major scandal because the manager feels invincible.

CEOs and CFOs often have little resistance when it comes to managing a corporation. Less resistance can lead to opportunities of financial fraud. Opportunity includes having the power and means to successfully report false information. Upper management generally answers to a Board of Directors (BOD) and stockholders. Although the BOD or stockholders can request to look at financial records at any time, as long as a company is earning money for its investors, most will not question the manager’s methods. (Pinto, 2010) According to researchers Zona, Minoja, & Coda (2011), the less cohesion from the stockholders the more likely the manager is to use unethical strategies. A manager is theorized as acting on the benefit of the stakeholder. Carson (2003) theorizes that Enron executives probably rationalized their false reporting of earnings as being in the best benefit of the stockholders. Depending upon the company, little control maybe placed on the head of the company. These circumstances often lead to opportunities for fraud and scandals.

Not all corporations involved in financial fraud begin with the intent to deceive. Most scandals occur to maintain current earnings, not create them. Individuals and corporations generally labeled as “good” firms have been found to commit fraudulent activity. According to researchers Mishina, Dykes, Block, & Pollock (2010), many “good” individuals are trying to maintain a current lifestyle or earnings performance. In those researchers’ opinion, an individual that has never owned it, will not participate illegally to get it.

4. Impacts of Corporate Scandals: Regulations & Training

As researchers observe, corporate scandals have become of great interest because of its apparent increase in corporate America, along with its harmful and encompassing consequences. The recent corporate scandals of Enron and
Arthur Andersen have led to changes in regulations, increased ethics training for business students and corporate employees, along with a negative connotation for certain business fields. The first consequence discussed is the changes in regulations due to corporate scandals.

The controversy of financial and accounting scandals, such as Arthur Andersen and Enron, damaged the reputation of the American accounting firms. As a rebuttal to the damage of reputation and financial burden, Congress implemented regulations to safeguard the business industry. Changes were brought forth in the form of new regulations to prevent future scandals. The damage not only occurred to accounting firms but to corporations. If fraud could occur in two of America’s corporate giants, what was to keep it from occurring in other corporations? The government felt that new regulations were required.

The Enron and Arthur Andersen cases brought about new methods being used in the courtroom when dealing with corporations. Previously convictions were held to individuals, instead of the corporation. Prosecutors wanted to be able to hold entire corporations responsible for actions enacted on the corporation’s behalf. The Court argued that if a corporation could benefit from its employees’ actions, it should also be held responsible for those same actions. (Bennett, LoCicero, & Hanner, 2013,) By enabling a corporation’s ability to be charged for criminal activity, prosecutors now had the upper hand when conducting investigations into criminal charges. Charges against a corporation could depend on how well the corporation cooperated with investigators. While some new regulations helped prosecutors gain convictions others gave businesses more rules and guidelines to follow to ensure fraud was kept to a minimum, such as the Sarbanes Oxley Act of 2002.

Regulation changes have been received negatively as the responsibility is placed on the corporation for compliance. The corporation is responsible for implementing, training, and monitoring the new regulations, which often places a financial burden on the corporation. Some view these changes as only affecting the firms that were already ensuring compliance. Study suggests that creating more regulations only results in managers finding other ways around the new regulations instead of halting fraudulent activity.

Ball (2009) asserts that most of the scandals in the United States involved accounting practices that fell within legal managerial bounds. By implementing more regulations managers would still be able to find ways for creative financial reporting. Ballpoints to the collapse of Arthur Andersen as support for his proposal of less regulatory presence in the corporation. Arthur Andersen collapsed of its own accord due to its reputation of poor audits and professionalism. A firm involved in illegal activity will eventually succumb to the market. Ball also hypothesizes that employees of firms could potentially lose more from a scandal than benefit from fraud. Ball conjectures that employees are more likely to whistle-blow on each other, regardless of stricter
In that same vein, Nielsen, Balachandra, & Nielsen (2012) argued that deregulating would promote economic growth, and permit corporations more flexibility and creativity when regulating within their own walls. Regulations not only have a negative implication on corporations but also on the agencies responsible for monitoring and enforcing the regulations. Regulatory agencies are suffering from being understaffed, under-budgeted, and under-trained. Nielsen, Balachandra, and Nielsen (2013) noticed that most employees at government regulatory agencies are newly out of college and inexperienced. The job is used as a stepping stone into a corporation. Therefore, the individuals monitoring regulations in a corporation usually have experience as a regulator and can manipulate the regulatory knowledge to benefit the corporation.

Regulatory agencies also often experience budget issues because budgets are not increased when new regulations are enacted. The same budget with more responsibility often leads to agencies being understaffed. One way that the agencies are abusing their regulatory power to compensate for low budgets is by pressuring firms under investigation into conducting most of the investigation for them. A trade-off will result in prosecutors being willing to work with the corporation should any charges or illegal activity manifest. (Bennett, LoCicero, & Hanner, 2013, pg. 418) The government currently has chosen to use regulatory methods to deter corporate fraud. Only time and research can show if this approach is the most effective.

Many researchers feel that the answer to preventing corporate scandals lies in ethics training. Individuals need to learn what is right and wrong, along with why it is so. Ethics training teaches individuals a moral responsibility to the business community as well as the corporation. Recent studies have indicated that ethics training is being conducted regularly in corporations, and being taught in universities around the nation (Bishop, 2013).

Weber and Wasielski (2013) discovered an increase in corporate ethics training over the past two and a half decades. According to the research data, in 1986 93% of corporations had a written code of ethics, with 44% participating in ethics training for their employees. After the 2013 study, 98.3% of corporations had written code of ethics, while 98% participated in ethics training for all employees. Ethics training for all employees increased over 50%.

Ethics topics have also become more prominent in textbooks and university curriculums due to past scandals such as Enron and Arthur Andersen. Ethics topics appear in most American and Canadian textbooks and there has been a significant increase in the number of times ethics is mentioned in a business textbook compared to pre-scandal Enron time frame (Gordon, 2011). While ethics has become a subject in upper level college courses, the Northern Illinois University (NIU) College of Business, is teaching ethics during all four years of attendance. By teaching ethics during all four years, NIU hopes to develop
individual characteristics such as honesty, loyalty, courtesy, fairness, integrity, excellence, and citizenship. (Dzuranin, Shortridge, & Smith, 2012, pg. 102)

5. Future Implications

Studies have shown a correlation between self-confidence and narcissism in individuals responsible for scandals. While positive evidence seems to exist, it is impossible to say that all narcissists or self-confident individuals will at some point commit corporate fraud. Corporations should not steer clear of these traits. Individuals that are self-confident are usually self-motivated and are responsible for creating some of the largest corporations. People in high positions of power often portray characteristics of self-confidence. Power allows the opportunity for an individual to participate in a corporate scandal. Past research has shown that if an individual does not have to answer to anyone, they are more likely to falsify earnings or records to ensure they appear successful.

The impacts of corporate scandals affect many aspects of society. Although regulations seem to be a quick response from the government, it is not always the best answer. Requiring that managers become personally responsible for financial statements is one of the best regulations in past history. By having management sign off on the statement, should the statement be falsified the government has an individual to personally prosecute and hold responsible. By holding the individual responsible, they are more likely to ensure the statement is accurate.

Changes in regulations have led to a Culture of Compliance. Corporations are now responsible for hiring compliance officers to ensure the company is following regulatory guidelines. The compliance officers are an added expense to a company that does not generate any revenue. These individuals have to be knowledgeable in the regulations, conduct internal audits, and train employees on regulations annually. As stated earlier, many corporate compliance officers begin their career as an examiner working for a government regulatory agency. By knowing the inner workings of the government agency that is monitoring corporate behavior, these officers gain knowledge that can help them to manipulate some of the regulations to the corporation’s advantage after career changes. Corporations often look for these individuals because it will give the corporation the upper hand when dealing with regulatory agencies.

Along with an increase in regulations, ethics training has become a major part of fraud prevention in the corporate world. Colleges as well as companies have implemented ethics programs in an effort to curb corporate fraud. Many minor frauds could be explained as a simple ignorance that the behavior was unethical. One disadvantage of ethics training is that it is easier to train someone in ethics that has not yet been a part of the business world. By focusing on ethics education in the workplace and college should minimize the number of future scandals. The increase in ethics education should give a better estimate of if ethics training prevents employees from behaving illegally. Prior to Enron,
ethics was not in the forefront so research related to ethics training and scandals can be skewed. As the workforce begins to change research could be conducted to see if ethics training has caused a decrease in corporate scandals. As time passes between the major scandals of the 2000s, further research will show if the changes brought forth by these scandals have resulted in fewer cases of corporate fraud.

6. Conclusion

Research into why corporations and individuals commit fraud revealed certain theories such as narcissistic and self-confident characteristics, and simple opportunity. Narcissistic and self-confident individuals tended to be more prone to initiating corporate fraud. Members of upper management have more opportunities to create fraud than those of lower management.

Corporate scandals have a negative impact on all aspects of society. Corporations in the same industry become subject to negative publicity which can affect net worth of the company. Investors become wary of investing life savings. Governments feel the impact of the national and international community looking to them for answers as to how and why such an event could occur. As a preventative response, government agencies pass new regulations to help prevent future scandals. Many colleges and corporations have become proactive by implementing required ethics training as a hope to curbing corporate fraud. By continuing to study corporate scandals and the changes they create, society can learn to detect possible causes, look for signs of fraud, and hopefully prevent scandals.

References


