2002 was the year of scandals and 2003 should be the year when we work to rebuild public trust in business and in the financial markets. So why did this crisis happen? Is it just the case of “a few bad apples”? or have we seen a major failure of the corporate governance system? In this article I would like to examine the causes and to suggest that:

1. we need to re-examine the whole corporate governance system, and
2. the crisis in corporate governance is not just a US problem, but a problem for the whole world.

As Warren Buffet once said, “It’s only when the tide goes out that you get to see who’s been swimming with their trunks off”. In 2001/2002, after the scandals in the USA and the collapse of share prices, many of the major players in the Western corporate governance system were found wanting and we need to consider carefully the causes of the crisis before we start to suggest remedies. The following analysis is in five parts:

Part I The Dot.com Bubble
Part II The Stock Market Crash
Part III High Risk Strategies
Part IV The Insiders’ Greed
Part V Rebuilding Public Trust

Fig. 1: The Corporate Governance Crisis

2002 will be remembered as the year of financial scandals. The list of companies under investigation in the USA includes stock market favourites like Enron, WorldCom, Adelphia and Global Crossing, and blue chip companies like Xerox and AOL Time Warner.

“All together, CEO’s at the 23 firms under investigation took home $ 1.4 bn from 1999 to 2001. But at the same time these companies laid off 162,000 employees and the value of their shares fell by $ 530 bn – about 73 % of their market value.” [1]

Major investment banks like CSFB, Morgan Stanley and Citigroup are also being investigated – accused of promoting the shares of companies which they knew were having problems, or cooperating in schemes that enabled companies to hide the extent of their debts. Also partners of the auditors, Arthur Andersen, were found guilty of shredding documents relating to Enron and the 88-year-old firm has since disappeared.

These events have had an impact on stock markets around the world, and governments, regulators, professional institutes and individual companies are now taking steps to restore public confidence in business and the integrity and transparency of financial markets.

British companies did not suffer from these malpractices in accountancy and auditing. However, Britain had similar scandals in the early 1990’s with Maxwell, Polly Peck, BCCI and many other businesses. So in the following decade British boards of directors became more independent and more professional through the implementation of the Combined Code of practice in corporate governance. Nevertheless, as companies and financial markets are international in scope, inevitably the corporate governance crisis is affecting companies based in the UK and other parts of Europe and elsewhere in the world.

The new Sarbanes-Oxley Act will affect all European companies with a US listing. Under this law, company audit committees must be truly independent, CEOs and CFOs must certify their company reports and directors who misbehave may be punished with significant fines and jail sentences of up to 20 years. Auditors too must have their fees for non-audit services approved by audit committees and audit firms may be required to change their partners after five years.

Part I: The Dot.Com Bubble

A unique feature of the drama, which has led to the present corporate governance crisis, was the huge speculation which occurred in shares associated with the Internet. Technically, a stock market bubble is “an upward price movement over an extended range that implodes” [2]. It is characterised by speculation and what Alan Greenspan, the Chairman of the US Federal Reserve Bank, called “irrational exuberance”.

When there is a large technological shift like the Internet – the invention of a “global information highway” – inevitably, there is great uncertainty about the future. If technologists, venture capitalists and entrepreneurs produce a convincing theory about the Internet, then business leaders feel they have to bet on it. Otherwise they might miss out on the next big opportunity. As a result, capital investment projects suddenly become more risky, even in established businesses, which may suffer if the theory comes true. The business leaders will not know if their investments were too risky until the bubble swells and bursts.