

The Impact of Additional Regulations on Corporate Collapses

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ABSTRACT: *There are some advantages and disadvantages associated with each rule and the introduction of new regulations have both benefits and difficulties for society and the determination of the extent of their responsiveness to scandals is subjective. Furthermore, though the existence of regulations to direct the people's actions is essential the implementation of further rules as the sole solution for the problem of scandals is not a wise response and the significance of ethics and morality to retain the welfare of a corporation should not be ignored. A combination of rules and principles in which the necessary rules are included while the guiding principles lead a company toward its aims is the best possible solution. Likewise, a principle-based approach with clear intentions and guidelines is more effectual wherein although various parties such as the management or auditors should be subject to some rules to govern their activities the existence of well-defined guidelines facilitates the organization's move toward its goals. The introduction of added rules increases the requirements and expands the scope of the involving parties' responsibilities which may initially seem to be an efficacious tool to preclude misconduct. Nonetheless, the concentration on regulations motivates people to find new ways of circumventing the law which in turn results in the occurrence of more corporate downfalls.*

Keywords: Corporate collapse, corporate scandal, principle, regulation, rule

I. Introduction

The major recent corporate collapses such as Enron, WorldCom or HIH encouraged many governing bodies as well as scholars to look for the reasons behind these collapses and to identify the possible solutions to prevent its re-occurrence in the future (Buttery and Shadur, 1991) [1]. However, the act of attributing accurate answers to the questions that who should be criticized and what ought to be done to maintain the companies in the right path is not easily achievable since numerous factors must be considered before arriving in a conclusion (Sexton, 2001) [2].

The introduction of extra regulations as a workable solution to overcome the issue of corporate scandals have been suggested by many academics whereas its efficacy is questioned by many others. The objective of this essay is to provide a critical evaluation of the notion that the introduction of additional rules can be a successful tool to respond to the problem of demises. For this purpose, the advantages and disadvantages of additional regulations concerning academic sources will be analyzed and a balanced picture regarding the effects of rules on the company's operation will be provided. Finally, the author's suggestions and conclusions which are consistent with the written materials will be presented.

II. Benefits of Additional Regulations

According to Hill (2005) [3], the introduction of supplementary regulations increases the accountability in which an increase in the legal enforcement of directors is regarded to be an effectual corporate governance mechanism since one of the reasons behind the recent collapses was the existence of unethical behaviors in the higher levels of the company. The liability of directors is regarded as the main concentration of corporate law in many countries such as the U.S. which has compelled them to increase their due care to obstruct the legal actions against them.

As stated by Dissanaik and Szilagyi (2010) [4] the executive remuneration has played a substantial role in many recent scandals in which the performance-based pay and option grants have significantly affected its construction. A movement in corporate law was the result of the new type of executive remuneration wherein the executive remuneration has not been a governance issue which requires some actions such as the inclusion of independent directors in a firm to lessen the egotism of managers. Conversely, the new regulations considered executive remuneration as a resolution since it attempted to align the interests of managers and shareholders (Johnson, 2000) [5].

A fact which has motivated many global downfalls was that the benefits that the executives could obtain because of their misbehaviors were much greater than the risks and costs involved with those misconducts. Therefore, they did not feel threatened and could simply commit themselves to unethical behaviors and were able to leave their companies with a huge amount of money. Furthermore, the punishments considered for the offenders were not sufficient to depress the desire of re-happening. So,

the introduction of further regulations with stricter punishments for the breaches alters the goal of executives from considering their interests to maximizing the shareholders' wealth when dealing with the company's affairs (Proimos, 2005) [6].

According to Hemraj (2004) [7] as the firm is responsible to ensure the correctness of its financial reports the insertion of new regulations to pressure the corporations to value their duty of care to their shareholders is imperative. Besides, the auditors' duty obliges them to express the suspected fraudulent activities in the organization and the failure brings negative consequences to many people. Furthermore, in the case of a lawsuit against the auditors, the courts investigate the unusual practices which were not identified by the auditors. Thus, the inclusion of rigorous rules to broaden the scope of the circumstances that should be reported by the auditors diminishes the likelihood of occurring fraud in the business.

All the recent downfalls happened after the provision of an unqualified audit opinion by the auditors though there have been some wrongdoings in the firm and the auditors were neither capable to recognize them due to their incompetence nor willing to disclose them because of their interests. Hence, the introduction of additional regulations to enhance the independence and objectivity of auditors is necessary and the insertion of stricter rules that provide an avenue to disqualify the auditors that fail to comply with their duties is mandatory. Besides, the provision of whistleblowers protects a company and provides a powerful tool to combat fraud in the company. Thus, the introduction of added regulations to make sure the safety of whistleblowers may largely increase their desire to reveal the potential threats to the business (Tomasic, 2002) [8].

Along with Tomasic (2002) [8], the audit committees need to seriously scrutinize every company's happenings and the concerns relating to transparency and adequate disclosures have to be completely considered by them. Likewise, the provision of new rules to make certain the efficacy of the internal audit departments and internal management controls and supplementary regulations to demand the auditors to assess the effectiveness of the organization's overall control environment and to directly inform the public about the unlawful activities of the firm decreases the possibility of future demises (Hemraj, 2004) [7].

In keeping with Wald (2004) [9], the recent demises damaged the image of the lawyers as the public was expecting the legal profession to stop them. The evidence from the Enron collapse indicated that some of the lawyers' rules of conduct were inefficient to inhibit the incident and they should get improved. Moreover, the lawyers did not act appropriately to protect the organization and compromised their moral duties by satisfying the corporate executives to stay in the business rather than to consider the interests of their client firms as their priority. The conflict of interest is a noteworthy threat that may distort the objectivity of lawyers and some powerful rules to discourage the lawyers to jeopardize the well-being of a firm should be carried out. Hence, the incorporation of extra regulations to enhance the quality of the lawyers' professional conduct to safeguard the investors and to increase their confidence level is obligatory.

III. The disadvantages of additional regulations

The occurrence of recent scandals obliged the standard setters to amend new laws to demand the chief executive and financial officers to certify the financial statements with the hope to increase their accountability and responsibility in the business. Nevertheless, the concentration of new rules on the company's directors underestimates the vital role of employees such as the middle-level managers of firm wherein the middle managers without consulting the directors have made many important decisions and have significantly caused the recent downfalls. The introduction of more regulations to increase the liability of middle management overburdens the organization with the high amount of rules and reduces the productivity of the business as the time and energy which should be dedicated to the company's operation will be spent to control the managers' movement (Hill, 2005) [3].

Consistent with Bolton, Scheinkman (2006) [10], the recent collapses questioned the executive remunerations' structure where many scholars assumed that the new regulations caused the remunerations to worsen the agency problem by encouraging the managers to focus on the short-term investments. The global corporate demises were an indication of the incapability of regulations to align the management and shareholders' interests since for instance in the case of One.Tel the CEOs were recommending the layout of the bonuses by themselves. Moreover, the remuneration packages were regarded to be tools for managers to increase their wealth as they measured performance based on improper standards and favored management while the managers have used their intrinsic influence in the business to present the financial statements in a way that increased their bonuses, and the regulations were not successful to stop it (Kreinberg, 1995) [11].

Along with Healy and Palepu (2003) [12], most corporate collapses such as Enron downfall have occurred in the rule-based systems wherein the existence of complicated rules encouraged the unethical financial experts to find the ways to get round of the regulations and facilitated their task to find loopholes in the rules. For example, Enron with special-purpose entities (SPEs) fulfilled the FASB requirements although its real purpose was to hide its debts and financial risks. The debates regarding the rules governing the SPEs were common among the scholars for a long time though they were unable to avoid the Enron failure. The introduction of new rules governing the SPEs cannot guarantee the proper use of them since there will be some techniques to always abuse them.

The context of additional rules is an important factor to be considered and the regulations should fit the environment. A combination of ethical principles with some detailed rules to cover the whole corporate governance issues has worked better in Britain. Therefore, the act of considering a mixture of both formal and informal regulations may provide a better solution rather than purely depending on criminal punishments. Furthermore, the institutions of regulation are central for the success of the regulation systems and the appropriateness of the regulator's resources should be guaranteed. Besides, the introduction of additional rules intensifies the task of the responsible bodies to ensure their implementation, execution and usefulness which may not be possible in all contexts and every country (Smith, 2004) [13].

As per Agrawal and Chadha (2005) [14], the existence of firmer rules to monitor the actions of management and employees throughout a company's operation is not essential since their cultural beliefs are more important. The introduction of more rules may signal any probable future failures whereas the non-presence of the cultural values of employees and the non-consideration of the nature of their relationships with other parties in the new rules increase the possibility of future downfalls. Thus, the inclusion of supplementary regulations does not secure the company's operation and it does not motivate the investors to invest more in the company.

The circumstances of different countries vary, and the regulations ought to separately address the needs of each nation and the production of a universal set of regulations by the standard setters to globally overcome the accounting shortcomings is not useful. In line with Codina (2009) [15], every jurisdiction should evaluate its rules and determine whether its failures were due to the ineffectiveness of its regulations or the behavior of people outside of the legal boundaries. The provision of further regulations without a thorough prior analysis of the consequences of those rules on the company's operation and their extra costs to the investors is not an efficient solution since for example, the regulations may become suitable for Australia whereas they may disadvantage the businesses operating in Hong Kong. Likewise, the additional regulations decrease the flexibility and endanger the competitive advantages of the firms in the industries like financial services which are so flexible and dynamic.

IV. Suggestions

An evaluation of the contents of the paper demonstrates that the introduction of some supplementary rules as a workable response to corporate demises is not easily possible and many other factors influence the future prosperity of a business. Therefore, the standard setters in each jurisdiction should obtain a complete picture regarding the existing circumstances before introducing new laws to increase their effectiveness. Moreover, an assessment of the preceding regulations to determine their weaknesses helps to eliminate the flaws in the new standards. Likewise, the shareholders should not purely rely on the rules to safeguard their interest and they need to increase the amount of their intervention in the company's affairs.

Because the managers play a vital role in the organization's future success new rules must address their duties and responsibilities and workable instruments of motivation and punishment should be planned to direct them toward the firm's purposes. Besides, each sector of society and every industry has its requirements and preferences, and the rules should be designed in a way that meets those requirements. The execution of new regulations is another factor to be considered wherein the standard setters ought to make sure their adaptability before their introduction. Moreover, the applicability of new rules must be checked, and the necessary amendments should be made.

V. Conclusions

Every rule has its advantages and drawbacks, and the insertion of additional regulations brings both benefits and harms for the community and the act of measuring the degree of their usefulness to inhibit corporate failures is impractical. Moreover, even though the organizations need to employ some regulations to govern their activities the introduction of extra laws is not the best tactic to preclude the re-happening of demises and the importance of ethics among the players should be stressed.

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An efficient way to confront the fraudulent behaviors is to introduce a mixture of regulations and principles so the indispensable regulations are incorporated in the firm while it is guided toward its targets with the help of guidelines. Besides, the principle-based accounting is more efficacious because while through the inclusion of some rules the involving parties' actions are structured and monitored the guiding principles lead the organization toward its objectives. The inclusion of supplementary regulations may initially be considered as an effectual instrument to prevent additional failures since it increases the obligations for different groups. But the probability of further demises increases because the emphasis on rules encourages the people to search for new means to evade them.

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