Bryant University

HONORS THESIS

Changes to Corporate Codes of Ethics: A Twelve-Year Analysis

BY Curtis L. Silverman

ADVISOR • Dr. Charles Cullinan
EDITORIAL REVIEWER • David Beausejour

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ABSTRACT

The Enron scandal caused companies and their Board of Directors to reconsider how they were utilizing their code of ethics, especially after the legislation of the Sarbanes-Oxley Act of 2002. Enron's Board of Directors provided the CFO, Andy Fastow, with a waiver of the code of ethics to negotiate with himself, while also on behalf of Enron. The issue with this waiver was that, at the time, investors were left in the dark because they did not need to be notified about any changes or exceptions made to the code of ethics. After learning about why codes of ethics and any changes to them needed to be disclosed, I looked at all the changes made to companies' codes of ethics over the last twelve years and classified them. I classified the types of changes into either a waiver, an amendment, a new code of ethics, or other. From the classified data, I was able to discover two main trends: most changes are made during the fourth quarter of the year, and the number of amendments has been decreasing while the number of new codes of ethics is increasing.

INTRODUCTION

Why should an investor care about a company's code of ethics? According to the Code of Federal Regulations

"The code of ethics means written standards that are reasonably designed to deter wrongdoing and to promote: (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant; (3) Compliance with applicable governmental laws, rules and regulations; (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (5) Accountability for adherence to the code." (CFR 229.406(b))

Originally, companies were not required to report their code of ethics to investors; however, that changed due to governmental actions made as a response to the Enron scandal. Enron, a massive company worth over $70 billion at its peak, collapsed due to the fraud its leadership committed, causing a considerable impact on the United States' Economy. A brief investigation into how this fraud occurred will be performed in order to discover what allowed a 70 billion dollar company to disappear within a year. After analyzing the cause of the fraud, governmental actions will be examined to see what was done in order to prevent a fraud of this magnitude from reoccurring again. Then, a deeper dive into codes of ethics and how they were changed as a result of the scandal will be performed. After examining the codes of ethics, the research question will be established and discussed. With the research goal having been established, the research methodology will then be examined to show how the research was conducted in order for the process to be replicable. Finally, the research results and the trends discovered will be shown, along with the importance of the research.

LITERATURE REVIEW

The Enron scandal occurred in 2001, requiring massive changes to be made to prevent fraud of this magnitude from happening again. This change came in the form of the Sarbanes-Oxley Act of 2002 (SOX). SOX required companies to follow stricter rules for accounting while imposing stricter record-keeping requirements. In order to better understand codes of ethics, a crucial part of my research, a background into what they actually are and why they need to be reported will occur.

Enron Scandal

Honest financial reporting has always been difficult to guarantee and regulate. Over the years, there have been many financial crises that have resulted from companies trying to "game the system." The Securities and Exchange Commission's (SEC) roll is to have a set of fair and reliable guidelines that regulate businesses in order to protect investors (SEC, 2019), and when these guidelines fail, Congress needs to step in to revise them. The Enron scandal illustrates a case where government regulations failed. In 1992, Enron received permission from the SEC to allow them to use the mark-to-market (MTM) accounting method. MTM is an acceptable accounting method when used correctly and has been allowed under Generally Accepted Accounting Principles (GAAP), guidelines that accountants are required to follow. However, the MTM method of accounting is based upon the fair market value, not the book value of long-term contracts (Hosseini & Mahesh, 2016). Fair market value is the value the asset would have if sold on an open market, while book value is the purchase price of the asset adjusted for depreciation, amortization, or impairment. MTM allowed Enron to report its profits based upon the estimated revenue from long-term contracts and not the actual revenue that was generated from those contracts. In fact, the traders at Enron were pressured to forecast high future cash flows, while simultaneously projecting low discount rates which inflated Enron's perceived profit (Hosseini & Mahesh, 2016).

Enron intentionally used a loophole within MTM accounting, which allowed the company to grossly overstate its profits by using projected cash flow instead of the contracts' actual cash flow (Hosseini & Mahesh, 2016). Enron then attempted to transfer the losses by using Special Purpose Entity (SPE) companies to hide the difference (Hosseini & Mahesh, 2016). A SPE could hide losses if the parent company had less than a 97% stake in the initial investment, as the SPE did not need to be added to the parent company's accounts (Hosseini & Mahesh, 2016). Enron used these SPEs to take out debts backed by their stock that did not need to be reported on Enron's financial statements (Hosseini & Mahesh, 2016). This resulted in Enron using these loans to offset the losses incurred from the overvalued contracts, increasing their revenue while misleading investors into believing that Enron was in a better financial position than it was (Hosseini & Mahesh, 2016). The Enron scandal was the result of unethical management by the Board of Directors who had a desire to increase the stock price due to their significant stake in the company from stock bonuses and incentives.

Enron also had the issue where Andy Fastow, the Chief Financial Officer (CFO) of Enron, signed a waiver granted to him by Enron's Board of Directors that allowed him to ignore the conflict-of-interest rules, allowing him to run the SPE (Cutler, Stephen, et al., 2002). From July 1999 to October 2001, Enron used these SPEs to defraud their shareholders (Cutler, Stephen, et al., 2002). Fastow's behavior was allowed by Enron's Board of Directors because it enabled Enron to appear as a better investment than it actually was (Cutler, Stephen, et al., 2002). This waiver to Enron's conflict-of-interest rules allowed Enron to get away with the fraud in order to make their financial situation look the way that they wanted (Cutler, Stephen, et al., 2002). This waiver, however, did not need to be reported to shareholders, and therefore, outsiders did not know it existed due to the governmental regulations of the time.

The regulations regarding how corporations can be run are constantly evolving in order to fix errors and oversites that occur within a company's management. Enron's shady accounting is a perfect example of when the government needs to step in and make changes for the good of investors. Enron's Board of Directors also failed to regulate their reporting system, which allowed for the misreporting of profits (Cohan, 2002).

The use of MTM and inaccurate financial reporting had allowed the Enron Board of Directors and the company to misinform and trick investors into believing that Enron was more successful than it actually was. This ultimately gave investors a false perspective on how healthy the company was financially. In addition, through MTM, Enron hid debt and inflated their profits which goes against the spirit of what ethical financial reporting should be.

<u>Response to Enron Scandal</u>

The Enron scandal brought to light an issue in how corporations allowed auditors to be chosen and regulated. This issue led many financial experts to attempt to find a solution to prevent this from reoccurring. Abdel-khalik's research (2002) analyzed where the current business model failed to regulate the external auditors and created a proposition to create a Shareholder's Board of Trustees to regulate them. Abdel-khalik discussed the way in which the Board of Directors of a company decided how the company is audited. He claims that the issue with the Board of Directors deciding how the company is audited, is that Board members typically have large stakes within the company, as was the case with Enron (Abdel-khalik, 2002). Along with the Board of Directors' control of the auditors, the management within a company has ultimate control of what is disclosed in the financial statements. The Board of Directors and management both have a large stake within the company due to bonuses and incentives; therefore, the Board is encouraged to provide a misrepresentation of financial statements to the auditors. This, in turn, would cause investors to inflate the stock price, benefitting the Board and management.

Experts were uncertain about what changes to regulations needed to be put in place in order to prevent the Enron scandal from happening again. Many disagreed about what the main problem was and held several different theories on how to solve the issue of how corporations were currently being run. Two of the experts, Bowen and Heath (2005), offered suggestions regarding how corporations could implement changes in both ethical decision making and education about ethics. They proposed four different imperatives to guide the Board of Directors into making ethical decisions. The four imperatives are that management needs to be cautious, distinguish ethical and legal issues, make a strategic plan to avoid issues, and that management should elevate ethics over legal standards in order to maintain positive public image. Other experts, including Petrick and Scherer (2003), concluded that three positive actions are necessary to improve the integrity of management. The actions are to educate managers, expand management accountability to include system integrity, and include institutionalized stakeholder democracy. The authors argue that corporations could prevent a new Enron disaster from reoccurring by increasing accountability and education in ethics. Finally, experts such as Keefe and Tipgos argue that the Enron scandal resulted from employees being marginalized and treated as disposable. Keefe and Tipgos suggested that employees needed to be treated as more than just a factor in the corporation, and instead as a critical part of the organization (Keefe & Tipgos, 2004). Keefe and Tipgos thought that this would make the employees feel valued and allow them to feel that they are making a difference within the organization. While not all of these suggestions have been implemented, it shows that many scholars have endeavored to find ways to prevent another Enron scandal.

<u>Code of Ethics</u>

A change made by Congress that is still in effect today is the need to disclose a company's code of ethics. A code of ethics guides how the company and its employees should act. From a survey of 100 ethics officers, it was concluded that just having a code of ethics was not enough. The survey concluded that if the company did not follow through with and punish the offenders of the code of ethics, as was the case of Enron, nothing would change (Verschoor, 2002). Employees could violate the code of ethics without suffering consequences or punishment, which would in turn, encourage others to violate them to better their position within the company. Congress required the disclosure of the code of ethics and any changes or exceptions that the company made when they enacted SOX (Section 406). These disclosures of the code of ethics needed to be made within the Form 8-K under Item 5.05. A Form 8-K is a current report made by a company when the change occurs. The disclosure of the code of ethics would allow the shareholders to understand whether the company appeared to be acting in an ethical manner. The code of ethics is also a standard used by companies to hold individuals responsible, as most companies require employees to sign that they have read and understood it. While SOX Section 406 does not require all companies to have a code of ethics, it does require them to explain why they do not have one allowing the stockholders to know why they did not choose to implement one (CFR 229.406(b)). A code of ethics is important to a company because it guides corporate culture and helps prevent Enron's situation from repeating itself (Brandl & Maguire, 2002). However, as mentioned above, if the code of ethics is not followed, it undermines the corporate culture the company was trying to create. This would create an image that management fails to recognize the importance of ethical decision-making, enabling employees to escape consequences when violating ethical codes.

As a direct result of Enron's Board of Directors granting a waiver to Andy Fastow, companies now need to disclose changes to their codes of ethics to investors. These changes could include waivers from their code of ethics, slight changes or amendments to codes of ethics, and even entirely new codes of ethics. This disclosure is essential as it provides stockholders with an inside look at what is changing within the corporation. Pirrone and Trainor (2015) analyze the rationales behind why each disclosure was made, using an approach that I plan to model in the present study. First, the authors examined the amendments made by companies to their codes of ethics and then rated them as value or compliance-oriented. This categorization indicated whether the changes made were to adhere to new governmental policies or whether the company changed in order to improve their values. The article concluded that firms tend to be more focused on improving their company values instead of just complying with governmental regulations. They also found that amendments to codes of ethics were the most common reason for Form 8-K to include item 5.05 rather than waivers or entirely new codes (Pirrone & Trainor, 2015). Pirrone & Trainor's setup is very similar in design to what this paper researches, as they both look into why corporations needed to fill out their Form 8-K with item 5.05 and what type of changes were made to the code of ethics.

Summary

While exploring the causes of the Enron scandal, I discovered that the Board of Directors at Enron granted a waiver to their code of ethics for Andy Fastow. As a result, Congress determined that investors should be notified of any changes made to the code of ethics, allowing investors to be able to stay up to date on the company's affairs. As a result, Congress, as part of SOX Section 406, required that companies now disclose their code of ethics and any changes made to them. After learning what Congress did, I then looked into the importance of having and following through with a code of ethics and how it guides a company's culture.

RESEARCH QUESTION

The goal of the present study is to understand different types of disclosures made to the code of ethics in Form 8-Ks. The research will answer the question, "Are there any trends for when companies have waived their code of ethics, changed their code of ethics, or created a new code of ethics?" These trends are important to understand as they enable a greater understanding of how future codes of ethics in a company might change from looking at past trends. It is also essential to understand how often companies change their ethics, as ethics are always changing over time and it is important that companies keep up with these changes.

METHODOLOGY

Observations

The sample consists of Form 8-Ks reported from January 1st, 2010, to December 31st, 2021. In order to keep the sample relevant, the Form 8-Ks will be filtered to contain only those including Item 5.05. From January 1st, 2010, to December 31st, 2021, there have been 911 fillings of Form

8-K that include Item 5.05. This sample of 911 filings consists of publicly traded companies that have reported changes to their code of ethics. All Form 8-Ks are freely accessible from the SEC through their website, www.sec.gov.

Measures

From these Form 8-Ks, the data will be hand-coded to show when it was filed, the period it was reporting for, and the reporting company. The data will also be hand-coded to show the type of change occurring within the Form 8-K involved whether it be waived, amended, newly created code, or other. For waivers or others in the code of ethics, the reason for this occurring will also be recorded. "Dates" will be recorded to show when the form was filed, and the time the form is reporting for. "Filed" is when Form 8-K was sent and filed with the SEC, and "Reporting for" is the date that the change that requires the form to be filed occurred. "The company" is recorded in words and is the company that filed the form. "Waiving" is when a section of the code of ethics is allowed to be bypassed for a particular reason. The waiver will be recorded as a 1 if a waiver occurred or a 0 if no waiver occurred. "Amendment" is when a section of the code of ethics changes. Amending will be recorded as a 1 if an amendment occurred or 0 if no amendment occurred. "New Code of Ethics" will be reported as a 1 if a new code is created or a 0 if no new code was created. "Other" will represent any Form 8-K that does fall into any of the previous classifications. Some examples of the "Other" category include, a violation to the code of ethics, a disclosure of an inexistent code of ethics, or a declaration that amendments to the code of ethics will be made soon. "Other" will be either a 1 or a 0 to show whether the Form 8-K mentions Item 5.05. "Description" will include a description of the reason for this change and will be recorded in a small blurb to add color to the input. The data will be coded to create variables, and then an analysis will be performed to identify any trends in the data for reasons that Item 5.05 was listed in the Form 8-K.

RESULTS

The research results have provided helpful information about how often codes of ethics have changed over the last 12 years. Over the last 12 years, there have been 41 waivers, 502 amendments, 297 new codes of ethics, 23 others, and 48 Form 8-Ks that did not affect the code of ethics. The 48 Form 8-Ks were removed from the data set as they are not helpful to the analysis because they are mislabeled or simply state how they will comply and report any changes to the code of ethics.

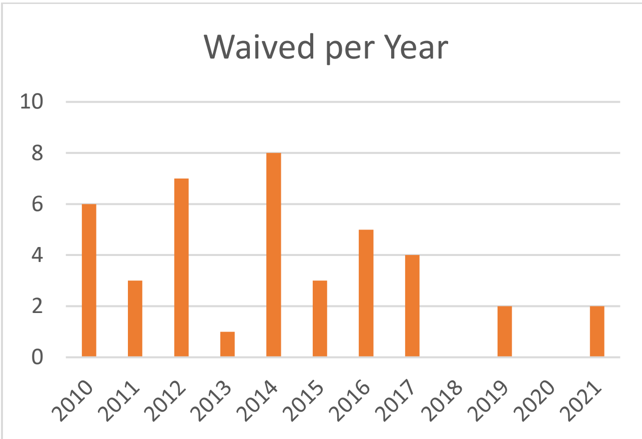


Figure 1 – Waivers made per Year

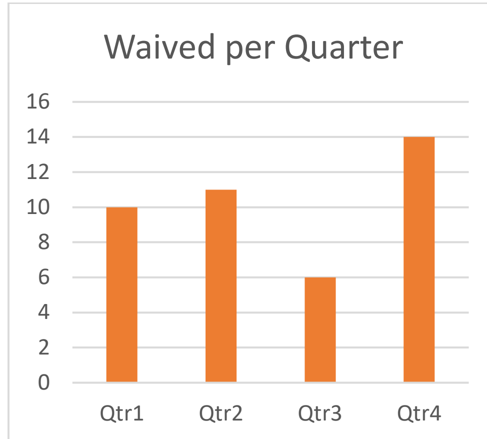
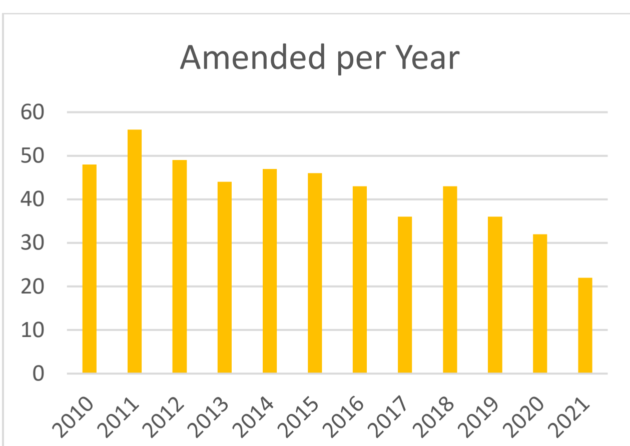


Figure 2 – Waivers made per Quarter

When examining the 41 waivers that were made over the 12 years it can be seen from Figure 1 that there was not a consistent number of waivers per year and that it was hard to find a discernable trend from year to year. As illustrated in Figure 2, the waivers seemed to occur every quarter with a slight preference for the fourth quarter. In addition, there seemed to be no pattern of time when a waiver was given and was instead just given when the situation demanded one. This might be due to the limited number of waivers given over the time period. Unlike what I expected, there was no abnormal increase in the number of waivers made in 2020 due to COVID-19. I expected some Board members to bail themselves out of financial trouble by selling required stocks in order raise capital.



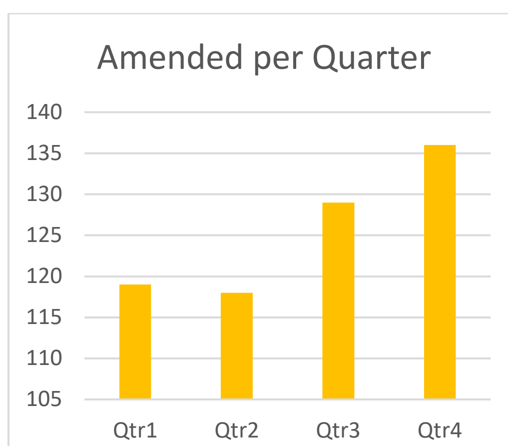


Figure 3 – Amendments made per Year *Figure 4 – Amendments made per Quarter*

Amendments from Figure 4 seem to have a trend of occurring towards the end of the year, mainly the third and fourth quarters. Over the years, Figure 3 shows that there has been a slight decrease in the number of amendments made to codes of ethics. From a high of 56 amendments in 2011, the number of amendments decreased every year, with slight increases in 2014 and 2018.

Figure 5 – New Codes of Ethics made per Year

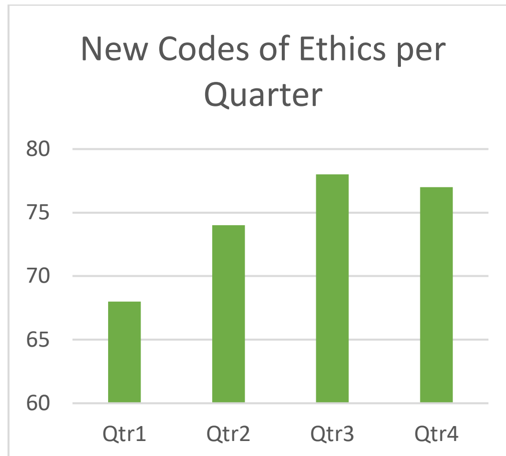


Figure 6 – New Codes of Ethics made per Quarter

Unlike the results with both waivers and amendments, Figure 6 shows the third quarter, as opposed to the fourth quarter of the year, as being the most popular time to release a new code of ethics. This trend leads to the conclusion that companies do meet during the year to discuss changes to the code of ethics, usually meeting during the third or fourth quarter. Over the years, Figure 5 shows the number of new codes of ethics steadily increased starting from 2016, with a massive decrease in 2019.

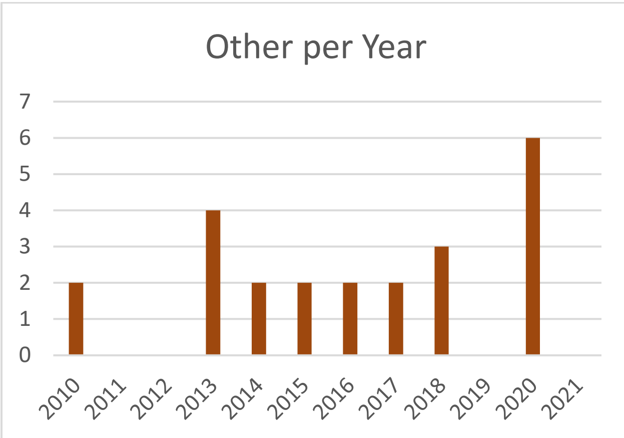


Figure 7 – Other Form 8-K submitted per Year

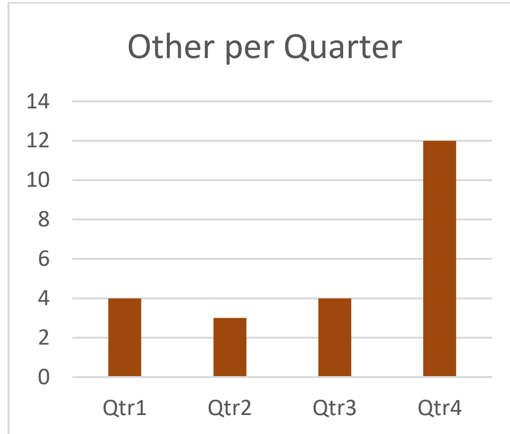


Figure 8 – Other Form 8-K submitted per Quarter

When looking at the other category of Form 8-K, the vast majority deals with companies that did not have a code of ethics or were saying that they would soon adopt a code of ethics. Others discuss how the waiver did not need to be disclosed due to the nature of it. One Form 8-K involved an employee failing to disclose certain transactions that violated the code of ethics. From Figure 8, there was also a trend that the other Form 8-Ks were filed during the fourth quarter.

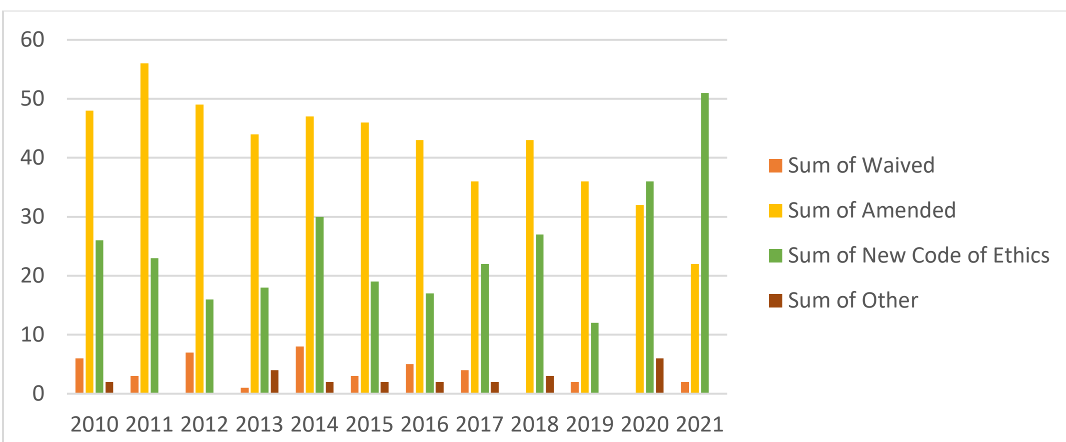


Figure 9 – All Form 8-K Compared per Year

When looking at the individual categories, some minor trends become prevalent; however, a larger trend seems to occur when comparing the different classifications directly with one another. Over the last twelve years, the number of amended codes of ethics has gone down. Although this does not mean anything by itself, combined with the last six years of a rising number of new codes of ethics, it does mean something. While in 2019, there was an abnormally low number of new codes of ethics, this does not seem to affect the overall trend of increased new codes of ethics. The low in 2019, instead, seems to have caused some of the two highest years in the number of new codes of ethics in the analyzed twelve years. If this trend continues, it might be possible that next year there would be even more new codes of ethics and fewer amendments. This change could be as a result of companies being affected by new technologies, requiring new codes of ethics to include the changing technological climate. The increased number of new codes of ethics could also be a result of companies needing to change to become more remote-oriented to deal with the COVID-19 pandemic.

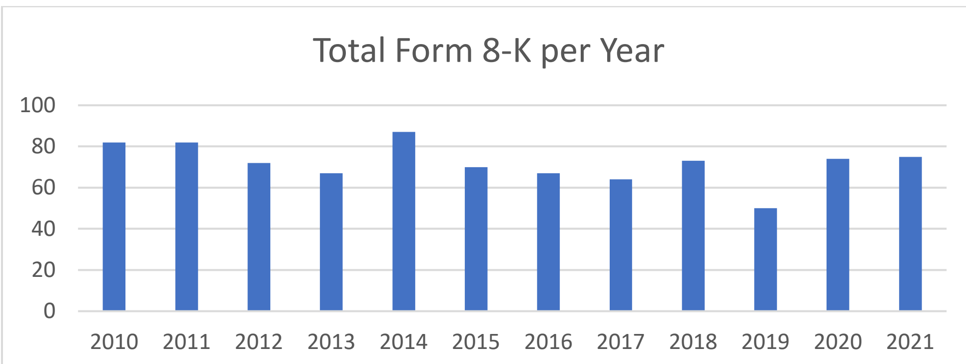


Figure 10 – Cumulative Form 8-K submitted per Year

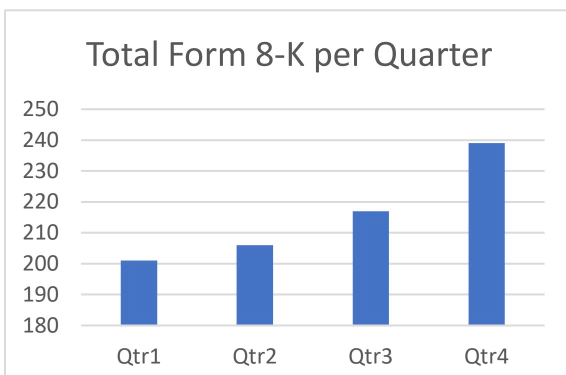


Figure 11 – Cumulative Form 8-K submitted per Quarter

Finally, when looking at Figure 10 for when the Form 8-Ks were filed in general, it can be seen that there has been a relatively consistent number over the years, only deviating slightly with a decrease in 2019. Then when looking at Figure 11, which breaks down cumulative classifications into quarters, the fourth quarter stands out as the primary time to make changes to the code of ethics.

SUMMARY AND IMPLICATIONS

Since ethics are constantly changing to fit the time and technology, companies must keep their codes of ethics current and inform their investors of any changes. The fact that investors can see a company's code of ethics is significant as the investor can ensure that the employees have guidelines to act in an ethical manner. From the research conducted, it can be seen that companies are creating and changing their codes of ethics often, and it is important to be able to determine what types of changes are being made.

From the research, it can be concluded that while the number of codes of ethics being affected is not changing, there is a trend of having more new codes of ethics than amendments made. COVID-19 has affected business by causing a shift towards remote working which may be a reason why there has been an increase in new codes of ethics written versus amendments made to already established codes. Unlike my prior expectations, codes of ethics were not negatively affected by the pandemic, as there were not many waivers made. Finally, it was found that most changes to the code of ethics take place during the fourth quarter, suggesting that companies meet and discuss changes in the code of ethics at the end of the year.

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