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**"HOW CORPORATE GOVERNANCE AFFECTS  
STRATEGY OF CORPORATIONS?"**  
**- Lessons from Enron Corporation -**


Masters Thesis in Business Administration

Supervisor:  
Prof. Jörgen Ljung

Authors:  
Hameed Ahmed, Ali Najam  
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Department of Management and Economics  
Linköping University, Sweden



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**Abstract**

Corporate governance is a subject of academic and professional debate. It has and it will continue to be a topic under scrutiny for subsequent deliberations since there are many different research dimensions and contexts associated with it. However, it has been observed that the linkage between corporate governance and strategy of a corporation remains as an untapped area with considerable avenues of research. This paper tends to explore this linkage, using Enron scandal as backdrop.

In the aftermath of the debacle of US energy giant Enron in 2001, the significance of corporate governance has come under heavy scrutiny of different researchers. Whereas different explanations have been attributed to its downfall, it has been widely accepted that this was a case of failed corporate governance. This paper tends to explore Enron downfall from the perspective of failed corporate governance. By defining and exploring corporate governance and its underlying issues, the authors have used Agency theory as a theoretical framework in unison with internationally renowned auditing company - Ernst & Young's model - to understand the role of different actors and forces responsible for Enron collapse.

By using qualitative research method, the authors have used secondary literature as well as combination of questionnaires and telephonic interviews to obtain viewpoint of renowned international academic / professional researchers. They have been identified through convenience sampling methodology. A few internationally renowned auditing companies have also been used as part of this survey to explore diversity of perspectives in this context. Efforts have been made; to explore the main causes rather than to write just another case on Enron.

After drawing lessons from Enron, the paper concludes with the understanding that there is direct link between corporate governance and strategy of corporations. However there is diversity of perspectives in this context and hence it requires further exploration and debate.

**Keywords**  
*Enron, Corporate governance, Corporate Strategy, Strategic Management, Corporations*



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Finally we wish to thank all those who either directly or indirectly helped us in the accomplishment of this task.

**Hameed Ahmed, Ali Najam**

Linköping University, Linköping, Sweden

Jan 2006

# DEDICATION

I wish to dedicate this thesis to my family. Whatever I am today, and whatever small steps that I have taken in my life, its all because of them. They have been a profound influence towards my intellectual, professional and personal development. My father Akbar, my mother Anjum, my sister Saima, Uncle Rashid, Peelu Aunty, Rafi and my grand mom Mrs. H.I. Ahmed have enriched me at every step of my life. They held me together when I was struggling and they inspired me to strive for excellence. Whereas I struggled to maintain balance at every step of my life, their unconditional love and support made me handle life's challenges with a greater resilience. Thank you for being there with me.

Special credit goes to my dad Mr. Akbar Ahmed, for his visionary thinking and for serving as an inspiration at every step of my life. I wish I could make you the happiest dad in the world. May your humane thinking and inspirational ideas guide us in making this beautiful world, a better place to live.

Thank you for all your love, support and guidance

*Hameed Ahmed*

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## List of Abbreviations

BoD	Board of Directors
CEO	Chief Executive Officer
CFO	Chief Financial Officer
GAAP	Generally Accepted Accounting Principles
IFC	International Finance Corporation
OECD	Organization For Economic Cooperation And Development
SBP	State Bank of Pakistan
SEC	Securities Exchange Commission
UK	United Kingdom
USA	United State of America
USD	United States Dollar
WB	World Bank



# 1. INTRODUCTION

*This chapter presents brief introduction of the concept of Corporate Governance and its importance for organizations. Citing Enron scandal as a case of failed Corporate Governance, this chapter sets stage for a detailed subsequent discussion as to how corporate governance influences strategy of Corporations. This chapter contains background, problem discussion, hypothesis, purpose, research questions, limitations, academic contribution, outline and research model of the study.*

*“A number of high profile corporate failures in 2001-2002 have brought a renewed focus on the importance of good corporate governance, bringing the topic to a broader audience. Enron and Parmalat notwithstanding, corporate governance is not merely an issue for rich countries. Developing countries tend to have poor standards and much to gain by improving them. The basic principles are the same everywhere: fairness, transparency, accountability and responsibility are minimum standards that provide legitimacy to the corporation, reduce vulnerability to financial crisis, and broaden and deepen access to capital. However, applying these standards across a wide variety of legal, economic, and social systems is not easy. Capacity is often weak, vested interests prevail, and incentives are uncertain.”<sup>1</sup>*

*Source: James Wolfensohn, Former President of World Bank, (1999)*

## 1.1 Background

According to McGee et al (2005), Bankruptcy and subsequent collapse of Houston-based energy giant Enron in December 2001 on charges of hidden debt, inflated profits, questionable accounting and governance; marked the beginning of a new debate on the significance of corporate governance for organizational sustainability.<sup>2</sup> Henceforth, it has been realised that in order to enhance profitability and to achieve operational objectives, companies at times undermine stakeholders’ interest. They often commit corporate crimes that also damage shareholders’ interest in the longer range.

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<sup>1</sup> “Corporate Governance: Improving Transparency and Accountability” by World Bank, Available online <http://rru.worldbank.org/Themes/CorporateGovernance/> accessed on 2005-10-27

<sup>2</sup> McGee J et al (2005) “*Strategy- Analysis and Practice*”, McGraw-Hill Education, Berkshire, United Kingdom, Chapter 17, Page-629-630

Once regarded as icons of success, such companies end-up making media headlines for corporate malpractice. More recently, the United Nations Organization (UNO) along with 2,000 other companies such as Volvo, Siemens, Daimler Chrysler, Daewoo have been named for alleged mismanagement of varying magnitude in the oil-for-food deal with Iraq, thus prompting a great need for improved governance, better transparency and accountability.<sup>3</sup>

## 1.2 Problem Discussion

Corporate governance is a broad structure by which corporations are monitored and controlled. It can be viewed as collective set of relationships between an organization and its various stakeholders, with the Board of Directors responsible for the overall governance of the organization as a whole.<sup>4</sup> Following definition explains broadly the core concept of Corporate Governance:

*“Corporate governance is about promoting corporate fairness, transparency and accountability. The corporate governance structure specifies the distribution of rights and responsibilities of the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.”<sup>5</sup>*

Source: White Paper of KPMG (2002)

In view of OECD’s <sup>6</sup> definition, Corporate Governance is a system that helps organizations to control and monitor their business process. Efficient structure of governance entails distribution of rights and responsibilities among different entities such as: “Board of directors, Management, Shareholders and Stakeholders” of a corporation. They make rules for making decisions on corporate affairs. This way of structured governance provides opportunity to monitor processes that can enhance performance.<sup>7</sup>

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<sup>3</sup> “Iraq scandal taints 2,000 firms” By BBC News, Available online <http://news.bbc.co.uk/1/hi/world/americas/4382820.stm> accessed on 2005-10-27

<sup>4</sup> Alacaogullari M., (2003), “Corporate Governance: A System for Private and Public Companies”, Available online [http://www.lightmillennium.org/3rd\\_april\\_03/malacaogullari\\_corp\\_govern.html](http://www.lightmillennium.org/3rd_april_03/malacaogullari_corp_govern.html) accessed on 2005-11-20

<sup>5</sup> “Corporate governance the new strategic imperative” written by KPMG International Available online [http://www.us.kpmg.com/microsite/Attachments/corp\\_govern\\_newstrat.pdf](http://www.us.kpmg.com/microsite/Attachments/corp_govern_newstrat.pdf) accessed on 2006-02-27

<sup>6</sup> OECD stands for ‘Organization for Economic Co-operation and Development’ at Paris, France

<sup>7</sup> “Corporate Governance”, defined by OECD, Available online [http://www.oecd.org/topic/0,2686,en\\_2649\\_37439\\_1\\_1\\_1\\_1\\_37439,00.html](http://www.oecd.org/topic/0,2686,en_2649_37439_1_1_1_1_37439,00.html) accessed on 2005-11-02

Corporate Governance provides in-depth policies and framework; from initial-to-end stage; that brings organisation rights and duties under single umbrella. These governance policies discuss matter of governance structure, financial matters, company law, privatisation, market entry and exits, health of economies and insolvency. The integration of healthy governance attributes enhances a country's economic performance and stability.<sup>8</sup>

According to Cook & Deakin (1999), corporate governance is a fairly inter-disciplinary field. It draws its roots from Management, Accounting, Finance, Economics, and Law. Since 1990s, it has got considerable attention of academia and practitioners, thereby creating an appropriate blend of theory and practice. However, since 1995 and beyond, there have been some unbelievable cases of poor corporate governance among top ranked companies, which have prompted further debate about this field and its significance; specially in the context of implementation in organizations.<sup>9</sup>

### **1.2.1 Examples of Renowned Corporate Frauds**

According to Fred (2003)<sup>10</sup>, there are occasions when management of several corporations failed to fulfil corporate responsibilities and duties. In the following cases, several organisations collapsed by committing crimes, frauds, corruption and self-dealing at corporate level:

#### **ENRON (2001) Energy business**

Biggest scandal of underprivileged corporate governance, where a leading energy products and services company (Enron), with revenues more than US \$100 Billion went bankrupt in 2001. Management failed owing to creative accounting and inappropriate disclosures, mainly due to underestimated costs, thereby showing large profit at forecasting long term projects<sup>11</sup>

#### **SUNBEAM (2001) Small Appliances Business**

Another case of corporate failure, where company showed bogus shipment of its products to one of its major client, Wal-Mart. The Company showed its account receivable as sale to boost the profitability without receiving cash in hand<sup>12</sup>

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<sup>8</sup> Ibid

<sup>9</sup> Cook J. and Deakin S., (1999) Stakeholding and corporate governance: Theory and evidence on economic performance, *ESRC Centre for Business Research, University of Cambridge, July 1999*

<sup>10</sup> J. Fred et al. (2003), "*Takeovers, Restructuring and Corporate Governance*", Pearson Prentice Hall, 4<sup>th</sup> edition Page 558-560

<sup>11</sup> Ibid

<sup>12</sup> Ibid

**DYNEGY (2002) Power Plant and Natural Gas Liquids Business**

Company artificially manipulated its share price by cross selling with Enron and other customers to show high profit for each other<sup>13</sup>

**WORLDCOM (2002) Telecommunications Business**

WorldCom, the United States No. 2 long-distance phone company<sup>14</sup>, forged accounts by showing operational expenses as capital expenses. Furthermore, top executives looted the company by taking large loans.

**ADELPHIA (2002) Cable Television business**

Adelphia was guilty of submitting false information to lenders and made fabricated financial statements to the public in order to maintain company's declining stock price.<sup>15</sup>

These incidents of failed corporate governance in previously high performing companies, have opened avenues for further research. Governments, business community, academicians and public at large are showing great interest in this particular field. Corporate governance seeks even greater significance in the context of large corporations<sup>16</sup> (Companies listed at stock exchange). These companies usually entail huge capital investments, are highly susceptible to governmental regulations, market conditions, and their ownership is distributed amongst different shareholders.

An organisation's success largely depends upon the vision expressed by the top management of corporation. Active corporate strategy linked with the vision plays a pivotal role in enhancing performance of a successful organisation.

According to Oracle's<sup>17</sup> Business Strategy Study<sup>18</sup>, Board of directors can optimise the corporate governance if they fulfil five major responsibilities:

1. It is Directors' responsibility to endorse the strategic way of a corporation.
2. Board must ensure effective and efficient ways to develop a corporation's strategy.

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<sup>13</sup> Ibid

<sup>14</sup> "WorldCom files largest bankruptcy ever" by CNN Money , Available online [http://money.cnn.com/2002/07/19/news/worldcom\\_bankruptcy/](http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy/) accessed on 2005-11-10

<sup>15</sup> "Adelphia execs arrested for fraud", By BBC News, Available online <http://news.bbc.co.uk/1/hi/business/2149956.stm> accessed on 2005-11-10

<sup>16</sup> The term public sector organization has different interpretations in different countries. For some it may mean government owned organizations, and for some it means companies that are listed on stock exchange and have distributed ownership amongst different individual and group of shareholders.

<sup>17</sup> Oracle is a reputable data management and enterprise resource planning Company.

<sup>18</sup> Michael E & Chris R. , (2003), "Improving Corporate Governance: A Balanced Scorecard Approach" by Oracle Corporation , Available online [http://www.oracle.com/applications/financials/corp\\_gov\\_bal\\_sc.pdf](http://www.oracle.com/applications/financials/corp_gov_bal_sc.pdf) accessed on 2005-11-10

3. The Board acts as a major player in guiding and giving professional advise to the CEO.
4. Another task of the Board is to select and to motivate executives of organisation.
5. A Director is a supervisory body for diminished risk and act like a protector for compliance.<sup>19</sup>

According to Brennan (2003), Enron scandal served as major starting point, which promoted the debate concerning the significance of corporate governance. It identified that whereas companies use different strategies to create value, yet at the same time they should refrain from committing corporate crimes that would undermine stakeholder interest. There has to be an optimum mix between shareholder and stakeholder value without damaging profitability of the company as a whole.<sup>20</sup>

Nevertheless, there has been widespread emphasis on the need of certain agreed set of international principles or conventions pertinent to corporate governance for the conduct of corporations. Hence, it is of scholastic and professional interest to have a certain understanding of the basic causes of downfall of Enron and to identify lessons from it. Such lessons could help large corporations to prevent themselves from violation of corporate governance principles.

### **1.3 Hypothesis**

The essential premise of this thesis is that corporate governance affects the strategy of corporations. This hypothesis entails a constant exchange of information between internal and external environment, which ultimately leads to strategy of an organization. How this is carried out, we will explore through a discussion on Enron debacle and will draw lessons from it.

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<sup>19</sup> Ibid

<sup>20</sup> Brennan M., (2003), "*Enron and Failed Futures: Policy and Corporate Governance in the Wake of Enron's Collapse*" Duke University Press, Winter 2003, Volume 21, Number 4 pp. 35-50

## **1.4 Purpose**

The purpose of this paper is to explore the link between corporate governance and strategy of large corporations to see if any relationship exists between these two concepts. By critically reviewing Enron scandal as a case and by identifying key lessons from it, the authors intend to explore how corporate governance can affect the strategy of corporations in their endeavour to achieve sustainable competitive advantage. Enron is taken as a case in point because its debacle entailed failed corporate governance. We wish to explore if Enron's corporate strategy, in anyway, was affected by its corporate governance mechanism. As a sub-theme of this thesis, we would also like to explore to what are the impediments in implementing corporate governance (a western concept) to Pakistan; having a different cultural orientation. Pakistan's perspective has been incorporated in this study since it's a country which is at a considerable psychic distance in comparison with the west. Hence there are inherent impediments associated since there are different socio-cultural, religious, and economic systems prevalent and in vogue; both in Pakistan and in the west. Since corporate governance has a lot to do with the financial market mechanism of a country hence it would be meaningful to explore financial market conditions and norms based on cultural orientation in the Pakistani society. By presenting corporate governance scenario of Pakistan, we feel it can be helpful for international companies to develop a better understanding of the Pakistani market and to have an effective use of corporate governance scenario prevalent in the country. The lessons as derived from Enron would be seen in the Pakistani perspective to see if Pakistani society can learn something which can prevent a recurrence of Enron-type scandal in our country.

## **1.5 Research Questions**

1. What is corporate governance? How it has an impact on corporate strategy of corporations?
2. How Enron scandal can be viewed from the perspective of failed corporate governance?



3. Based on the lessons of Enron debacle, how corporation can use corporate governance for their sustainable competitive advantage and how does it affect its strategy as whole?
  - 3-a. What are the impediments of implementing corporate governance in Pakistani context? (*This is a sub question in relation to our main theme*)

## 1.6 Limitations

It will be quite ambitious to discuss all aspects of good corporate governance. Keeping this in mind, the authors have restricted the area of study to specific issues. Hence, we have set following boundaries of the study:

- This work is primarily restricted to the perspective of other authors and sources that have critically evaluated Enron, its associated developments and debates. This is because Enron is under investigation for fraud and hence it was quite difficult to obtain primary data from corporate sources.
- There are at present 72 different codes and conventions<sup>21</sup> associated with the field with 17 codes originating from USA, while 2 from Sweden.<sup>22</sup> Hence it is difficult to present a global, regional or national context associated with it.
- The authors are not tracing the evolution of corporate governance or various debates associated with it. The period under consideration mostly is of year 2001 and beyond when Enron scandal took place.
- Most of the work done on corporate governance related area, is based on North American origin. European contribution to the field is limited and at times it is in a language other than English. Hence the authors have primarily relied on work of US based authors and American research.
- The contexts associated with the field are broad and range from different practices such as finance, audit, taxation, board management, transparency and

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<sup>21</sup> “Corporate Governance Codes and Principles in USA” provided by NYSE Corporate Accountability and Listing Standards Committee, Available online [http://www.ecgi.org/codes/documents/corp\\_gov\\_pro\\_b.pdf](http://www.ecgi.org/codes/documents/corp_gov_pro_b.pdf) accessed on 2005-11-10

<sup>22</sup> McGee J. et al, (2005) “*Strategy- analysis and practice*”, McGraw-Hill Education, Berkshire, United Kingdom Chapter 17, p-629-630

accountability in procedures to - as wide as corporate social responsibility. Hence the underlying dimensions vary in description and prescription.

While keeping these factors in mind, the authors have decided to cover corporate governance in general terms and to limit its span to overall context of corporate governance.

## **1.7 Academic Contribution of Study**

Various researchers discuss varying aspects of corporate governance. However, its impact on corporate strategy is a relatively newer concept that requires more in-depth research, debate and analysis. This study contributes vivid flow of information for reader about strategic effects of corporate governance over long term growth of organisation.

Whereas most of the literature on corporate governance has been from North American and European sources, academic contributions from other parts of the world are relatively low. Since the authors hail from Pakistan, a country of 160 million<sup>23</sup> inhabitants from South Asia region, the topic in our part of the world is still nascent. There is growing awareness about it.

Some countries in the South Asian region, namely Pakistan, India, Bangladesh and Sri Lanka serve as vital trading partners to the international community, particularly the US and European countries, owing to their favourable demographics, and economic conditions. Hence, leading international companies are investing in Pakistan, either in collaboration with government or with the general public, particularly in the Telecommunications and energy sector.

The lessons drawn from this paper will be of utility to academic and professional circles in Pakistan in general and for Pakistani listed companies in particular who are now realising the importance of corporate governance. This paper will also highlight the fact that corporate scenario in many countries is inherently different from the scenario which is prevalent in the West. Hence there are inherent impediments for implementing a western concept to an Eastern country which has different cultural, legal and socio-economic orientation. Such impediments ought to be kept in mind while developing

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<sup>23</sup> "Pakistan People 2005", Population of Pakistan = 162,419,946 (July 2005 EST.) Available online [http://www.theodora.com/wfbcurrent/pakistan/pakistan\\_people.html](http://www.theodora.com/wfbcurrent/pakistan/pakistan_people.html) accessed on 07-01-06

international business relationships. Furthermore this paper may help further in an international debate and research on the vital link between corporate governance and strategy – a link which has not been explored explicitly by researchers and professionals.

## **1.8 Outline of the Thesis**

This study comprises of eight parts; detail of each part is given below:

### **Part 1 – Introduction**

It describes a general introduction of the topic, background, problem discussion, purpose, research questions, limitations, contribution and outline of this research.

### **Part 2 - Methodology**

It presents an overview of methods and methodology adopted to explore answer to the research questions.

### **Part 3 – Frame of Reference**

It presents an overview of theoretical aspects of corporate governance using Agency theory and Ernst & Young Model for corporate governance as a general frame of reference to understand the case at hand.

### **Part 4 – Corporation, Corporate Strategy and Enron**

This part of study contains three major parts; Corporation, Corporate Strategy and Enron. Firstly, it provides general information about Corporation and its importance for this specific study. Secondly, it explains corporate strategy. Lastly, it contains an overview of the Enron Scandal, and its background in the realm of corporate governance.

### **Part 5 – Empirical part**

It presents a general analysis in light of interviews and questionnaire responses to present as to how companies can use corporate governance to have sustainable competitive advantage and how it can affect the strategy of such corporations.

### **Part 6 – Analysis**

This part combines analysis derived from empirical part as well as the frame of reference. While analysing the case in light of the theoretical framework this part identifies key lessons that should be drawn from the Enron debacle in the sphere of corporate

governance and strategy. Insights are presented regarding corporate governance scenario in Pakistan and impediments in this context.

#### **Part 7 – Conclusion**

It presents conclusive remarks about the research, summarises answers and key findings to the research questions. It further highlights avenue for future research on similar theme.

#### **Part 8 – Reference**

This chapter includes sources of data collected from books, articles, websites and interview response.

#### **Part 9- Appendix**

Last part contains specimen of questionnaire used for email response. It also includes a copy of a speech delivered by Governor, State Bank of Pakistan, regarding corporate governance scenario in the country and the need to improve the existing mechanism.

## 1.9 Research Model

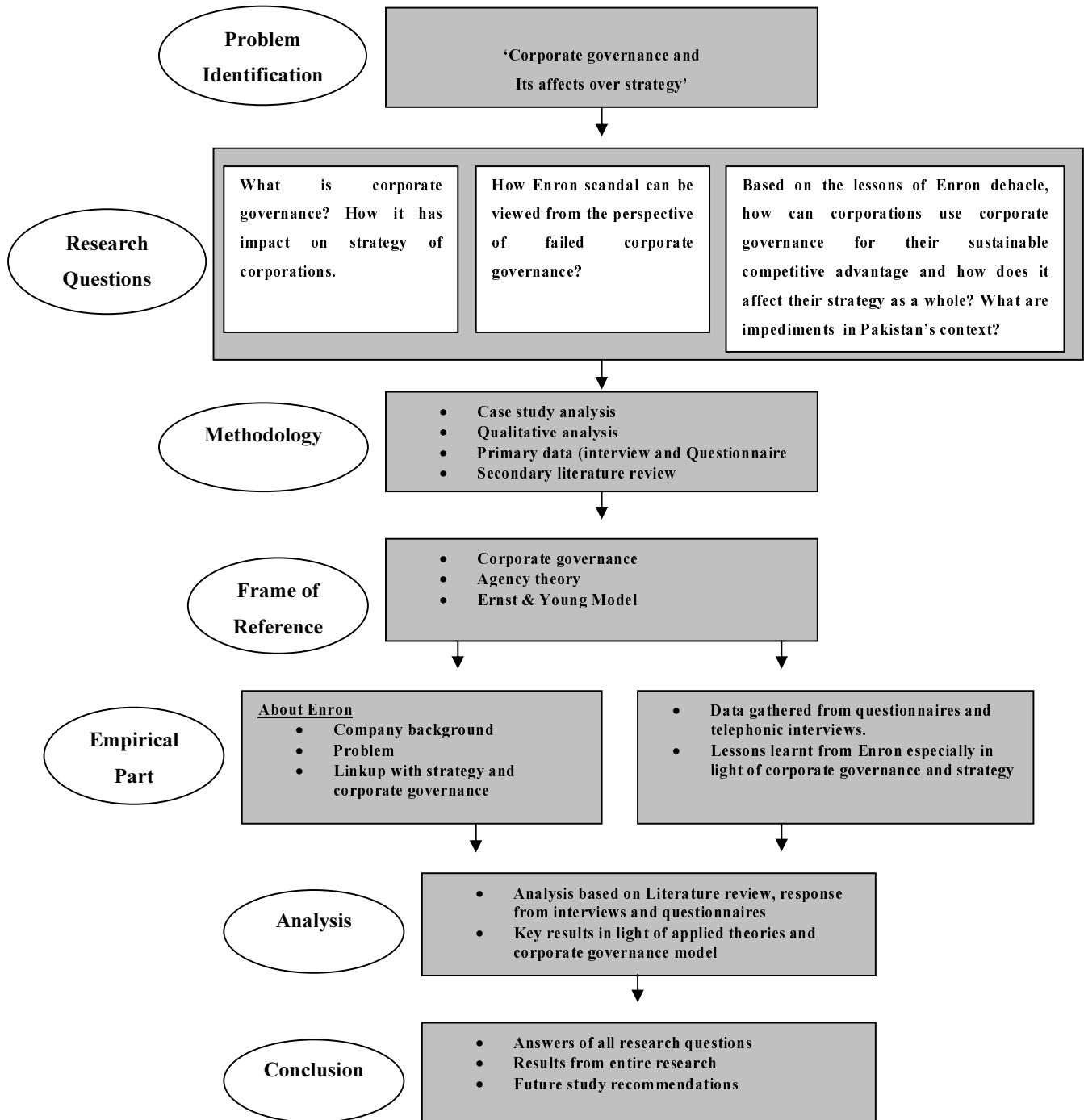


Figure 1.1: Our Research Model

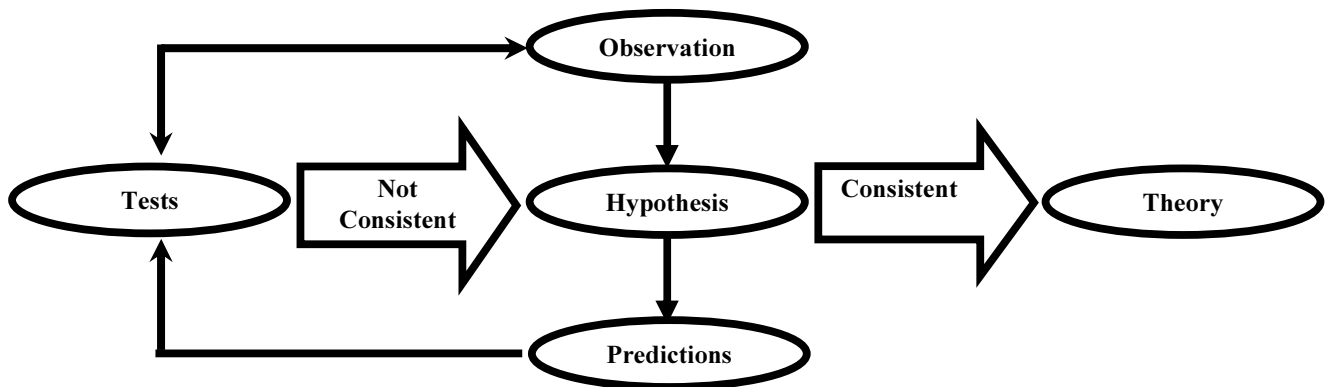
## 2. METHODOLOGY

*Every scientific study entails certain methods and procedures. In this section, as authors, we present detail of scientific research approach, that has been used in the study. This chapter explains research approach, data collection methods, kind of case study and conclusively it presents concepts of validity and reliability.*

*'Science is best defined as a careful, disciplined, logical search for knowledge about any and all aspects of the universe, obtained by examination of the best available evidence and always subject to correction and improvement upon discovery of better evidence.'*<sup>24</sup>

*James Randi (1998)*

The field of Social sciences entails usage of scientific research method to study social phenomena.<sup>25</sup> Scientific research method is a systematic approach towards analyzing a research issue. The following Figure reflects elements of a scientific research:



**Figure 2.1: Scientific Method Flow chart<sup>26</sup>**

Above drawn flow chart discuss necessary attributes of scientific research methods and processes. This flow chart entails the following characteristics:<sup>27</sup>

<sup>24</sup> "Overview of Scientific Method"(1998), Available online

[http://phyun5.ucr.edu/~wudka/Physics7/Notes\\_www/node5.html](http://phyun5.ucr.edu/~wudka/Physics7/Notes_www/node5.html) accessed on 2005-11-21

<sup>25</sup> "Overview of Social Science", Available online [http://en.wikipedia.org/wiki/Social\\_science](http://en.wikipedia.org/wiki/Social_science) accessed on 2005-11-20

<sup>26</sup> Scientific Method Flow chart, Available online [http://phyun5.ucr.edu/~wudka/Physics7/Notes\\_www/node6.html#SECTION02121000000000000000](http://phyun5.ucr.edu/~wudka/Physics7/Notes_www/node6.html#SECTION02121000000000000000) accessed on 2005-11-21

<sup>27</sup> Ibid

1. Firstly scientific study scrutinizes some aspect of the universe.
2. It creates a hypothesis that is derived from the observation of a consistent particular phenomena.
3. Usage of hypothesis while forecasting and explaining behavior of the phenomena.
4. Test these forecasted results in light of observations and experiences, then make amendment in hypothesis according to results.
5. Do again steps 3 & 4 until you get very few inconsistencies between theory and experiment.

In Filstead's (1971) point of view, method is a set of techniques including the ways of gathering, recording, verifying and analyzing data in social or natural setting on individual behaviors.<sup>28</sup> Moreover, method is like a tree that solves general case, directed acyclic graph, rooted at the problem statement and includes the general acceptable rules that satisfies all of the goals in the problem statement.<sup>29</sup>

Further in his study, Filstead (1971) distinguishes methodology from method as a scientific technique that helps in solving theoretical problem in the way of organizing, classifying and interpreting particular data.<sup>30</sup> The scientific methodology helps to diminish the effects of biasness in testing a hypothesis or a theory.<sup>31</sup> After concise view of theoretical aspects of methods and methodology, we would like to express the study as a scientific research, in which we would demonstrate explicit presentation of both primary and secondary sources of information.

## 2.1 Research Design

A research method in social science field presents research design as key variable that keeps the research project collective. A good quality layout of research design helps

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<sup>28</sup> Filstead W J., (1971), "Qualitative Methodology: Firsthand involvement with the social world", Markham publishing company, Chicago Page: 345

<sup>29</sup> "Towards the Definition of Methodology", by University of Stanford, Available online <http://www-db.stanford.edu/~burback/watersluice/node75.html> accessed on 2005-11-22

<sup>30</sup> Filstead W J., (1971), "Qualitative Methodology: Firsthand involvement with the social world", Markham publishing company, Chicago Page: 347

<sup>31</sup> Introduction to the Scientific Method, Available online [http://teacher.nsr1.rochester.edu/phy\\_labs/AppendixE/AppendixE.html](http://teacher.nsr1.rochester.edu/phy_labs/AppendixE/AppendixE.html) accessed on 2005-11-22

reader in understanding the study span. It explains the ways, methods, measurements and tools being used by researcher on the basis of research questions.<sup>32</sup>

Whereas, the study conducted in this research is about social sciences phenomena occurring in the corporate world, the approach followed is scientific in nature. The authors observed that there is existence of correlation between corporate governance and corporate strategy. It has lead to formulation of hypothesis that corporate governance affects strategy of corporations. On the basis of this hypothesis, we would explore an objective case study on basis of experiences and discrepancies of Enron's corporate strategy. As mentioned earlier, corporate governance is a fairly diversified and interdisciplinary field with multidimensional areas. In this context, this study entails information from various dimensions and geographical views. Further, we examine whether the hypothesis can be rejected from this exploratory research or not. Acceptance of hypothesis would confirm relationship between corporate governance and strategy. Rejection of hypothesis would open avenues for future research.

## **2.2 Kind of Research**

Scientific research entails systematic collection of data through qualitative or quantitative methods or through a combination of both. In recent years, several studies are based on a hybrid approach, in which researchers have used both approaches while conducting social science research.

In general, Quantitative research is a method that generates numerical value from analyzed data; it can be better explained with example of Census that calculates the population and other countable items. Whereas, Qualitative research is method that usually explores human believes, ideas, experiences and behaviors towards any study or experiment. As example; a patient's behavior & description about pain rather than measurement of pain. In this study, the authors have explained the effects of corporate governance over corporate strategy by using qualitative information. The Authors

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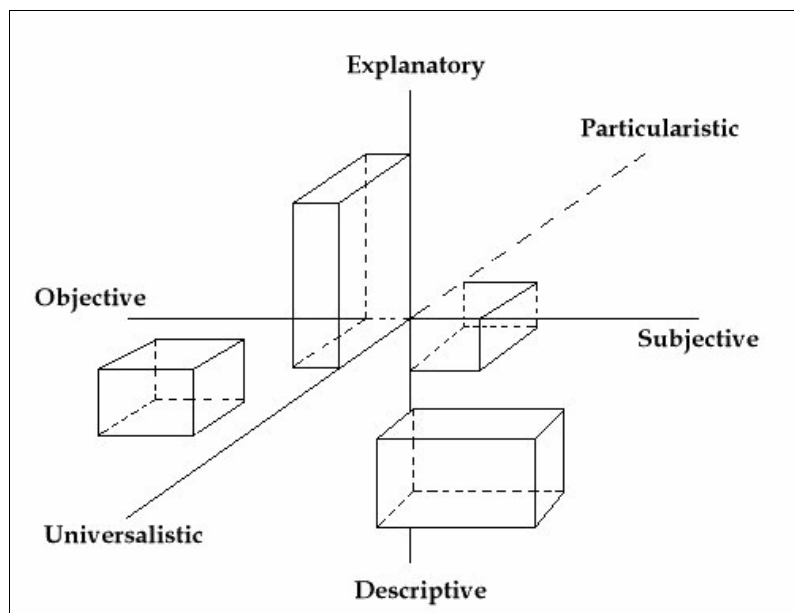
<sup>32</sup> Research design, Available online <http://www.socialresearchmethods.net/kb/design.htm> accessed on 2005-11-23



observed that behavior of an organization's corporate strategy can be explained better through qualitative study in comparison to quantitative one.<sup>33</sup>

Donna (1998) describes valuable comparison between these two approaches. There are various factors that distinguish between quantitative and qualitative approach. However, some of the salient features to study this comparison are:<sup>34</sup>:

- Qualitative research is more towards subjective orientation while quantitative is objective in nature.
- Qualitative research explores in-depth description about occurrence of a particular phenomena whereas quantitative approach explores explanatory laws.
- Qualitative research tends more toward exploration of particular reality in social science research as compared to quantitative one which measures static reality of universal laws.



**Figure 2.2: Dimensions of Social Research<sup>35</sup>**

<sup>33</sup> Qualitative and quantitative research, Available online <http://www.jr2.ox.ac.uk/bandolier/booth/glossary/qualres.html>, accessed on 2005-11-23

<sup>34</sup> Donna L. (1998), "Quantitative versus Qualitative Research: An Attempt to Clarify the Problem"

<sup>35</sup> Ibid

Moreover, above mentioned Figure 2.2 presents study types while explaining social research. Such research can be discussed in four dimension; explanatory, descriptive, subjective and objective. As far as our study is concerned, we have used case study in qualitative research approach and this study lies in fourth Quadrant in between descriptive and subjective. Descriptive and subjective dimensions of research study well describe our topic; corporate governance and its effects on strategy of large corporations.

## 2.3 Case Study

*“A case study is a particular method of qualitative research. Rather than using large samples and following a rigid protocol to examine a limited number of variables, case study methods involve an in-depth, longitudinal examination of a single instance or event: a case. They provide a systematic way of looking at events, collecting data, analyzing information, and reporting the results. As a result the researcher may gain a sharpened understanding of why the instance happened as it did, and what might become important to look at more extensively in future research.”<sup>36</sup>*

*Wikipedia Contributors (2006)*

According to Hartley J. (2004), case study research is a comprehensive examination of data collected and analyzed in a particular social context, so as to study specific phenomena. The context is of vital significance since it is intrinsically associated with these social phenomena. The case study method presents picture of different behavioral, procedural or influencing forces that affect a particular situation. It is suitable to research situations wherein a detailed examination of influencing forces is required and hence it is generally inductive in nature. <sup>37</sup> In case of this research, the authors have studied relationship between corporate governance and strategy in the organizational context of Enron debacle. It is a longitudinal study since we have considered just one organization

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<sup>36</sup> “Case study” from Wikipedia, (2006), Available online [http://en.wikipedia.org/wiki/Case\\_study](http://en.wikipedia.org/wiki/Case_study) accessed on 2006-01-05

<sup>37</sup> Hartley J. et al (2004) “Essential Guide to Qualitative methods in organizational research”, SAGE publications Ltd. London, UK p 323-324

and analyzed it in-depth with different research dimensions i.e. the impact of different forces and key actors upon organizational strategy in the realm of corporate governance. Case study was used in this research because it is flexible in nature and has got wider explanatory powers. It gives a diversified perspective of the situation and its underlying forces. In the words of Stake (1995), “most researchers find that they do their best work by being thoroughly prepared to concentrate on a few things, yet ready for unanticipated happenings that reveal the nature of the case”.<sup>38</sup> Thus a case study helps to identify intended and unintended (emergent) research elements that could lead to a plausible explanation of the research phenomena and evidence.

Yin (1994), Further stated by Cassell C. (2004), suggests that, “a high quality case study is characterized by rigorous thinking, sufficient presentation of evidence to reach appropriate conclusions, and careful consideration of alternative explanations of the evidence”.<sup>39</sup> Thus case study can at times be a useful tool to elaborate on causes, affects and associated behavioral explanation of particular phenomena and hence it has been used in our research.

Essential characteristics of using case study methodology are uniqueness, generalisability and replicable. The unique aspect of a case captures a researcher’s attention –thereby qualifying as single event or a case. This attribute enables him to carryout further research in the behavioral aspect of social phenomena. This uniqueness aspect of a case indicates that it has got certain elements which are different from norms. The other vital aspects of case study are generalisable and replicable. A case study analysis suggests certain aspects which are in conformity with the norms and the lessons learnt from a case can be replicable on other scenarios under similar situations. The information and findings of a case study analysis should be generalisable in similar circumstances as well as they should be applicable beyond current study.<sup>40</sup>

Keeping this criterion in mind, and as stipulated in the research questions part mentioned in chapter 1 of this thesis, we shall draw lessons from the Enron case to identify linkage between strategy and corporate governance. Therefore these aspects of Enron justify it as

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<sup>38</sup> Stake, R. (1995), “The Art of Case Study Research”, Sage Publication, page 55, p-324

<sup>39</sup> Yin, R. (1994) “Case study research: Design and Methods”, Sage Publication, second edition, p-324

<sup>40</sup> Hartley J. et al (2004) “Essential Guide to Qualitative methods in organizational research”, SAGE publications Ltd. London, UK p 331

a unique, replicable and generalisable case. Therefore a combination of these attributes brings in a lot of diversity in analysis and tends to yield better results.

A major disadvantage of case study method is that whereas it gives a comprehensive insight about reasons behind occurrence of social phenomena, yet a case is often subjected to inferences, interpretation and induction. However owing to its greater explanatory power, it has been used in this research.

Enron has been used a case for it is the biggest corporate debacle in US history. From being a highly respected company in the energy business having assets worth \$ 47.3 billions internationally, it filled for bankruptcy in 2001. Its financial impact is highly complex is still being tabulated by analysts. The company transactions and top management are under-investigation and it is widely regarded as an example of failed corporate governance by the top management and the board of directors. Hence, authors have used it as a case for this research.

## **2.4 Data Collection Techniques**

According to Lyberg (1991), “There are several data collection techniques while considering its overall appropriateness to the research, along with other practical factors, such as: expected quality of the collected data, estimated costs, predicted no response rates, expected level of measure errors, and length of the data collection period.”<sup>41</sup>

Whereas in a quantitative research, data collection and analysis is quantified (expressed in numerical terms). It can be tabulated and analyzed with the help of statistical software. However the challenge becomes more prominent in a qualitative research wherein data has to be gathered and analyzed in non-numeric terms. It is highly subjected to interpretation of the respondents and researcher.

In a qualitative research, popular data collection techniques include: surveys, literature review, content analysis, interviews, Focus groups and Participant observation techniques.

In Kerlinger (1986) view, “It is of course possible that a given research question may not be satisfactorily studied because specific data collection techniques do not exist to collect

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<sup>41</sup> Lyberg, L. E. and Kasprzyk, D. (1991), *"Data Collection Methods and Measurement Error: An Overview," Measurement Errors in Surveys*. New York: Wiley, Chapter 13

the data needed to answer such a question”.<sup>42</sup> However, effectiveness and credibility of research lies in the ability of researcher; that answer the research questions on the basis of the data collected and analyzed, without any preconceived opinions or biasness. For this study, the authors have used the following techniques to collect data; secondary literature review and primary source of data gathering.

### **2.4.1. Secondary Literature Review**

Secondary literature review entails summarization and analysis of existing data on a subject under research. “Sometimes secondary research is required in the preliminary stages of research to determine what is known already and what new data is required, or to inform research design.”<sup>43</sup>

Its advantage is that it gives multiple perspectives and avoids element of biasness in a research since it utilizes content of different published sources and by renowned authors. For this research thesis, the authors have used data from published secondary sources such as: Web pages, Journal articles and Books. A major reason for relying on secondary sources was that Enron Corporation is under litigation investigation by US authorities for financial embezzlement. Hence access to company officials and official records was not possible. Hence, the authors have mostly relied on the research of other sources that had direct access to Enron or its officials.

### **2.4.2. Primary Data**

Primary data on the contrary is defined as the “data collected directly from respondents or "research subjects" for the express purposes of a project, (often called "empirical" or "primary research")”.<sup>44</sup> It’s advantageous since it’s directly suited to the research requirements and is collected first hand by the authors through a pre-specified methodology.

For this thesis, the authors have used the following ways to collect primary data:

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<sup>42</sup> Kerlinger N., (1986), “*Foundations of Behavioural Research*”, Harcourt Brace Jovanovich,

<sup>43</sup> What is secondary research? By Asia Market research, Available online

<http://www.asiamarketresearch.com/glossary/secondary-research.htm> accessed on 2005-10-25

<sup>44</sup> Ibid

### **i. Primary Data Collection**

Since Enron is under investigation from authorities hence it was quite difficult to get primary data from corporate sources. However the authors used a combination of the following tools to collect data from academic and professional experts in the area of corporate governance; Personal and telephonic interviews conducted and questionnaires sent through emails.

### **ii. Sampling of Respondent**

Respondents for interviews and questionnaires were selected on the basis of convenience sampling i.e. respondents selected on the basis of convenience in terms of accessibility. Questionnaires were electronically mailed (e-mailed) to leading professors on corporate governance, strategy, strategic management, accounting and international law at universities from: United States of America, Sweden, Australia and Pakistan. Since they are associated with thought development and analysis hence their perspectives aided in our cross dimensional analysis.

In addition, respondents from leading international audit houses / financial consulting companies and practitioners of corporate governance were also sent questionnaires. They were from: Sweden, United States of America, Pakistan and United Kingdom.

Reason behind selection of audit houses was that they are associated with auditing activities of corporations hence they are in a better position to identify issues concerning corporate governance. Practitioners are concerned with the implementation aspect of corporate governance and hence they can comment better on linkage with strategy. Some respondents requested anonymity hence we have not mentioned their names in this research, thus complying with ethical standards of scientific research.

This was done to get diversity of perspectives and to facilitate analysis of the research. Questionnaires were e-mailed to 25 respondents out of which 7 replied. Sample Questionnaire is attached as Appendix.

## **2.5 Interviews**

Cassell (2004), (Kvale, 1983; King N, 2004) defines the qualitative research interview as; “an interview, whose purpose is to gather descriptions of the life-world of the interviewee

with respect to interpretation of the meaning of the described phenomena.”<sup>45</sup> According to him, such interviews help in understanding perspectives of the respondent about the causes and reasons of the occurrence of particular phenomena.<sup>46</sup>

Interviews differ in their format and on the basis of the relationship between interviewer and interviewee. Irrespective of the medium of communication used (such as face to face, electronic or telephonic interviews) they can be classified as:

1. **Exploratory Interview** – The perspective of the respondent is of greater significance and hence such interviews are marked by probing questions, encouraging the respondent to speak more and to give deeper insights about the topic under discussion.
2. **Semi structured Interview** – Questions are asked in a semi prepared format. However the interviewer also picks up questions from the discussion of the respondent to have greater views about his research.
3. **Unstructured Interview** – Such interviews have a very flexible format. They do not follow a pre-specified pattern. Their length and content can vary depending upon the relationship aspect between the interviewer and interviewee<sup>47</sup>

Such interviews help in getting first hand information from people who have knowledge, experience and insight about a particular issue under discussion. They help significantly in shaping the qualitative aspects of research that give wider and deeper perspective to a researcher.

Researchers have their own limitations too. The interviewer has a greater dependency upon the views of the interviewee. Furthermore, he has difficulty in identifying as to what are objective views of the respondent and what are his own inner / biased feelings. The measurability of responses at times also poses serious problem in research based on qualitative interviews, as there is absence of numeric and objective data. Furthermore, cultural issues, language problems at times can be greater barriers to an objective interview.

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<sup>45</sup> Cassell C. & Symon G. , (2004), “*Using interviews in qualitative research*”, Essential Guide to Qualitative methods in organizational research, SAGE publications Ltd. London, UK, P-11

<sup>46</sup> Ibid p-10

<sup>47</sup> Ibid p-10

For this research, authors used semi-structured format for telephonic and face-to-face interviews. After a lot of tries, we were finally able to manage interviews with two respondents. Willingness of the respondents to participate in this research was a substantial operational constraint. We primarily developed our interviews based on the format mentioned in appendix. However, we encouraged our respondents to speak as often as possible so that we could have more in-depth insight.

## 2.6 Questionnaires

Questionnaires are popular means for primary data collection in qualitative research. They entail a set of questions about a research topic. A researcher seeks answers to these questions and they facilitate in shaping a research. Questionnaires can be generally classified as:

- **Open Ended Questionnaires**

The questionnaire is designed in such a way so as to encourage the respondents to give detailed answer within the domains of a question. The objective is to obtain deeper insights about an issue. However issue of objective response verses subjective response is of major concern since susceptibility to respondent's viewpoint is high. Furthermore the researcher may use his own interpretation of the responses and hence element of biasness or non-objectivity are observed. Nevertheless, they remain a popular tool in qualitative research.

- **Closed Ended Questionnaires**

The questions are designed in such a way so that their responses can be easily categorized in a specific way such as: YES / NO or showing certain different ranges of opinion such as never, sometimes, occasional, often, all the time. They are easily measurable and are more objective. However they don't give deeper insights about the respondent or his experiences. He is more intimidated to shape his response within the available option categories and hence may not be able to express his true perceptions about a topic under research.

For this research, the authors used open-ended questionnaires to collect perspectives of different academicians and practitioners of corporate governance. These were mailed electronically to the respondents. Responses thus obtained aided in our empirical analysis.



## 2.7 Reliability and Validity

It is essential for any research that it should express valid and relevant information. As a researcher, it's imperative responsibility to provide information and analysis in well-organized and reliable form. A vital element or characteristic of scientific research is being valid and reliable in authenticity for both researcher and reader's perspective. By making superior level of validity, we would like to exploit most appropriate and acceptable research methods in gathering and evaluation of our study.

In simple definition reliability can be defined as how consistent measurement is for any experiment while validity refers to the study that reflect accuracy in measurement for which it has been chosen. Validity of any research is based on authenticity of reliability.<sup>48</sup> Study is usually regarded as successful when it fulfills the requirements that are supposed to be done. Just like as an example of normal life; "A ruler is called to be valid when measuring length of any device but on contrast it not valid for measuring volume of any product".<sup>49</sup>

In social science research, measurement accuracy is necessary component of study. Keeping this important factor in mind, researchers have social responsibilities to make data gathering instruments more reliable and valid. In this context, we have tried to meet the level of objectivity and acceptability in our point of view as well as other linked parties. As both authors are from Pakistan, there may be some elements of cultural biasness in writing, but we would like our best to eliminate this kind of biasness. Our international and educational experience at Sweden helps us in exploring impact of corporate governance and strategy in the context of large corporations. At various levels, our report has been studied and criticized by our supervisor and fellows, which has helped us in diminishing the errors and unreliability.

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<sup>48</sup> Filstead W J., (1971), "Qualitative Methodology: Firsthand involvement with the social world", Markham publishing company, Chicago Page: 189-193

<sup>49</sup> "Validity and Reliability" Available online <http://www.georgetown.edu/departments/psychology/researchmethods/researchanddesign/validityandreliability.htm> accessed on 2005-10-27

## **2.8 Problem and Amendment**

For empirical research on this topic, we faced certain resistance from people to share data and perspectives. Since corporate governance entails board room dynamics and about issues which entail secrecy elements of an organization hence some of our respondents were resistant in sharing information with us, especially from auditing companies. Some of our respondents requested anonymity. Furthermore, we had to bring in adjustments in our topic. During the course of the research we realized that the term “Public Limited Companies” had different connotations in different cultures. For some it meant companies that are listed on the stock exchange while for others it meant bureaucratic organizations. Hence we had to bring in amendment in our topic. Earlier it was “How Corporate Governance affects strategy of Public Limited Companies”. After realizing that the term has different perceptions, we changed it to “How Corporate Governance affects strategy of Corporations.” To make our research more valid and unbiased, we have changed term “Public Limited Companies” into “Corporation” during the research.

## 3. FRAME OF REFERENCE

*This chapter helps reader in making bridge between the basic research question and theoretical side of this study. This chapter discusses the theoretical side in three parts: An overview of corporate governance, Agency theory and Ernst & Young model of corporate governance. The chapter concludes with a discussion on the corporate governance debate and is followed by some criticism.*

*“The proper governance of companies will become as crucial to the world economy as the proper governing of countries.”<sup>50</sup>*

James D. Wolfensohn (1999)

### 3.1 Corporate Governance

The roots of corporate governance can be traced up to nineteenth century when American state corporation enforced a law about governing of corporate board with mutual consent of the shareholders in exchange of legislative rights and benefits in order to make corporate governance more efficient. Since that time, most of the companies get engaged with this corporate friendly Delaware law. This law increases regulations in right of owners, corporate entities and the shareholders. After successful implementation of this concept in American based organisations, rest of the world has also applied similar laws to gain advantage of this concept.<sup>51</sup>

Corporate governance has got greater attention in both developed and developing countries in a way that a firm can derive benefit from both economic performance and its ability to access long-term, low-cost investment capital. Corporate governance can thus be regarded as a decision making and integrative management frame work of fair do's and don'ts (a collection of acceptable behaviour/ practices arising out of different roles, responsibilities, situational demands, and expectations) within which the organizations achieves its goals and objectives while maintaining its relations with different actors,

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<sup>50</sup> Quotes from James Wolfensohn, Former president of World Bank, (1999), Available online <http://web.worldbank.org/> accessed on 2005-10-29

<sup>51</sup> “Historical view of corporate governance” Available online <http://www.answers.com/topic/corporate-governance>, accessed on 2006-01-01

forces and environments. It varies from organizations to industries and hence is highly sensitive to socio-cultural, regulatory, economic and political context of a society.<sup>52</sup>

### **3.1.1. Definition of Corporate Governance**

According to definition of Wikipedia, “Corporate governance is a process that direct, control and monitor the processes of any corporation. It includes the laws and customs affecting that direction, as well as the goals for which it is governed. The principal participants are the shareholders, management and the board of directors. Other participants include regulators, employees, suppliers, partners, customers, constituents for elected bodies and the general community”<sup>53</sup>

Corporate Governance can be viewed as an intricate set of relationships between a company, its stakeholders and its operating environment. According to OECD (2004), corporate governance is a linkage between different entities of any organization. These entities; company’s management, its board of directors, shareholders and other stakeholders, require strong relationship among each other in order to achieve corporate objectives. Effective way of corporate governance provides structure through which the goals of the organization are set and the ways of accomplishing those objectives and monitoring performance are determined. Excellent corporate governance should offer appropriate inducement for the board and management to follow objectives that are in benefit for the company and its stakeholders.<sup>54</sup> In its landmark publication, OECD (2004) further states corporate governance as a part of only macro level economies that faces high level of competition and stress market situation. The corporate governance structure also relies on the legal, regulatory and institutional environment. There are several additional factors such as business ethics and corporate awareness of environment and societal interests of communities that can affect on company’s operations and also have an impact on its reputation and its long-term success.<sup>55</sup>

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<sup>52</sup> Ibid

<sup>53</sup> “Definition of corporate governance” by Wikipedia, Available online <http://www.answers.com/topic/corporate-governance> accessed on 2006-01-01.

<sup>54</sup> McGee et al, (2005) “Strategy- Analysis and Practice”, McGraw-Hill Education, Berkshire, United Kingdom, Chapter 17, p-629-630

<sup>55</sup> Ibid

Thus, it can be argued that corporate governance has a systemic way of viewing firm's operations. Through a collective mechanism of interlinking decisions with identifiable authorities and responsibilities it ensures a code of conduct by which an organization attains its objectives through a series of strategic decisions / plans as a whole, without compromising the collective benefit of the society as a whole. It can be viewed as a way of creating collective value for all stakeholders. Corporate governance can be seen as vast field and its works as regulatory body that includes:

- Chief Executive Officer (CEO)
- Board of Directors (BoD)
- Management of Organization
- Shareholders
- Stakeholders (Suppliers, Employees, Creditors, Clients and Social Communities)<sup>56</sup>

### **3.1.2. Key Principal of Corporate Governance**

There are different fundamental elements of good corporate governance that influence the performance of any organisation. Some key elements that can be regarded as appropriate in achieving effective corporate governance are: trustworthiness, honesty, sincerity, performance orientation, mutual interest, and commitment to the organisation. Few generally accepted rules and principal for effective corporate governance are as following:

- Its organisation's obligation to respect the rights of shareholders and facilitate shareholders in getting their rights.
- Organisations should be aware that they have legal and lawful duties for all stakeholders.
- Organisation has vital obligation to provide effective and understandable information to the shareholders and all participations of annual general meeting.
- Board of directors has responsibility to check and perform proper scrutiny of management's performance.

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<sup>56</sup> "OECD principles of Corporate governance" Accessed online <http://www.oecd.org/dataoecd/32/18/31557724.pdf> accessed on 2005-11-17

- Another responsibility is to state visibly and clearly the duty and tasks of management and board of the organisation in order to get full confidence of the shareholders towards organisation.<sup>57</sup>

### **3.1.3. Guidelines of Corporate Governance**

Corporate governance has been visualized as a vast field and it covers almost every dimension of the organization. It has got significant importance in developed countries as well as in developing countries. Every country has its own codes and principles for corporate governance which have been issued by organizations like stock exchanges, corporations, institutional investors, directors' associations and such organisation get direct or indirect support by their governments and international institutions. As an example, companies listed at stock exchange of London (United Kingdom) and Toronto (Canada) are not legally liable to follow the rules of their respective corporate governance codes. Although, this is not obligatory to follow by the organization, but still companies are required to disclose proper documentation and explain their rules and practices. Such kind of documents are necessary for listed organization in order to provide authentic information to their prospective shareholders. Besides this, the guideline provided by associations of directors, corporate managers and individual companies in different countries lead to disclosure of mandatory and voluntary information for stakeholders. The board of GM (General Motor) voluntarily provides guideline for the organization in order to increase the capacity of their own efficient governance. These kinds of documents may have long run multiplying effect while prompting other companies to adopt similar documents and standards of best practice.<sup>58</sup>

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<sup>57</sup> "OECD principles of Corporate governance" Accessed online <http://www.oecd.org/dataoecd/32/18/31557724.pdf> accessed on 2005-11-17

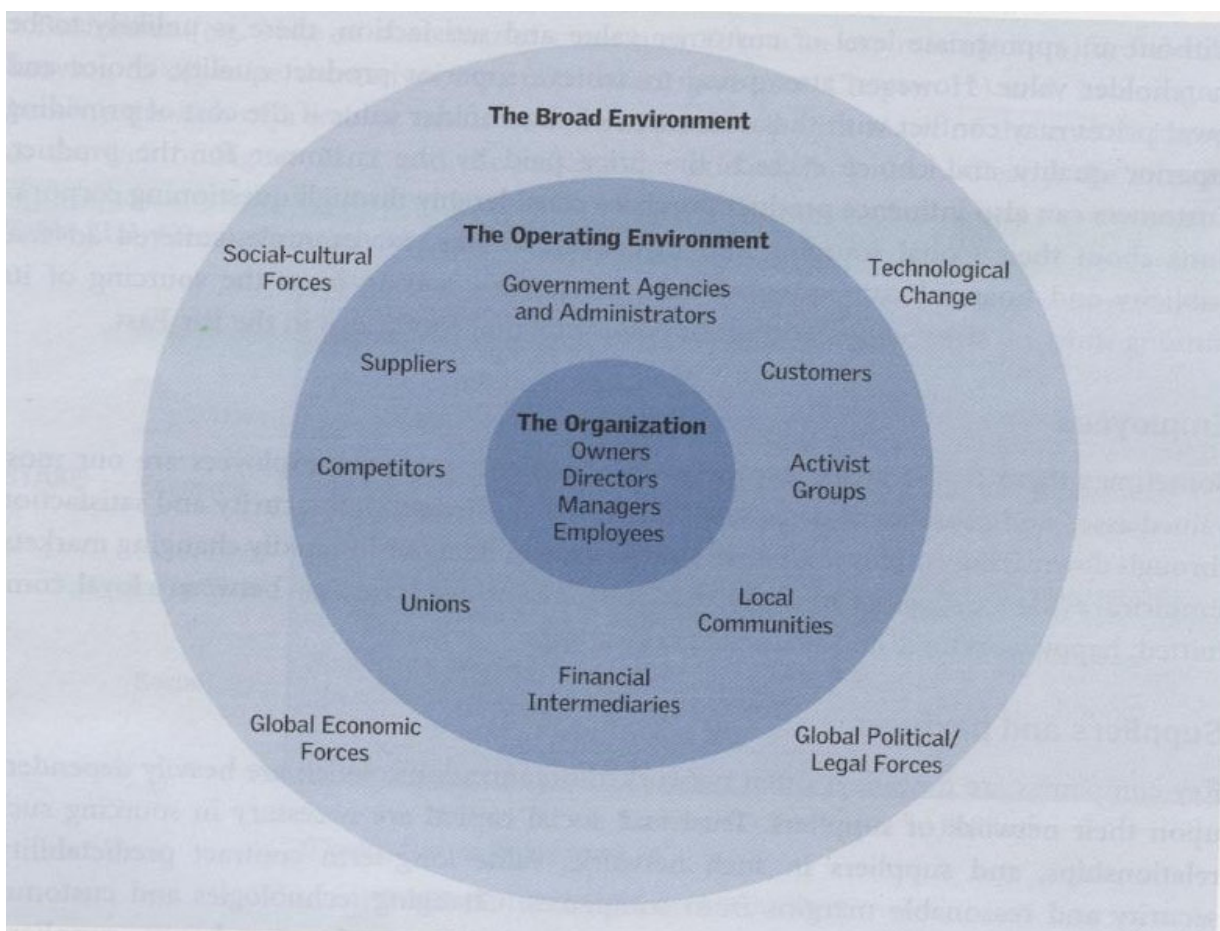
<sup>58</sup> "Systemic problems of corporate governance" By Wikipedia, Available online [http://en.wikipedia.org/wiki/Corporate\\_governance#Systemic\\_problems\\_of\\_corporate\\_governance](http://en.wikipedia.org/wiki/Corporate_governance#Systemic_problems_of_corporate_governance) accessed on 2005-11-17

### 3.1.4. Environment & Key Actors of Corporate Governance

Figure 3.1 derived from McGee et al (2005)<sup>59</sup> depicts a summarized version of a firm and its different environments in which it operates:

- **The Internal Environment**
- **The Operating Environment**
- **The Broad Environment**

It also shows various forces and key actors that have a significant impact upon the behaviour of an organization and its strategic dynamics.

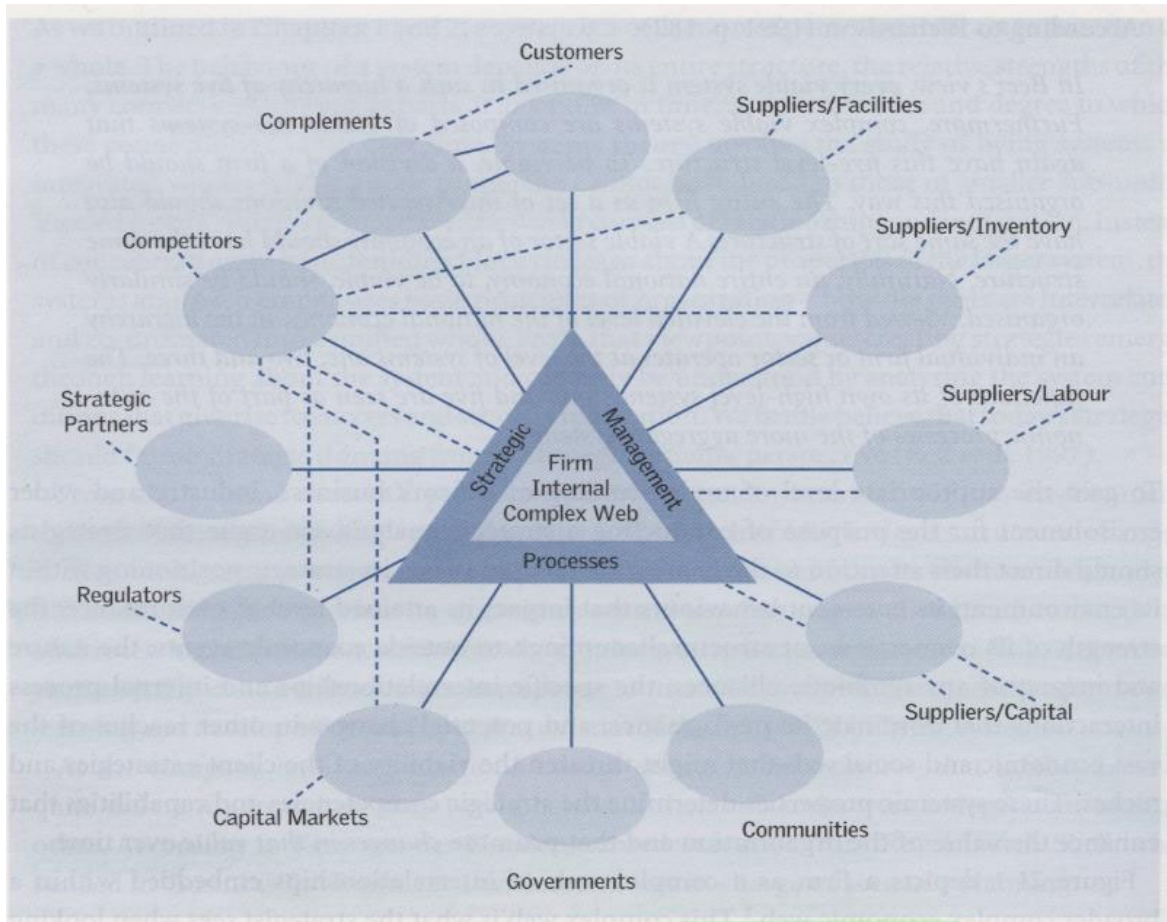


**Figure 3.1: “Viewing the organization as a complex web of interrelationships”<sup>60</sup>**

<sup>59</sup> McGee J. et al (2005), “*Strategy- Analysis and Practice*”, McGraw-Hill Education, Berkshire, United Kingdom, Chapter 21, Managing business value as a system

<sup>60</sup> Ibid

Figure 3.2 presents a network of different relationships that a firm enters with other key actors in order to operate in a market. These relationships are like a web, which is from within an organization as well as outside.



**Figure 3.2: “The Organization and its Primary Stakeholders”<sup>61</sup>**

Figures 3.1 and 3.2 together reflect an organization’s dependency on behaviour of different entities which ultimately have an impact on the way a firm acts, either proactively or reactively. This action or a series of actions in order to achieve a goal can be regarded as a strategy. Thus it can be said that all these forces have an impact on the strategy of an organization.

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<sup>61</sup> Ibid



### 3.1.5. Impediments to Corporate Governance

According to McGee et al (2005), there is no perfect and unique model for effective corporate governance.<sup>62</sup> However, researchers as well as organisations around the globe have used several types of models. These kinds of models differ according to the extent of capitalism in which they operate. “The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model that one finds in Continental-Europe and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community. Both models have distinct competitive advantages, but in different ways. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition.”<sup>63</sup>

According to Weston F. et al (2004), “In the United States, by tradition and by legislation enacted in the 1930s, commercial banks and insurance companies are limited in their ability to hold large equity positions in individual corporations. Under this idealize scenario, issues of corporate governance and control are muted. However, over time, the effectiveness of this governance system has been questioned.”<sup>64</sup> They further state, “In the United States, the system of corporate enterprise that developed was the limited liability public corporation, whose ownership in theory was widely dispersed among individual shareholders. After legislation in 1933, commercial banks were not permitted to make equity investments and insurance companies had long been circumscribed in the percentage of their funds they could invest in equities. In contrast, the system that grew up in Germany and Japan was characterized by large equity and loan investments by banks and insurance companies. In addition, substantial cross holding of ownership shares among corporations developed.”<sup>65</sup>

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<sup>62</sup> Ibid

<sup>63</sup> Systemic Problems of Corporate governance, Available online [http://en.wikipedia.org/wiki/Corporate\\_governance#Systemic\\_problems\\_of\\_corporate\\_governance](http://en.wikipedia.org/wiki/Corporate_governance#Systemic_problems_of_corporate_governance) accessed on 17-11-2005

<sup>64</sup> Weston F. et al, (2001 4<sup>th</sup> edition 2004) “*Takeovers, restructuring, and Corporate Governance*”, Pearson Prentice Hall., New Jersey, USA, P - 563

<sup>65</sup> Ibid

## 3.2. Agency Theory

Corporate governance draws its roots from many different theories of management and organizational studies. Different theories explain different organizational phenomena. For this thesis, Agency Theory has been as part of our theoretical framework.

<b>3.2.1 Agency Theory Overview</b>	
Key idea	Principal & agents relations should create such a relation that reduce cost and risk of uncertainty
Unit of analysis	Agreement between principal and agents
Human assumptions	Self interest Bound rationality Risk aversion.
Organizational Assumptions	Partial goal conflict among participants. Efficiency as the effectiveness criterion Information asymmetry between principle and agents
Information assumption	Information for reachable product
Contracting problems	Agency & Risk Sharing
Problem domain	Relationships between principal and agents for goals and tasks

**Table 3.1: Agency Theory Overview** <sup>66</sup>

### 3.2.2 Origin of Agency Theory

Agency theory was developed in 1970's. It refers the way in which agents linked by contractual arrangement with a firm, influence its behaviour. These may include organizational and capital structure, remuneration policies, accounting techniques and attitudes toward risk-taking. Agency costs are deemed the total cost of administering and enforcing these arrangements.<sup>67</sup> The root of Agency Theory is linked with field of economics that expresses the idea of expending business into unrelated industries. The basic motive of expanding in completely different market is to reduce manager's employment risk and to assure their own income streams by diversifying into unrelated

<sup>66</sup> Kathleen M. (1989), "Agency theory: An Assessment and Review", The Academy of Management Review, Volume 14, 1, January 1989, Page 57-74.

<sup>67</sup> Agency Theory by Economy Professor, Available online [http://www.Economyprofessor.Com/Economic theories/Agency-Theory.Php](http://www.Economyprofessor.Com/Economic%20theories/Agency-Theory.Php) accessed on 2005-12-17

businesses, even though there was little justification for furthering shareholder interest. This idea of theory emphasized the link between the shareholders and the management of the organisation in attaining their desired motives. This economics based study further got attention in 80's as a comprehensive study for the management itself and shareholders in order to get proper attention for their interests. After the collapse of large corporate giants it has been the emphasis of research concerning corporate governance. Now a days, it has been used as more effective and useful theory for social research on corporate world.

### 3.2.3. Definitions of Agency Theory

*“Agency theory argues that shareholder interests require protection by separation of incumbency of roles of board chair and CEO. Stewardship theory or Agency theory argues shareholder interests are maximised by shared incumbency of these roles.”*<sup>68</sup>

Lex D. (1991)

Agency theory mainly engages in creating strong link between shareholders, stakeholders and management of organisation and it involves in solving financial and cost matters of two groups; shareholders and company's management.<sup>69</sup> It is essential to discuss the key players of the agency theory before explaining it in detail. There are two main players of this theory:

**Principal:** In light of this theory, 'Principal' is the entity that put their investments and resources in any organisation to run its operations.

**Agent:** This theory presents 'Agent' as management of the organisation who have responsibility to run the operations to achieve desired objectives of organisation in term of revenue.

According to Spake D. F. et al (1999), Agency theory creates link between two parties in the globe: A Principal (Shareholders) & An Agent (Management); who join hands to achieve certain profitability and revenue goals. According to this theory, principal need to

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<sup>68</sup> Lex D. et al, (1991), *“Stewardship Theory or Agency Theory: CEO Governance and Shareholder”*, Australian Journal of Management, Number 16, Volume 1

<sup>69</sup> *“About Agency theory”*, Available online <http://www.investopedia.com/terms/a/agencytheory.asp> accessed on 2005-12-17

put sufficient effort in a way to attain desired outcomes / results but does not know what amount or what type of effort is needed. Furthermore, the principal does not have ample information about agent's capabilities whether agent is capable for performing this job or not. But still principal has to trust on agent's effort for outcomes. A characteristic of agency relationships is that the agent makes decisions and undertakes actions on behalf of principal<sup>70</sup>

### **3.2.4. Varieties of Agency Theories**

Agency theory was developed almost three decades earlier; in the mean time it has been shaped in several different forms which can be regarded as extensions of agency theory. According to Franklin K. et al. (1989), from the very beginning, Agency theory has seen as controversial one among the researchers. The term 'Corporate Governance' has been discussed in two different ways in study of Franklin (2002): In Anglo-Saxon countries like US and UK, where interest of shareholders are largely influenced by directions of good corporate governance. While in countries like Japan, Germany and France etc. corporate governance concept describes the involvement of all stakeholders (Includes employees, management and customers) interest.<sup>71</sup>

According to Cook et al (1999), "Another major concern about agency theory of the firm which identifies the separation between management and 'ownership' as an efficient response to the need for specialisation, would be the extent to which broadening stakeholder representation would undermine management accountability by blurring performance measures and incentive structures, which would ultimately have a detrimental effect on performance, however defined. The conventional agency theory interpretation of the firm to include implicit and explicit contracts between all stakeholder groups - *stakeholder-agency theory* - by showing that relations between management and stakeholder groups have many of the characteristics of typical agency relationships"<sup>72</sup>

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<sup>70</sup> Spake D. F. et al, (1999), "Advertising Agency Compensation: An Agency Theory Explanation" Journal of Advertising, Fall 1999

<sup>71</sup> Franklin K. et al. (2002), "A Comparative Theory of Corporate Governance", December 2002

<sup>72</sup> Cook, Jacqueline & Deakin, Simon, (1999), "Stockholding and Corporate Governance: Theory and evidence on economic performance" ESRC centre for business research, University of Cambridge July 1999

### 3.2.5. Agency Theory as Problem Solving Theory

In view of Franklin K. et al. (1989), Agency theory is regarded as problem-solving theory in some situations of corporate conflict. It can resolve two areas of problems that occur in agency relations:

1. Agency theory plays vital role, when conflicts arise between the principal and agent. In some cases where it is difficult or expensive to determine for the principal to analyze what actually and exactly agent is doing.
2. Secondly, agency theory can be important, when it is seemed that risk of sharing information between agent and principle. It normally occurs when both agents and principal have different attitude and preference toward risk.<sup>73</sup>

Summing up, Principal and Agent are two streams of agency theory. These streams also provide common assumptions about stakeholders of organization. Jensen (1983) further discusses the mechanism of governance in problem solving route and principal agent stream engage with general kind of theory that can be applied in creation of relations between employer & employees, lawyer & client, buyer & customer and others.<sup>74</sup> Typical principal-agent relationships (between shareholders and management) are seen as subset of a number of stakeholder-agency relationships.

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<sup>73</sup> Ibid

<sup>74</sup> Jensen, M. (1983), "*Organization Theory & Methodology*", Accounting review, Number 56, Pages: 319-338

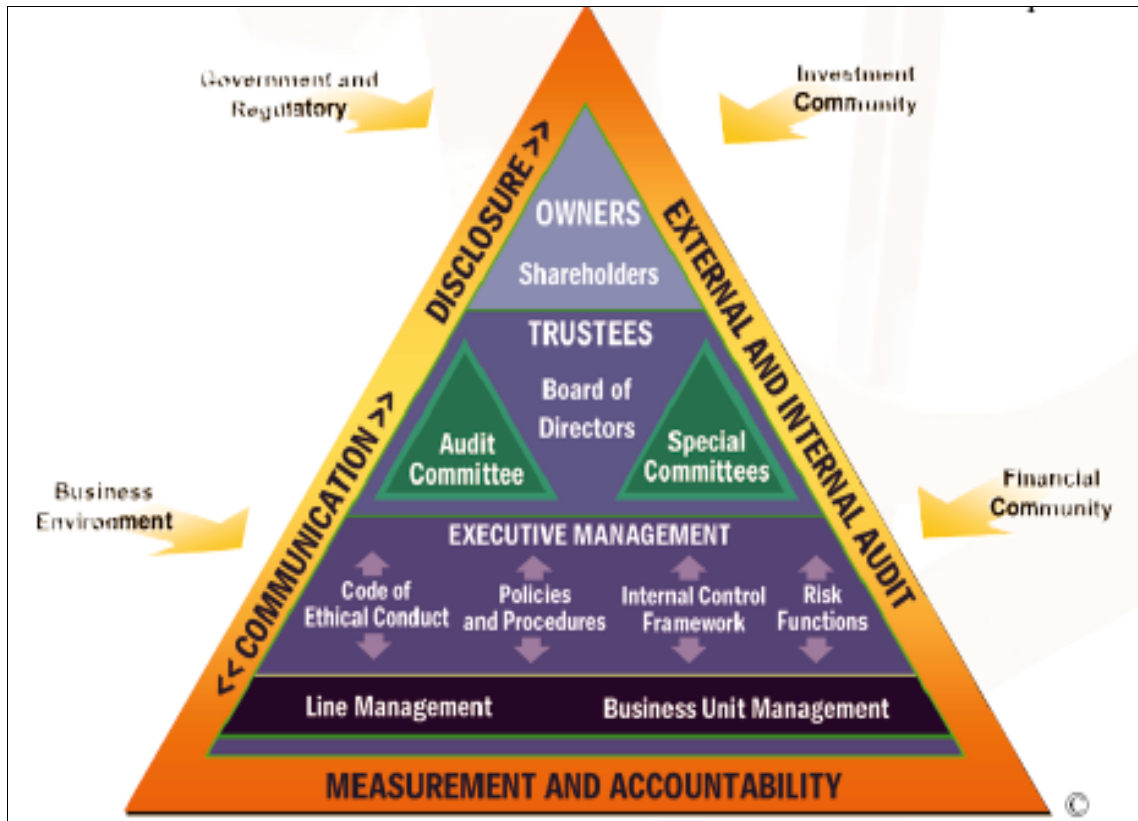
### **3.3 Ernst & Young Model for Effective Corporate Governance**

As authors of this paper we wanted to explore corporate governance using a model which could help us in order to develop a better understanding of key actors that are involved in a corporate governance system in the context of a corporation. In this context, we explored certain models / research dimensions - notably, the model of Harvard Business School on corporate governance to identify key actors. Another point we found worthy of consideration was the fact that corporate governance is a nascent field , with plenty of room for future research and development. It requires a combination of academic and industrial input to develop models of common interest.

Hence we realised that if corporate governance is to be studied in depth, there should a combination of a theoretical input and an industrial model. Whereas we used agency theory to explain the theoretical perspective on corporate governance, we also used industrial model as developed by auditing houses. It is difficult to have an Effective model of good corporate governance that covers all dimensions of wide field. However, a world-renowned auditing company and management consultant, Ernst & Young, has provided a model of effective corporate governance as mentioned below in Figure 3.3. This model highlights the necessary elements and variables of effective corporate governance.<sup>75</sup>

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<sup>75</sup> “Achieving Effective Corporate Governance”, Ernst & Young, Available online [http://www.ey.nl/download/publicatie/achieving\\_effective\\_corporate\\_governance\\_eng.pdf](http://www.ey.nl/download/publicatie/achieving_effective_corporate_governance_eng.pdf) accessed on 21-12-2005



**Figure 3.3: Ernst & Young’s effective Governance model<sup>76</sup>**

This model provides an in-depth insight about the corporate governance framework and its key components. It presents an overview of major actors and their influences in an organization’s corporate governance and strategic framework. It gives a basic parameter to study information flow and behavioural impact of key constituents in an organization and who are the potential users of the information.

### **3.3.1 Components of Ernst & Young Model**

Ernst & Young model provides benchmark for effective corporate governance. This part explains the key areas of this model. According to study needs, Authors have split the Model into three main parts; description of each part is as follow:

- a) External variables
- b) Internal variables

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<sup>76</sup> Ibid

c) Linkage between external & internal variables

**a) External Variables**

According to Ernst & Young model, external environment of a firm consists of its stakeholders who either directly or indirectly have an interest in operations and results of the company. The stakeholders can play vital role in boosting overall performance of corporation. Components of these external variables are as follow:

**i. Government and Its Regulation**

Ernst & Young Model expresses that role of efficient government regulation and policies can be effective in gaining public confidence towards market development. Governments have to take necessary actions in the way to regulate the systems for corporate sector. Government policy makers have to insure improvement in auditing policies and enhance law enforcement. It is government's ethical responsibility to implement state and federal level law in the way to sustain regulatory standards.<sup>77</sup>

**ii. Business Environment**

For ethical and good business environment, Board of Directors (BoD) needs to play / role for regulations and legal matters. It largely depends on Board regulations to create atmosphere conducive for business. Mutual trust of each stakeholder can be gained with the help of corporate excellence and commitments of management.

**iii. Investment Communities**

Investment banks and corporations also make sufficient contribution for effective corporate governance. Through their deeper insight about equity market mechanism and wider industrial insights, they can help the company in finding ways that can earn maximum, sustainable and fair returns on investment. These communities should provide transparent information for organisation for better corporate governance.

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<sup>77</sup> Coglianesi C. et al, (2004), "*The Role of Government in Corporate Governance*", Social Science Research Network, Harvard university, November 2004



#### **iv. Financial Community**

Banks and financial communities play very important role in shaping dynamics of corporate world. Without involvement of these communities it's difficult to get desired goals of effective corporate governance. Accountability and Transparency of these communities can be milestone for a firm's corporative progress.

#### **b) Internal Variables**

Internal variables consist of parties that engage directly with daily operations and performance of the organisation. The influence of these parties has direct impact on overall performance of any firm. Following are some internal variables that can influence corporate governance:

##### **i. Owner**

The Owner or shareholder (also known as Principal), is an entity who has invested his capital in the company for seeking profit and for maximizing returns on invested capital. Since they are not directly involved in the operations of the company and because of the fact that owners usually don't have technical know-how of operations of large public sector companies (owing to their diversified background and inappropriate geographical proximity to corporate head quarters) hence they appoint board of directors (agents) to represent the owners' interest.

##### **ii. Trustees (Board of Directors)**

The agents are responsible to monitor ethical compliance of the organization to different stipulated and implied standards of ethics, thereby meeting the statutory obligations of the law of the land. They take decisions concerning the appointment and firing of the CEO and through distribution of efforts in the form of Audit committee and other Special committees they seek to protect interest of the shareholder. While maintaining non-involvement in day-to-day operations of the firm, they seek to monitor the activities of top management in running affairs of organization. Hence, they serve as representative of the owners in ensuring that their (owners') investments are preserved and multiplied.

##### **iii. Management**

The executive management comprising of the CEO and the top general managers monitor day-to-day operations of the company, in meeting its strategic objectives. They set yearly targets of performance and ensure that those targets are achieved for value maximization.

They administer respective divisional and functional operations / activities of the organization within the laid down policy directives and procedures as stipulated by top management; Code of Ethical Conduct, Procedures, Internal Control Framework and Risk Function.

– **Line Management & Business Unit Management**

The line and business unit managers serve as a bridge between other employees and top management of the company. They administer and control activities of line and business unit managers and ensure that an organization's internal control, and other practices are in conformity with the code of ethics.

**c) Linkage between External and Internal Variables**

The entire process of corporate governance involves information generation and flow for decision-making and controls within the stipulated laws, norms and procedures of the land as well as that of different agencies such as GAAP (Generally Accepted Accounting Principles). Following are some points that can be effective in creation of linkage between external and internal variables.

- **Communication:** The process requires transparency in decisions with clearly defined authorities and responsibilities.
- **Disclosure:** Good corporate governance entails appropriate disclosure of information in general and for resource allocation in particular.
- **Measurement & Accountability:** Effective corporate governance requires proper accountability for decisions and entails measurement of resources of allocation and authenticity of information.
- **External Auditor & Internal Auditor:** It should be kept in mind that good corporate governance meets requirement of external and internal audit.

### **3.4 Correlation between Concept, Theory and Model used.**

The frame of reference - comprising of agency theory along with Ernst & Young model – highlights interrelatedness of internal / external forces for an organization's strategic decision making. This framework taken in unison indicates that the entire process entails

constant information flow and feedback thus leading to decision making at the top – which in turn affects strategy of the organization. External feedback and evaluation determine the viability of organizational decisions.

Furthermore, this framework prominently identifies different layers of key stakeholders at intra-organizational and external level who have overlapping as well as conflicting motivation and varying dependencies amongst key constituents of the system. While segregating authorities, responsibilities and boundaries of involvement, it also brings into account motivational and behavioural aspects, which are not so explicitly covered, in other models. This is the essential premise of this thesis.

This framework helps to understand that corporate strategy is a function of different domains, layers, and personalities. It is a highly interactive process. Apart from numbers and performance, corporate strategy is highly dependent upon various factors, market forces and internal flow of information, assimilation, action and behavioural aspects of decision makers. Strategy can thus be regarded as a function of combination of these forces. When the organizational system as a whole resorts to questionable practices and collapses due non-conformity to acceptable practices, norms and values, it is regarded as failed corporate governance.

**a) Cultural sensitivity, national context and Corporate governance**

Another factor noteworthy of consideration is the fact that apart from influencing factor of the agency theory, which explains dynamics of principal-agent relations and conflict of interest, there are various other actors which influence corporate governance and strategy of an organization. These are depicted by the Ernst and Young Model.

However the socio-cultural context of a country has a lot to do with the corporate governance mechanism of its organizations. Socio-cultural patterns are often evolved as a result of religion, language, traditions, culture, norms and values. In some societies, religion plays a pivotal role in shaping social interaction patterns. Hence when such a western concept is extended in its scope to an eastern country, like Pakistan which has an Islamic orientation, then there are going to be cultural obstacles in implementing the mechanism across the board. It would be realistic to state that corporate recipes, lessons,

do's and don't's from one nation or one-case study cannot be applicable in its totality in a different land with divergent orientation.

Furthermore in some western democratic societies, political forces may not be dominant in shaping the corporate governance mechanism. However in some third world countries, political forces have a major effect on corporate governance system as well as on the strategy of the organization. Mutual complementarity between the political, economic, socio-cultural forces will ensure a better corporate governance system for organizations. De-stabilisation or lack of complementarity between and amongst these forces may prevent transparency and unethical orientation in a system.

Hence by reviewing corporate governance scenario in Pakistan, it would be interesting to see as to what are the associated impediments in implementing a western concept to an eastern nation, where political, economic, and socio-cultural dynamics are quite different from those in the western world.

### **3.5 Theoretical Conclusion and Model**

Since firms have got different ownership setup, operate in different industries, in cross-cultural settings, with different regulatory and statutory framework hence it is difficult to have a consolidated corporate governance theory. In this study, we have merged Concepts, Theory, and Model in a way to get accurate picture of corporate governance's effects on strategy of corporations. This prompted us as researchers to hypothesize that corporate governance has an effect on corporate strategy. Corporations are highly complex organizations, having their own industrial dynamics and are dominant actors in the economy of a country. Their inception, survival, growth and decline are interlinked with many determinants. These factors provide direction for our study in a way that helps us in attaining desired task. Hence, we evaluate how corporate governance affects strategy of corporations by using:

- Agency Theory
- Ernst & Young Model of Corporate Governance

- Enron downfall will be used, as case in point and lesson will be drawn from it.

Hence corporate governance can be regarded as an integrated framework. Conformity to its requirements ensure sustainability of the organization. Hence, these factors operating under the umbrella of corporate governance directly affect strategy of an organization. We have used following important steps to bring our study to final conclusion:

- Discussion of conceptual aspects of Corporate Governance and its elements.
- Corporation and Corporate Strategy in relation with effective Corporate Governance.
- In-depth study of Enron case; its collapse and remedies for corporations after its collapse
- Views of world's academic researchers and practitioners concerning linkage between corporate governance and corporate strategy.
- Application of effective Corporate Governance in the organisations; to reduce tendency of collapse / systemic failure.
- A review of corporate governance setup in Pakistan and impediments associated with its implementation.

To use this theoretical framework, we used a combination of primary and secondary sources in order to have empirical support. As far as review of Enron debacle is concerned, we used secondary literature from published sources. In particular, secondary sources were used to apply Ernst and Young model, and agency theory. While applying Ernst and Young Model, we also used perspective of different academicians and practitioner of corporate governance, through telephonic interviews and questionnaires. We used these in unison with the afore stated model and theory to get deeper insights and strong empirical backing by collecting views points from western and eastern professional and academic perspective.

## 4. CORPORATIONS, CORPORATE STRATEGY AND ENRON

*This chapter presents the concept of Corporation and why it is different from other business organizations. It then explores the concept of Corporate Strategy and presents its types. By interlinking Corporate Governance with Strategy, it further presents discussion as to how corporate governance affects strategy of corporations. This chapter then presents a brief overview of Enron Corporation and why it was regarded as a high performing company. It then presents the main reason behind collapse of Enron and explains the failure in light of Agency Theory. This chapter marks beginning of our empirical part and entails data primarily from secondary sources.*

### 4.1 Corporation

In its simplest form a corporation is defined as an organization having its own legal entity separate from its owners thereby having its own rights, responsibilities and obligations.<sup>78</sup> Commercial corporations operate for a profit motive, capitalizing on their expertise, reach, resources and networks. Its owners usually are very high in number (general public, group of investors, consortiums) and they pool their investments in the form of shares, which are traded at stock exchange. It is chartered and regulated by the government. By law, accounts are audited by independent external auditors; the company is subjected to the statutory and financial laws of the land and those of relevant regulatory authorities.<sup>79</sup> They usually entail capital-intensive industries and services. Capital requirements are often met by obtaining credit from financial institutions and equities from investors and shareholders. Scale and scope of operations is very broad and such entities deal in high volumes of capital, products or services.

A vital aspect of corporation is that the owners have limited liability i.e. if the corporation is bankrupted, there won't be claims on the share holders / owners.<sup>80</sup> They won't get

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<sup>78</sup> What is corporation? Available online [http://www.advfn.com/money-words\\_term\\_1140\\_corporation.html](http://www.advfn.com/money-words_term_1140_corporation.html) accessed on 2005-12-17

<sup>79</sup> For-profit and non-profit, Available online [http://en.wikipedia.org/wiki/Corporation#For-profit\\_and\\_non-profit](http://en.wikipedia.org/wiki/Corporation#For-profit_and_non-profit) accessed on 2005-12-26

<sup>80</sup> What is corporation? Available online [http://www.advfn.com/money-words\\_term\\_1140\\_corporation.html](http://www.advfn.com/money-words_term_1140_corporation.html) accessed on 2005-12-27

preference in the settlement of claims as usually creditors have primary claims on corporate assets for liquidation.<sup>81</sup>

Such corporations usually have a Chief Executive Officer (CEO) or Managing Director, and top management responsible for day-to-day operations and strategy making. Since share holders (owners) are huge in number, lacking technical expertise and have inadequate access to company information / operations hence they are represented by an independent Board of Directors (technical experts in different facets of organizational performance and having substantial track record in this context) who are elected by share holders in annual general meetings. Chairman heads Board of Directors and together they appoint The CEO.<sup>82</sup>

Corporations are marked by going concern assumption i.e. they are expected to sustain beyond the life of owners, directors or officers. Since ownership floats due to stock market trading mechanisms hence corporations exceed beyond life of decision makers and stakeholders.<sup>83</sup>

Another underlying requirement from commercial corporations by law is that they are required to maximize value for shareholders and to protect their interests. Hence by nature they are profit-seeking entities. While attaining profitability they are expected to fulfill their social obligations to the society, environment and other stakeholders and not to violate their interests.<sup>84</sup>

A significant attribute of corporation lies in the segregation between:

- **Ownership (shareholders)** – they invest in shares and are not involved in day-to-day operations. They are interested in results and profitability of the company. They are also known as Principals.
- **CEO and Top management** – they are responsible for running day to day operations. They take strategic decisions for value maximization and also acting as agents of the principal.

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<sup>81</sup> For-profit and non-profit, Available online [http://en.wikipedia.org/wiki/Corporation#For-profit\\_and\\_non-profit](http://en.wikipedia.org/wiki/Corporation#For-profit_and_non-profit) accessed on 26-12-2005

<sup>82</sup> “For profit and non profit” by Wikipedia, Available online [http://en.wikipedia.org/wiki/Corporation#For-profit\\_and\\_non-profit](http://en.wikipedia.org/wiki/Corporation#For-profit_and_non-profit) accessed on 28-12-2005

<sup>83</sup> Ibid.

<sup>84</sup> “Corporate Governance Reform in Asia” by ABD Institute, Available online <http://www.adbi.org/book/2005/02/02/884.corporate.governance.asia/corporate.governance.reform.in.asia/> accessed on 28-12-2005

- **Board members** – they act on behalf of the owners so as to monitor corporate activities and thus act as agents on behalf of the shareholders. They are not involved in day-to-day operations. They have a reviewing, endorsing and checking mechanism to ensure that no wrong doing takes place, there is ethical compliance and that whatever management is doing, it is correct in accordance with the acceptable, rules, norms and values of the land. Through their technical expertise they help management in working out better strategic alternatives for optimum utilization of resources and for value maximization.

Hence in order to enhance value, corporations have various corporate strategies so that growth in revenues as well in the scale and scope of operations is achieved. Such growth seeking ventures are possible through adequate deployment of resources.

The CEO and the top management develop a vision and mission for the corporation. Business plans are developed so as to have clearly defined objectives for each divisional and functional unit of the corporation. While setting out these goals, the top management evolves means of attaining those goals. The task of implementing and achieving those goals are delegated to middle and lower level management while the top management ensures follow-up and compliance to these. The top management also lays out policies, procedures, rules and norms of acceptable and unacceptable performance. Ethics turns out to be a vital issue in this context.

## **4.2 Corporate Strategy**

Corporations are usually involved in multiple businesses and multiple markets, thereby operating through different units or subsidiary organizations. According to Collis et al (1997), corporate strategy can be regarded as a value creating course of action for all stakeholders by virtue of deploying and coordinating resources in different markets and in different corporate activities.<sup>85</sup> It's this aspect of multi-market operations that differentiates a corporate strategy from that of business strategy, product strategy or any functional strategy. Thus it can be agreed that corporate strategy has a holistic view of the entire corporation and takes the combined strategy of all individual constituent

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<sup>85</sup> Collis et al, (1998) "*Creating Corporate Advantage*", Harvard Business Review, May-June 1998, p. 70



organizations, functional units and departments into account for collective sustainable competitive advantage.

Strategic issues faced by a corporation are different from other types of business organizations. The corporation has a synergistic view of its playing field. By managing its portfolio of products, services, business and functional activities at different organizational layers, a corporation mainly looks at the entity as a whole. As mentioned in previous section, commercial corporations are required by law to make a profit for its shareholders. Hence they constantly seek profit-seeking ventures and are constantly in need of business expansion or diversification.

According to Collis et al (1997), “such diversification can be classified as:

- Business diversification – horizontal expansion.
- Vertical integration – forward or backward expansion.
- Geographic scope – geographic and / or global expansion.”<sup>86</sup>

“Corporate (or Company-wide) Strategy is the overall plan for a multi-business unit company. Corporate strategy is what makes the corporate whole add up to more than the sum of its business unit parts.”<sup>87</sup> Furthermore, it should provide “tangible benefits (through) economies of scope in operations (and) economies of scale in administration and internal financing”.<sup>88</sup> In other words corporate strategy would entail resource allocation so as to have business expansion.

Hence it can be inferred that corporations use the following as part of their corporate strategy to enhance shareholder value:

- Internationalisation
- New business initiatives
- Business expansion
- Mergers
- Acquisitions

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<sup>86</sup> “Corporate strategy, creating corporate advantage” Available online [http://www.csus.edu/indiv/h/hany/Teaching/Slides/Corporate%20Strategy.ppt#264,4,Three Dimensions of Corporate Strategy](http://www.csus.edu/indiv/h/hany/Teaching/Slides/Corporate%20Strategy.ppt#264,4,Three%20Dimensions%20of%20Corporate%20Strategy) accessed on 24-12-05

<sup>87</sup> Ibid

<sup>88</sup> Ibid

- Strategic alliances
- Takeovers
- Joint ventures

Such initiatives entail resource, operations and image implications for the organization as a whole. Corporate strategy setting phase is extremely complex process and entails constant information flow between all units, middle and top management. Whenever corporate strategy is evolved, reviewed or scrutinized, it has to meet requirements of disclosure, transparency and accountability, giving optimum consideration to the interest of all stake holders. Since these are essential elements of a strong corporate governance mechanism, hence it can be argued that corporate governance is a cornerstone in strategic issues. In a well governed corporate setup, requirements of disclosure, transparency and accountability give sufficient leverage to the organization's future course of action. In this way, the evolved strategy is credible, reliable and value-added. It earns confidence of all major stakeholders.

However there should be mutual complementarity between the roles of:

- CEO - Top Management (who are mainly responsible for corporate strategy making) and
- The Board of Directors (who are required to oversee the performance of the organization on behalf of the owners). In their capacity as Board members, they are responsible for implementing corporate governance in the organization.

This complementarity of role ensures that corporate governance mechanism and corporate strategy mechanism are mutually inclusive of each other. This mutual dependency has a reciprocal value added effect on both governance and strategy as well as on the corporation as a whole.

### **4.3 How Corporate Governance affects Strategy of Corporations**

An underlying aspect of the strategy-setting phase is that Board of directors should stay aloof from day to day operations of the company. According to Lorsch (2002), they

should however gauge the general performance of the company through special committees like the audit committee, compensation committee, etc. They have to oversee the affairs of the company and see its statutory and legal compliance (corporate governance aspects). They preserve shareholder interest in seeing if the management is taking the right course of strategic decision for value maximization.<sup>89</sup>

Empirical data suggests that there appears to be a paradox and non-clarity of roles between the CEO and the Board. According to a survey by Ernst & Young in 2005 of leading international companies with over \$1bn in revenue, the strategy-setting phase is not clear amongst these two vital actors of a corporation. According to the survey, “Opinions also differ somewhat among these groups on the role of the Board. Board members see a greater role for themselves in debating company strategy rather than setting the board strategic objectives. In contrast, CEOs and CFOs, believe that the primary role of the Board is in setting strategy and reviewing management performance.”<sup>90</sup>

Whereas Board sees for themselves a role of corporate oversight and for monitoring ethical compliance, thereby agreeing more on a legitimizing /approving function for top management decisions – the CEO and top management on the other hand, in the aftermath of recent corporate scams now need greater involvement of the board in corporate strategy setting phase as well. This would entrust board with responsibility sharing for strategic decision making as well.

As of now the boards expect the top management to do all the strategy setting work while they review it, debate pros and cons of strategic choices, identify weaknesses and suggest improvements. In light of their greater technical expertise they can guide the management better in value creation aspect. A major weakness of this kind of setup is that the board is highly susceptible to the figures that they receive from the top management. Since they are away from day to day operations and decide about corporate strategy, review performance, endorse decisions and allocate resources in just a few meetings every year,

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<sup>89</sup> Lorsch W. J. (2002), “Board failed in its duty, but others must learn”, Available online [http://www.corpgov.hbs.edu/pdf/lorsch\\_failed.pdf](http://www.corpgov.hbs.edu/pdf/lorsch_failed.pdf) accessed on 20-12-05

<sup>90</sup> Ernst & Young Corporate Governance Web Survey 2005, Key findings and valuable insights, P- 2, website: Available online [http://www.ey.com/global/download.nsf/International/AABS - Corporate Governance Survey Digest/\\$file/EY\\_Corporate\\_Governance\\_Survey\\_digest.pdf](http://www.ey.com/global/download.nsf/International/AABS_-_Corporate_Governance_Survey_Digest/$file/EY_Corporate_Governance_Survey_digest.pdf) access on 20-12-05

hence they are likely to have a rubber stamp function. According to the Ernst & Young survey (2005), in large organizations, “Board is less involved in reviewing management’s performance and less involved in the development of detailed strategies than in smaller companies.”<sup>91</sup>

On the contrary, this paradox has become even more prominent after the Enron debacle. CEOs want the board to be equally involved in the strategy-making phase, in addition, to their traditional role of endorsing top management actions and to share in the responsibility of success or failure.

When an organization meets its obligations and creates value through ethical means, it earns the confidence of investors, creditors, business community and other stakeholders at large. Thus through good corporate governance system, a firm is able to earn confidence of stakeholders who in turn help the company in meeting its strategic objectives. They provide the necessary resources and relationships in this context. Therefore it can be argued that corporate governance is a confidence building and authenticating mechanism, which helps the company to achieve its strategic objectives, in partnership with its stakeholders.

The linkage between corporate governance and corporate strategy is that of legitimacy and credibility which communicates the message to stakeholders that whatever activities and results the company has achieved in the past, it has done through fair means and at an optimum level. Whatever activities the company is doing right now, it is also in accordance with rules, values and expectations of all concerned. And the value creation mechanism that the company will seek in the future, it will also be done in the right way and that too in the best interest of all stakeholders.

Any shortfalls or deviation from acceptable pattern will be rightly and timely communicated to the stakeholders and appropriate remedial measures will be taken. Based on this implied legitimizing and authenticating link, the company attracts confidence of investors, creditors, strategic partners and society at large to meet its relevant requirements for value creating initiatives. Thus it can be argued that without corporate governance mechanism, corporate strategy is meaningless and non-sustainable.

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<sup>91</sup> Ibid

In the previous sections, we presented the notion of corporate governance, corporate strategy and the link between them. We now present a brief review of Enron corporation, our case company, to develop a better understanding of the linkage between corporate governance and strategy and to highlight the relationship between the two.

## 4.4 About Enron Corporation

Enron Corporation was established in 1985 as a result of a merger between Houston Natural Gas and InterNorth in USA. Initially starting as a natural gas pipeline company, involved in transportation of natural gas from source to end consumer, interlinking hubs in between, Enron diversified its operation into other energy related business, moving into retail, exploration, electricity generation, power infrastructure development, water business, financial service, trading business and broadband services. The following table presents a summary of Enron Corporation and its scope of activities.

### 4.4.1 Enron Corporation at a Glance

Top management	Chairman Ken Lay CEO Ken Lay	Previous CEO Jeff Skilling CFO Andy Fastow
Foundation	Its foundation was a merger between Houston Natural Gas and Inter North USA in 1985. Later Florida Gas was also a part of this company.	
Operative years	1985 – bankruptcy in 2001	
Achievements	USA's 7 <sup>th</sup> largest company in terms of revenues One of biggest energy company in the world in terms of revenues.	Fortune most innovative company for 5 years. Most innovative CEO award Most innovative CFO award.
Major companies under Enron	Enron Corporation Enron Oil and Gas Enron Derivatives Gas and Power trading group (Enron Capital and Trade)	Enron Finance Azurix (Water Business) Enron Broadband Services Enron Energy Services (retail power business)
Key business	Pipelines (cash cow) Energy Exploration Energy Production Gas processing Energy Trading business Gas services Natural gas liquids business Electric power generation Gas bank Gas trading business	Electricity trading Expertise in Energy infrastructure project development, Asset management Involvement in energy Regulation and policy Financial services Risk management Water business Broadband services
Major international projects	Teesside (UK), Dabhol (India), Buenos Aires (Water Business)	

Financials	As mentioned in 2000 <sup>92</sup> Assets: 47.3 Billion (US\$) Revenues: 101 Billion (US\$)	Share price during 2001 <sup>93</sup> Highest stock price:90.0(US\$) Lowest stock price:0. 30(US\$)
Allegations	Failed corporate governance Inadequate interest of the board Non-independent board Bad accounting practices / financial embezzlement Inaccurate disclosures Personal interest of top echelons in company affairs Group think	Hyper aggressive organisational culture that believed in getting things done and achieving results without taking into account modus operandi. Overspending Improper checks and balances Improper succession planning
Corporate values	RICE (respect, integrity, communication , excellence)	

Table 4.1: **Enron Corporation at a Glance**  
Source: Based on description in Bryce (2002) <sup>94</sup>

Enron was regarded as the biggest energy trading company in the world, having revenues worth more than 101 billion US dollars. Truly being a transcontinental company, it extended its scope of operations in UK, Gulf, India and Argentine to name a few, thereby having a global vision that entailed capitalising on energy deregulation wave around the world. It was also regarded as the most innovative company for 5 consecutive years by Fortune magazine. In terms of revenues it was 7<sup>th</sup> biggest firm in USA in any category. <sup>95</sup> Its Founder, Chairman and CEO, Mr. Kenneth Lay was also regarded as an industry icon for innovation. He was on board of numerous companies and also on advisory panel on energy sector reform in USA. The company’s Board of Directors consisted of eminent people from government, financial and business sector.

#### 4.4.2 Enron as a Highly Innovative Company

Enron was a flag ship company of USA, which revitalised energy sector. Through the following pioneering initiatives, it consolidated its position as one of the top-notch companies in the energy sector.

<sup>92</sup> “Company Snapshot” Available online <http://www.enron.com/corp/pressroom/factsheets/> accessed on 20-12-05

<sup>93</sup> “Decline of Enron”, Available online <http://en.wikipedia.org/wiki/Enron#Decline> accessed on 23-12-05

<sup>94</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, P 1-100

<sup>95</sup> *Ibid* p-20

### **i. Energy Banking**

“It began life as an energy producer, moved to become an energy trader, and ended up an energy "bank" providing guaranteed quantities at set prices over the long term. Enron owned power plants, water companies, gas distributors and other units involved in the delivery of services to consumers and businesses. But it was the first to realise energy and water could be bought, sold, and hedged just like shares and bonds. Enron became a huge "market-maker" in the US, acting as the main broker in energy products, also taking financial gambles far bigger than its actual core business.”<sup>96</sup>

The energy sector is a highly complex industry. Following deregulation in the 1980s in USA, the industry becomes even more intricate. Issue of concern for all players involved in this vital sector was about volatility of prices, highly linked with demand and supply patterns, seasonal variations, and linkage with politico-economic climate and highly susceptible to speculative manoeuvre.

According to Bryce (2002), Enron saw an opportunity that producers, needed assurance of constant upliftment. Pipelines companies needed assurance of volumetric availability from producers' side, and upliftment from receiving end distributing companies so as to utilise idle capacity. Distributors needed continuous supply, at lowest prices so that they could forward it to consumers. However they also needed to create equilibrium between supply and demand. Since prices fluctuated, season variations and temperature sensitivity affected consumption patterns hence the industry was highly sensitive and volatile. Enron thus came up with its concept of energy trading and banking, assuring producers, transporters, distributors and consumers of constant supply at pre-determined forward prices. Thus it would capitalise on assured volumes and prices. This mechanism was known as “take- or- pay”.<sup>97</sup>

However this also had its negative aspects. Since the market was highly interlinked and if any company defaulted on its pledge of delivery or upliftment, Enron had to pay heavy fines. The mechanism was not secured appropriately; especially in the event of multiple

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<sup>96</sup> “Q&A: The Enron collapse” by BBC News, Available online <http://news.bbc.co.uk/1/hi/business/3398913.stm> access on 24-12-05

<sup>97</sup> Bryce, R. (2002) “Pipe Dreams Greed, Ego and the Death of Enron”, Public Affairs Ltd. Oxford, UK. P-53

default by partner companies. Hence in order to save itself from susceptibility to these factors, Enron initiated other business initiatives and pursued a growth oriented strategy.

#### **ii. Financing Infrastructure and Traders**

Enron entered into financial services, helping small companies in their exploration and other energy related initiatives. It would offer loans or equities in their quest to seek presence in the energy business. It would also finance infrastructure development, besides playing pivotal role through its technical expertise.

#### **iii. Broadband and E-Business Services**

Enron ventured into E-business and broadband services, establishing an Internet company as well as initiating online trading of energy products. Enron Online, “an internet-based global transaction system which allowed Enron's customers to view real-time prices from Enron's traders and transact instantly online”. Within two years the platform was averaging 6,000 transactions a day worth about \$2.5bn.”<sup>98</sup> However, it lacked expertise in broadband services.

### **4.4.3 Collapse of Enron Corporation**

What makes the company an interesting case is its sudden demise from operations in 2001 owing to improper financial performance and bankruptcy. Whereas the main reason was financial embezzlement and inaccurate financial disclosure, it was later revealed that there are many underlying causes behind its downfall, most important of which was failed corporate governance by top management and board of directors who didn't act to secure shareholder interest. Some of the key attributable reasons are briefly discussed here:

#### **i. Unbridled Growth and Expansion**

To begin with, Enron's business concept was flawed. It was venturing into many divergent businesses areas such as water and broadband services, without having the relevant technical expertise and know how about industry dynamics.

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<sup>98</sup> “Enron Internet monster” By BBC, Available online <http://news.bbc.co.uk/1/hi/business/1684503.stm> accessed on 2005-01-03



Furthermore it was pledging beyond its capacity. Since the energy and trading business is highly susceptible to speculation, and is extremely interlinked, hence collapse through ripple effect was witnessed. Enron guaranteed supplies and uplifting in case if third party partner companies fell back on their pledge. When many trading groups who were financially unsecured fell back on their professional commitment, Enron had to bear financial losses for their actions.

## **ii. Financial Reasons**

According to Bryce (2002), ever since its inception till 1990s, Enron had accrual basis of accounting in vogue. Meaning thereby, revenues were realised when they were earned. The previous CEO, Rich Kinder who was an expert on financial matters, always focussed on cash flow from operations. All project managers were under scrutiny to meet cash generating targets of the company. Hence the company had strong financials, and especially cash position was solid. The company had the ability to have controlled growth.

However, when Jeff Skilling took over as CEO, he viewed futures and trading business as a high growth area that required strong financial statements. Hence after seeking approval from board and SEC, he initiated mark-to-market accounting method. Under this mechanism, revenues were realised in accounting books as soon as deals were struck. This method skyrocketed the revenues. This kind of accounting method, suited company's trading business. Later on the entire corporation adopted this mechanism of accounting.

Since revenues were sky high, hence management turned a blind eye to cash flow issues. The company lacked the capacity to realise that the revenues reported were not actually earned. Whereas profits were high, actual cash position was declining sharply. The company squandered resources, in maintaining top quality life style for its executives in the form of compensation and fringe benefits. It also invested heavily in other activities outside its core business, without tangible cash basis. Cash is lifeblood of a commercial company. When trading business started showing a downturn due to high volatility of prices, the company realised that it didn't have sufficient cash to pay back on its pledges.

Furthermore, it needed cash to pay back its day-to-day expenditures, debts and penalties for energy banking initiatives.<sup>99</sup>

### **iii. Creative Accounting**

Since the company's trading business depended substantially in gambling on future prices of energy products, it required attractive financial statements so that the company could attract suitable business opportunities, investors and creditors.

However, when future guaranteed energy prices showed a downturn, sending ripple effects on business models, the company was left with a weak cash position and mounting debt. Hence to hide this debt and potential losses, the company formed new partner companies, (associated with top executives of the company, thus violating its own ethics of no personal interest of management in business operations of the company or its partner companies).<sup>100</sup> Such partnerships would shift debt of Enron to that of the partner companies' accounts, thus improving balance sheet position of Enron Corporation as well as shifting losses to partner companies' accounts, showing them as sales for Enron thereby boosting profitability.<sup>101</sup>

The bubble of Enron growth suddenly exploded in 2001 when the company restated its financial position, reflecting a huge loss of \$644m which was earlier shown as a profit of more than \$600m.<sup>102</sup> When Security exchange commission (SEC) the institution responsible for financial regulation in the US initiated investigations, Enron admitted that it had fudged its numbers, profitability and debt. In December 2001, Enron filed for bankruptcy and its top management is under court proceedings, while its assets are being liquidated.<sup>103</sup>

Around 21,000 workers from different ranks within the company were rendered unemployed, many of them who had contributed a fair chunk of their professional life with Enron and had their pensions funds associated with the company's stock options

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<sup>99</sup> Bryce, R. (2002) "Pipe Dreams Greed, Ego and the Death of Enron", Public Affairs Ltd. Oxford, UK. P-132-136

<sup>100</sup> "Q&A: The Enron collapse", Available online <http://news.bbc.co.uk/1/hi/business/3398913.stm>, accessed on 23-12-05

<sup>101</sup> "Timeline: Enron's rise and fall", Available online <http://news.bbc.co.uk/1/hi/business/1759599.stm>, accessed on 24-12-05

<sup>102</sup> Bryce (2002), p-328-329

<sup>103</sup> "Q&A: The Enron collapse", Available online <http://news.bbc.co.uk/1/hi/business/3398913.stm>, accessed on 23-12-05

which were now of no value. Other financial companies including banks, suffered huge losses owing to their deals with Enron.<sup>104</sup>

It is estimated that investment bankers JP Morgan had an exposure of around USD 900m while Citigroup's exposure is around 800m USD. Furthermore, Enron's external auditing company M/s Arthur Andersen, which failed in its duties to check the accounts properly and which, helped Enron in shredding off 17 days worth of documents had their license for professional auditing cancelled.<sup>105</sup>

#### **4.4.4 Failure in light of Agency Theory**

The main reason of Enron's downfall was that the board turned absolutely blind eye, as if they were just a rubber stamp authority that approved anything that top management suggested to them. This suggests that they were not fulfilling their responsibilities as true agents of shareholders. Agency theory clearly suggests that- any business association between agents and the company in terms of conflict of interest and in terms of lack of professional conduct in protecting shareholder interest- will lead to corrupt practices and systemic collapse.

Another attribute associated with Enron downfall is that the top management also being agents of shareholders in running the company, associated personal interests with the operations of the organization. They not only used insider information in capitalising stocks, selling it as the downfall was imminent, yet they also established personal associations with subsidiary companies, thereby profiting on their association.<sup>106</sup>

##### **a. Corporate governance setup and Pakistani context**

In any country, corporate governance practices and regulations are generally developed with the collaboration of Government, regulatory authorities, public and private sector enterprises. Through mutual consultation, following international trends and keeping the national context in mind, they develop a broad code of conduct for the companies.

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<sup>104</sup> Paulsen S., (2002), "Workers lose jobs, health care and savings at Enron", Available online <http://www.wsws.org/articles/2002/jan2002/enro-j14.shtml> accessed on 24-12-05

<sup>105</sup> "Banks for Roles in Enron's Collapse" Available online <http://www.nysscpa.org/home/2003/0703/4week/article6.htm>, accessed on 24-12-05

<sup>106</sup> "Timeline: Enron's rise and fall", Available online <http://news.bbc.co.uk/1/hi/business/1759599.stm>, accessed on 24-12-05

Pakistan has three main stock exchanges namely, at Karachi, Lahore and Islamabad. The country also has Securities and Exchange Commission of Pakistan, in addition to the State Bank of Pakistan, other financial and regulatory authorities. Through mutual consultation, they share in best practices and develop a broad framework of fair governance for companies.

In Pakistan, the trend of family owned businesses in the form of Small and Medium Enterprises in textiles, chemicals, banks and agriculture related activities are quite common. These companies start of as family business with family members taking key positions in the organization and on the board. With the passage of time as market position is consolidated, such enterprises are listed at the Stock exchange and then become public limited companies. However family members still retain the top slots because they hold majority of shares. Hence it can be argued that, in the Pakistani context, it is difficult to have full segregation between principals and agents and thus it is quite difficult to segregate conflict of interest amongst these two vital actors and the enterprise.

However in the case of large corporations, the pattern changes a little bit. Usually other firms, government and group of companies are majority share holders. Hence there is an element of professionalism in the Board and Management. Since general public is also associated as shareholders hence requirement for transparency, accountability and fair disclosure becomes even more prominent.

In March 2002, the Securities and Exchange Commission of Pakistan promulgated Code of Corporate Governance for Publicly traded companies. This 23 page document entails broad guideline for the Board and top management of corporations.<sup>107</sup> There are frequent information seminars organized by various bodies to create awareness for the need of good governance, to share best practices and to identify solution to common problems in the realm of governance. The current Prime Minister Mr. Shaukat Aziz is a former banker by profession and thus has great interest in the professional conduct of corporations.

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<sup>107</sup> “Code of Corporate Governance” Available online  
[http://www.ecgi.org/codes/documents/code\\_corporate\(revised\).pdf](http://www.ecgi.org/codes/documents/code_corporate(revised).pdf) accessed on 30-01-06

The cases of failed corporate governance are difficult to eliminate in any society. Greed is in born in human nature. Laws can minimise chances of malpractice and corruption but they cannot prevent it completely. However if there are loopholes in law, regulations are not followed in true letter and spirit, politico-economic-socio-cultural and religious forces lack complimentarity then chances of failed corporate governance can be high.

In a country like Pakistan, where political climate is not stable, owing to formation of collation administration, removal of elected governments on charges of corruption and frequent military intervention, the corporate governance setup could not be enforced in its true letter and spirit. At times there is conflict of interest between principals and agents.

Another constraining factor in Pakistan is that listed companies usually don't declare dividends. According to Mahmood J. (2003), "About 60 per cent of the listed companies did not declare dividend in last financial year. Out of a total of 536 companies (listed at stock markets and registered with the Securities and Exchange Commission of Pakistan (SECP), only 214 companies announced dividend in financial year 2003-04 while a vast majority of 322 companies did not declare the dividend."<sup>108</sup>. He states that operational cost of listed companies to meet documentation, regulatory and audit requirements as proposed by Security Exchange Commission of Pakistan are some of the main reasons why listed companies fail to declare dividends which make it quite difficult for small and medium enterprises to retain their enlistment. He also states that since main objective of enlistment is to raise capital and currently capital can be easily obtained from banks at competitive rates hence stock-enlistment proves ineffective for such enterprises.<sup>109</sup>

Hence it can be argued that corporations in Pakistan have to comply with the requirements of regulatory authorities to implement good corporate governance. They have to optimise conflicting impact of external forces on their business operations and also need to be profitable. Since profitability aspect at times is difficult to achieve hence principal-agent conflict of interest to implement good corporate governance is bound to arise in the Pakistani setup. Corporate strategy in Pakistan can at times pose serious difficulties for top management since no one is sure as to how long governments will last

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<sup>108</sup> Mahmood J. (2003), "60pc listed cos failed to declare dividend in 2003-04". Available online <http://www.nation.com.pk/daily/may-2005/4/bnews1.php>. accessed on 30-1-2006

<sup>109</sup> Ibid

or what new regulations will Islamists ask for. Furthermore being in a politically volatile region, it's difficult for Pakistani companies to have increased business performance. Hence top management and board of directors can at times may have the tendency to fulfil political obligations rather than to meet principal agent relation requirements. Since external forces are extremely dominant and laws have loopholes hence there may be chances of occurrence of Enron-like scandal in the country.

## 5. EMPIRICAL ANALYSIS

*This part presents our empirical findings based on primary and secondary sources. We conducted telephonic interviews and got response from academicians and professionals on corporate governance through questionnaires. Components of Agency theory along-with Ernst and Young model have been discussed with our respondents to gather their perspective. Their insights have facilitated our understanding as how corporations can use corporate governance to have sustainable competitive advantage and how it can affect their strategy.*

*“Well-governed companies often draw huge investment premiums, get access to cheaper debt, and outperform their peers.”*

International Finance Corporation (IFC) World Bank Group<sup>110</sup>

*We received perspective of respondents from diversified backgrounds ranging from academic profession to audit. The respondents were randomly selected on the basis of convenience sampling. Efforts have been made to present eastern and western perspective to yield greater reliability of our research. Owing to space constraints and for reasons of anonymity, we will mention them as respondents in alphabetical order. Wherever permitted, we will mention their names as well. Readers can get details of each respondent in ‘Reference’ section.*

### 5.1 How the Strategy Making Process Works?

According to Mr. Q, strategy making is a continuous process rather than a single day activity. The top management views the external environment vigilantly. It constantly receives information from company management and employees regarding internal resources and activities through continuous information flow, thereby indicating systemic strengths and weaknesses. Key developments in macro-economic, social, political, business spheres as well as competitors’ activities indicate opportunities and threats. Hence, top management whose ultimate objective is to channel corporate efforts towards

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<sup>110</sup> “The irresistible case for Corporate Governance”, Corporate Governance Department, IFC/World Bank Group, Sept 2005, available online <http://rru.worldbank.org/Documents/PapersLinks/IrresistibleCase4CG.pdf> accessed on 2006-01-05

profitable growth and expansion is vigilant about all these activities. It conceives scenarios, models, projects, business plans and strategic moves for growth.<sup>111</sup>

Such high venture projects, which are ultimately directed towards growth and corporate enrichment, require high sum of resources. The top management works out estimates for these resources, their requirements/ utilizations, feasibilities and likely sources of resources such as investments through stock flotation, credits, other material resources and probable strategic partners.

Once such plans are developed, they are presented to the Board for debate, improvements and approval. The Board having superior technical knowledge / relevant networks and having greater market insights along with experience fine-tunes these areas. It views the accuracy of these models and strategic plans.

In Board meetings, it reviews companies past performance on previously committed plans. It then approves, or suggests alternatives for the next year. It also sees that past projects met ethical / statutory obligations of the company and requirements for disclosure. In addition, those profits were earned in the right manger. It then endorses faith in the performance of the top management, agrees or improvises plans for next year or period. Then next year resource allocation takes place. In addition, previous years financial results are approved. Executives, top management are elected or their tenures are extended based on previous year's performance.

According to Respondent A, The Chairman in his capacity as Head of the Board endorses performance, and renders approvals. Through various committees of the Board, he ensures that previous performance of the company was properly audited and scrutinized. Performances have been measured against previously stipulated targets appropriately and resources were properly utilized. He then announces returns on investments and through the Board, approves expenditures, and commitments for the next period.

Since investors are away from the company, hence they mostly rely on whatever the Board approves. In Annual General Meetings, every year in which performance is declared and dividends are announced, they discuss with top management and the Board about company performance. They express their concerns and suggest ways and means to

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<sup>111</sup> (Respondent A) Mr. Q is an auditor by profession. He has extensive experience of audit of corporations in Pakistan. His perspectives were obtained through telephonic interview dated 24-12-2005



improve performance. However, their major reliance is on whatever Figures they receive from the Board.

The Board relies on whatever Figures it receives from top management. The top management relies on whatever Figures it receives from company employees. It ensures necessary checks and balances. Since they are involved in day-to-day activities, hence they are in a better position to identify systemic loopholes, deviation from acceptable performance and authenticity of Figures presented.

The Board usually has a rubber stamp function. After debating, they usually approve whatever information and plans top management suggests them. They just ensure that things are as accurately stated as possible. However, major handicap for the Board is that they do not have much time for corporate activities. Hence, through a few meetings every year, they decide and approve the complete fate of investors, creditors, businesses and the company. This is how the strategy making takes place in a corporation.

However an important aspect to all this is high level of dependency of the Board to the Figures provided by the top management. The top management in their bids to retain their places in the company is determined to show performance and results. They not only use their authority on company employees to meet specified targets, they also use their expertise in removing hitches and obstacles that come in between for necessary results, hence pave the way forward. The top management is rewarded / compensated based on the overall performance for the previous period and likely growth plans for next period.

Thus, corporate governance can be viewed as an umbrella – a domain under which all major actors of the strategy process operate through a process of interaction and dependency. It specifies roles, responsibilities, and limits of authority of all major parties within an organization. The responsibility to implement corporate governance, i.e. appropriate disclosures, ethical compliance and endorsements lies with the Board. Thus, corporate governance should be seen as a monitoring, legitimizing, authenticating, and approving mechanism for corporate strategy through which investors, creditors, and other stakeholders build confidence about corporate affairs, thereby ensuring availability of resources and carrying out further business relations with the corporation. It adds credibility and confidence in management decisions, thus attracting more investment,

credit, partnerships and business. Accordingly, it is directly linked with corporate strategy. Without appropriate corporate governance, corporate strategy would be meaningless.

However, it should be kept in mind that “Corporations are complicated organizations and pin-pointing who knew what when and who did what when is rarely clear.”<sup>112</sup> The strategy making process is so complex that it is difficult to lay out clear-cut responsibilities on exact persons in the event if things go wrong, as was the case in Enron.

*“A commitment to good corporate governance—well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, and an empowered board of directors—make a company both more attractive to investors and lenders, and more profitable. Simply put: it pays to promote good corporate governance.”*

International Finance Corporation (IFC) World Bank Group<sup>113</sup>

Strong corporate governance structure ensures corporate credibility in the eyes of all stakeholders -thereby improving the net-worth of the company. According to Prof. M., it can be argued that corporate governance and corporate strategy are two mutually complementary concepts. If profitability and value creation are the results of corporate activities - strategy serves as the means to achieve these ends.<sup>114</sup>

According to him, corporate governance serves as the framework under which strategy is developed and evaluated. It reinforces strategy. Nevertheless, successful corporate strategy augments corporate governance mechanism. Since there is an element of mutuality between these two concepts, hence they both form a system of decision-making and influence, both within and outside the organization.<sup>115</sup>

Hence, it can be argued that there exists a systemic view of corporate governance and corporate strategy. Taken in unison they both form an integrated management system comprising of key actors and stakeholders. They influence the behavior of a corporation

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<sup>112</sup> “Corporate America in the dock”, Available online <http://news.bbc.co.uk/2/hi/business/3411063.stm> accessed on 20-12-05.

<sup>113</sup> “The irresistible case for Corporate Governance”, Corporate Governance Department, IFC/World Bank Group, Sept 2005, available online <http://rru.worldbank.org/Documents/PapersLinks/IrresistibleCase4CG.pdf> accessed on 2006-01-05

<sup>114</sup> (Respondent B) Telephonic interview with Prof. M. from Pakistan, dated 27-12-2005, He is a lecturer of Business Strategy at a business school in Paksitan.

<sup>115</sup> Ibid

and in turn are influenced by the behavior of the corporate entity. Thus, this influence is a two-way process that entails a lot on information transference between the corporation, its internal and external environment. Because of this systemic orientation, the components are interrelated through a process of social interaction and dependency arising out of information flow.

According to an international researcher, “Corporate Governance make(s) the general public more aware of how important corporate governance is. The differences between corporate governance and strategy are that sometimes corporate governance can be used as a strategy, but in essence, good governance practices are the fundamentals of the company.”<sup>116</sup>

According to Respondent A, if however there is an element of relative importance, it can be argued that corporate governance takes precedence over corporate strategy. If the strategy fails, it does not imply failure in corporate governance. Strategy failure is basically a management shortcoming which can be rectified through remedial measures. However if there is failure of corporate governance (as was the case in Enron), there is likely hood that the organizational system will collapse.

## **5.2 Shortcoming of Agency Theory**

Whereas agency theory presents the role of agents and principals in ensuring systemic integrity and sustainability, it has a limited scope of behavioral evaluation. It does not depict the role of other major actors within and outside the organizational system, who are either beneficiaries of corporate governance mechanism. These actors also play a pivotal role in shaping corporate strategy. They are also end users of information generation process of corporate governance system.

Hence, to develop a better understanding of corporate governance mechanism and to study its linkage with corporate strategy, we decided to study the role of key actors in this context. Hence, we used the model developed by famous auditing company Ernst & Young (as mentioned in chapter 3).

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<sup>116</sup> (Respondent C) Questionnaire response from an international researcher on Corporate Governance dated Dec 24, 2005. Name of the researcher has been intentionally concealed on request.

### **5.3 Why Ernst & Young Model has been used**

This model is used because it identifies key actors in a corporate governance framework. The same actors also play a pivotal role in shaping corporate strategy. The model developed by this audit house has been used since auditors are outside parties, who not only critically view a company's resource management abilities but they also can view the system critically, identify loopholes in processes, and indicate remedial measures.

We have also augmented our findings by using examples from Enron debacle and taking into account, empirical views as collected from leading professors and practitioners of corporate governance through interviews and questionnaires. It will help us to identify key lessons. It should be kept in mind that here we have not attempted to discuss chronological sequence of Enron debacle. Rather we have used certain examples from its case to understand corporate governance framework and its impact on corporate strategy.

### **5.4 Enron Corporate Governance & Strategy in light of Ernst & Young Model**

“Enron's vision (was) to become the world's leading energy company – creating innovative and efficient energy solutions for growing economies and a better environment worldwide.”<sup>117</sup> This vision entailed continuous growth and expansion and hence it was intrinsically embedded in corporate strategy. Enron's corporate strategy was to show continuous growth in corporate performance. It was in accordance with this global vision that Enron expanded its operations readily in Europe, US, Latin America, Middle East and Asia.

#### **5.4.1 External Environment**

Any corporation in its pursuit for profitability and growth enters into partnerships with many outside actors to meet resource requirements or to foster network for business activities. Such parties are interested with company operations and results, in accordance with acceptable norms and laws of the land. According to an international auditor (A),

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<sup>117</sup> Press room – “vision”- Available online [http://www.enron.com/corp/pressroom/responsibility/human\\_rights\\_statement.html](http://www.enron.com/corp/pressroom/responsibility/human_rights_statement.html) accessed on 2005-12-25

“The corporate governance is the environment that the company is working in”.<sup>118</sup> Hence external actors play a pivotal role in shaping corporate strategy. They stimulate strategic thinking of a company. Being stakeholders they are also end users of information as generated by corporate governance mechanism. If they get false information and lucrative compensation, they will turn blind eye to corporate governance failure, only to realize it when things go real out of control. As a consequence key actors in the external environment of a corporation are equally responsible to extract good corporate behavior from a firm.

The following are key actors in the external environment that can influence strategy as well as corporate governance mechanism:

**i. Government and Regulation**

Governments play a pivotal role in shaping strategy of a corporation. They influence the behavior of the firm by controlling regulatory framework of the country in areas which can directly affect the scope of operations of the company and its industry. Their fiscal, monetary, taxation and industry policy initiatives (in the form of privatization, nationalization, deregulation, liberalization to attract greater Foreign Direct Investment) can serve as an opportunity as well as a threat for a company.

Such organizations are directly aided by Government’s lobbying function to facilitate entrance in foreign markets and in getting necessary concessions from recipient states. In return governments earn substantial revenues from such firms in the form of taxation, social contribution and for participation in the political process of the land. Such corporations are constantly in need of conducive policies and patronage by government to facilitate their operations.

Governments also have major equity investments in large scale capital intensive corporations. According to Prof. Song “Having the State as a company’s largest shareholder negatively impacts its valuation.”<sup>119</sup> Whereas such an equity setup can bring in stability for investors, it can also mean bureaucratic involvement in decision making procedure which can slow down business owing to systemic inefficiencies. Hence owing

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<sup>118</sup> (Respondent G) Questionnaire response from an international auditor dated 2005-12-20. Name of the auditor and firm intentionally concealed on request.

<sup>119</sup> Song et al, (2002)“*Corporate Governance and Firm Valuations in China*” , November 2002, Available online [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=361660](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=361660) Accessed online on 2005-12-15

to this factor, they can at times manipulate such corporations so as to derive maximum benefit out of them, through a win-win relationship.

Enron would form close alliance with policy makers, politicians and bureaucrats at the helm of affairs in UK, and US. They in turn would favor Enron in policy related issues, facilitating its operations and internationalization. As stated by Mc Gee et al (2005), “Enron made small donations to both US political parties including \$10,000 to support the Florida recount in the Presidential elections. Kenneth Lay (former Founder Chairman and CEO), subsequently secured a seat on key advisory committee on energy policy (a post previously unavailable to anyone outside government).”<sup>120</sup> Thus Enron would use its resources to do favor for the government. It would be repaid in kind through participation in the policy process.

In UK, Enron was able to develop such relationship with key decision maker who in turn permitted Enron to buy facilities such as Wessex Water (Azurix) and to build gas-fired power station in Kent, without seeking permission from any other government authority. In return, according to Bryce (2002), Enron rewarded the official by naming him on Board of directors of the corporation.<sup>121</sup>

Because of government involvement, such organizations also have the added responsibility to serve as icons of ethical behavior. Any failure on corporate governance aspect can also tarnish the government’s image. According to Prof. Neil Andrews, “(Corporations) are limited by the expectations of higher standards and greater transparency and accountability that public can expect from public or crown agencies. The managers are not justified at making profits at the cost of other priorities and responsibilities. If such bodies inflict injuries on individuals – such as in tort or delict law - they should not have the shield of limited liability. It is not required to encourage investors to diversify. It may encourage public officials to shirk their monitoring role. The public treasury should be made to pay for the damage done to individuals.”<sup>122</sup> Thus it can be argued that governments favor corporations in their bid for growth and the favors

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<sup>120</sup> John McGee, Howard Thomas and David Wilson (2005) “Strategy- analysis and practice”, McGraw-Hill Education, Berkshire, United Kingdom, Chapter 17, *Strategy and corporate governance*, p-631,

<sup>121</sup> Bryce, R. (2002) “*Pipe Dreams Greed, Ego and the Death of Enron*”, Public Affairs Ltd. Oxford, UK, P-72

<sup>122</sup> (Respondent F) Questionnaire response from Prof. Neil Andrews dated Dec 11, 2005. He is a professor of corporate governance at Victoria University, Australia.

are returned in kind, in one way or another. However, being associated with government entails expectation of socially responsive and ethical behavior, which is difficult to achieve owing to paradox of growth.

Similarly, regulatory mechanism serves as a broad system of do's and don'ts for the corporation. However, corporations in their bid to grow manipulate statutes of law for their benefit or seek questionable exemptions from it. According to Bryce (2002), Enron appointed Wendy Lee Gramm, a former Chairman from Commodity Futures Trading Commission, a federal regulatory authority in USA, as its Board member. Earlier she had helped Enron by getting approved an exemption from federal regulation on energy derivatives contract. This business segment was rapidly growing and needed certain out-of-the-box exclusion in the regulatory framework. This kind of regulation was primarily for Wall Street financial firms. Under law, it required Enron to have a license from Securities and Exchange Commission or other regulatory authority to carry out derivatives business. However after this exemption, the requirement was waived and Enron went on its derivative rampage of bubble growth despite inadequate cash.<sup>123</sup>

Similarly Enron changed its accounting method to mark-to-market method, with consent of Security Exchange Commission in 1992. The approval was primarily for Enron's gas trading business. However Enron extended it through out the corporation, without getting necessary approval from SEC.<sup>124</sup>

Thus it can be argued that governments and regulatory environment can play a significant role in fulfilling strategic ambition of corporations. However by eradicating systemic loopholes, they can ensure good corporate governance behavior from the firm, thereby endorsing its strategy and growth requirements.

## **ii. Business Environment**

The business environment of a corporation consists of its customers, competitors, suppliers, and other strategic partners. Their requirements, behavior and offer play a significant role in determining the strategy of a corporation. Especially in the context of internationalization, the strategy and the business plan needs to be comprehensively

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<sup>123</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd, Oxford, UK, P-81-84

<sup>124</sup> *Ibid*, p-67-68

evaluated before committing resources. The top management should see if they are familiar with industry dynamics in the international market.

According to Bryce (2002), Enron ventured into broadband services despite its lack of experience in the relevant industry. The Chairman and CEO of Enron Broadband Services, Ken Rice lacked technical exposure to the dynamics of the IT industry. Hence during critical management meetings, he would watch cartoons on his laptop, depicting lack of interest while his management worked out details of operations.<sup>125</sup>

Similarly, in 1993, Enron entered in a fuel driven power plant construction project with Maharashtra State Electricity Board in India. The plant was to be constructed at Dabhol near Mumbai. The project had already been labeled as not feasible by a World Bank study owing to non-feasible demographics of Indian population. Indian per capita income was \$450 and around 54% of power produced was stolen in the target city. The project construction, its operations and maintenance required substantial capital investment to the tune of \$4bn initially and subsequent payment of \$26 bn over 20 year period, by the Indian government. Undoubtedly it was biggest foreign direct investment in India. By virtue of diplomatic pressure, and lobbying, the project was approved by Indian government, though with great skepticism. The Head of the project, Rebecca Mark also used her personal charms to get the deal across. She would wear sari's (Indian cultural dress) and would show cultural affinity towards the society, in order to win over the deal from Indian politicians.<sup>126</sup> In the words of Bryce (2002), "Over the life of the contract, India would pay Enron and its partners nearly nine times what Dabhol had cost. Furthermore, India was required to pay for any cost increases causes by price hikes associated with plant's fuel, electricity transmission lines or plant maintenance".<sup>127</sup>

The project was commissioned and power generation took place. However soon Indian government realized that project was exorbitantly high and non feasible for their economy. Negotiations at the highest level were carried out but to no avail. Indians stopped payment on the project unless there was revision in tariffs by Enron. On the other hand Enron was not in a position to revise tariffs. India's lack of political stability also

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<sup>125</sup> Ibid, p-196

<sup>126</sup> Bryce, R. (2002) Pipe Dreams Greed, Ego and the Death of Enron, Public Affairs Ltd, Oxford, UK, P-81-84

<sup>127</sup> Ibid, p-102-103



made the project an icon of media and political scrutiny. Lack of profitability on this project was not taken well by the stock market. Unfinished agenda of this project was one of many reasons of Enron collapse.<sup>128</sup>

The above two examples indicate that Enron didn't care for its business environment. By applying political and diplomatic pressure in getting the deal across, it didn't take into account market dynamics. Furthermore its entrance into broadband services without adequate technical expertise made it vulnerable to external shocks.

In high risk cross cultural ventures, a corporation must evaluate its strategic offer in relation to market and industry dynamics, before committing resources. If Enron's strategy was flawed, how were its top executives coming up with more and higher risk projects? Secondly, why was the board endorsing continuous resource allocation on strategic projects which were technically not feasible? The board clearly failed to protect the shareholder interest.

Hence it can be argued that volatility of international markets can at times make capital intensive cross cultural projects extremely vulnerable to external shocks. In such projects its imperative for the board to use its international networks and superior market insights to help the management in working out better strategic alternatives for the corporation as a whole. Similarly if the company doesn't have technical expertise in certain kinds of industries then its prudent to commit resources gradually.

### **iii. Investment Community**

To meet their capital requirements, corporations require equity financing through, partnerships, institutional investors, consortium funds and stock floatation. However investment community commits resources based on past performance, fair-play in operating activities, risk and return potential on investment.

In a study conducted by renowned international consultants McKinsey International in 2002, it was revealed that institutional investors (consortiums) would be willing to pay premium prices to have equity stakes in well-governed corporations to the tune of 30%

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<sup>128</sup> Ibid, p-284-292

more value in Easter Europe and African countries and 22% more value in Asian and Latin American countries.<sup>129</sup>

According to Bryce (2002), Enron's decision to take up mark-to-market method of accounting was intended to facilitate its trading business as it could to appear attractive and expanding for its investors. This kind of method was not suitable for an energy company which is associated with the transference of a physical product. Since this method realized future revenues in current financial year, it helped company boost its revenues and profitability.<sup>130</sup> However this kind of book keeping brings in shortage of cash. If revenues are growing, investment partners may be lured by profitability and may ensure more availability of stock investment.

According to Prof. Neil Andrews, "In the strategic context in most companies corporate governance is associated with public relations and investor relations. Companies may be forced to take it seriously when the company is subject to media scrutiny or it is subject to investor or other interest group concern. Otherwise it is something which is done for appearance".<sup>131</sup> Hence misguiding investment community may work out in the short range through ready availability of stock investment, it brings with it additional responsibility of deliverance. For corporation, this also brings with it pressures for continuous growth to provide sustainable return on investment.

#### **iv. Financial Community**

According to IFC research " Good governance makes for cheaper debt"<sup>132</sup> as banks and other financial institutions are able to judge the financial credibility of the company better thereby reducing cost of borrowed capital for companies that have a strong culture of corporate governance.

According to Bryce (2002), Enron had formed close business alliance with the banking and financial sector community. Since Enron provided them good business hence they

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<sup>129</sup> McKinsey's Global Investor Opinion Survey, 2002, available online <http://www.mckinsey.com/client/service/organizationleadership/service/corp-governance/pdf/GlobalInvestorOpinionSurvey2002.pdf> accessed on 2005-12-19

<sup>130</sup> Bryce, R. (2002) Pipe Dreams Greed, Ego and the Death of Enron, Public Affairs Ltd. Oxford, UK, p-66  
<sup>131</sup> Respondent F

<sup>132</sup> "The irresistible case for Corporate Governance", Corporate Governance Department, IFC/World Bank Group, Sept 2005, available online <http://rru.worldbank.org/Documents/PapersLinks/IrresistibleCase4CG.pdf> accessed on 2006-01-05

would recommend “strong buys on the company stock”.<sup>133</sup> If a corporation’s financial position is strong, it enjoys stronger credit ratings thereby attracting more and more secured debt to meet its capital requirements. However there is an element of financial charges (interest) on debt. Enron’s overseas assets were around \$9bn however very few of them were profitable ventures<sup>134</sup>. The company was heavily indebted. In the words of Bryce, “In the first six months of the year, (2001) the company paid \$426 million in interest, or more than \$2.3million per day. Short-term and long-term debts were soaring, too. Between the last day of 2000 and the end of June 2001, Enron’s short-term debt load more than doubled, rising from \$1.67 bn to over \$3.45 billion. Long-term debt went from \$8.55 billion to \$9.35 billion.”<sup>135</sup>

Partnership with financial community is one of the main anchors of a corporation’s sustainability. Their integrated mechanism and words of confidence can add a lot to corporate credibility. Similarly their frank analysis of corporate ill-health can stumble corporations. Enron was repeatedly carrying out foul-play with the financial market. Not only was it tampering with regulations, it was also misguiding the financial community through inadequate disclosures.

## **5.4.2 Internal Environment**

The internal environment of a company consists of various stakeholders. They have a key role to play in corporate governance. Excluding the shareholders, they are part of corporate culture and are an integrated constituent of its strategy making process. They constantly provide input to top management and facilitate corporate strategy and implementation. Their involvement is discussed below:

### **i. Owners’ Shareholders**

According to research conducted by International Finance Corporation, “investors will pay for good governance”.<sup>136</sup> Being principals in a corporate entity, they are interested in earning substantial, incremental and sustainable return on their investment. Hence they

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<sup>133</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-6

<sup>134</sup> Ibid

<sup>135</sup> Ibid

<sup>136</sup> “The irresistible case for Corporate Governance”, Corporate Governance Department, IFC/World Bank Group, Sept 2005, available online <http://rru.worldbank.org/Documents/PapersLinks/IrresistibleCase4CG.pdf> accessed on 2006-01-05

exert pressure on management to show growth in profitability, earnings and share value. This pressure forces the top management to find innovative growth potential areas and to work out corporate strategy in this context. Expansion or any re-organizational effort by top management is directed towards minimizing losses and maximizing value creation, especially for the shareholders. Investor confidence however is a very volatile attribute in corporations. Owing to speculative phenomena of the stock-market, share prices fluctuate rapidly. Thus a corporation has to be innovative in order to have growth in value. According to Bryce (2002), Enron downfall brought with it a loss of approximately \$70bn in equity value.<sup>137</sup> Thus investor confidence has been shattered.

Hence it can be argued that corporations need to give maximum leverage to their principals in order to show rapid growth. The enhancement of shareholder value is the ultimate objective. All strategic decisions are associated with this aim.

#### **ii. Trustees / Board of Directors**

Being elected by the principals, the Board of Directors is responsible for implementation of good corporate governance. Being technical experts and having relevant background, they are entrusted with the task of overseeing corporate affairs and to ensure fair-play in decisions. They monitor the activities of the CEO and top management. However they are not involved in day to day activities of the company. They sanction approvals on strategic proposals proposed by top management. They debate pros and cons of strategic decisions. However their role is oriented towards endorsement and overall monitoring. They give legitimacy to the activities of CEO and top management. An essential requirement of a well governed corporate setup is that the board should not have any conflict of interest with the corporation (agency). In such an event, there is likely hood that corporate requirements will be undermined for personal benefits, a phenomena well explained by agency theory.

According to Lorsch (2002), "Many of the outside directors were not independent. One had been a well-paid consultant to Enron since 1996. At least, half seem to have been "friends of Ken", technically independent but with close ties to the founder."<sup>138</sup> Enron had sixteen members on its Board. Some of them were associated with Enron in one way or

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<sup>137</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-7

<sup>138</sup> Lorsch W. J., (April 2002), "Board failed in its duty, but others must learn", Available online [http://www.corpgov.hbs.edu/pdf/lorsch\\_failed.pdf](http://www.corpgov.hbs.edu/pdf/lorsch_failed.pdf) Accessed on 2005-12-15

another and also held substantial shares in the company. According to Bryce (2002), if directors are associated in a businesses relationship with the company, there would be instance of conflict of interest. They would not raise objections on questionable practice by top management fearing retribution.<sup>139</sup>

Furthermore Enron's Board of directors faced problem of group think. They owed their loyalties not to their principals but to the Chairman who later on also served as the CEO and endorsed strategic plans for corporate expansion despite technical and ethical loopholes. According to a research conducted by Prof. Song et al ( 2002) "Having the CEO of the Company also serve as the Chairman or Vice-Chairman of the board obscures the monitoring role that the board is supposed to perform and negatively impacts a firm's valuation."<sup>140</sup>

Thus it can be argued that segregation of the post of Board Chairman and CEO serves corporate objectives better. It helps the CEO and top management to work out the day to day operations of the company in a better way and to have a growth oriented corporate strategy. Top management's optimism can be appropriately balanced by an independent board having a separate chairman. In their conservative ways, they can ensure a more realistic strategic outlook for the corporation. They can thus implement corporate governance better in the organization. An impartial, independent and empowered board is likely to enrich corporate strategy.

### **iii. Functional Aspects of BOD**

According to Lorsch (2002)<sup>141</sup> "The board delegates the job of running the company to management, while the board's role is to oversee the performance of management and the company. Most boards accomplish this in six daylong meetings each year. (Enron had five.)"<sup>142</sup>

In addition a vital responsibility of the Board is to appoint the CEO, the CFO and to monitor their performance. By working in different committees, they check the

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<sup>139</sup> Bryce, R. (2002) Pipe Dreams Greed, Ego and the Death of Enron, Public Affairs Ltd. Oxford, UK, p-163-164

<sup>140</sup> Song et al, (2002)"Corporate Governance and Firm Valuations in China" , November 2002, Available online [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=361660](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=361660) Accessed on 2005-12-15

<sup>141</sup> Lorsch W. J., (April 2002),"Board failed in its duty, but others must learn", Available online [http://www.corpgov.hbs.edu/pdf/lorsch\\_failed.pdf](http://www.corpgov.hbs.edu/pdf/lorsch_failed.pdf) Accessed on 2005-12-15

<sup>142</sup> Ibid

performance of the top management. Without having a commercial interest with the company's operations, they ensure its ethical compliance.

However the most critical aspect of effective corporate governance as executed by the Board is the appointment of CEO. He is the forerunner of strategy in the organization. His personal attributes such as business insight, shrewdness, aggression, ambition etc have a lot to do with corporate strategy. An aggressive CEO will stress for taking on more high risk ambitious projects. A considerably mild CEO would prefer a low profile strategy for the company, thereby maintaining the status quo. According to Prof. William Pounds, Enron scandal "focused attention on improved reporting to the public - which may turn out to be mildly constructive, it has led to a few other changes – like board meetings without the CEO that I think may be more constructive. It did not remind boards that their principal responsibility to have an effective CEO which, as you may have gathered by now, I think is what it's all about."<sup>143</sup> Hence appointment of the CEO is perhaps the most aspect of corporate governance in relation to corporate strategy. Appointing Ken Lay as the CEO at the beginning of the collapse, in addition to his responsibilities as the Chairman clearly reflected that board failed in its duty monitors previous CEO Jeff Skilling more effectively and also the fact that board failed to work out alternative choice for a CEO. The board of a corporation operates by distributing efforts in the following committees.

#### **a) Audit Committee**

A vital component of the Board's corporate governance mechanism is through the audit committee. It is assigned with the task to scrutinize authenticity of accounting activities and to ensure proper checks and balances on the activities of the top management. It also ensures that there is no conflict of interest between the agents and principal. It is the basic controlling forum of the board. Through its traditional conservative thinking it scrutinizes corporate activities and prospective strategic deals to identify any wrongdoings on part of the management. It's on the basis of audit committee approval that the boards takes decision on resource related matters. However because there was conflict of interest involved between the board members, top management and the principals hence audit

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<sup>143</sup> (Respondent E) Questionnaire response from Prof. William Pounds, Prof. Emeritus, MIT's Sloan School of Management, dated Dec 20, 2005.

committee failed to identify systemic loopholes. According to Lorsch (2002), “boards own Special Investigative Committee admits "the board failed in its oversight duties." Among other errors in judgment, it authorized CFO Andrew Fastow to serve as a general partner in off-balance sheet partnerships.”<sup>144</sup> Furthermore the audit committee could not control exorbitant and wasteful expenditures incurred by the company in socializing, and in maintaining lavish lifestyles for top executives.

#### **b) Special Committees**

Other than the audit committee, Board activities are divided into various other committees to oversee work of different strategic and governance aspects of the organization that could have material implications on the corporation as a whole. In the case of Enron other committees were:

- “Executive committee
- Finance committee
- Compensation committee
- Nominating committee”<sup>145</sup>

These committees although established to facilitate the strategy approval process and to ensure adequate governance practices, failed to judge material interest of agents in corporate affairs. These committees could not maintain appropriate checks and balances on Enron’s series of wrong doings.

#### **iv. Executive Management**

The executive management comprising of the top management and the CEO are the custodians of corporate resources. They are responsible for the firm’s success or failure. Appointed by the Board of Directors to manage the day-to-day affairs of the company, they are responsible for determining corporate strategy. In accordance with the agency theory, they have been delegated the task of maximizing share holder wealth through strategic initiatives. The success of their decisions results in enhanced value creation for all stakeholders. Since they are appointed by the Board of Directors, hence they are

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<sup>144</sup> Lorsch W. J. (April 2002), “Board failed in its duty, but others must learn”, Available online [http://www.corpgov.hbs.edu/pdf/lorsch\\_failed.pdf](http://www.corpgov.hbs.edu/pdf/lorsch_failed.pdf) Accessed on 2005-12-15

<sup>145</sup> “Enron’s Annual Report 2000”, Available online <http://www.enron.com/corp/investors/annuals/2000/board.html> accessed on 2006-01-05

accountable to the Board. Compensation rewards and extension in tenure of top management is determined by the Board of Directors.

According to Prof. William Pounds, Governance has its principal effect on strategy through the recruiting, selection and the occasional de-selection (firing) of the CEO.<sup>146</sup>

According to him, “The most important aspect (of a good governance structure) is the recruiting, hiring and firing of the CEO. Efforts to help and all that committee work are can make minor contributions only if an effective CEO is in place”.<sup>147</sup>

As custodians of resources the top management is required not to have any commercial interest associated with the company. Furthermore, since they have insider information hence they should not use it for personal gains. According to McGee et al (2005), the executive management comprising of founder and Chairman Ken Lay, former CEO Jeff Skilling and his CFO Andrew Fastow had access to company’s vital information. Once they realized that Enron’s future share price may go down on account of impending investigations for financial embezzlement, hence between 1998 and 2001, “Lay sold shares with gross proceeds of \$184 million, Skilling \$ 71 million, Fastow \$34million and Rebecca Mark \$83 million.”<sup>148</sup>

It can thus be argued that a committed, honest, and competent executive management plays a major role in implementing good corporate governance. Such a committed joint team headed by an able CEO can facilitate the Board, who, owing to their structural constraints cannot have greater insight beyond numbers as suggested by the CEO. If a strong and competent CEO is at the helm of affairs, he will ensure appropriate strategy for the company, making an appropriate tradeoff between risk and return. He would ensure appropriate resource management to ensure that strategies as approved by the Board are implemented in their right letter and spirit. He can enforce an ethics oriented corporate culture in the organization so that everyone within the large organization can be part of overall value creation and ethical compliance process. By virtue of the authority bestowed on him, the CEO can take corrective measures to remove impediments in achieving strategic objectives.

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<sup>146</sup> Respondent E

<sup>147</sup> Ibid

<sup>148</sup> John McGee, Howard Thomas and David Wilson (2005) “Strategy- analysis and practice”, McGraw-Hill Education, Berkshire, United Kingdom, Chapter 17 *Strategy and corporate governance*, p-631-63.



Through a combination of the following ways, an effective CEO and executive management can get corporate strategies implemented within the whole organization. They set a broad framework of do's and don'ts.

#### **a) Code of Ethical Conduct**

Code of ethical conduct serves as a broad guideline for acceptable and unacceptable behavior. It clearly implies the way corporate strategic objectives will be achieved without compromising on ethics. It serves as a clearly communicated controlling tool that is shared with all employees soon after hiring in the company. It is reminded to them every now and then. Corporations usually have tolerance for honest mistakes but ethical issues are seldom compromised. Laxity on ethical issues often sets a precedent for others to follow suit and depicts failing managerial control.

Enron's core values were RICE (Respect, integrity, Communication and Excellence).<sup>149</sup> However the top management failed in exercising these core values. Furthermore, Enron's code of conduct clearly stipulated non-involvement of its serving executives in any commercial venture with another company. However, the Board violated its own code by granting exceptions to the CFO to serve as a partner on companies, which were later on known as off-balance-sheet entities. They served as tools for hiding Enron's liabilities and losses.<sup>150</sup> Whereas the board encouraged the strategy of expansion, it did so at the expense of an essential element of corporate governance framework.

#### **b) Policies and Procedures**

According to World Bank study, "Most company anticorruption programs rely on compliance systems that consist of a company code of conduct, training, and decision making and reporting mechanisms."<sup>151</sup>

It appears that Enron didn't have appropriate control mechanisms in vogue or such massive fraud would not have taken place. If the top management is unable to lead by example, other layers of management and employees may be equally lured into corruption and mal-practice detrimental to the firms' interest. The company needed

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<sup>149</sup> "Our Values", Available online <http://www.enron.com/corp/investors/annuals/2000/ourvalues.html> accessed on 2005-01-06

<sup>150</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-140-143

<sup>151</sup> World Bank PREM Notes Public Sector, (2002) "*Implementing anticorruption programs in the private sector*" April 2002. Issue Number 66, Available online <http://www1.worldbank.org/prem/PREMNotes/premnote66.pdf> accessed on 2005-01-02

proper codes for ethical compliance and clearly stipulated policies and procedures to ensure standard operating procedures. Financial mismanagement clearly suggests that even if such documents existed, they were not strongly adhered and practiced. According to an international auditor, “It is no longer taken for granted that controls are in place and really functioning. The naivety is gone. It is also clear that controls cost.”<sup>152</sup>

A major problem with Enron was that of its compensation and remuneration policy. As stated in Bryce (2002), top executives were given lucrative compensation in terms of salaries, fringe benefits, stock options “based on the price of stock, and the price of stock (was) based on the earnings they report(ed). So there was tremendous incentive on the part of key people to keep those earnings growing. As earnings went up, their options were worth that much more”.<sup>153</sup>

This policy of lucrative compensation, stock options for top executives and the controversial procedure for performance evaluation made the corporate culture extremely competitive. It promoted a sales oriented culture. Those who made it to the top, had a direct conflict of interest i.e. creation of personal wealth at the expense of organizational sustainability. Hence those people made it to the top that lacked corporate ethical compliance requirements. They as a group developed corporate strategies that favored personal enrichment and engulfed the company in non-feasible commercial ventures, all under the cloak of growth and expansion.

### **c) Internal Control Function**

Auditing activities, standard operating procedures, limits to authority are some of the key ways by which executive management maintain control on organizational resource utilization. In this way corporate strategy can be executed properly within the stipulated resource constraint. Enron didn't have proper controls on wasteful expenditures. To transport top executives for different meetings, the company would charter planes instead of using commercial airlines. Such activities gravely disturbed the cash flow cycle of the company, which already facing astronomical financial constraints owing to mark-to—market accounting method.<sup>154</sup>

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<sup>152</sup> Respondent G

<sup>153</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-10

<sup>154</sup> *Ibid* p-260-262

#### **d) Risk Functions**

A corporation has to do trade-offs between risk and returns. In this way it decides about corporate strategy. Risk management, diversification and minimization are essential characteristics of executive management. In this way they can properly safeguard principals' interest. Whereas Enron had a strong orientation towards high risk cross cultural projects, it was not proactive to minimize risks. Resources wasted due to failed projects at Dabhol and broadband services are examples in this context. In these projects, market risk was very high. There weren't adequate measures to minimize risks and to safeguard shareholder interest.

#### **v. Line Management and Business Unit Management**

Line Management, business unit management and people in charge of other functional areas are responsible for execution of strategic plans as given to them by top management. These managers and their staff ensure compliance to the stipulated standards of performance. Any deviation is readily rectified.

The top management is constantly given feedback about progress and impediments towards accomplishing respective divisional and functional goals. Feedback from all units indicates to the top management if corporate strategy is working as intended or otherwise. The top management sets broad guideline for the conduct of operations, through policies, procedures, codes of conduct. It's up to lower management level to work out details for their functional areas in such a way so that they could all contribute towards implementing corporate strategy. For a well governed corporation, employees at its lowest level should also conform to ethical standards of the company through trickle down effect. In this way, there will be synergistic effect in the corporation.

According to Prof. William Pounds, critical activity to a good governed corporate set up is through the hiring and retention of an effective executive who will serve the public interest. However a major impediment to implementation of across the board transparency and accountability is the availability and interest of well-qualified people who want to be a part in improving the system.<sup>155</sup>

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<sup>155</sup> Respondent E

At Enron, the top management was not following the code of ethics. Since performance appraisals lacked merit hence lower level managers and employees could not prevent top management from distorting the system.

### **5.4.3 Linkage between External and Internal Variables**

Corporate strategy can only be successful if the company can carry on its operations well together with its external and internal environment. This success is a lot dependent upon transparent disclosures, honest and unambiguous communication, appropriate standards of performance measurement and accountability for decisions.

A well-governed corporate setup caters to these requirements for internal and external cohesion between different stakeholders. Furthermore, good corporate governance entails fair procedures of internal and external audit. These points are explained as follows.

#### **i. Disclosure (Transparency)**

“All types of firms—large and small, multinational and local—recognize that corruption raises the cost of doing business and should be prevented.”<sup>156</sup>A basic premise of fair corporate governance is transparency and fair disclosure. Enron had clearly violated these essential principals of corporate governance. It was spending heavily to maintain lifestyles of its top executives, compensating them with astronomical salaries, fringe benefits and stock options. However owing to lack of profitability in overseas operations, miscalculated deals, mark-to-market accounting method had drained the company of its cash resources. According to Bryce (2002), on Nov 19, 2001, Enron restated its financial position since 1997. It was repeatedly revising its profitability for previous years in Nov 2001, thus shattering investor confidence. The disclosures though made, were quite late. In the words of Bryce (2002), “The \$105 million in profits that surprised analysts at the end of 1997, Skilling’s first year, had been almost entirely fabricated. That year, the company made \$9 million, not \$105 million. The off-the-balance-sheet deals had allowed

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<sup>156</sup> World Bank PREM Notes Public Sector, (2002) “*Implementing anticorruption programs in the private sector*” April 2002. Issue Number 66, Available online <http://www1.worldbank.org/prem/PREMNotes/premnote66.pdf> accessed on 2005-01-02

Enron to overstate its 1998 profits by \$113 million; the 1999 profits were too high by \$250 million, and the 2000 profits, by \$132 million.”<sup>157</sup>

Furthermore while the stock prices were gradually declining from 2000, the top management of the company, despite being insiders and custodians of shareholder wealth, were sending wrong signals to the market. They were not disclosing corporate ill health. They were still projecting to the investors and creditors that Enron’s stock was still worth buying and its operational difficulties would soon be overcome. However secretly they were selling stocks themselves and piling in substantial returns. According to Bryce (2002), one board member had sold 300,000 shares in one day. By the time he left Enron he sold stocks worth \$270.2m.<sup>158</sup>

This clearly shows that investment and financial community relies heavily on adequate and timely disclosures. They also require transparent decision-making. According to Prof. Neil Andrews, “For me, personally, (corporate governance’s most significant aspect) is to curb the anti-social tendencies of a profit making machine which is personality poor.”<sup>159</sup> Furthermore, according to Prof. Dr. Gary M. Cunningham, “Openness and transparency, holding top executives personally accountable and liable” are the most important attributes for corporate governance in relation with corporate strategy.<sup>160</sup>

#### ii. **Communication**

Clear internal and external communication is required for appropriate information flow between the firm and its stakeholders. Fair information exchange ensures all major stakeholders are at equally bandwidths with the firm. This aids in achieving corporate strategy, especially in the implementation phase of agreed plans. According to an international researcher on corporate governance, “I think now people (are) taking corporate governance very seriously if not from practice but purely for the purpose of

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<sup>157</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-328

<sup>158</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-291

<sup>159</sup> Respondent F

<sup>160</sup> (Respondent D) Questionnaire response from Prof. Doctor Gary M. Cunningham Visiting Professor at Bilkent University, Ankara, Turkey dated Dec 17, 2005.

compliance and disclosure to show to the public that they are doing the right thing (as if you don't disclose, the general public will assume the worst)."<sup>161</sup>

Enron was not fair in its communication. Neither was it informing its employees that things were not going strong, for the company, nor was it keeping its other stakeholders in confidence. According to Bryce (2002), when Enron's problems were coming in light, it tried to avert major disaster by showing intentions to merge with Dynegy Inc., another key player in the energy market in USA. The deal was quite on the way. The top executives of the two companies were in close collaboration in working out modalities for a merger. However when Enron kept on revising its profitability and liabilities, Dynegy bailed out of the merger, stating that Enron didn't take them into confidence earlier on.<sup>162</sup> Hence it can be argued that any strategic decision by a corporation has ripple effects for many stakeholders. Thus fair communication to all ensures that strategy can be rightly executed. Failure in fair communication can breach trust of all associated and can send signals of foul-play.

### iii. **Measurement and Accountability**

A major constituent behind success of corporate strategy is the quality of human resource in the organization and how performances are measured in a corporate structure. This factor is of vital significance in implementing strategic plans. If incorrect method of performance measurement is in vogue, it will prevent people with good corporate credibility to make it to the top echelons of an organization. If incompetent personnel with questionable practices in the past make it to the top, they will have a negative influence on the strategy as a whole. They will also serve as a major impediment to good corporate governance and will dilute its accountability procedures.

According to Bryce (2002), Performance appraisals in Enron were carried on through Performance Review Committee (PRC). It required employees to be graded by their peers on a scale of 1 (top most rank) up to 5 (bottom most) on attributes such as leadership, technical competence and ability to generate revenues. This ensured a cut-throat corporate culture. Each employee was ranked by his peers. In turn they were

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<sup>161</sup> Respondent F

<sup>162</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-330

ranked by their supervisors till the procedure would stretch up in the hierarchy.<sup>163</sup> In the words of an employee and as narrated by Bryce (2002), “It didn’t matter how good you were. It only mattered who you knew”.<sup>164</sup> This kind of peer review and mentorship method made the corporate culture negatively competitive. It also wiped out accountability from the system.

Accountability entails holding an entity answerable and responsible for the occurrence of a phenomenon.<sup>165</sup> According to an international researcher on corporate governance, “Disclosure, transparency and accountability, are the most important aspects” of a well-governed corporate setup.<sup>166</sup> The top management is accountable to the Board for their strategic decisions. The Board is liable to the shareholders for granting approvals.

According to Prof. Doctor Gary M. Cunningham, “The affect of corporate governance varies widely among countries. It is not easy to give a single answer. In general, corporate governance is oriented to making companies’ activities more open and transparent, and accountable to the board of directors and the public. If this notion is not consistent with the culture, as in some continental European countries, then chaos can result. It can also cause companies to operate more lawfully and ethically.”<sup>167</sup>

In the words of Bryce (2002), the founder and Chairman of Enron “became incapable of firing executives at Enron for bad decisions or poor performance.”<sup>168</sup> He was let down by his team yet he did not fire them. Instead he nurtured his team well. Even when Enron’s Chief Financial Officer was found guilty of fraud and financial embezzlement, he was not held accountable. Similarly the Board did not hold the top management accountable for their strategic mistakes in steering the company towards gradual disaster and for its questionable practices. Lack of accountability and remedial action can encourage corrupt practices within an organizational system. While determining corporate strategy, the top management must address these questions as to who is accountable to whom, and other

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<sup>163</sup> Ibid, p- 126-128

<sup>164</sup> Ibid, p-128

<sup>165</sup> “Accountability”, Available online <http://dictionary.reference.com/search?q=accountability> accessed on 2006-01-02

<sup>166</sup> Respondent C

<sup>167</sup> Respondent D

<sup>168</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-30

questions such as why it is required, how accountability will take place etc. this essential aspect of corporate governance can help in the success of corporate strategy.

#### iv. **External and Internal Audit**

Corporations are capital intensive entities and since they are formed through public and institutional investors hence they are required by law to get their accounts audited by external auditing companies. This is to avoid agent-principal conflict of interest and to avoid chances of financial embezzlement. Furthermore third-party audit of accounts ensures credibility of company performance. If auditors approve accounts, it implies that all disclosures are correct. It helps the company to meet its next year's capital requirements by earning trust of stakeholders, once accounts are impartially audited. In order to ensure that auditing activity is impartial, it is advisable for external auditors not to have any sort of association with their client company.

According to Bryce (2002), Enron's auditing company M/s Arthur Andersen had sufficient financial interest in the company. They also acted as consultants to Enron. "In his words, in 1999, the firm billed Enron \$46.8 million for its auditing, consulting, and tax work. In 2000, that figure rose to \$52 million".<sup>169</sup> Arthur Andersen in their capacity as auditors did not bring to light foul-play in Enron's financial performance. Instead, upon realizing that revision in Enron's financial position in Nov 2001 is opening federal level inquiries, the auditors destroyed Enron's documents which could have facilitated the inquiry. The company is under investigation for gross violation of standards of ethical conduct of the accounting profession and for hampering Enron's investigation.<sup>170</sup>

Similarly internal auditing activities, standard operating procedures also serve as gauging mechanism to identify any systemic loopholes. However in the case of Enron, internal auditing was virtually non-existent. Since people feared retribution from top executives during performance appraisals hence they remained silent on internal audit matters.

Internal and external audit mechanism while acting in unity ensures credibility of corporate financial system. It helps stakeholders in judging financial performance of a company. After being satisfied with the numbers, they grant it credit and investments, thus becoming partners to corporate strategy process. On one hand it helps the top

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<sup>169</sup> Bryce, R. (2002) *Pipe Dreams Greed, Ego and the Death of Enron*, Public Affairs Ltd. Oxford, UK, p-237

<sup>170</sup> *Ibid*, p-359



management and the Board in making educated decisions about corporate resource flow; yet on the other hand, it adds on a layer in the corporate checks and balance mechanism. Therefore the Board usually relies on strength of audited accounts. Rather than engaging themselves in debate regarding their authenticity, the Board involves itself in substantiating function and on debating other corporate matters of strategic significance. According to Prof. Dr. Gary M. Cunningham Enron scandal has contributed to the extent that it has resulted in the enactment of Sarbanes Oxley act which places intense focus on the role of auditors in implementing good corporate governance mechanism. It has also highlighted the need of Boards of directors to become more personally involved and personally accountable to corporate strategic decisions.<sup>171</sup>

## **5.5 Corporate Governance, Strategy and Pakistan**

Pakistan's nascent corporate setup serves as a challenge for professionals and researchers. International practices are difficult to implement in true letter and spirit. However there is vision of top professionals to introduce an enabling environment for fair corporate governance.

Former Governor, State Bank of Pakistan, Dr. Ishrat Hussain has been particularly instrumental in implementing good corporate governance in the banking sector of Pakistan. While realizing that Pakistan follows a blend of Islamic and western system, he has often stressed the need for banks to adopt practices in the realm of corporate governance.<sup>172</sup> According to him, "corporate governance in the banking sector would be developed in such a way that the Pakistan's banking sector would be rated at least A+ or equivalent by the world renowned Rating Agencies, i.e. M/s. Standard & Poor and the Moody's."<sup>173</sup>

Banks in Pakistan can be categorized under three classes:

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<sup>171</sup> Respondent D

<sup>172</sup> "SBP Governor stresses the need of adopting best international practices in corporate governance" Available online, <http://www.sbp.org.pk/press/2003/Corporate-Governance-13102003.pdf> accessed on 2006-01-07

<sup>173</sup> Ibid

- 1) State owned banks
- 2) Private banks (owned by family groups or private consortiums or in collaboration with the Government or the military wherein the former doesn't hold majority shares)
- 3) Foreign banks

The problem of governance comes in state owned banks where political appointees head these organizations and their board. Their appointments are usually based on preferences of political groups in power, hence they are obliged to fulfill political commitments and channel shareholder funds into questionable loans and grants. Hence in Pakistan there have been instances of corruption in the banking sector in the past.

Whereas all banks have pursued a growth oriented corporate strategy, its mostly the state owned banks or the family owned banks who have faced scenarios of failed corporate governance in the past. Since CEOs of such banks and the Board members were political appointees or family members of the owners hence they endeavored to enhance their tenures through political or family favours rather than to safeguard the corporate system. Hence there were instances of Principal-Agent conflict of interest. The actors highlighted in Ernst and Young model (chapter 3) were also dominant in the case of corporate mechanism in Pakistan, specially the external forces.

However since 1999 military government in Pakistan has insisted on professionalism especially in the banking sector. In this context, the former Governor State Bank of Pakistan proposed and introduced following international corporate governance practices:

- “Selection of right people as Directors who possess the courage to challenge the CEO and who can engage in real debate without dragging in their egos.
- Training of directors by arranging face-to-face meetings with all the top executives of the banks and providing them with briefings, books and arranging site visits etc.
- Prompt delivery of relevant information in multiple formats and structure board meeting in such a way as to provide ample time for discussion.

- Balancing the CEO's power by making sure that the independent directors appoint new directors, take control of committees' chairmanship, hold meetings without the CEO, and control succession planning in the organization.
- Establishment of new behavior by appointing CEOs who value teamwork and want full feedback with a tone of collegiality and constructive skepticism.
- Allow time to board members for preparing discussion and developing interaction for the board meetings.
- Establishment of a tradition to continuously evaluate and improve the performance by refining practices.”<sup>174</sup>

Hence basic impediment to good corporate governance framework in Pakistan is due to enhanced role of external forces on the corporate setup and regulatory framework that has loopholes. Furthermore there is a lack of trained professionals, especially at the top who are familiar with requirements of corporate governance. Hence there is probability of occurrence of Enron type scandals in Pakistan. However checks and balances are being incorporated in the system to minimize such chances.

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<sup>174</sup> “SBP Governor stresses the need of adopting best international practices in corporate governance” Available online, <http://www.sbp.org.pk/press/2003/Corporate-Governance-13102003.pdf> accessed on 2006-01-07

## 6. ANALYSIS

*In this section, we present our analysis in light of findings as to how corporate governance serves as a sustainable competitive advantage for firms. After deriving main arguments from these aspects, we move on to corporate governance scenario in Pakistan and see as to what are the impediments to implement a western principle in Pakistani context.*

### 6.1 Enron downfall in light of Agency theory

From our empirical findings in the previous section, we gathered that Enron downfall occurred because of agency-principal conflict of interest. Principals (shareholders) were lured by Enron's past success and strategic reach. In their desire for incremental value creation, they exerted pressure on Enron to continuously grow and be innovative. The agents on the other hand, felt justified in enriching themselves and this desire took precedence over their prime responsibility i.e. to protect shareholder interest. Hence they associated personal interests with Enron's commercial activities and failed in their duty.

### 6.2 Enron downfall in light of Ernst and young model of Corporate Governance

Different forces associated different expectations from Enron. Each actor asserted his own pressure on the corporation to grow in an unprecedented fashion. The external environment wanted to capitalize on Enron's resources, growth and reach. They also wanted to be strategic partners in Enron's success and to enter into a win-win relationship. It is to be kept in mind that whereas good corporate governance is the prime responsibility of the Board, but it is equally imperative for stakeholders that they help the company in fulfilling its obligations as a good corporate citizen. Had Enron not enjoyed privilege treatment from Government authorities and the market, it could have averted this debacle. There was laxity on the side of external stakeholders, hence Enron failed in its corporate governance. Had external stakeholders monitored Enron well in its early

stages, this debacle would not have happened. The exchange of information between external and internal environment was neither accurate, nor transparent and was not disclosed properly. Thereby stakeholders got lured by fake claims of growth and innovation.

The internal environment was a product of strict corporate culture which was marked by cut-throat competition amongst peers. Since top management didn't lead by example, hence other employees could not prevent this disaster from happening. Since other employees also wanted promotions, bonuses and privileges hence they acted as silent spectators while agents plundered wealth from the corporate system and thus violated their own code of ethics. Thus as a whole, the company collapsed because the system had become self-destructive, owing to principal-agent conflict of interest.

### **6.3 Key Lessons from Enron**

Enron had a global vision. To achieve this aim, it had an expansion oriented corporate strategy. Its strategy was shaped by influence of external and internal stakeholders, with both being connected through non-transparent, inappropriately disclosed information exchange.

- Enron collapsed because its corporate strategy was not equally supported by its corporate governance mechanism. Once the governance mechanism failed, strategy failed and the firm collapsed as a whole.
- In case of Enron key problem occurred because there was a problem of failed corporate governance and groupthink. Since Enron was performing high, hence, Board had a blind faith in the performance of top management and they generally endorsed, whatever the top management proposed without exploring the tradeoff between risk, returns, and authenticity of information that was communicated to them by the top management. The element of accountability was immensely missing at Enron.
- Enron's top management consisted of people who had great industry experience, and the Board consisted of people who had policy and government background as well as market experience. The top management consisted of people who were mostly graduates from Ivy League universities of USA hence there was this

element of blind trust in each others judgment and decisions. Since Enron was like a golden egg laying entity, hence none of them wanted to question the Chairman, the CEO or performance of top management. Company was excessively growing hence the Board found no need to turn things around, since the results were coming up fine, hence the Board was not skeptical as to how this unprecedented growth was taking place.

- Main lesson to be learnt from Enron is that conflict of interest must not arise between principal and agents. If such a scenario arises, it would be imperative for the agents to subordinate their interest for the collective benefit of the system as a whole. Agents have a moral obligation to ensure that principal's interest is secured in ethical way and that principal is rightly communicated about developments in the corporate entity.
- Furthermore, conflict of interest should never arise amongst the agents i.e. the top management and the board of directors or it may lead to systemic collapse. They should not have any business association with the company. In the event of such violations, accountability should be done speedily.
- Agents must ensure not to set precedents for corporate malpractice. Corruption travels down the organization in through a trickle down mechanism. External and internal stakeholders must be vigilant to ensure that the company is acting as a good corporate citizen.
- They should not be lured by its growth rates but must be skeptical in wider interest of all concerned.
- The corporate culture of an entity plays a pivotal role in its ethical orientation as well as strategy implementation. If culture is cut-throat in nature, it will not serve stakeholder interest as a whole.
- A key point is that the Board Chairman and the CEO should be separate persons. In this way appropriate blend of CEO's aggressive strategies coupled with conservative thinking of the Chairman board will work in the organizational interest as a whole.

- Auditors being valuers of public funds must never connive with agents. Furthermore there should not be a conflict of interest between the auditors and the organization.
- Corporate strategy will only be successful if it is backed by a well-governed corporate system.
- Since both these attributes have external and internal implications hence their mutually complimentary role will serve as a unique competitive advantage for the corporation.

## **6.4 Corporate governance as a source of sustainable competitive advantage:**

Better corporate governance mechanism is a source of sustainable competitive advantage for corporations as it not only helps them in becoming more competitive through cheaper and sustainable access to resources and networks, it also them to be more trustable and more reliable. They get more business if they are well-governed. According to a research finding, US based firms with better governance structure in practice, have a faster rate of growth in sales volume thereby ensuring greater profitability than their competitors.<sup>175</sup>

Well structured corporate governance mechanism gives credibility to a corporation. It legitimizes organizational activities through greater transparency, disclosure and accountability thereby endorsing its corporate strategy. It is like a fulcrum upon which corporate foundations are erected. It helps a corporation to earn sufficient trust of stake holders. It should be kept in mind that trust is an intangible asset and is a sustainable competitive advantage.

## **6.5 Corporate Governance & Pakistan's Perspective**

As far as thought development on corporate governance is concerned, Pakistan's contribution at the international forum is still in evolutionary stages. Pakistan, which has

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<sup>175</sup> Gompers, Paul; Ishii, Joy; and Metrick, Andrew, "Corporate Governance and Equity Prices" *Quarterly Journal of Economics* 118(1), February 2003, 107-155

a colonial legacy of the British rule, has a business and regulatory framework, which has an Anglo-Saxon orientation, as well as Islamic shariah system.<sup>176</sup>

However, according to Islamic laws, earning, charging and paying financial interest on loans (Riba) on accounts and other kinds of interest based transactions are prohibited. Whereas Islamic shariah courts have proposed abolishment of interest from Pakistan's economy, senior economic advisors have requested the judicial setup to leave the system flexible on the choice of individual consumers. An interest-based economy is not encouraged in Islam.<sup>177</sup> However, it is hard to visualize a corporate setup, which is based on loans but does not have an element of interest in it. Hence in Pakistan equity market is more dominant than debt financing market.

Thus, individual shareholders and consortiums in recent years have shown an equity based orientation in corporations instead of loans based. Whereas there are high numbers of banks, the demand for credit is not high. Owing to absence of strong regulatory mechanism, the interests of those intending equity partnerships are not fully secured. Pakistan has faced corporate frauds of failed corporate governance, especially in the banking sector. Embezzlement incident as that of Mehran Bank is a renowned defaulted bank in Pakistan.<sup>178</sup>

In this context, Pakistan is introducing substantial reforms in its regulatory framework to protect shareholder interest. In 1970s Pakistan's industrial setup nationalized industrial units, especially in banking, energy, telecom, insurance sectors. The policy of nationalization had its advantages, which encouraged stock market mechanism. However, the negative side was that large corporations were subjected to political climate of the country.

However, since 1990s, the successive governments initiated gradual privatization policy of nationalized units, commencing with privatization of Muslim Commercial Bank. It was expanded to other areas such as banks, telecom and moving slowly towards energy sector. The government, which mostly had above 50% stake in nationalized units, is

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<sup>176</sup> "Pakistan Investment Climate Statement", Available online <http://www.buyusa.gov/pakistan/en/52.html> accessed on 2006-01-08

<sup>177</sup> "Religious leaders threaten government of street protests if interest-free economy is delayed", Available online [http://www.islamic-banking.com/news/pakistan/archive/religious\\_0601.php](http://www.islamic-banking.com/news/pakistan/archive/religious_0601.php), accessed on 2006-01-08

<sup>178</sup> "What is the true state of affairs?", Available online [http://www.ghazali.net/book1/Chapter11a/body\\_page\\_4.html](http://www.ghazali.net/book1/Chapter11a/body_page_4.html) accessed on 2006-01-08



divesting its equities, floating shares for public as well as to different private parties and consortiums. Pakistani organizations lacked standard operating procedures. Contracts were awarded without procedures to politically backed groups. Massive corruption resulted in exorbitant costs.<sup>179</sup>

A major problem with Pakistan's corporate governance setup lies with its high susceptibility to political and security climate of the country. Frequent government changes have shattered investor confidence. Hence corporate strategy is highly dependent on external environment. The corporate governance setup faced its complications as well, marked by bureaucratic culture of state owned enterprises. In such organizations government has the CEO and the Chairman as political appointees. Hence although they may not be one person, but their backgrounds are the same. Hence there have been instances when these two actors entered into conflict with organizational goals and used corporate resources to enrich personal pockets. Contracts were awarded without appropriate tenders and lowest tenders didn't get contracts for procurement supplies.

Furthermore with the clarity of interest-free economy dictum, Pakistan may more equity based collaborations by institutional investors, who may help in strategy making phase as well as in executing good corporate governance.<sup>180</sup> The points as mentioned in section 5.5 are some of the measures that have been taken to implement good corporate governance in Pakistan. Furthermore Securities and Exchange Commission of Pakistan's 2002 code of good corporate governance will ensure minimization of instances of failed corporate governance, if its followed in true letter and spirit.

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<sup>179</sup> "Experience with State Owned Enterprises – Rationale and policy – Privatization Commission", Available online <http://www.privatisation.gov.pk/about/Rationale-policy.htm> accessed on 2006-01-06

<sup>180</sup> "SBP Governor stresses the need of adopting best international practices in corporate governance" Available online, <http://www.sbp.org.pk/press/2003/Corporate-Governance-13102003.pdf> accessed on 2006-01-07

## 7. CONCLUSION

*This chapter presents conclusive remarks about the research and summarises answers and key findings to the research questions. It further highlights avenues for future research on similar theme.*

In a rapidly globalizing world, where cross-border and trans-continental trade is taking place at the click of a button, corporations have emerged as one of the key actors in the international system. Global integration through faster and cheaper communication technology and rapid flow of financial capital has set about a new kind of playing field for corporations as well as their stakeholders.

### 7.1 Answers of Research Questions

#### 7.1.1 What is Corporate Governance? How Corporate Governance has an impact on Corporate Strategy of Corporations?

Corporate governance can be regarded as a system of checks and balances so that value is created by the organization in ethical ways. It ensures that the company achieves its strategic objectives and meets its obligations in the right manner. The board of directors is responsible for implementing corporate governance in a corporation. Therefore corporate governance can be regarded as an umbrella under which a corporation operates and the affairs of the company are run under this umbrella.

Good corporate governance is a confidence building and authenticating mechanism, which helps the company to achieve its strategic objectives, in partnership with its stakeholders. The linkage between corporate governance and corporate strategy is that of legitimacy which communicates the message to stakeholders that whatever activities and results the company has achieved in the past, it has done through fair means and at an optimum level. Whatever the company is doing right now, it is also in accordance with rules, values and expectations of all concerned. In addition, the value creation mechanism that the company will seek in the future, it will be done in the right way and that too in the best interest of all stakeholders. Any shortfalls or deviation from acceptable pattern

will be right and timely communicated to the stakeholders and appropriate remedial measures will be taken. Based on this implied legitimizing and authenticating link, the company attracts confidence of investors, creditors, strategic partners and society to meet its relevant requirements for value creating initiatives.

### **7.1.2 How Enron scandal can be viewed from the perspective of failed corporate governance?**

This was evident from Enron downfall, which despite being a profitable company, declared bankruptcy in 2001 owing to financial embezzlement of top management. They associated personal interests in the profit making and sustainability mechanism of Enron by initiating ventures that filled their own pockets. They adopted dubious accounting mechanisms to hide their losses. They used insider information to trade in Enron's stocks at a time when they feared that Enron downfall was imminent.

Empirical data suggests that the board had failed in its duties to check loopholes in the Enron system. Earlier the board members, which were also beneficiaries of Enron operations by acting as consultants and advisors thus attaching personal benefit with the company and shown blind confidence in whatever information they received from top management, thus failed to protect interest of shareholders and stake holders. Thus, the system collapsed. The board failed in its duties to exercise legitimate corporate governance mechanism of checks and balances. It kept on authenticating and approving corporate strategy and initiatives of Enron, thereby earning investor and creditor confidence for greater business relations despite the fact that Enron was losing its financial and technical capacity in handling capital-intensive projects. Thus, it is a case of failed corporate governance. By the time the company disclosed its accounting loopholes, market confidence in Enron was shattered.

### **7.1.3 Based on the lessons of Enron debacle, how can corporations use corporate governance for their sustainable competitive advantage and how does it affect their strategy as a whole?**

We based our findings on Enron through empirical work, Whereas our empirical findings suggests that there exists a direct relationship between corporate governance and strategy,

we observe that this area requires further quantitative studies to determine the exact nature and impact between the two areas. Well governed corporations earn trust of customers and other strategic partners. This trust serves as a sustainable competitive advantage. Corporate governance gives a lot of credibility and legitimacy to corporate strategy as a whole. Both are mutually complimentary concepts. However corporate strategy will fail if corporate governance system is not in order.

#### **7.1.4 What are the impediments of implementing corporate governance in Pakistani context?**

Islamic financial system based on interest free economy is an evolutionary concept. Inherently, it encourages equity financing over debt financing, there by encouraging institutional and individual shareholders to participate more in corporate governance matters. However, the scenario in Pakistan is changing. There is growing awareness of corporate governance and for an impartial and independent board without government involvement. The government is disassociation itself from corporate activities and encouraging independent boards. A success factor in Pakistan for any corporation is to have some kind of association with the military, in terms of strategic partnership. Military resources are generally strong and they at times give professional insights for strategy making.

### **7.2 Future study recommendations**

The relationship between corporate governance and corporate strategy has been identified in this research. However a quantitative relationship needs to be identified between these two concepts. Some issues in the realm of these two concepts are open for research. The first and foremost is “Should CEOs be shareholders in their company”? The relationship between corporate governance and corporate strategy is a lot dependent upon board room dynamics and researchers normally don’t have access to board room meetings. Hence it will be of interest if future research encompasses these areas.

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## 8.2 Web links

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“Corporate governance the new strategic imperative” written by KPMG International [http://www.us.kpmg.com/microsite/Attachments/corp\\_govern\\_newstrat.pdf](http://www.us.kpmg.com/microsite/Attachments/corp_govern_newstrat.pdf) Available online accessed on 2006-02-27

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“Iraq scandal taints 2,000 firms” By BBC News, Available online <http://news.bbc.co.uk/1/hi/world/americas/4382820.stm> accessed on 2005-10-27

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“Towards the Definition of Methodology”, by University of Stanford <http://www-db.stanford.edu/~burbach/watersluice/node75.html> Available online accessed on 2005-11-22

“Validity and Reliability”, Available online <http://www.georgetown.edu/departments/psychology/researchmethods/researchanddesign/validityandreliability.htm> accessed on 2005-10-27

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Overview of Wikipedia about Social Science, [http://en.wikipedia.org/wiki/Social\\_science](http://en.wikipedia.org/wiki/Social_science) Available online accessed on 2005-11-20

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What is secondary research? By Asia Market research, Available online  
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“Code of Corporate Governance” Available online  
[http://www.ecgi.org/codes/documents/code\\_corporate\(revised\).pdf](http://www.ecgi.org/codes/documents/code_corporate(revised).pdf) accessed on 30-01-06

“SBP Governor stresses the need of adopting best international practices in corporate governance” Available online, <http://www.sbp.org.pk/press/2003/Corporate-Governance-13102003.pdf> accessed on 2006-01-07

### 8.3 Interviews

**Respondent A:** Mr. Q. is an auditor by profession. He has extensive experience of auditing of corporations in Pakistan. His perspectives were obtained through telephonic interview dated 24-12-2005.

**Respondent B:** Prof. M. is a lecturer of Business Strategy at a business school in Pakistan. His perspectives were obtained through telephonic interview dated 27-12-2005.

**Respondent C:** Questionnaire response from an International Researcher on Corporate Governance dated Dec 24, 2005. Name of the researcher has been intentionally concealed on request.

**Respondent D:** Questionnaire response from Prof. Doctor Gary M. Cunningham Visiting Professor at Bilkent University, Ankara, Turkey dated Dec 17, 2005.

**Respondent E:** Questionnaire response from Prof. William Pounds, Prof. Emeritus, MIT’s Sloan School of Management, dated Dec 20, 2005.

**Respondent F:** Questionnaire response from Prof. Neil Andrews dated Dec 11, 2005. He is a professor of corporate governance at Victoria University, Australia.

**Respondent G:** Questionnaire response from an international auditor, dated Dec 20, 2005. Name of the auditor and firm intentionally concealed on request.

## 9. APPENDIX

*This part of study provides questionnaire specimen which is being used for email based responses. More detail of this area has been already discussed in previous chapters.*

### 9.1 Questionnaire

How do you think corporate governance affects strategy of big companies listed on stock exchange?

Which do you think are the most important aspect of corporate governance?

How do you think that Enron scandal shaped debate over relevance of corporate governance over strategy?

Can there really be full implementation of corporate governance principles in companies listed on stock exchange. What are the likely impediments in this context?

Name: \_\_\_\_\_

Designation: \_\_\_\_\_

Institution: \_\_\_\_\_

Contact information: \_\_\_\_\_

**Note:** Should we mention your name as our respondent in the thesis (please tick appropriate one):

Yes

No

## 9.2 Appendix 2

13<sup>th</sup> October, 2003

### SBP GOVERNOR STRESSES THE NEED OF ADOPTING BEST INTERNATIONAL PRACTICES IN CORPORATE GOVERNANCE

The Governor, State Bank of Pakistan, Dr. Ishrat Husain has stressed upon the banks to adopt best international practices in corporate governance. He was speaking at the concluding session of the Conference on Corporate Governance organized by the State Bank in Karachi today.

The Governor outlined the following seven principles, of good corporate governance on best international practices:-

- Selection of right people as Directors who possess the courage to challenge the CEO and who can engage in real debate without dragging in their egos.
- Training of directors by arranging face-to-face meetings with all the top executives of the banks and providing them with briefings, books and arranging site visits etc.
- Prompt delivery of relevant information in multiple formats and structure board meeting in such a way as to provide ample time for discussion.
- Balancing the CEO's power by making sure that the independent directors appoint new directors, take control of committees' chairmanship, hold meetings without the CEO, and control succession planning in the organization.
- Establishment of new behavior by appointing CEOs who value teamwork and want full feedback with a tone of collegiality and constructive skepticism.
- Allow time to board members for preparing discussion and developing interaction for the board meetings.
- Establishment of a tradition to continuously evaluate and improve the performance by refining practices.

The Governor expressed the hope that the corporate governance in the banking sector would be developed in such a way that the Pakistan's banking sector would be rated at least A+ or equivalent by the world renowned Rating Agencies, i.e. M/s. Standard & Poor and the Moodys.

He impressed upon the Board and Management of the Banks to work in close cooperation to achieve better results.

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<sup>181</sup> This entire text has been derived from the following website and has been incorporated verbatim as an appendix.

“SBP Governor stresses the need of adopting best international practices in corporate governance” Available online, <http://www.sbp.org.pk/press/2003/Corporate-Governance-13102003.pdf> accessed on 2006-01-07

Dr. Ishrat Husain also stressed upon the management of banks to adopt self-regulatory approach with regard to the corporate governance.

Earlier, the State Bank Deputy Governor, Mr. Tawfiq A. Husain while inaugurating the conference said that SBP has provided framework of good Corporate Governance by issuing instructions in areas of Fit and Proper test for Board/Senior Management of Banks. He was of the view that there are four lines of defense in case of banks/DFIs. First line of defense is the professional and sound management of these institutions. Second is a responsible Board of Directors. Diligent External Auditors are the third line of defense and the State Bank playing its role of an effective and firm but fair regulator comes as last line of defense. Mr. Tawfiq A. Husain made it clear that there is zero of tolerance for unprofessionalism, poor ethics and bad governance on the part of BOD/Senior Management.

Mr. Jameel Ahmad, Director, Banking Supervision Department, State Bank of Pakistan gave an overview of the roles and responsibilities of the Board of Directors (BOD) as well as the guide lines on Risk Management recently issued by the State Bank. He also apprised the participant of the result of survey done by SBP regarding short comings in the corporate governance of the banks.

Mr. Ebrahim Sidat, Senior Country Managing Partner/CEO of M/s. Ford Rhodes Sidat Hyder & Co. speaking on the occasion said that Corporate Governance is a continuing activity and not a one time phenomena. 'Effective MIS is the eyes and ears of BOD. It should be meaningful and facilitate decisions making by the board', he added.

Mr. S. Masood Ali Naqvi, Senior Partner, M/s. Taseer Hadi Khalid & Co deliberated on disclosures and auditing. In his presentation, he covered the corporate disclosures, financial and non-financial, their need, importance and international practices in this regard.

Mr. Etrat H. Rizvi, Commissioner SECP apprised the participants of the salient features of the code of Corporate Governance issued by the SECP.

Mr. Zakir Mahmood, President, Habib Bank was of the view that market risk is now becoming one of the major challenges faced by the banks and that boards should be vigilant in this area also.

Mr. Aftab Manzoor President MCB and Mr. Naveed A Khan, Country Manager, ABN AMRO Bank, also participated in a panel discussion on the subject of corporate governance.

The conference was organized to increase awareness about the corporate governance and the responsibilities of all stakeholders, particularly the Board of Directors and emphasized that sound Corporate Governance envisages setting up an environment of trust, transparency ethics, responsible behaviour, checks and balances.