

TYCO: A TOP-DOWN APPROACH TO ETHICAL FAILURE

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Abstract

In the midst of a time plagued by corporate scandals, Tyco has captured headlines and undoubtedly shocked and appalled many inside and outside the business world. While there is little doubt of Tyco's absence of morality and ethics, blame cannot be simply placed on the organization itself. Within this paper, we explore the concept of top-down corporate ethics, delineate between individual and corporate values, examine the individual values of CEO L. Dennis Kozlowski, as well as analyze the impact that societal influences may have had on his values. Further, we expound the need for ethical reform by means of constructive external influence by society upon top management. Finally, we conclude by stating that such occurrences of ethical failures are not limited to Tyco, nor are they both the consequences of external influences and the need for strong ethical individual values.

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INTRODUCTION

Over the past few years, the names Enron, WorldCom, and Adelphia have become synonymous with corporate greed and immorality. Tyco, in a scandal of epic greed, has boldly redefined and projected these sentiments to their zenith. As the urgent need for governance in this seemingly lawless corporate environment has become apparent to all, we must consider whether this departure from ethical actions is simply a firm-specific morality issue, or if it is indeed a broad social trend.

In this paper, we discuss how the responsibility for ethical behavior rests upon the organization. We stress that public policy and legislation cannot be a substitute for strong individual ethical values. Further, we relate how these individual values, whether ethical or unethical, lead to organizational values. Finally, we examine how in the case of Tyco, external influences from both investors and business society harmfully affected corporate and individual values. Throughout this work, it is primarily held that Tyco's failure resulted directly from the erosion of the individual values of its leaders, which were influenced by greed and societal norms, as well as the failure of these leaders to create and ensure ethical top-down organizational values.

TYCO

Tyco International Inc. is a large global conglomerate that manufactures a wide variety of products including electronic components, healthcare products, fire, and security systems. For the 2004 fiscal year, Tyco reported net income 14.50 billion. In January 2002, questions began to arise regarding the validity and legality of Tyco's bookkeeping, which led to a full criminal investigation of Tyco's current CEO, L. Dennis Kozlowski (Kay 2002). Kozlowski, as well as Mark Swartz, CFO; and Mark Belnick, chief legal officer, were accused of acting with "egregious, self-serving, and clandestine misconduct" accusing these men of effectively looting the company by obtaining over \$170 million in loans for themselves with no formal approval or knowledge to shareholders. In addition, Kozlowski and Swartz

engaged in profitable related party transactions and awarded themselves lavish perks. (SEC 2005) Unquestionably, this case has made headlines for its shocking corporate misconduct, but also for the flagrant personal excesses of these men at the company's expense. Both Kozlowski and Swartz were convicted on 22 counts related to theft and fraud, and each has received a maximum sentence of 25 years in jail.

From a conventional view, it appears as though a stunning lack of morals and ethics has brought about this end. However, we must remind ourselves that this is not an isolated incident or a 'closed case'. In keeping such in mind, it is unlikely that this greedy behavior be can attributed to being merely a product of an immoral or unethical organization. Rather, it is a manifestation of the pervasive societal norms within today's business world as they have affected the individuals within an organization.

LITERATURE REVIEW

In this section, we will explore the influences on the corporation that may impact ethical behaviors. We consider the effects of individual values, corporate values, and the pressures that management faces that may have contributed to the lack of ethics at Tyco.

Pressures to Meet the Numbers?

Although there is no certain answer as to what, other than self-serving greed, influenced Kozlowski and Belnick to loot the company, we can analyze the situation Tyco has been in previous to such behavior. Tyco financed its deals primarily through the stock market, faced constant pressure by big investors to produce high rates of return, resorting to the looting of existing corporate assets, as well as financial manipulation and speculation (Kay 2002). While Tyco treated stock debt as essential to its growth through acquisition, perhaps this financing structure permitted ravenous stock investors to exert the largest external influence of greed and earnings growth upon itself. Both Kozlowski and Belnick derived most of their compensation from stock options

with Kozlowski receiving over \$40 million in 2001. Therefore, through both natural and fraudulent means, both men sought to keep the stock prices high.

Efforts to keep stock prices high is not isolated to Tyco; Bartov and Mohanram (2004) provide empirical evidence from 1200 companies that management manipulate earnings during pre-exercise periods to artificially inflate stock prices prior to exercising stock options. Cheng and Warfield (2005) found that managers with high equity incentives are less likely to report large positive earnings surprises and are more likely to report earnings that meet or just beat analysts' forecasts suggesting that equity incentives lead to incentives for earnings management. Further, Sennetti, Shawver, and Bancroft (2004) and Shawver, Sennetti and Bancroft (2006) discuss the pressures that exist in an IPO environment where accountants recognized ethical issues but did not choose to avoid procedures to manage earnings suggesting that the culture of the organization may impact ethical choice. Even in CPA firms Lord and DeZort (2001) found "obedience pressure" increases an auditor's likelihood to complete other unethical acts even if that behavior is contrary to an individual's ethical beliefs.

Further, anecdotal evidence exists of unethical business cultures motivating unethical behavior at Enron and Arthur Andersen. Many have discussed the downfall of Arthur Andersen where the importance for fees overcame judgment (Toffler and Reingold 2003) and "cultlike" behaviors and pressures of earnings manipulations from management at Enron (Swartz and Watkins 2003). Top management characteristics contribute to this culture that "either encourages or fails to discourage corporate illegal activity" (Latham, Jacobs and Kotchetova, 2000, p 154). Although some claim executive stock options are meant to encourage executives to behave in the best interests of the shareholders; clearly this may not occur in practice. Further evidence from Epstein and Roy (2005) confirms that 59 companies on Fortune magazine's 'Americas' Most Admired Companies' list primarily evaluate CEOs on financial performance criteria while only 5

companies within this sample, or a relative 8.46%, evaluated their executives based on ethics criteria††.

Where Does Corporate Governance Fit In?

Empirical research in the area of corporate governance has been mixed. Some researchers have found that firms that have committed financial statement fraud have poor corporate governance mechanisms. Some studies have found that a firm performs better having more outside independent directors on the board (Barnhart et al., 1994; Daily and Dalton, 1992) while other researchers suggest there is not a link between outside independent directors and improved firm performance (Hermalin and Weisbach, 1991; Molz, 1988). Peasnell et al (2005) suggests that outside directors play an important monitoring role by upholding the integrity and credibility of published financial statements. This study confirms that firms with a higher percentage of outside board members are less likely to participate in earnings management to increase income when pre managed earnings fall below expectations (Peasnell et al, 2005).

Farber (2005) found that firms that have fraudulently manipulated their financial statements have fewer outside board members and financial experts on the audit committee, fewer audit committee meetings, a smaller percentage of Big 4 auditing firms, and higher percentage of CEOs who are also chairman of the board of directors. Beasley (1996) found that fraud firms have a lower percentage of outside board members, and a higher likelihood of combining the CEO and the Chairman of the Board position, and hold fewer audit committee meetings (Beasley 1996). However, Jensen (1993) suggests that companies with larger board of directors operate less effectively and may be easier for the CEO to control. Smaller board of directors improves efficiencies of control, decreasing the likelihood of fraud. Consistent with Jensen's views, Beasley (1996) found that the likelihood of fraud increases as the size of the board of directors increases.

Sommer (1991) suggests that the audit committee needs to meet on a regular basis and must be independent of the

management of the firm. Bedard et al. (2004) found empirical evidence supporting the precept that an audit committee which is comprised of members with financial expertise is more effective in decreasing earning management. Further, this study found a direct correlation between the presence of one member of the committee having financial expertise and a lower likelihood of aggressive earnings management techniques. In addition, it is shown that when 100 percent of the committee members are independent, there is also a significant reduction in likelihood of aggressive earnings management.

While societal norms may influence corporate behavior, society cannot easily attempt to correct such behavior through public policy or regulations. As Coates (2003) states “public policy merely addresses the manifestations of corporate social pathology. The cause itself lies in the stickier region of institutional visions, values and beliefs, as modeled by the top executives in corporations.” In following this argument of public policy set by corporate social values, Coates (2003) further suggests that the law should be viewed as a moral minimum and that even the most carefully prepared legislation is less than comprehensive and simply satisfies (Coates, 2003). So, where then are we left? Assuming that this notion is correct and the law cannot wholly satisfy moral requirements, who is left to dictate and promulgate the values and standards within the organization and ensure that they are adequate to meeting these requirements?

As a society, we can change public policy and pass legislation to fill any moral void between the accepted values of our culture and the values as they already exist within the corporate structure. However, rather than maintaining this solely reactive approach to corporate ethics, we should seek to understand what is the cause of the moral influence of the leaders from society. The very concept of the individual values of those at the top being passed down and thus contributing the organizational values of the corporate entity certainly can be seen to emphasize the need to provide adequate constructive and sound moral influence to those at the top. While this can be achieved by means

of legislation, it can perhaps be more efficiently and effectively achieved via direct influence from both company stockholders and society as a whole. Indeed, both groups have the ability to provide such influence and drastically 'raise the bar' on moral requirements. Epstein and Roy (2005) suggest that implementing a multi-dimensional performance evaluation system, which is inclusive of more non-financial metrics, would improve CEO performance. Indeed, Attention must be paid to whether the CEO continues to follow in the best interests' of the company, not just himself. Alas, all too often the lust for compensation has lead the CEO to entirely lose focus on organizational goals, company stakeholders, and even the law in pursuit of their compensation-based stock price.

Corporate governance reforms now require firms to maintain boards with a majority of outside independent directors. It is expected that by eliminating insiders and having outside independent directors will strengthen corporate governance by monitoring management and verifying that management decisions are made in the best interests of shareholders. This assumption may be correct; however the board must take their job seriously to safeguard the assets and interests' of the corporation. Further, new regulations require that the audit committee be independent of management and that the audit committee should have members predominantly representing outsiders of the firm and should meet on a regular basis.

Changes at Tyco

Tyco has attempted to restructure its governance mechanisms by replacing Kozlowski with a new outsider (Breen); formed a new, independent, board of directors; and developed an entire new reporting structure (Jorgenson 2005). Today, Tyco's corporate culture is framed on the premise of each employee being responsible for the conduct and the success of the company.

Seemingly, this post-failure change in corporate culture can be attributed to the direct influence from both company stockholders and society as a whole to require reforms at Tyco. In

the past these negative pressures from greed and societal norms, including the failure of Tyco's leaders to create and ensure ethical top-down organizational values has eroded the corporations' ethical values. Pressures resulting from the ethical collapse from both investors and society have led to the massive ethical reforms at the top-management level, as well as the need to create and ensure these values are passed down.

Changes at Tyco are viewed as positive. Governance Metrics International, a governance-rating consulting firm, has increased Tyco's governance rating from a 1.5 out of 10 in December 2002, to a 9.0 in August 2005. Currently, the company distributes an in-depth ethical guide to all of its employees which is built upon several corporate core values including integrity, excellence, teamwork, and accountability. Every employee is obligated to assert acceptance and understanding of this guide. (Verschoor, 2006).

Tyco has announced the intension to split up its company into three separate publicly traded companies focusing around its major divisions of healthcare, electronics, and fire and security products. (Varchaver and Levinstein, 2006). This breakup will create three separate boards of directors and senior management staff. Additional oversight of three companies may improve the governance mechanisms in comparison to one giant conglomerate. Recently, Tyco agreed to pay a \$50 million fine to the SEC stemming from claims of inflated profits. Deutsch (2006) notes that although still it faces a number of lawsuits from shareholders, Tyco should be able to settle these suits without significant impact to its earnings. Being that both Kozlowski and Swartz received lengthy jail sentences and \$240 million in fines and restitution (Deutsch, 2006), the spotlight on this scandal has likely shifted in the mind of many investors and the public. After overcoming the swarming effects of this scandal and once again being able to find confident investors, Breen and other top management must continue to elect change within the organization to ensure ethical behavior becomes a key component of Tyco's corporate culture.

Tyco's struggle to regain its image with the public is likely to take years.

CONCLUSION

Corporate culture is an evolving entity and can be changed for the better. Efforts must be made by executive teams to ensure that the corporate culture of their organization is healthy and operating in the best interests of the firm. We can not express the importance of integrity, leading by example and that public policy and legislation cannot be a substitute for strong individual and corporate ethical values.

Tyco's organizational ethical and moral failures have resulted from the failures of the individual values of the leaders and failures of poor corporate governance mechanisms. While these factors may be attributed to self-serving greed, influence from investors and the business society have also likely played some role. As public policy and legislation change in attempts to prevent such failures, we must realize that these efforts are not as preventative as strong ethical values. Although the scope of this paper is generally limited to this company, these external influences and the need for strong ethical individual and corporate values may certainly be expanded well beyond Tyco.

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