10. The new anti-bribery prosecution regime involves serious charges and penalties for bribery in foreign countries during past times when many people were bribing in the normal course of international business, and penalties were not levied. Is it unreasonable to levy extremely high fines at the beginning of the new regime, and/or not to limit the period over which bribery can trigger those fines? Why and why not?

References

Cohan, William. 2009. *House of Cards: A Tale of Hubris and Wretched Excess on Wall Street.* Doubleday.

Lewis, Michael. 1989. *Liar's Poker: Rising Through the Wreckage of Wall Street.* Penguin Books.

Lewis, Michael. 2010. *The Big Short: Inside the Doomsday Machine.* W.W. Norton & Company, Inc.

Lowenstein, Roger. 2000. *When Genius Failed: The Rise and Fall of Long-Term Capital Management.* Random House.

Sorkin, Andrew. 2009. *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—and Themselves.* Viking.

Wolfe, Tom. 1987. *Bonfire of the Vanities.* Farrar, Straus and Giroux.

Case Insights

- *Enron's Questionable Transactions* is an account of the questionable transactions underlying the massive fraud made possible by flaws in corporate governance and professional accounting. A more detailed analysis is available in the digital archive for this book at www.cengagebrain.com.
- *Arthur Andersen's Troubles* is the story of the once-revered, but systematically flawed, auditor of all the companies that forgot to whom fiduciary duty was owed.
- *WorldCom: The Final Catalyst* explains the massive fraud that triggered meaningful reform of corporate governance and professional accounting standards.
- *Bernie Madoff Scandal—The King of the Ponzi Schemes* describes how the subprime lending crisis destroyed Bernie Madoff's ability to attract new investors and use their money to pay off those who had invested earlier. As a result, in late 2009, his $65 billion fraud was exposed and he was arrested, although the SEC had been alerted ten years earlier.
- *Wal-Mart Bribery in Mexico* describes how a company that wanted to improve its reputation for integrity was sabotaged by self-interested executives who were erroneously supported at head office by misguided executives and an unaware board of directors.
- *LIBOR Manipulations Cause Widespread Impacts* reviews the huge impacts on those banks and their executives whose employees were found to have manipulated the information on which the LIBOR benchmark rate was based.

ETHICS CASE

Enron's Questionable Transactions

An understanding of the nature of Enron's questionable transactions is fundamental to understanding why Enron failed. What follows is an abbreviated overview of the essence of the major important transactions with the SPEs, including Chewco, LJM1, LJM2, and the Raptors. A much more detailed, but still abbreviated, summary of

these transactions is included in the *Enron's Questionable Transactions Detailed Case* in the digital archive for this book at www.cengagebrain.com.

Enron had been using specially created companies called special purpose entities (SPEs) for joint ventures, partnerships, and the syndication of assets for some time. But a series of happenstance events led to the realization by Enron personnel that SPEs could be used unethically and illegally to:

- overstate revenue and profits,
- raise cash and hide the related debt or obligations to repay,
- offset losses in Enron's stock investments in other companies,
- circumvent accounting rules for valuation of Enron's treasury shares,
- improperly enrich several participating executives,
- manipulate Enron's stock price thus misleading investors and enriching Enron executives who held stock options.

In November 1997, Enron created an SPE called Chewco to raise funds or attract an investor to take over the interest of Enron's joint venture investment partner, CalPERS,[1] in an SPE called Joint Energy Development Investment Partnership (JEDI). Using Chewco, Enron had bought out CalPERS interest in JEDI with Enron-guaranteed bridge financing, and tried to find another investor.

Enron's objective was to find another investor, called a *counterparty*, which would:

- be independent of Enron,
- invest at least 3 percent of the assets at risk,
- serve as the controlling shareholder in making decisions for Chewco.

Enron wanted a 3 percent, independent, controlling investor because U.S. accounting rules would allow Chewco to be considered an independent company, and any transactions between Enron and Chewco would be considered at arm's length. This would allow "profit" made on asset sales from Enron to Chewco to be included in Enron's profit even though Enron would own up to 97 percent of Chewco.

Unfortunately, Enron was unable to find an independent investor willing to invest the required 3 percent before its December 31, 1997, year end. Because there was no outside investor in the JEDI-Chewco chain, Enron was considered to be dealing with itself, and U.S. accounting rules required that Enron's financial statements be restated to remove any profits made on transactions between Enron and JEDI. Otherwise, Enron would be able to report profit on deals with itself, which, of course, would undermine the integrity of Enron's audited financial statements because there would be no external, independent validation of transfer prices. *Enron could set the prices to make whatever profit it desired and manipulate its financial statements at will.*

That, in fact, was exactly what happened. When no outside investor was found, Enron's CFO, Andrew Fastow, proposed that he be appointed to serve as Chewco's outside investor. Enron's lawyers pointed out that such involvement by a high-ranking Enron officer would need to be disclosed publicly, and one of Fastow's financial staff—a fact not shared with the board—Michael Kopper, who continued to be an Enron employee, was appointed as Chewco's 3 percent, independent, controlling investor, and the chicanery began.

Enron was able to "sell" (transfer really) assets to Chewco at a manipulatively high profit. *This allowed Enron to show profits on these asset sales and draw cash into Enron accounts without showing in Enron's financial statements that the cash stemmed from Chewco borrowings and would have to be repaid. Enron's obligations were understated—they were "hidden" and not disclosed to investors.*

Duplicity is also evident in the way that Chewco's funding was arranged. CalPERS' interest in JEDI was valued at $383 million; of that amount, Kopper and/or outside investors needed to be seen to provide

[1]The California Public Employees' Retirement System.

3 percent, or $11.5 million. The $383 million was arranged as follows:

$240.0	Barclays Bank PLC—Enron would later guarantee this
132.0	JEDI to Chewco under a revolving credit agreement
0.1	Kopper and his friend Dodson ($125,000)
11.4	Barclays Bank PLC "loaned"[2] to Dodson/Kopper companies
$383.5	

These financing arrangements are diagramed in Figure 1.

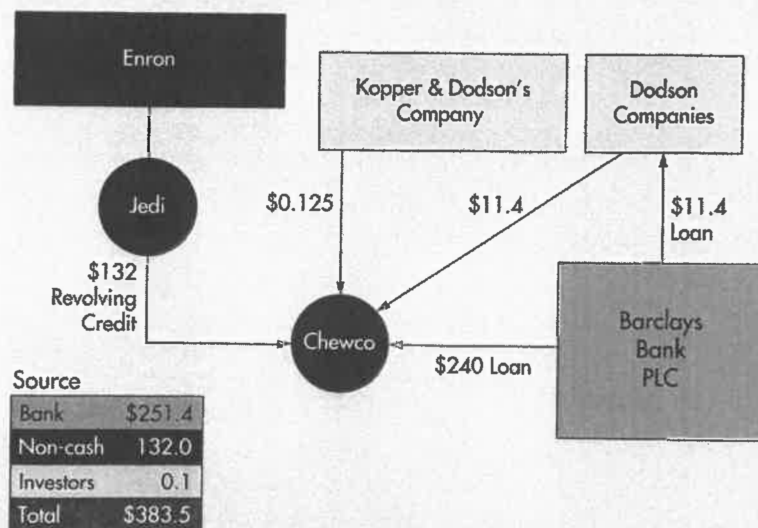
Essentially, Enron as majority owner put no cash into the SPE. A bank provided virtually all of the cash, and in reality the so-called 3 percent, independent, controlling investor had very little invested—not even close to the required 3 percent threshold. Nonetheless, Chewco was considered to qualify for treatment as an arm's-length entity for accounting purposes by Enron and its auditors, Arthur Andersen. Enron's board, and presumably Arthur Andersen, was kept in the dark.

A number of other issues in regard to Chewco transactions were noted in the Powers Report, including:

- Excessive management fees were paid to Kopper for little work.[3]
- Excessive valuations were used upon winding-up thus transferring $10.5 million to Kopper.
- Kopper sought and received $2.6 million as indemnification from tax liability on the $10.5 million.
- Unsecured, non-recourse loans totaling $15 million were made to Kopper and not recovered.
- Enron advance-booked revenues from Chewco.

This pattern of financing—no or low Enron cash invested, banks providing most of the funding, Enron employees masquerading as 3 percent, independent, controlling investors—continued in other SPEs. Some of these SPEs, such as the LJM partnerships, were used to create buyers for Enron assets over which Enron could keep control, but convert fixed assets into cash for growth at

FIGURE 1 Chewco Financing, in Millions



[2]"Loaned" through shell companies, and for "certificates" that would generate a yield.

[3]Fastow's wife did most of the work.

inflated prices, thus overstating cash and profits. Other SPEs, such as LJM1 and LJM2, provided illusionary hedge arrangements to protect Enron against losses in its merchant[4] investment portfolio, thereby falsely protecting Enron's reported profits.

In March 1998, Enron invested in Rhythms NetCommunications, Inc. (Rhythms), a business Internet service provider. Between March 1998 and May 1999, Enron's investment of $10 million in Rhythms stock soared to approximately $300 million. Enron recorded the increase in value as profit by increasing the value of its investment on its books. But Jeffrey K. Skilling, Enron's CEO, realized that the mark-to-market accounting procedure used would require continuous updating, and the change could have a significant negative effect on Enron's profits due to the volatility of Rhythms stock price. He also correctly foresaw that Rhythms stock price could plummet when the Internet bubble burst due to overcapacity.

LJM1 (LJM Cayman LP) was created to hedge against future volatility and losses on Enron's investment in Rhythms. If Rhythms stock price fell, Enron would have to record a loss in its investment. However, LJM1 was expected to pay Enron to offset the loss, so no net reduction would appear in overall Enron profit. As with Chewco, the company was funded with cash from other investors and banks based partly on promises of large guaranteed returns and yields. Enron invested its own shares, but no cash.

In fact, LJM1 did have to pay cash to Enron as the price of Rhythms stock fell. This created a loss for LJM1 and reduced its equity. Moreover, at the same time as LJM1's cash was being paid to Enron, the market value of Enron's shares was also declining, thus reducing LJM1's equity even further. Ultimately, LJM1's effective equity eroded, as did the equity of the SPE (Swap Sub) Enron created as a 3 percent investment conduit. Swap Sub's equity actually became negative. *These erosions of cash and equity exposed the fact that the economic underpinning of the hedge of Rhythms stock was based on Enron's shares—in effect, Enron's profit was being hedged by Enron's own shares. Ultimately, hedging yourself against loss provides no economic security against loss at all.* Enron's shareholders had been misled by $95 million profit in 1999 and $8 million in 2000. These were the restatements announced in November 2001, just before Enron's bankruptcy on December 2, 2001.

Unfortunately for Enron, there were other flaws in the creation of LJM1 that ultimately rendered the arrangement useless, but by that time investors had been misled for many years. For example, there was no 3 percent, independent, controlling investor—Andrew Fastow sought special approval from Enron's chairman to suspend the conflict of interest provisions of Enron's *Code of Conduct* to become the sole managing/general partner of LJM1 and Swap Sub; and Swap Sub's equity became negative and could not qualify for the 3 percent test unless Enron advanced more shares, which it did. Ultimately, as Enron's stock price fell, Fastow decided the whole arrangement was not sustainable, and it was wound up on March 22, 2000. Once again, the wind-up arrangements were not properly valued; $70 million more than required was transferred from Enron, and LJM1 was also allowed to retain Enron shares worth $251 million.

Enron's shareholders were also misled by Enron's recording of profit on the treasury shares used to capitalize the LJM1 arrangement. Enron provided the initial capital for LJM1 arrangements in the form of Enron's own treasury stock, for which it received a promissory note. Enron recorded this transfer of shares at the existing market value, which was higher than the original value in its treasury, and therefore recorded a profit on the transaction. Since no cash had changed hands, the price of transfer was not validated, and accounting rules should not have allowed the recording of any profit.

Initially, the LJM1 arrangements were thought to be so successful at generating profits on treasury shares, hedging against

[4]A merchant investment is an investment in a company's shares that are held for speculative purposes, not for control purposes.

investment losses, and generating cash, that LJM2 Co-Investment LP (LJM2) was created in October 1999 to provide hedges for further Enron merchant investments in Enron's investment portfolio. LJM2 in turn created four SPEs, called "Raptors," to carry out this strategy using similar methods of capitalization based on its own Treasury stock or options thereon.

For a while, the Raptors looked like they would work. In October 2000, Fastow reported to LJM2 investors that the Raptors had brought returns of 193, 278, 2,500, and 125 percent, which was far in excess of the 30 percent annualized return described to the finance committee in May 2000. Of course, as we know now, Enron retained the economic risks.

Although non-transparent arrangements were used again, the flaws found in the LJM1 arrangements ultimately became apparent in the LJM2 arrangements, including:

- Enron was hedging itself, so no external economic hedges were created.
- Enron's falling stock price ultimately eroded the underlying equity and creditworthiness involved, and Enron had to advance more treasury shares or options to buy them at preferential rates[5] or use them in "costless collar"[6] arrangements, all of which were further dilutive to Enron earnings per share.
- Profits were improperly recorded on treasury shares used or sheltered by non-existent hedges.
- Enron officers and their helpers benefited.

In August 2001, matters became critical. Declining Enron share values, and the resulting reduction in Raptor creditworthiness, called for the delivery of so many Enron shares that the resulting dilution of Enron's earnings per share was realized to be too great to be sustainable. In September 2001, accountants at Arthur Andersen and Enron realized that the profits generated by recording Enron shares used for financing at market values was incorrect because no cash was received, and shareholders' equity was overstated by at least $1 billion.

The overall effect of the Raptors was to misleadingly inflate Enron's earnings during the middle period of 2000 to the end of the third quarter of 2001 (September 30) by $1,077 million, not including a September Raptor winding-up charge of $710 million.

On December 2, 2001, Enron became the largest bankruptcy in the world, leaving investors ruined, stunned, and outraged—and quite skeptical of the credibility of the corporate governance and accountability process. By that time, the Enron SPEs and related financial dealings had misled investors greatly. Almost 50 percent of the reported profits driving Enron stock up so dramatically were false. Table 1 summarizes

TABLE 1 Enron's Key Special Purpose Entities (SPEs)

SPE SCHEME	PURPOSE	IMPACT
Chewco/JEDI	Syndicated investment	Off-balance-sheet liabilities hidden ($628 million) Revenues recognized early Profits on own shares
LJM	Provided market for assets	Artificial profits Off-balance-sheet liabilities hidden Equity overstated ($1.2 billion)
LJM1/Rhythms	Investment "hedge"	Unrecognized losses ($508 million)
LJM2/Raptors	Investment "hedge"	Unrecognized losses ($544 million)

[5]Raptors III and IV were not fully utilized and/or used to shore up the equity of Raptors I and II.

[6]A "costless collar" is a two-step arrangement wherein Enron offered to contain LJM2's risk of Enron's stock price falling below a lower limit using its own Treasury shares, while at the same time making an offsetting arrangement for LJM2 to pay Enron if Enron's share price were to rise above a threshold. Since the arrangements offset one another in risk premium, and Treasury stock was to be used, the transaction was considered to be an equity transaction which did not affect the income statement of Enron. See page 110 of the Powers Report.

the impacts of Enron's questionable transactions through key Enron SPEs.

Questions

1. Enron's directors realized that Enron's conflict of interests policy would be violated by Fastow's proposed SPE management and operating arrangements and they instructed the CFO, Andrew Fastow, as an alternative oversight measure, endure that he kept the company out of trouble. What was wrong with their alternatives?
2. Ken Lay was the Chair of the Board and the CEO for much of the time. How did this probably contribute to the lack of proper governance?
3. What aspects of the Enron governance system failed to work properly, and why?
4. Why didn't more whistleblowers come forward, and why didn't some make a significant difference? How could whistleblowers have been encouraged?
5. What should the internal auditors have done that might have assisted the directors.
6. What conflict of interests situations can you identify in:
   - SPE activities, and
   - executive activities.
7. Why do you think that Arthur Andersen, Enron's auditors, did not identify the misuse of SPEs earlier and make the board of directors aware of the dilemma?
8. How would you characterize Enron's corporate culture? How did it contribute to the disaster?

ETHICS CASE

Arthur Andersen's Troubles

Once the largest professional services firm in the world, and arguably the most respected, Arthur Andersen LLP (AA) has disappeared. The Big 5 accounting firms are now the Big 4. Why did this happen? How did it happen? What are the lessons to be learned?

Arthur Andersen, a twenty-eight-year-old Northwestern University accounting professor, co-founded the firm in 1913. Tales of his integrity are legendary, and the culture of the firm was very much in his image. For example, "Just months after [Andersen] set up shop in Chicago, the president of a local railroad insisted that he approve a transaction that would have inflated earnings. Andersen told the executive there was "not enough money in the City of Chicago" to make him do it."[1] In 1954, consulting services began with the installation of the first mainframe computer at General Electric to automate its payroll systems. By 1978, AA became the largest professional services firm in the world with revenues of $546 million, and by 1984 consulting brought in more profit than auditing. In 1989, the consulting operation, wanting more control and a larger share of profit, became a separate part of a Swiss partnership from the audit operation. In 2000, following an arbitrator's ruling that a break fee of $1 billion be paid, Andersen Consulting split completely and changed its name to Accenture. AA, the audit practice, continued to offer a limited set of related services, such as tax advice.[2]

Changing Personalities and Culture

Throughout most of its history, AA stood for integrity and technical competence. The firm invested heavily in training programs and a training facility in St. Charles, a small town south of Chicago, and developed it until it had over 3,000 residence beds and

[1]"Fall from Grace," *Business Week*, August 12, 2002, 54.
[2]Ibid., see table on page 53.

outstanding computer and classroom facilities. AA personnel from all over the world were brought to St. Charles for training sessions on an ongoing basis. Even after the consulting and audit operations split, both continued to use the facility.

Ironically, AA was the first firm to recognize the need for professional accountants to study business and professional accounting formally. In the late 1980s, AA undertook a number of programs to stimulate that formal education, including the development of ethics cases, the creation of an approach to the resolution of professional ethical problems, and the hosting of groups of 100 accounting academics to get them started in the area. Most had no formal ethics training and were uncertain how to begin ethics teaching, or even if they should. It is likely that AA's far-sighted policies are responsible for the genesis of much of the professional ethics education and research in accounting that is going on today.

What happened to the AA culture that focused on integrity and technical competence? What changed that would account for AA's involvement in the major scandals noted on Table 1 as the audit firm that failed to discover the underlying problems?

Some observers have argued that a change in AA's culture was responsible. Over the period when the consulting practice was surpassing the audit practice as the most profitable aspect of the firm, a natural competitiveness grew up between the two rivals. The generation of revenue became more and more desirable, and the key to merit and promotion decisions. The retention of audit clients took on an increasingly greater significance as part of this program, and since clients were so large, auditors tended to become identified with them. Many audit personnel even looked forward to joining their clients. In any event, the loss of a major client would sideline the career of the auditors involved at least temporarily, if not permanently. For many reasons, taking a stand against the management of a major client required a keen understanding of the auditor's role, the backing of senior partners in your firm, and courage.

The pressure for profit was felt throughout the rest of the audit profession, not just at Arthur Andersen. Audit techniques were modified to require higher levels of analysis and lower investment of time. Judgment sampling gave way to statistical sampling, and then to strategic risk auditing. While each was considered better than its predecessor, the trend was toward tighter time budgets, and the focus of the audit broadened to include development of value-added

TABLE 1 Arthur Andersen's Problem Audits

CLIENT	PROBLEM MISSED, DATE	LOSSES TO SHAREHOLDERS	JOB LOSSES	AA FINE
WorldCom	$4.3 billion overstatement of earnings announced on June 25, 2002	$179.3 billion	17,000	N.A.
Enron	Inflation of income, assets, etc., bankrupt Dec. 2, 2001	$66.4 billion	6,100	$.5 million (for shredding)
Global Crossing	Candidate for bankruptcy	$26.6 billion	8,700	
Waste Management*	Overstatement of income by $1.1 billion, 1992–1996	$20.5 billion	11,000	$7 million
Sunbeam*	Overstatement of 1997 income by $71.1 million, then bankruptcy	$4.4 billion	1,700	
Baptist Foundation of Arizona	Books cooked, largest nonprofit bankruptcy ever	$570 million	165	

*Cases are in the digital archive for this book at **www.cengagebrain.com**

Source: "Fall from Grace," *Business Week*, August 12, 2002, 54

nonaudit outcomes, suggestions, or services for clients. Such nonaudit services could include advice on the structuring of transactions for desired disclosure outcomes and other work on which the auditor would later have to give an audit opinion.

According to discussions in the business and professional press, many audit professionals did not see the conflicts of interest involved as a problem. The conflict between maximizing audit profit for the firm and providing adequate audit quality so that the investing public would be protected was considered to be manageable so that no one would be harmed. The conflict between auditing in the public interest with integrity and objectivity that could lead to the need to roundly criticize mistakes that your firm or you had made in earlier advice was considered not to present a worry. In addition, the conflict between the growing complexity of transactions, particularly those involving derivative financial instruments, hedges, swaps, and so on, and the desire to restrain audit time in the interest of profit was thought to be within the capacity of auditors and firms to resolve. The growing conflict for auditors between serving the interests of the management team that was often instrumental in making the appointment of auditors, and the interests of shareholders was recognized but did not draw reinforcing statements from firms or professional accounting bodies. Some professional accountants did not understand whether they should be serving the interests of current shareholders or future shareholders, or what serving the public interest had to do with serving their client. They did not understand the difference between a profession and a business.

Ethical behavior in an organization is guided by the ethical culture of that organization, by any relevant professional norms and codes, and particularly by the "tone at the top"[3] and the example set by the top executives. Also, presumably the selection of the CEO is based partly on the choice of the values that an organization should be led toward. Joe Berardino was elected AA's CEO on January 10, 2001, but he had been partner-in-charge of the AA's U.S. audit practice for almost three years before. He was the leader whose values drove the firm from 1998 onward, and probably continued those of his predecessor. What were his values? Barbara Ley Toffler, a former Andersen partner during this period and before, has provided the following insight:

> When Berardino would get up at a partners meeting, all that was ever reported in terms of success was dollars. Quality wasn't discussed. Content wasn't discussed. Everything was measured in terms of the buck.... Joe was blind to the conflict. He was the most aggressive pursuer of revenue that I ever met.[4]

Arthur Andersen's Internal Control Flaw

Given this "tone at the top," it is reasonable to assume that AA partners were going to be motivated by revenue generation. But if too many risks are taken in the pursuit of revenue, the probability of a series of audit problems leading to increasingly unfavorable consequences becomes greater. That is exactly what happened. Unfortunately, the leaders of AA failed to recognize the cumulative degree to which the public, the politicians, and the SEC were angered by the progression of AA audit failures.

If they had recognized the precarious position they were in, the AA leadership might have corrected the flaw in the AA internal control that allowed the Enron audit failures to happen. *AA was the only one of the Big 5 to allow the partner in charge of the audit to override a ruling of the quality control partner.* This meant that at AA, the

[3] "This is a concept emerging in new governance standards that boards of directors are to monitor.

[4] "Fall from Grace," 55, 56.

most sensitive decisions were taken by the person who was most concerned with the potential loss of revenue from the client in question, and who was most likely to be subject to the influence of the client. In all of the other Big 5 firms, the most sensitive decisions are taken by the person whose primary interest is the compliance with GAAP, the protection of the public interest, and the reputation of the firm.

On April 2, 2002, the U.S. House Energy and Commerce Committee[5] released a memo dated December 18, 1999, from Carl Bass, a partner in AA's Professional Services Group in Chicago, to David Duncan, the AA partner in charge of the Enron account. That memo asked for an accounting change (believed to be in regard to SPE transactions) that would have resulted in a $30–$50 million charge to Enron's earnings. In February 2000, Bass emailed Duncan to object to the setting up of an LJM partnership because he indicated that "this whole deal looks like there is no substance."[6] On March 4, 2001, Bass wrote that "then-chief financial officer Andrew Fastow's role as manager of special partnerships compromised deals Enron made with the entities."[7] Duncan overruled Bass on the first issue, and Bass was removed from Enron audit oversight on March 17, 2001, less than two weeks after he questioned Fastow's role in Enron's SPEs. In any other Big 5 firm, Duncan would not have been able to overrule a quality control partner on his own. History might have been different if a quality-focused internal control procedure had been in place at AA, rather than one that was revenue focused.

Arthur Andersen's Apparent Enron Mistakes

The previously presented "Enron Debacle" discussion covers in detail many of the questionable accounting transactions, legal structures, and related disclosures that AA reviewed as auditors of and consultants to Enron. Without repeating these in detail, it is possible to provide the following summary of significant issues that AA could be questioned about in court proceedings:

- AA apparently approved as auditors and consultants (and collected fees for the consulting advice) the structure of many Special Purpose Entities (SPE) that were used to generate false profits, hide losses, keep financing off Enron's consolidated financial statements, and failed to meet the required outsider 3 percent equity-at-risk, and decision control criteria for nonconsolidation.
- AA failed to recognize the Generally Accepted Accounting Principle (GAAP) that prohibits the recording of shares issued as an increase in shareholders equity unless they are issued for cash (not for notes receivable).
- AA did not advise Enron's audit committee that Andrew Fastow, Enron's CFO, and his helpers were involved in significant conflict of interest situations without adequate alternative means of managing these conflicts.
- AA did not advise the Enron Audit Committee that Enron's policies and internal control were not adequate to protect the shareholders' interests even though AA had assumed Enron's internal audit function.
- Many transactions between Enron and the SPEs were not in the interest of Enron shareholders since:
  - Enron profits and cash flow were manipulated and grossly inflated, misleading investors and falsely boosting management bonus arrangements.
  - Extraordinarily overgenerous deals, fees, and liquidation arrangements were made by Fastow, or under his

[5] "Andersen under fire over memos: Carl Bass Documents," *Financial Post*, April 4, 2002, FP1, FP10.

[6] "Andersen partner warned on Enron in '99: Questioned Partnerships," *Financial Post*, April 3, 2002, FP9.

[7] "Andersen under fire," FP1.

influence, with SPEs owned by Fastow, his family, and Kopper, who was also an employee of Enron.

- AA apparently did not adequately consider the advice of its quality control partner, Carl Bass.
- AA apparently did not find significant audit evidence, or did not act upon evidence found, related to the:
  - Erroneous valuation of shares or share rights transferred to SPEs.
  - Side deals between Enron and banks removing the banks' risk from transactions such as the:
    - Chewco SPE Rhythms hedge.
    - Numerous prepay deals for energy futures even though AA made a presentation to Enron on the GAAP and AA requirements that precluded such arrangements.[8]

Why Did Arthur Andersen Make These Apparent Mistakes?

The term "apparent" is used because AA's side of the story has not been heard. The so-called mistakes may have logical, reasonable explanations, and may be supportable by other accounting and auditing experts. That stated, these apparent mistakes may have been made for several reasons, including:

- Incompetence, as displayed and admitted in the Rhythms case
- Judgment errors as to the significance of each of the audit findings, or of the aggregate impact in any fiscal year
- Lack of information caused by Enron staff not providing critical information, or failure on the part of AA personnel to ferret it out
- Time pressures related to revenue generation and budget pressures that prevented adequate audit work and the full consideration of complex SPE and prepay financial arrangements
- A desire not to confront Enron management or advise the Enron board in order not to upset management, and particularly Fastow, Skilling, and Lay
- A failure of AA's internal policies whereby the concerns of a quality control or practice standards partner can and was overruled by the audit partner in charge of the Enron account. AA was the only one of the Big 5 accounting firms to have this flaw, and it left the entire firm vulnerable to the decision of the person with the most to lose by saying no to a client
- A misunderstanding of the fiduciary role required by auditors

Because AA has now disintegrated, it is unlikely that the cause of specific audit deficiencies will ever be known. However, it is reasonable to assume that all of the causes listed played some part in the apparent mistakes that were made.

A review of additional cases of failure where Arthur Andersen was the auditor, such as the Waste Management and Sunbeam failures that may be found in the digital archive at **www.cengagebrain.com**, reveal that AA's behavior was strikingly similar to that in the Enron debacle. In each case, AA appears to have been so interested in revenue generation that they were willing not to take a hard line with their clients. AA personnel apparently believed that there was no serious risk of default and that, over time, accounting problems could be worked out. At the very least, AA's risk-assessment process was seriously flawed. Also, when AA's client had a combined chairman of the board and CEO who intimidated or was willingly helped by his CFO, neither additional professional accountants working for the corporations nor other nonaccounting personnel who knew of the accounting manipulations

[8]Testimony of Robert Roach to the Senate Permanent Subcommittee on Investigations, July 23, 2002, Appendix A, A-6.

raised their concerns sufficiently with AA or the Audit Committee of their board of directors to stimulate corrective action. This lack of courage and understanding of the need and means to stimulate action left AA, the board, and the public vulnerable.

Shredding Enron Audit Documents: Obstruction of Justice

The final disintegration of AA was not caused directly by the Enron audit deficiencies, but by a related decision to shred Enron audit documents, and the conviction on the charge of obstruction of justice that resulted. This charge, filed on March 7, 2002, raised the prospect that if AA were convicted, the Securities and Exchange Commission (SEC) would withdraw AA's certification to audit SEC registrant companies.[9] That would preclude those large public companies that needed to be registered with the SEC to have their shares traded on U.S. stock exchanges (the NYSE and NASDAQ) or raise significant amounts of capital in the United States.

Since these clients represented the bulk of AA's U.S. and foreign accounting practices, if convicted AA would be effectively reduced to insignificance unless a waiver could be arranged from the SEC. The SEC, however, was very angry about the Enron audit deficiencies, particularly in view of the earlier similar cases involving the AA audits of Waste Management and Sunbeam. In regard to the Waste Management debacle, "The commission argued that not only did Andersen knowingly and recklessly issue materially false and misleading statements, it failed to enforce its own guidelines to bring the company in line with minimally accepted accounting standards."[10] As a condition of the $7 million fine paid in June 2001 settling AA's Waste Management audit deficiencies, AA had agreed to rectify its audit inadequacies, and the SEC believed that AA had not honored this undertaking. Consequently, since AA's behavior in the Enron debacle was so similar, the SEC provided only a temporary and conditional waiver,[11] pending the outcome of the trial.

The conviction was announced on Saturday, June 15, 2002, but many large clients had already transferred their work to other large audit firms. Some boards of directors and CEOs thought that AA's reputation was so damaged by the Enron fiasco that they no longer wanted to be associated with AA, or that such an association might weaken their company's ability to attract financing at the lowest rates. The outrage of the public was so intense that other boards could not face the lack of credibility that continuing with AA would have produced with their shareholders. Still other boards realized that if AA were convicted, there would be a stampede to other firms, and their company might not be able to make a smooth transition to another SEC-certified audit firm if they waited to switch. By the time the conviction was announced, only a small percentage of AA's largest clients remained. Even though AA's chances of acquittal upon appeal were considered by some observers to be good, AA was a shell of its former self and was essentially finished as a firm in the United States, and ultimately around the world.

The chain of events that led to the shredding of some of AA's Enron audit documents begins before Enron decided to announce a $618 million restatement of earnings and a $1.2 billion reduction of equity on October 16, 2001. An SEC investigation was launched into Enron's accounting on October 17, and AA was advised on October 19. However, AA had advised Enron that such an announcement was necessary to correct its accounting for SPEs and, on October 9 as the eight-page indictment states, "retained an

[9] AA could also face probation for up to five years and a $500,000 fine as well as fines for up to twice any gains or damages the court determines were caused by the firm's action.

[10] "'Back time' may catch Andersen," *Toronto Star*, March 21, 2002, D11.

[11] "SEC Announces Actions for Issuers in Light of Indictment of Arthur Andersen LLP," SEC Release 2002-37.

experienced New York law firm to handle further Enron-related litigation."[12] Eleven days later, the subject of shredding was discussed as part of an emergency conference call to AA partners, and shredding began three days after that.[13]

Shredding was undertaken in AA's Houston office, as well as in London, Chicago and Portland. "... according to the U.S. government, ... the destruction was 'wholesale', with workers putting in overtime in order to get the job done." "Tonnes of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction. The shredder at the Andersen office at the Enron building was used virtually constantly and to handle the overload, dozens of large trunks filled with Enron documents were sent to Andersen's Houston office to be shredded."[14]

At the trial, AA argued differently. AA's lawyer attempted to clarify the purpose of Chicago-based AA lawyer Nancy Temple's email of October 10 to Michael Odom of AA's Houston office. In that e-mail she wrote that "it might be useful to consider reminding the (Enron audit) team that it would be helpful to make sure that we have complied with the policy[15] which calls for destruction of extraneous and redundant material."[16] This lack of relevance, of course, was difficult to prove after the documents in question had been destroyed. Essentially, AA contended that "the order to follow the document retention policy was an innocent effort to organize papers, emails and computer files and eliminate extraneous material."[17]

David Duncan, however, testified against AA. He had been fired from AA (where he had been the partner in charge of the Enron audit) on January 15, one day after he met with the U.S. Justice Department. He said: "I obstructed justice ... I instructed people on the (Enron audit) team to follow the document retention policy, which I knew would result in the destruction of documents."[18]

The jury deliberated for many days, emerged, and was sent back for additional deliberations. Ultimately, AA was declared guilty. Although AA planned to appeal, it agreed to cease all audits of public companies by the end of August. Ironically, AA's conviction turned upon the jury's view that the shredding was part of a broad conspiracy, and that rested on testimony that was re-read to the jury, indicating that an AA memo (or memos) was altered. The acts of shredding alone were not enough for conviction. The jury was reported as concluding that:

> Duncan eventually pleaded guilty to one count of obstruction and testified on the government's behalf, but jurors said afterwards that they didn't believe his testimony. Instead, the jury agreed that Andersen in-house attorney Nancy Temple had acted corruptly in order to impede the SEC's pending investigation. One of Temple's memos was a response to an email from Duncan about Enron's third quarter earnings statement. Enron wanted to describe a massive earnings loss as "non-recurring," but Duncan advised Enron against using that phrase. Temple's memo advised Duncan to delete any language that

[12] *Grand Jury Indictment on the Charge of Obstruction of Justice, United States of America against Arthur Andersen, LLP,* filed in the United Sates District Court Southern District of Texas on March 7, 2002, 5.

[13] Op. cit., "Back time" D11.

[14] Ibid., D11.

[15] "Auditor evidence attacked," *Toronto Star*, May 22, 2002, E12.

[16] Ibid., E12.

[17] Ibid., E12.

[18] "Andersen partner admits wrongdoing," *Toronto Star*, May 14, 2002, D3.

> might suggest that Andersen disagreed with Enron, and further advised Duncan to remove her own name from his correspondence, since she did not want to be called as a witness in any future litigation stemming from Enron's earnings announcements.[19]

On October 16, 2002, AA was fined the maximum of $500,000 and placed on five years' probation. AA appealed out of principle, eventhough only 1,000 employees remained. Interestingly, on May 31, 2005, the U.S. Supreme Court overturned the conviction on the grounds that the "jury instructions failed to convey the requisite consciousness of wrong-doing"[20]—that AA personnel needed to think they were doing wrong rather than right to be convicted. The U.S. government must decide whether to retry the case. Unfortunately, the Supreme Court's ruling came too late for AA.

Lingering Questions

Within a few months, arrangements had been made for the AA units around the world to join other firms, but not before many staff had left, and not all those remaining were hired by the new employers. A firm of 85,000 people worldwide, including 24,000 in the United States, was virtually gone.

Was this an appropriate outcome? Perhaps only 100 AA people were responsible for the Enron tragedy, but 85,000 paid a price. Will the reduced selection of large accounting firms, the Big 4, be able to serve the public interest better than the Big 5? What if another Big 4 firm has difficulty? Will we have the Big 3, or are we now facing the Final Four? Will fate await other individual AA partners and personnel beyond David Duncan, or by the AICPA through the exercise of its code of conduct? Will a similar tragedy occur again?

Emerging Research

These questions, and others, have stimulated the accounting research community to investigate them. Conferences are being held, and research articles are appearing.

One of the early studies, by Paul R. Chaney and Kirk L. Philipich entitled "Shredded Reputation: The Cost of Audit Failure,"[21] provided insights into the impact of AA's problems on its other corporate clients and their investors. On January 10, 2002, AA admitted shredding Enron's documents, and in the ensuing three days the stock prices of most of AA's 284 other large clients that were part of the Standard & Poor's 1,500 Index fell. Over that time, these stocks dropped an average of 2.05 percent and lost more than $37 million in market value. This was the largest movement observed for the four critical information events tested. The other events were November 8, 2001, when Enron announced its restatements, December 12, 2001, when AA's CEO admitted AA made an error, and February 3, 2002, the day following the release of the Powers Report, when AA hired former Federal Reserve Chairman Paul Volcker to chair an independent oversight board to shore up AA's credibility. Volcker later resigned when it became evident that AA was unwilling to embrace significant changes.

Additional research studies have examined many aspects of the conduct of the directors, executives, lawyers, and accountants involved in the Enron, Arthur Andersen, and WorldCom tragedies. In addition, the roles of regulators, of directors, and of professional independence have come under scrutiny. These studies are to be found in many academic and professional

[19]Greg Farrell, "Arthur Andersen convicted of obstruction of justice," *USA TODAY*, June 15, 2002.

[20]Barry McKenna, "Supreme Court overrules jury—but too late to save Andersen," *Globe & Mail*, Report on Business, June 1, 2005, B1, B11.

[21]Paul R. Chaney and Kirk L. Philipich, "Shredded reputation: The cost of audit failure," *Journal of Accounting Research*, Vol. 40 No. 4, September 2002, 1235–1240.

journals as well as the popular business press. In particular, useful articles can be found in the *Journal of Business Ethics, Business Ethics Quarterly, Journal of Accounting Research, Contemporary Accounting Research, Journal of Research in Accounting Ethics*, and *Business Week*.

Questions

1. What did Arthur Andersen contribute to the Enron disaster?
2. Which Arthur Andersen decisions were faulty?
3. What was the prime motivation behind the decisions of Arthur Andersen's audit partners on the Enron, WorldCom, Waste Management, and Sunbeam audits: the public interest or something else? Cite examples that reveal this motivation.
4. Why should an auditor make decisions in the public interest rather than in the interest of management or current shareholders?
5. Why didn't the Arthur Andersen partners responsible for quality control stop the flawed decisions of the audit partners?
6. Should all of Arthur Andersen have suffered for the actions or inactions of fewer than 100 people? Which of Arthur Andersen's personnel should have been prosecuted?
7. Under what circumstances should audit firms shred or destroy audit working papers?
8. Answer the "Lingering Questions" on page 105.

ETHICS CASE

WorldCom: The Final Catalyst

This case presents, with additional information, the WorldCom saga included in this chapter. Questions specific to WorldCom activities are located at the end of the case.

WorldCom Lights the Fire

WorldCom, Inc., the second largest U.S. telecommunications giant and almost 70 percent larger than Enron in assets, announced on June 25, 2002, that it had overstated its cash flow by $3.8 billion.[1] This came as a staggering blow to the credibility of capital markets. It occurred in the middle of the furor caused by:

- The Enron bankruptcy on December 2, 2001, and the related Congress and Senate hearings and Fifth Amendment testimony by Enron executives
- The depression of the stock markets
- The pleas by business leaders and President Bush for restoration of credibility and trust to corporate governance, reporting, and the financial markets
- Responsive introduction of governance guidelines by stock exchanges and the Securities and Exchange Commission
- Debate by the U.S. Congress and Senate of separate bills to improve governance and accountability
- The conviction of Arthur Andersen, auditor of both Enron and WorldCom, for obstruction of justice on June 15, 2002

WorldCom's Accounting Manipulations

WorldCom's accounting manipulations involved very basic, easy-to-spot types of fraud.[2] Overstatements of cash flow and income were created because one of

[1]Simon Romero and Alex Berenson, "WorldCom says it hid expenses, inflating cash flow $3.8 billion," *New York Times*, June 26, 2002.

[2]Bruce Myerson, "A WorldCom primer," the Associated Press, June 26, 2001.

WorldCom's major expenses, line costs, or "fees paid to third party telecommunication network providers for the right to access the third parties networks,"[3] were accounted for improperly. Essentially, line costs that should have been expensed, thus lowering reporting income, were offset by capital transfers or charged against capital accounts, thus placing their impact on the balance sheet rather than the income statement. In addition, WorldCom created excess reserves or provisions for future expenses, which they later released or reduced, thereby adding to profits. The manipulation of profit through reserves or provisions is known as "cookie jar" accounting.

The aggregate overstatement of income quickly rose to more than $9 billion[4] by September 19, 2002, for the following reasons:

- $3.85 billion for improperly capitalized expenses, announced June 25, 2002[5]
- $3.83 billion for more improperly capitalized expenses in 1999, 2000, 2001, and the first quarter of 2002, announced on August 8, 2002[6]
- $2.0 billion for manipulations of profit through previously established reserves, dating back to 1999

Ultimately, the WorldCom fraud totaled $11 billion.

Key senior personnel involved in the manipulations at WorldCom included:

- Bernard J. Ebbers, CEO
- Scott D. Sullivan, CFO
- Buford Yates Jr., Director of General Accounting
- David F. Myers, Controller
- Betty L. Vinson, Director of Management Reporting, from January 2002
- Troy M. Normand, Director of Legal Entity Accounting, from January 2002

According to SEC's complaint against Vinson and Normand:[7]

> 4. WorldCom fraudulently manipulated its financial results in a number of respects, including by improperly reducing its operating expenses in at least two ways. First, WorldCom improperly released certain reserves held against operating expenses. Second, WorldCom improperly recharacterized certain operating costs as capital assets. Neither practice was in conformity with generally accepted accounting principles ("GAAP"). Neither practice was disclosed to WorldCom's investors, despite the fact that both practices constituted changes from WorldCom's previous accounting practices. Both practices artificially and materially inflated the income WorldCom reported to the public in its financial statements from 1999 through the first quarter of 2002.
>
> 5. Many of the improper accounting entries related to WorldCom's expenses for accessing the networks of other telecommunications companies ("line costs"), which were among WorldCom's major operating expenses. From at least the third quarter of 2000 through the first quarter of 2002, in a scheme directed and approved by senior management, and participated in by VINSON, NORMAND and others, including Yates and Myers, WorldCom

[3]Complaint: *SEC v. WorldCom, Inc.*, U.S. Securities and Exchange Commission, June 26, 2002, para. 5, www.sec.gov/litigation/complaints/complr17588.htm.

[4]"WorldCom to reveal more bogus accounting," Associated Press, September 19, 2002; David E. Royella, "WorldCom faces two new charges, misstatement grows," *Financial Post*, November 6, 2002, FP4.

[5]WorldCom Inc., *Form 8-K, Current Report Pursuant To Section 13 Or 15(D) Of The Securities Exchange Act Of 1934*, August 14, 2002, para. 2, www.sec.gov/archives/edgar/.

[6]Ibid., para. 3.

[7]*Complaint: SEC v. Betty L. Vinson, and Troy M. Normand*, U.S. Securities and Exchange Commission, modified October 31, 2002, para. 4, 5, 6, www.sec.gov/litigation/complaints/comp17783.htm.

concealed the true magnitude of its line costs. By improperly reducing reserves held against line costs, and then—after effectively exhausting its reserves—by recharacterizing certain line costs as capital assets, WorldCom falsely portrayed itself as a profitable business when it was not, and concealed the large losses it suffered. WorldCom's fraudulent accounting practices with respect to line costs were designed to and did falsely and fraudulently inflate its income to correspond with estimates by Wall Street analysts and to support the price of WorldCom's common stock and other securities.

6. More specifically, in the third and fourth quarters of 2000, at the direction and with the knowledge of WorldCom's senior management, VINSON, NORMAND and others, by making and causing to be made entries in WorldCom's books which improperly decreased certain reserves to reduce WorldCom's line costs, caused WorldCom to overstate pretax earnings by $828 million and at least $407 million respectively. Then, after WorldCom had drawn down WorldCom's reserves so far that the reserves could not be drawn down further without taking what senior management believed was an unacceptable risk of discovery, VINSON, NORMAND and others, again at the direction and with the knowledge of senior management, made and caused to be made entries in WorldCom's books which improperly capitalized certain line costs for the next five quarters, from the first quarter 2001 through the first quarter 2002. This accounting gimmick resulted in an overstatement of WorldCom's pretax earnings by approximately $3.8 billion for those five quarters.

The motivation and mechanism for these manipulations is evident from the SEC's description of what happened at the end of each quarter, after the draft quarterly statements were reviewed. Steps were taken by top management to hide WorldCom's problems and boost or protect the company's stock price in order to profit from stock options, maintain collateral requirements for personal loans, and keep their jobs. These steps were required, in part, to offset the downward pressure on WorldCom's share price caused by U.S. and European regulators' rejection of WorldCom's US $115 billion bid for Sprint Communications.[8] Ebbers' company had been using takeovers rather than organic growth to prop up earnings, and the financial markets began to realize this would be increasingly difficult.

According to the SEC:

27. In or around October 2000, at the direction and with the knowledge of WorldCom senior management, VINSON, NORMAND and others, including Yates and Myers, caused the making of certain improper entries in the company's general ledger for the third quarter of 2000. Specifically, after reviewing the consolidated financial statements for the third quarter of 2000, WorldCom senior management determined that WorldCom had failed to meet analysts' expectations. WorldCom's senior management then instructed Myers, and his subordinates, including Yates, VINSON and NORMAND, to make improper and false entries in WorldCom's general ledger reducing its line cost expense accounts, and reducing—in amounts corresponding to the improper and false line cost expense amounts—various reserve accounts. After receiving instructions through Yates, VINSON and NORMAND ensured that these entries were made. There was no documentation supporting these entries, and no proper business rationale for them, and they were not in conformity with GAAP. These entries had the effect of

[8] "Ebbers became symbol of scandals" *Financial Post*, July 14, 2005, FP1, FP3.

> reducing third quarter 2000 line costs by approximately $828 million, thereby increasing WorldCom's publicly reported pretax income by that amount for the third quarter of 2000.[9]

Manipulations followed the same pattern for the fourth quarter of 2000, but a change was required for the first quarter of 2001 for fear of discovery.

> 29. In or around April 2001, after reviewing the preliminary consolidated financial statements for the first quarter of 2001, WorldCom's senior management determined that WorldCom had again failed to meet analysts' expectations. Because WorldCom's senior management determined that the company could not continue to draw down its reserve accounts to offset line costs without taking what they believed to be unacceptable risks of discovery by the company's auditors, WorldCom changed its method of fraudulently inflating its income. WorldCom's senior management then instructed Myers, and his subordinates, including Yates, VINSON and NORMAND, to make entries in WorldCom's general ledger for the first quarter of 2001, which fraudulently reclassified line cost expenses to a variety of capital asset accounts without any supporting documentation or proper business rationale and in a manner that did not conform with GAAP.
>
> 30. Specifically, in or around April 2001, at the direction and with the knowledge of WorldCom's senior management, defendants VINSON, NORMAND and others, including Yates and Myers, fraudulently reduced first quarter 2001 line cost expenses by approximately $771 million and correspondingly increased capital asset accounts, thereby fraudulently increasing publicly reported pretax income for the first quarter of 2001 by the same amount. In particular, in or about April 2001, NORMAND telephoned WorldCom's Director of Property Accounting (the "DPA") and instructed him to adjust the schedules he maintained for certain Property, Plant & Equipment capital expenditure accounts (the "PP&E Roll-Forward") by increasing certain capital accounts for "prepaid capacity." NORMAND advised the DPA that these entries had been ordered by WorldCom's senior management. Correspondingly, a subordinate of NORMAND made journal entries in WorldCom's general ledger, transferring approximately $771 million from certain line cost expense accounts to certain PP&E capital expenditure accounts.[10]

In future periods, the increase of certain accounts for "prepaid capacity" remained the manipulation of choice.

WorldCom's Other Revelations

It should be noted that Ebbers was not an accountant—he began as a milkman and bouncer, and became a basketball coach and then a Best Western Hotel owner before he entered the Telcom business,[11] where his sixty acquisitions and style earned him the nickname "the Telcom Cowboy." However, he was ably assisted in these manipulations by Scott Sullivan, his Chief Financial Officer, and David Myers, his Controller. Both Sullivan and Myers had worked for Arthur Andersen before joining WorldCom.

Other spectacular revelations offer a glimpse behind the scenes at WorldCom. The company, which applied for bankruptcy protection in July 21, 2002, also

---

[9]*Complaint: SEC v. Betty L. Vinson, and Troy M. Normand,* U.S. Securities and Exchange Commission, modified October 31, 2002, www.sec.gov/litigation/complaints/comp17783.htm.

[10]*Complaint: SEC v. Betty L. Vinson, and Troy M. Normand,* U.S. Securities and Exchange Commission, modified October 31, 2002, www.sec.gov/litigation/complaints/comp17783.htm.

[11]Krysten Crawford. "Ex-WorldCom CEO Ebbers guilty," CNN Money, March 15, 2005, http://money.cnn.com/2005/03/15/news/newsmakers/ebbers/?cnn=yes.

announced that it might write off $50.6 billion in goodwill or other intangible assets when restating for the accounting errors previously noted. Apparently other WorldCom decisions had been faulty.

The revelations were not yet complete. Investigation revealed that Bernard Ebbers, the CEO, had been loaned $408.2 million. He was supposed to use the loans to buy WorldCom stock or for margin calls as the stock price fell. Instead, he used it partly for the purchase of the largest cattle ranch in Canada, construction of a new home, personal expenses of a family member, and loans to family and friends.[12]

Finally, it is noteworthy that:

> At the time of its scandal, WorldCom did not possess a code of ethics. According to WorldCom's Board of Director's Investigative Report, the only mention of "ethics" was contained in a section in WorldCom's Employee Handbook that simply stated that "... fraud and dishonesty would not be tolerated" (WorldCom 2003, p. 289). When a draft version of a formal code was presented to Bernie Ebbers ... for his approval before the fraud was discovered in 2001, his response was reportedly that the code of ethics was a "... colossal waste of time" (WorldCom 2003, 289).[13]

Why Did They Do it?

According to U.S. Attorney General John Ashcroft:

> the alleged Sullivan-Myers scheme was designed to conceal five straight quarterly net losses and create the illusion that the company was profitable.[14]

In view of Ebbers' $408.2 million in loans, which were largely to buy or pay margin calls on WorldCom stock and which were secured by WorldCom stock, he would be loathe to see further deterioration of the WorldCom stock price. In short, he could not afford the price decline that would follow from lower WorldCom earnings.

In addition, according to the WorldCom's *2002 Annual Meeting Proxy Statement*,[15] at December 31, 2001, Ebbers had been allocated exercisable stock options on 8,616,365 shares and Sullivan on 2,811,927. In order to capitalize on the options, Ebbers and Sullivan (and other senior employees) needed the stock price to rise. A rising or at least stable stock price was also essential if WorldCom stock was to be used to acquire more companies.

Finally, if the reported results became losses rather than profits, the tenure of senior management would have been shortened significantly. In that event, the personal loans outstanding would be called and stock option gravy train would stop. In 2000, Ebbers and Sullivan had each received retention bonuses of $10 million so they would stay for two years after September 2000. In 1999, Ebbers received a performance bonus allocation of $11,539,387, but he accepted only $7,500,000 of the award.[16]

An Expert's Insights

Former Attorney General Richard Thorn-burgh was appointed by the U.S. Justice Department to investigate the collapse and bankruptcy of WorldCom. In his

[12] Royella. "WorldCom faces two new charges," FP4.

[13] Mark S. Schwartz. "Effective Corporate Codes of Ethics: Perceptions of Code Users," *Journal of Business Ethics*, 55:323–343, 2004, p. 324, and WorldCom 2003, "*Report of the Investigation by the Special Investigative Committee of the Board of Directors*" June 9, 2003.

[14] "WorldCom accounting fraud rises to $7 billion," *The Baltimore Sun*, August 9, 2002.

[15] WorldCom's *2002 Annual Meeting Proxy Statement*, SEC Edgar File, April 22, 2002, www.sec.gov /Archives/edgar/data/723527/000091205702015985/0000912057-02-015985.txt.

[16] Ibid.

Report to the U.S. Bankruptcy Court in Manhattan on November 5, 2002, he said:

> One person, Bernard Ebbers, appears to have dominated the company's growth, as well as the agenda, discussions and decisions of the board of directors, ...
>
> A picture is clearly emerging of a company that had a number of troubling and serious issues ... [relating to] culture, internal controls, management, integrity, disclosure and financial statements.
>
> While Mr. Ebbers received more than US $77 million in cash and benefits from the company, shareholders lost in excess of US $140 billion in value.[17]

The Continuing Saga

The WorldCom saga continues as the company's new management try to restore trust it its activities. As part of this effort, the company changed its name to MCI. "On August 26, 2003, Richard Breeden, the Corporate Monitor appointed by the U.S. District Court for the Southern District of New York, issued a report outlining the steps the Company will take to rebuild itself into a model of strong corporate governance, ethics and integrity ... (to) foster MCI's new company culture of 'integrity in everything we do.'"[18] The company is moving deliberately to reestablish the trust and integrity it requires to compete effectively for resources, capital, and personnel in the future.

The SEC has filed complaints, which are on its website, against the company and its executives. The court has granted the injunctive relief the SEC sought. The executives have been enjoined from further such fraudulent actions, and subsequently banned by the SEC from practicing before it, and some have been banned by the court from acting as officers or directors in the future.

WorldCom, as a company, consented to a judgment:

> ... imposing the full injunctive relief sought by the Commission; ordering an extensive review of the company's corporate governance systems, policies, plans, and practices; ordering a review of WorldCom's internal accounting control structure and policies; ordering that WorldCom provide reasonable training and education to certain officers and employees to minimize the possibility of future violations of the federal securities laws; and providing that civil money penalties, if any, will be decided by the Court at a later date.[19]

Bernie Ebbers and Scott Sullivan were each indicted on nine charges: one count of conspiracy, one count of securities fraud, and seven counts of false regulatory findings.[20] Sullivan pleaded guilty on the same day he was indicted and later cooperated with prosecutors and testified against Bernie Ebbers "in the hopes of receiving a lighter sentence."[21]

Early in 2002, Ebbers stood up in church to address the congregation saying: "I just want you to know that you're not going to church with a crook."[22] Ebbers took the stand and argued "that he didn't know anything about WorldCom's shady accounting,

[17]Don Stancavish. "WorldCom dominated by Ebbers," Bloomberg News, in *Financial Post*, November 5, 2002, FP13.

[18]*MCI* website, *Governance: Restoring the Trust*, http://global.mci.com/about/governance/restoring-trust/, (accessed January 3, 2006).

[19]*SEC Litigation Release No. 17883*/ December 6, 2002, http://www.sec.gov/litigation/litreleases/ lr17883.htm.

[20]"Jury convicts Ebbers on all counts in fraud case," *MSNBC*, March 15, 2005, http://www.msnbc.msn.com/id/7139448/.

[21]Crawford. "Ex-WorldCom CEO Ebbers guilty."

[22]"Ebbers became symbol of scandals," FP1, FP3.

that he left much of the minutiae of running the company to underlings."[23] But after eight days of deliberations, on March 15, 2005, a federal jury in Manhattan didn't buy his "aw shucks," "hands-off," or "ostrich-in-the-sand" defense.

The jury believed Sullivan, who told the jury that Ebbers repeatedly told him to "'hit his numbers'—a command … to falsify the books to meet Wall Street expectations."[24] They did not buy Ebbers' "I know what I don't know" argument, "especially after the prosecutor portrayed a man who obsessed over detail and went ballistic over a US $18,000 cost overrun in a US $3-billion budget item while failing to pick up on the bookkeeping claim that telephone line costs often fluctuated—fraudulently—by up to US $900-million a month. At other times, he replaced bottled water with tap water at WorldCom's offices, saying employees would not know the difference."[25]

On July 13, 2005, Ebbers was sentenced to twenty-five years in a federal prison.[26] Once a billionaire, he also lost his house, property, yacht, and fortune. At 63 years of age, he is appealing his sentence. Sullivan's reduced sentence was for five years in a federal prison, forfeiture of his house, ill-gotten gains, and a fine.

Investors lost over $180 million in WorldCom's collapse,[27] and more in other companies as the confidence in credibility of the financial markets, governance mechanisms and financial statements continued to deteriorate.

Questions

1. Describe the mechanisms that WorldCom's management used to transfer profit from other time periods to inflate the current period.
2. Why did Arthur Andersen go along with each of these mechanisms?
3. How should WorldCom's board of directors have prevented the manipulations that management used?
4. Bernie Ebbers was not an accountant, so he needed the cooperation of accountants to make his manipulations work. Why did WorldCom's accountants go along?
5. Why would a board of directors approve giving its Chair and CEO loans of over $408 million?
6. How can a board ensure that whistleblowers will come forward to tell them about questionable activities?

[23]Crawford. "Ex-WorldCom CEO Ebbers guilty."
[24]"Jury Convicts Ebbers on all counts in fraud case."
[25]"Ebbers became symbol of scandals."
[26]Ibid.
[27]Ibid.

ETHICS CASE

Bernie Madoff Scandal—The King of Ponzi Schemes

Bernie Madoff perpetrated the world's largest Ponzi scheme[1] in which investors were initially estimated to have lost up to $65 billion. Essentially investors were promised, and some received, returns of at least 1 per month. However, beginning in the early 1990s, these payments came from funds invested by new investors, not from returns on invested funds. Consequently, when new investor contributions slowed due to the subprime lending crisis in 2008, Madoff ran out of funds to

[1]Named after Charles Ponzi (March 3, 1882—January 18, 1949) who was born in Italy, lived in the United States, and became famous for his swindle of unsuspecting investors wherein early investors are paid returns from funds invested by later investors.

Questions

1. The argument is that market-to-market accounting caused AIG to record huge unrealized losses. These losses led to a downgrade in the quality of AIG stock. The downgrade and frozen credit markets led to eventual bailout. So, do you agree that the accounting rules contributed to AIG's demise?
2. The government said that AIG was "too big to fail." It was concerned that if AIG declared bankruptcy, then individuals holding personal insurance as well as other investments would have no insurance and would be in danger as the financial and liquidity crisis deepened. But many felt that the federal government should not be investing in publicly traded companies. There is risk in the marketplace, and one such risk is that occasionally businesses go bankrupt. Should the federal government have bailed out AIG, especially when it had not rescued Lehman Brothers and had let Merrill Lynch be taken over by Bank of America?

ETHICS CASE

Subprime Lending—Greed, Faith, & Disaster

In December 2002, Stan O'Neal became CEO of Merrill Lynch & Co Inc, the world's largest brokerage house. Known as "Mother Merrill" to insiders, the firm had a nurturing environment that accepted lower profit margins so that veteran employees could remain with the firm. O'Neal changed that culture. He laid off one-third of the workforce—24,000 employees—and fired nineteen senior executives while eliminating senior management perks. He put in a new young management team, expanded the firm's overseas activities, and made Merrill a more aggressive, risk-friendly organization. In 2006, for example, the firm made $7 billion in trading securities, compared with $2.2 billion in 2002. Under O'Neal's leadership Merrill became the most profitable investment bank in America, making more money per broker than any of its competitors. O'Neal was rewarded well—in 2007 he became one of Wall Street's best-paid executives, earning $48 million in salary and bonuses.

He pushed the company into new lines of business, including investing in collateralized debt obligations (CDOs). Merrill led the industry in its exposure to CDOs. Over an eighteen-month period, to the summer of 2007, its investment in these subprime mortgage-backed CDO pools rose from $1 billion to more than $40 billion. Then the subprime mortgage bubble burst.

The term "subprime" does not refer to the interest rate changed on the mortgage but, rather, to the risk associated with the borrower. Subprime mortgages are given to high-risk customers who are charged an interest rate that is greater than prime. These mortgages are typically given to people who would not normally qualify for a mortgage from a conventional lender such as a bank. From the lender's point of view, as long as house prices increase, the risk of a loss on the mortgage is low. As such, the mortgages became low-risk, high-yield investments. The lenders of these sub-prime mortgages would then package these mortgages as bundles of asset-backed synthetic securities, such as CDOs, which were sold to third parties, including individuals, corporations, pension funds, banks, insurance companies, and brokerage houses.

The subprime mortgage bubble bust when house prices in the United States began to fall. People could no longer refinance their homes nor pay off their mortgages by selling their homes. By late 2006, one in eight subprime mortgages was in default. Throughout 2007, nearly 1.5 million American homeowners lost their homes. As the housing market imploded, mortgage payment defaults increased and the value of subprime mortgages fell as did the value of the subprime mortgage-backed CDOs. By the summer of 2007, subprime-related losses were being reported by all the major financial institutions.

In the third quarter of 2007, Merrill announced a loss of $2.3 billion, compared with a profit of $3.05 billion for the third quarter in 2006. It also announced a $7.9 billion provision for losses on mortgage-related investments, larger than the warning of a possible $5 billion write-down that it had made a month earlier. Within a week of reporting the largest quarterly loss in the company's ninety-three-year history, O'Neal resigned as Chairman and Chief Executive Officer of Merrill Lynch. Although he did not receive any severance, O'Neal did receive $161 million in stock and retirement benefits.

Questions

1. Subprime mortgages targeted lower-income Americans, new immigrants, and people who had a poor credit history. The customers were told that because house prices had been rising, the borrower would be able to refinance the loan at a later date with the increased equity in the house. Was this an ethically correct sales pitch? Were the lenders taking advantage of financially naïve customers?
2. O'Neal transformed Merrill Lynch from a conservative bank into an aggressive risk-taking institution. Risk-taking means that there is the potential for high rewards as well as large losses. From 2002, when O'Neal became CEO, Merrill's share rose 53 percent. Should the investors now be upset that, as a result of the subprime mortgage meltdown, Merrill's stock price fell by about 30 percent in 2007?
3. As a result of the subprime mortgage debacle, the CEOs at Merrill Lynch, Citigroup, Bear Stearns, and Morgan Stanley all resigned or were fired. Their departure packages were $161 million, $68 million, $40 million, and $18 million, respectively. Are these settlements unreasonably high, given the huge financial losses and write-downs that their companies recorded?

Sources: McFarland, Janet, "Amid Billions in Write-downs and Plunging Stocks, Attention Turns to Executive Paycheques," *Globe and Mail*, March 21, 2008, B1.

"Merrill Lynch Chief Set to Resign," *Seattle Post-Intelligencer*, October 28, 2007. http://seattlepi.nwsource.com/business/337204_merrill29.html.

Rosenbush, Steve, "Merrill Lynch's O'Neil Takes the Hit," *Business Week*, October 24, 2007. http://www.businessweek.com/bwdaily/dnflash/content/oct2007/db20071024_830456.htm.

The U.S. Subprime Mortgage Meltdown," *CBC News*, August 31, 2007. http://www.cbc.ca/news/background/personalfinance/mortgage-meltdown.html.

Weiner, Eric, "Stan O'Neal: The Rise and Fall of a Numbers Guy," *NPR.org*, October 29, 2007. http://www.npr.org/templates/story/story.php?storyId515768986

ETHICS CASE

Moral Courage: Toronto-Dominion Bank CEO Refuses to Invest in High-Risk Asset-Backed Commercial Paper

Although the Canadian banks have not suffered as much as other financial institutions around the world, they have not been immune from the economic consequences of the sub-prime mortgage meltdown. In Canada, the earliest crisis concerned the liquidity of asset-backed commercial paper (ABCP) that was affected by the precipitous decline of U.S. housing prices and the related mortgage-backed securities on which those prices were based.

ABCP are short-term debt obligations, generally issued by a specially formed entity or a trust and secured by a bundle of assets such as mortgages and other types of consumer loans. The repayment and maturity of these ABCPs is dependent on the cash flow of the underlying assets. The ABCPs were issued to investors by trusts that were sponsored or managed by either banks or nonbank financial institutions. The nonbank-sponsored portion of the Canadian market was approximately $35 billion.

In July 2007, as the U.S. subprime mortgage market began to deteriorate, the Canadian issuers began to fear that they, too,