

# Accounting and Scandals

# What is accounting?

- To provide a record such as funds paid or received for a person or business.  
Accounting summarizes and submits this information in reports and statements. The reports are intended both for the firm itself and for outside parties.
- In other words: Recording business transactions through financial statements.

- Accounting provides three basic reports for any company.

- Income Statement: This report tells whether the business is making or losing money. It reports the income and expenses of a business for a certain period of time.

- Balance Sheet: This report provides information on the debt and assets of a business. It provides the “net worth” of a company by subtracting the debt from the assets.

- Cash Flow Statement: *Straight forward*. This provides information regarding how much cash is flowing through the business.

# Arthur Andersen



- Was founded in 1913.
- Was once one of the Big Five Accounting Firms.
- The founder, Arthur Andersen, once said:  
“As accountants our responsibility is toward investors, not our clients.”
- This firm ceased to exist after the Enron Scandal.

# What did they do wrong?

- First, they helped Enron conceal partnerships whose debts eventually brought it down.
- Second, they shredded Enron related documents.
- Former senior audit partner, David Duncan, was the main person responsible for this.

# Consequences

- On June 15, 2002, Arthur Andersen was convicted of obstruction of justice.
- On August 31, 2002 the firm agreed to surrender its accounting licenses and its right to practice before the SEC.
- The firm lost nearly all of its clients after it was convicted.
- It went from having 85,000 employees worldwide to 200 employees today. These are mainly attorneys dealing with pending lawsuits against the firm.
- Arthur Andersen basically no longer exists.

# Enron Scandal



- Enron was once the seventh largest company in America.
- Their industry was primarily transmission and distribution of energy (energy traders).
- They were the largest buyer and seller of natural gas and electricity in the United States.
- Enron also traded numerous other commodities.
- It is greatest corporate scandal in U.S. history.

# Key Players



- CEO: Jeffrey Skilling
- Worked for Enron since 1990 and became CEO in February of 2001.
- Resigned August 2001.
- On October 23, 2006 he was sentenced to 24 years and 4 months in prison on 19 counts of conspiracy, fraud, false statements, and insider trading.
- He was fined 45 million dollars.
- He would knowingly mislead investors by assuring them everything was going great and at the same time he would be selling his Enron shares. He sold 60 million dollars worth of shares.



# Skilling's New Home

- Federal Correction Institution Butner is located in the triangle area of Raleigh, Durham, and Chapel Hill.



# Key Players



- Chairman of the Board: Ken Lay
- Was a close friend to President Bush. In 2000 he was mentioned as a possible candidate for secretary of treasury under Bush.
- Served as CEO of Enron from 1986 up to its bankruptcy with the exception of a few months where Skilling was CEO.
- In May 25, 2006 he was convicted on 10 counts of securities fraud and related charges.
- He died while vacationing in Colorado on October 17, 2006.
- As a result the judge vacated Lay's conviction.

# Key Player



- CFO: Andrew Fastow
- He orchestrated a series of hidden partnerships designed to disguise debt and falsely inflate Enron's revenue while at the same time enriching himself.
- He was indicted on 78 charges of fraud, money laundering, and conspiracy.
- He pled guilty to two charges of wire and securities fraud and will serve a six year sentence.
- His reduced sentence is due to the fact that he became a government informant and agreed to cooperate with federal authorities.

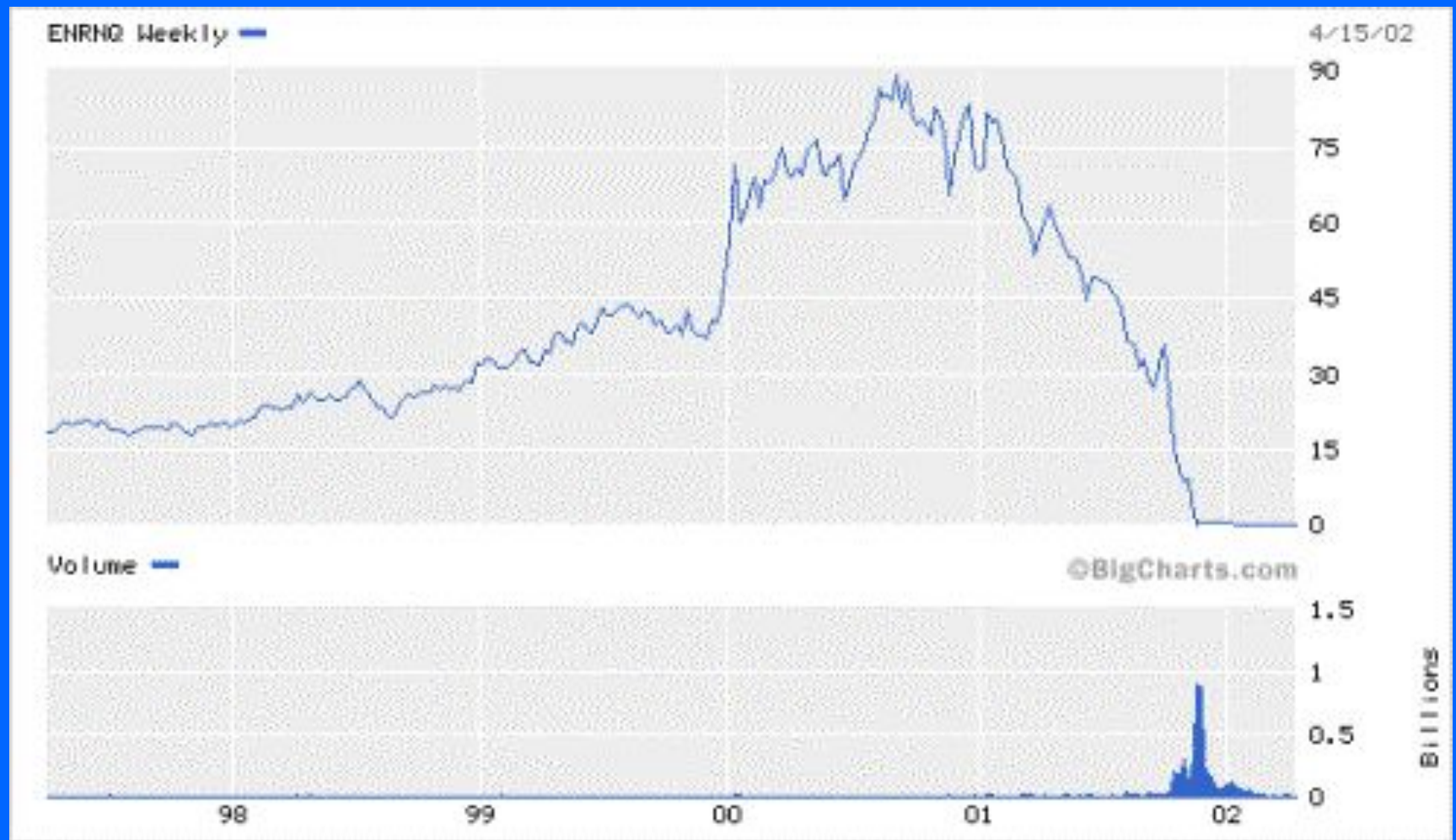
# What did Enron do wrong?

- This was a very complex scandal.
- First, in 1992 Skilling convinced federal regulators to let the company use the “mark to market” accounting method. This method allowed Enron to count projected earnings from long-term energy contracts as current income. Throughout the years this allowed Enron to inflate its revenues.
- The first problem with this was that revenues appeared to be high, keeping the stock price high, but since the money was not really flowing in, Enron was not paying taxes.

- Enron started buying companies exponentially so they set up off balance sheet entities so that they could move the debt out of Enron's balance sheet.
- They then developed what they called Raptor companies. These raptor companies served as partnerships. Some were controlled by executives such as Andrew Fastow. These companies would buy any of Enron's failing businesses which in turn boosted Enron's balance sheet.
- The raptors would do business with Enron and were responsible for a large chunk of Enron's revenues.
- Basically Enron was doing business with itself and in some cases with Fastow and other executives who profited greatly from them.
- As soon as the Enron stock fell below a certain point all the Raptors collapsed since they were backed only by Enron stock.
- Fastow was responsible for hiding these partnerships.

- The deals were so complex that no one could really determine what was legal and what wasn't.
- When the stock price started falling, the raptors collapsed as well and in October of 2001 Enron reported a third quarter 617 million dollar loss.
- Later, executives admitted to overstating the companies earnings by 57 million since 1997.
- In December of 2001 Enron filed for bankruptcy.

# Chart



- Let's say you had 250,000 dollars worth of Enron stock when it reached its peak at 86 dollars. One year later those same shares would be worth a total of 872 dollars.
- Enron stock went from 86 dollars to 30 cents in a little over a year.



# What is Enron today?

- “Enron is in the midst of liquidating its remaining operations and distributing its assets to its creditors” according to its website.
- On September 7, 2006 Enron sold Prisma Energy International Inc., its formerly sole remaining business, and it will likely be dissolved in the near future.

# Who was affected?

- Some Enron shareholders lost their life savings.
- Enron left behind 31 billion dollars worth of debt.
- Around 21,000 people lost their jobs.
- Most lost their pension plans.
- Others such as Clifford Baxter, former Vice Chairman of Enron, committed suicide.
- Investors were crushed as shown in the chart.
- The entire nation was affected because this scandal opened the door to new tough laws.

# Effect on Corporate America

- U.S. Congress passed the Sarbanes-Oxley law, which imposes stricter rules on auditors and made corporate directors criminally liable for lying about their accounts.
- As a direct result more and more companies rely on foreign stock exchanges such as the London Stock Exchange or Shanghai Stock Exchange to register their companies.

Another great corporate scandal.....



# WorldCom

- During the 1990's WorldCom was a leader in the telecom industry. It purchased over 60 telecom firms.
- By 2001 it owned one third of all data cables in the country.
- It was the second largest long distance phone company, only after AT&T.

# Key Players

- CEO: Bernie Ebbers



- CFO: Scott Sullivan



# What Happened?

- Revenue growth started to slow and CEO Bernie Ebbers was terrified of not meeting Wall Street expectations.
- He had amassed a fortune from WorldCom stock which he still owned.
- His solution: He moved 2.8 billion out of the company's reserves into the revenue portion of the financial statements.

# Solution....

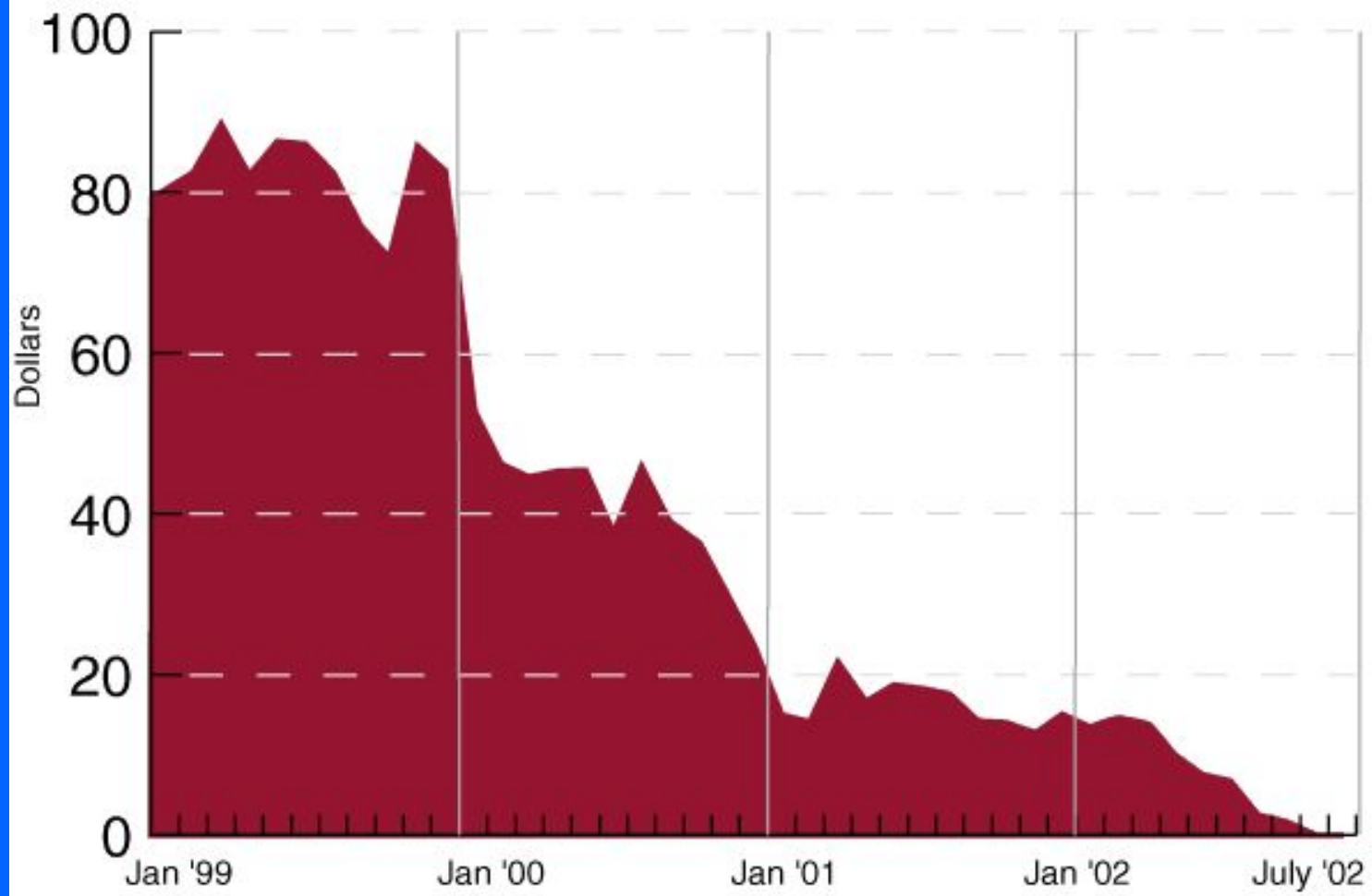
- He then classified operation expenses as long-term capital investments.
- Finally he added a journal entry in the accounting books of 500 million without proper documentation. In other words, he added 500 million to the company's declared revenue.
- Everything was in collusion with Scott Sullivan, the Chief Financial Officer.



# Consequences

- By the end of the Securities and Exchange Commission's investigation there was an estimated 9 billion worth in accounting errors.
- Ebbers and Sullivan were found guilty on charges including securities fraud, conspiracy, and false statements to the SEC.
- WorldCom filed the largest bankruptcy ever with a 41 billion dollar debt load.
- It came out not so long ago and is currently called MCI Communications.

### WorldCom Stock is Slippery Slope



# What we should learn from these scandals

- First, if you commit excessive corporate fraud, it does not matter who you are, in the long run you will get caught.
- Cooking the books as it is sometimes referred is illegal.
- As investors, the Sarbanes-Oxley law protects us from these scandals.

## **Most Important Lesson**

- Always diversify. Greed Kills. People that invested all their life savings in Enron lost everything and the truth is they deserve it for being greedy and not diversifying.
- Diversification protects us from these corporate scandals.