

***Business & Professional Ethics
for Directors, Executives &
Accountants, 6e***

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Chapter 2 – Ethics & Governance Scandals

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Chapter Questions

1. Do you think that the events recorded in this chapter are isolated instances of business malfeasance, or are they systemic through the business world?

The events chronicled in this chapter range over an eighty-year period from 1929 to 2010.

During that time there were horrendous business failures, frauds and debacles that cost investors, consumers, taxpayers, and the general public billions and billions of dollars, not only in the United States, but around the world. The scandals were worldwide, involving hundreds of companies, only some of whom are mentioned in this chapter. At the same time, however, throughout the world, there were millions and millions of businesses that were supplying the goods and services needed by society, in an efficient and effective manner. They were operating within the law and ethical standards.

The examples provided in this chapter, and throughout the textbook are aberrations. Most people and business, most of the time, act and behave in a responsible manner. They obey the law, ethical norms, and social standards of behavior. However, if executives, directors and accountants are not mindful of the ethical dangers that lurk in the business world, then they too can become part of this aberration that is so costly to society. These business exceptions challenge the integrity and humanity of everyone who has anything to do with business.

2. The events recorded in this chapter have given rise to legislative reforms concerning how business executives, directors, and accountants are to behave. Is this a case of too little legislation being engaged too late to prevent additional business fiascos?

No amount of legislation can ever prevent crimes from occurring. One key to preventing additional business fiascos from occurring is to create a business environment in which the focus of business is clear. The purpose of business is not to make a profit at any cost. Moreover, profit is the consequence of providing goods and services required by society, in an efficient and effective manner, while operating within the law and ethical standards. The more efficient and effective the operations, the more profits the business will generate. For far-sighted corporations, profits are not the goal, they are the consequence.

Many of the fiascos discussed in this chapter relate to greedy business leaders who, perhaps through hubris, lost sight of the goal of business. By focusing on profits they began to compromise their ethical standards, and so began a downward spiral that resulted in fraud and bankruptcy.

3. Is there anything else that can be done to curtail this sort of egregious business behavior other than legislation?

Archie Carroll ("The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders," *Business Horizons*, July-August, 1991) has argued that

businesses must first and always obey the law. Then they must be economically viable. They do this by operating in an efficient and effective manner. Next, they must behave with the highest ethical standards. Finally, businesses must give back to society. If businesses follow these four steps, as well as the lessons contained in this textbook, there will be less need for legislation to govern business behavior.

4. Many cases of financial malfeasance involve misrepresentation to mislead boards of directors and/or investors. Identify the instances of misrepresentation in the Enron, Arthur Andersen, and WorldCom cases discussed in this chapter. Who was to benefit, and who was being misled?

Enron

<u>Misrepresentation</u>	<u>Result</u>	<u>Who Benefited</u>
Premature recognition of revenue using 'prepaids'	Overstatement of revenue	These frauds resulted in net income and stock to increase, which benefited senior management that had lucrative stock options
Syndication of special purpose entities (SPEs)	Understatement of expenses	
Conflicts of interest by <ul style="list-style-type: none"> · Senior management · Board of directors 	Financial rewards to the related parties	Financial rewards to: <ul style="list-style-type: none"> · Jeffery Skilling · the board members
False financial statements audited by Arthur Andersen	Fraudulent financial reporting	Senior management at Enron and partners at Arthur Andersen

Investors, regulators, employees and the general public were all misled and harmed by this fraud.

Arthur Andersen

<u>Misrepresentation</u>	<u>Result</u>	<u>Who Benefited</u>
Culture focused on revenue production primarily through non-audit services	Compromise on audit quality	In the short-run, all the partners who shared in the profits derived from providing lucrative non-audit services to Enron
Removal of Carl Bass, quality control partner, from providing oversight on the Enron audit	Permitted David Duncan to accept the accounting policies of Enron	

The partners and employees of Arthur Andersen lost their jobs when the accounting partnership collapsed; all of Arthur Andersen's clients had to find new accountants.

WorldCom

<u>Misrepresentation</u>	<u>Result</u>	<u>Who Benefited</u>
Capitalized expenses	Overstatement of net income	Ebbers, Sullivan, and all the other WorldCom executives and board members that held lucrative stock options
No oversight of the CEO	Ebbers could orchestrate the fraud	

Investors, regulators, employees and the general public were all misled and harmed by this fraud.

5. Use the Jennings "Seven Signs" framework to analyze the Enron and WorldCom cases in this chapter.

<u>Jennings 'Sign'</u>	<u>Enron</u>	<u>WorldCom</u>
Pressure to meet goals, especially financial ones	Senior executives had lucrative stock options	Pressure after the collapse of Sprint takeover. Ebbers ordered Sullivan to 'hit the numbers'
Closed organizational culture	Conflicts of interests became acceptable business behaviors	This is detailed in Chapter 9 of the textbook
CEO with sycophants	Board ignored complaints from whistle-blower	No one challenged Ebbers' authority
Weak board of directors	Powers Report and Senate Subcommittee Report blamed the board for a failure to provide oversight	This is detailed in Chapter 9 of the textbook
Nepotism and favoritism	None	None
Hubris	This is detailed in Chapter 9 of the textbook	Ebbers had unlimited power with no oversight

Ethical trade-offs	None	None
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6. Rank the three worst villains in the film *Wall Street: Money Never Sleeps* (2010). Explain your ranking.
- Alan Loeb and Stephen Schiff, who wrote the screenplay, for simplifying a complex issue and attempting to make money by being the first to present a fictionalized account of the financial bailout associated with the subprime mortgage crisis.
 - Michael Douglas, the main actor, for reprising a role so that he could say, once again, 'Greed is good'
 - The customers, who did not listen to the critics who panned the movie
7. In each case discussed at some length in this chapter – Enron, Arthur Andersen, WorldCom, and Bernie Madoff – the problems were known to whistle-blowers. Should those whistle-blowers each have made more effort to be heard? How?

Whistleblowers in these cases did not use all of the following steps:

- Begin by talking to an immediate superior or relevant company official. At Enron and WorldCom this would probably have been someone in the accounting or internal audit departments; at Arthur Andersen, it would have been the partner in charge; and with Madoff it probably would have been someone in the accounting department.
- Notify the audit committee of the board of directors.
- Communicate with the external auditors.
- Present a formal complaint to the Securities and Exchange Commission.
- Failing all of the above, the whistle-blower could go public as a last resource (after seeking appropriate legal counsel).

In the Madoff case, the whistleblower was outside the company, and tried very hard to be heard, but his warnings fell on deaf regulatory ears. He could have gone public earlier, and perhaps a knowledgeable journalist could have caused some action with a public article. Alternatively, a letter to Elliott Spitzer might have done the trick.

Case Solutions

1. *Enron's Questionable Transactions*

What this case has to offer

The Enron Debacle is the icon for massive fraud allowed by failure of the company's governance system and the conflicted interests of its executives, auditors and lawyers. It precipitated the loss of credibility and trust in financial markets and corporate governance and accountability that ultimately led to reform of corporate governance and accountability, and of the accounting profession, through the Sarbanes-Oxley Act of 2002. It is a case that all businesspeople and professional accountants should be familiar with and understand.

Teaching suggestions

I use the PowerPoint slides on my website for instructors. First, I set up the topic of governance; second, I use "Enron Affair" to review the important elements of the case; and finally I use "Enron Debrief" to debrief, and review the rest of the material in Chapter 2 and models used in the course.

If you refer to the "Enron Affair" PowerPoint, you will see the order I have found to be very engaging and successful. I ask the audience to assume the role of a member of the Board of Directors, and then I challenge them throughout the case discussion with the following questions:

- What is your role as a Board member?
- What questions should you ask?
- Why didn't the Enron Board ask those questions?

Depending on the audience (non-accounting or accounting), I review less or more of the details of the fraudulent transactions. My PowerPoint provides a basic set. The key is to reveal enough that all audiences understand:

- Basic governance structure and roles of the Board, executives, professional accountants and lawyers, as well company policy (particularly on conflicts of interest) and compliance systems.
- What a Special Purpose Entity (SPE) is, the operation of the 3% rule for accounting for transactions, and how income, assets and liabilities could be manipulated using it.
- How and by whom the basic frauds were committed.
- The motivation for the frauds.
- Where the money went.
- What the impact of manipulation was on Enron's financial reports, and the investing public.
- How the governance system was short-circuited – **see overheads**.
- The role of an ethical or unethical corporate culture in preventing or abetting fraud.
- Why whistle-blowing is important.
- What Arthur Andersen contributed.
- What the banks contributed by facilitating the SPE transactions?

- How the Sarbanes-Oxley (SOX) Act arose.
- What changes SOX originated.
- How ethics risk management can help.

Discussion of Ethical Issues

The following questions are presented in the text for discussion of the significant issues raised in the Enron case:

1. Which segment of its operations got Enron into difficulties?

Wholesale services was the segment where most of the manipulation went on. See Enron PowerPoint (PPT) 6 for a breakdown of the relative profitability (IBIT) of Enron's divisions.

2. How were profits made in that segment of operations (i.e. what was the business model)?

See PPTs 5 and 7 for a word version of activities – note how hard it is to understand. Transparency was not in the interest of Enron's perpetrators.

3. Did Enron's directors understand how profits were being made in this segment? Why not?

Apparently they did not. They should have queried how almost 50% (See PPT 16 for the proportion of manipulated income) of Enron's profits could have come from SPEs whose operations had no economic substance, or that asset sales and repurchase transactions between Enron and the SPEs were circular. You can't make money off yourself. Also, there were apparently 1,000-3,000 SPEs created, and a good Director should wonder why so many were needed.

4. Enron's directors realized that Enron's conflict of interests policy would be violated by Fastow's proposed SPE management and operating arrangements because they proposed alternative oversight measures. What was wrong with their alternatives?

The Board's alternative controls were left to Fastow to institute, oversee and presumably report upon to the Board. He was the principal fraudster, and there was no internal audit follow-up (Arthur Andersen had taken the internal audit role as a subcontractor), nor did the Board demand feedback. No whistle-blower concerns reached the independent member of the Board. Like mushrooms, independent Board members were left in the dark.

5. 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?

"Kenny Boy" did not serve as a useful foil or overseer of his own CEO actions, as a good independent Chair of the Board should. The inherent conflict of interests in being CEO and Chair has led to increasing separation of these functions as a measure of good governance, and some jurisdictions are requiring it. For example, Lay's handling of the Sherron Watkins whistle-blowing letter showed either brilliance or evidence of incompetence on conflict of interest matters. He asked the lawyers who advised on creation of the SPEs if what they had done was all right.

6. *What aspects of the Enron governance system failed to work properly, and why?*

See PPTs 2, 11, 12, 17 and 19 to focus the discussion. See also Fig. 2.4. of the text.

7. *Why didn't more whistleblowers come forward, and why didn't some make a significant difference? How could whistleblowers have been encouraged?*

See PPT 19. If you were contemplating coming forward, and you knew that Enron's culture was unethical (see examples) and the bosses knew it, would you come forward – not likely because the risk was too high that you would be fired or not welcomed. There would have to be changes in the culture and systems to encourage whistle-blowers to come forward, such as measures to make the culture ethical (see text discussion, and a protected whistle-blower program. As a result of this apparent flaw, SOX/SEC has subsequently mandated that all SEC registrant companies have a whistle-blower system that reports to the Audit Committee.

8. *What should the internal auditors have done that might have assisted the directors?*

They should have been alert for flaws in Enron's conflict of interest policies, and any lack of compliance. When a policy was/is set aside by the Board, internal audit should have been advised or should have realized this by screening the relevant minutes. Also they should have been looking for any transactions with questionable economic substance. Their reports should go the Board of Directors as well as management.

9. *What conflict of interests situations can you identify in:*

- ☐ *SPE activities*
- ☐ *Arthur Andersen's activities*
- ☐ *Executive activities.*

The Enron Debacle shows conflicts of self-interest (personal gain of executives, employees, auditors, lawyers, bankers and directors) vs. shareholder (as many were misled and lost significantly) and other stakeholder interests (as the company objectives were not met and jobs etc, were lost. Each type of conflict has many examples.

An interesting additional discussion, is how each conflict of interest situation developed, and why the professionals and directors lost sight of their need for independence, and what the professional accountants and banker thought that their mandate really was.

10. *How much time should a director of Enron have been spending on Enron matters each month? How many large company boards should a director serve on?*

This depends on the complexity of the company's operations, the competence and trust placed in its management and governance systems, and the competence and skills of the Board member. On a company of significant size, a Director may have to spend 4-5 days per month to discharge their duties properly. On this basis, allowing for personal business, a person who serves only as a director could only serve on 3-4 Boards.

11. *How would you characterize Enron's corporate culture? How did it contribute to the disaster?*

Enron's corporate culture was unethical (see PPTs 17 and onward). It was fraught with conflicts of interest, unethical and also illegal and acts, poor examples were set by directors and executives, and the directors, professional accountants and lawyers involved were self-interested instead of in the sustainable interest of shareholders and other stakeholders. If the process of allowing the satisfaction individual self-interest of the company's directors, personnel and agents, they ignored their fiduciary duty to the shareholders and other stakeholders. The Board members who were independent of management and not conflicted, were in the dark. Measures to make a corporate ethical culture are discussed in the text and Chapter PPTs. This set introduces ethics risk management and other governance and accountability paradigm changes.

Subsequent Events

May 25, 2006. "Enron Verdict: Ken Lay Guilty on All Counts, Skilling on 19 Counts", by Gina Sunseri and Sylvie Rottman, ABC News, download from

<http://abcnews.go.com/Business/LegalCenter/story?id=2003728&page=1>

"Lay, 64, was convicted on all six counts against him, including conspiracy to commit securities and wire fraud. He faces a maximum of 45 years in prison. Lay also faces 120 years in prison in a separate case.

Lay posted a \$5 million bond secured with family-owned properties at a hearing following the verdict. He was ordered to stay in the Southern District of Texas or Colorado.

"I firmly believe I'm innocent of the charges against me," Lay said following the hearing. "We believe that God in fact is in control and indeed he does work all things for good for those who love the lord."

Skilling, 52, was convicted on 19 counts of conspiracy and fraud. Combined with his conviction on one count of insider trading, he faces a maximum of 185 years in prison. Skilling was acquitted of nine other charges relating to insider trading.

"Obviously, I'm disappointed," Skilling told reporters outside the courthouse. "But that's the way the system works."

"I think we fought a good fight — some things work, some things don't," he said."

"In a separate, nonjury bank fraud trial related to Lay's personal banking, U.S. District Judge Sim Lake found the Enron founder guilty of bank fraud and making false statements to banks. Lake had withheld his verdict in the Lay bank fraud case until the Lay-Skilling jury announced its verdict. Lay faces up to 120 years in prison in that case."

Useful Links, Videos, and Films

C-Span “Q&A with Bethany Mclean, author of *All the Devils are Here* and *Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*” October 25th 2010 <http://www.c-spanvideo.org/program/296214-1>

Gibney, Alex (2006) Film “Enron: The Smartest Guys in the Room” film preview, video footage and Enron timeline available at <http://www.pbs.org/independentlens/enron/index.html#>

Charlie Rose “A Conversation about Enron” including a series of one-on-one discussions and panels with for journalists, the then SEC chairman, political critics and US senators discussing the Enron scandal from its beginnings <http://www.charlierose.com/search/search/520?text=ENRON>

Time Enron Scandal webpage at <http://www.time.com/time/2002/enron/>

2. Arthur Andersen's Troubles

What this case has to offer

Arthur Andersen (AA) will forever be a key part of the Enron SOX chain that accelerated changes in the accountability and governance paradigm for corporations and the accounting profession. In fact, AA's problems were systemic as their root was in the firm's flawed governance system where the desire for profit was allowed to outweigh the firm's fiduciary interests to client shareholders and the public interest. The case presents excellent opportunities to review conflict of interest issues, the need for inclusion of ethics in an organization's strategy, operations and compliance processes, and for illustrating how the expectations of the public can dramatically affect an organization. AA's disappearance dramatically illustrates how risk managers had been in the habit placed too low a value on losing the ability to operate – known as “franchise risk”; post-Enron and AA that valuation has changed upward considerably.

Teaching suggestions

I use the AA PPTs (13-22) in the “Enron Affair” set to discuss the case. The key issues are:

- What happened and who did it?
- The 3% SPE accounting rule and how it led to manipulation.
- How following the 3% rule precisely, and ignoring the overall principle that there must be external validity (an independent outside buyer/seller) to allow the recording of profit, led to manipulation.
- What the flaw was in AAA's governance system that permitted the Enron, WorldCom, Waste Management and Sunbeam fiascoes?
- Other matters raised in the questions below.

Discussion of ethical issues

The following questions reveal the key points of the case:

1. *What did Arthur Andersen contribute to the Enron disaster?*

AA failed to protect the interest of current and future shareholders, and stakeholders that relied upon the financial reports and integrity of the company. AA failed to form a reliable part of the Enron governance system, thereby leaving the directors and other stakeholders at risk. See the list of AA's apparent mistakes in the case.

2. *What Arthur Andersen decisions were faulty?*

See list of AA's apparent mistakes in the text, as well as the section on AA's internal control flaw.

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.*

It was revenue generation and retention. They served their self-interest rather than the public interest by not acting upon the memos from their quality control personnel, and not challenging the manipulative practices and structures at Enron.

4. *Why should an auditor make decisions in the public interest rather than in the interest of management or current shareholders?*

An auditor is the agent of the shareholders, and is elected annually at the Annual general Meeting of Shareholders by the shareholders. As such, the auditor must make sure that audited annual financial statements comply with GAAP, and GAAP are designed to produce statements that do not favor the interests of current shareholders or executives and mislead future shareholders and other stakeholders such as governments, taxing authorities and the like. GAAP is therefore designed to produce statements that are in the public interest, and the auditor is the agent who should ensure GAAP is properly applied. An auditor who does not protect the public interest can face reputational and legal consequences because the expectations of the public have not been met.

5. *Why didn't the Arthur Andersen partners responsible for quality control stop the flawed decisions of the audit partners?*

They tried via memos, but the firm's governance structure had earlier determined that the audit partner in charge could over-ride them. Clearly, AA's governing body made the wrong decision.

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?*

I don't think so, because it seems unfair to the many innocent partners, staff and audit client stakeholders that lost value because of the resulting discontinuity. I further do not believe that society was well-served by the loss of one of the Big 5, thus concentrating the choices for independent audit work in the future. On the other hand, the disappearance of AA sent a significant signal to the rest of the audit world. I would have preferred larger fine and imprisonment for AA's decision makers who determined and carried out the policy of audit partner primacy, plus a very large fine and sanctions (no new SEC clients for 3 months) for the continuing firm. I would also consider carefully whether non-partner audit personnel had a responsibility for whistle-blowing, and would signal how this should be done in the future.

7. *Under what circumstances should audit firms shred or destroy audit working papers?*

Given the developments in the AA Case, audit working papers should not be destroyed before they could be of assistance and/or relevant in any legal, tax or other dispute. This means that the auditor should retain paper or digital versions for a very long time. In some jurisdiction, the statute of limitations might come into play at the end of seven or ten years, but may not where fraud is concerned. An audit firm may chose not to follow the statutory limits because they might wish to be able to respond to protect themselves for a longer period. Public expectations that affect reputations are not bound by

legal limits.

8. Answer the “Lingering Questions” in the case (p. 111 in the text).

See the answer to Question 6 above. I do not think that the Big 4 firms could be shrunk to the Big 3 in the future because it would not be seen to be in the public interest. I think that other AA partners will be brought to trial, but not many. Perhaps only the head of the firm, the lawyer involved and the partners-in-charge of the firm and the region or function will be brought before the courts. Finally, I am sure that a similar tragedy will occur again – probably after the pain of ignoring the public interest abates again as it has from earlier scandals in earlier decades. Our memory fades as generations retire, and unless the education system plays a stronger role with students in the future, ethics lessons will be forgotten again.

Subsequent events

July 15, 2003.

“Andersen Worldwide settles Enron Suits”, Jef Feeley, *Financial Post*, July 15, 2003, FP9.

“The network of foreign accounting firms once linked to Arthur Andersen LLP will pay US\$40-million to resolve lawsuits stemming from Enron Corp.’s collapse...

Andersen Worldwide Société Cooperative is seeking to erase liability in suits filed by Enron investors and workers over the accounting firm’s role in helping Enron hide more than US\$1-billion in losses... The accord doesn’t cover Arthur Andersen LLP, Enron’s auditor for more than a decade... Andersen Worldwide also agreed to pay US\$20-million to Enron’s bankruptcy creditors.

The settlement is a small fraction of the US\$29-billion that shareholders and former workers say they lost in Enron’s meltdown.”

May 31, 2005.

In the case of *Arthur Andersen, LLP v. United States*, [544 U.S. 696](#) (2005), the Supreme Court of the United States unanimously reversed AA’s conviction due to serious flaws in the jury instructions.

As of 2008, there were over 100 civil lawsuits pending against AA.

Useful Links, Videos, and Films

C-Span – Washington Journal “Arthur Andersen and Enron” Jan. 21, 2002. <http://www.c-spanvideo.org/program/168280-2>

- Participating by remote connection from Chicago, Mr. Greising discusses the Arthur Andersen accounting corporation and the Enron bankruptcy.

C-Span – Department of Justice Briefing Room “Arthur Andersen Indictments” Mar. 14, 2002
<http://www.c-spanvideo.org/program/169155-1>

- The deputy attorney general announces that a federal grand jury has indicted the accounting firm Arthur Andersen with obstruction of justice.

C-Span – Washington Journal “Accounting Regulation” Mar. 28, 2002 <http://www.c-spanvideo.org/program/169358-5>

- Mr. Castellano discussed proposals to regulate the accounting industry as a result of the Enron bankruptcy and the failures at Arthur Andersen.

Oppel, Richard and Kurt Eichenwald (2002) “Enron’s Collapse: The Overview; Arthur Andersen Fires an Executive for Enron Orders” The New York Times Jan. 16
<http://select.nytimes.com/gst/abstract.html?res=F50A1EF9385C0C758DDDA80894DA404482>

Ackman, Dan (2002) “The Scapegoating of Arthur Andersen” Forbes.com Jan. 18
<http://www.forbes.com/2002/01/18/0118topnews.html>

3. WorldCom: The Final Catalyst

What this case has to offer

When WorldCom announced massive overstatements of profit in June 2002, it completely shattered the trust in corporate accountability and governance that President Bush and others had been trying to rebuild. Sarbanes and Oxley combined their separate efforts in the U.S. Congress and Senate, and the Sarbanes-Oxley Act emerged in late July 2002, thus triggering a change in corporate accountability and governance, and well as the accounting profession. The WorldCom case involves simple manipulations, but once again offers lessons about the need for an ethical corporate culture, whistle-blower protection, over-dominant CEO, no independent Chair of the Board, and incompetence of Directors. The prosecution and dissolution of AA was so far along by June/July 2002, that their role in not finding the problems earlier was overshadowed by the emergence of SOX.

Teaching suggestions

I review the events after Enron and up to SOX, and I indicate how it galvanized the development of SOX. I then deal with the questions listed below.

Discussion of ethical issues

The following questions were presented for discussion of the significant issues raised in the case:

1. *Describe the mechanisms that WorldCom's management used to transfer profit from other time periods to inflate the current period.*

Details are in the case, but the major mechanisms use included:

- Capitalization of current costs to move them to future periods
- Reduction of current costs by drawing down reserves

2. *Why did Arthur Andersen go along with each of these mechanisms?*

AA may not have known about the manipulations, or at least some of them. Cynthia Cooper, Vice-president for Internal Audit was apparently the first to identify the irregularities. According to the SEC quotations in the case, WorldCom went to some lengths to conceal the manipulations from AA. However, this raises the question of how effective AA's audit work was because the manipulations were significant. Moreover, if AA knew of some of the manipulations, then is it another case of AA wishing not to confront management and preferring to protect future fee revenue.

3. *How should WorldCom's board of directors have prevented the manipulations that management used?*

An ethical corporate culture should have been developed that would have encouraged the personnel who were ordered to manipulate to whistle-blow. If scrutiny and analysis by internal and external auditors were known to have been tighter, then perhaps the manipulation attempts would not have been attempted. Moreover, if WorldCom had not been so dominated by Bernard Ebbers (i.e. if an

independent Chair of the Board and appropriate whistle-blowing mechanisms had been in place) then he might not have tried to manipulate, and/or other might have reported the attempt. Ebbers might not have attempted the manipulation if the Board had not allowed him to borrow \$408 million and spend it in ways that required rising WorldCom stock prices and/or cash.

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?*

Because they thought they could get away with it for a while, and that when profits returned that "adjustments" would be restored. They might have thought that everyone was manipulating and that smoothed earnings were 'good'. They did not see their duty as protecting the shareholders' interests or the public interest.

5. *Why would a board of directors approve giving its Chair and CEO loans of over \$408 million?*

The Board did not recognize the risk that Ebbers would misuse the funds borrowed. To some extent the Board was at fault for allowing a loan arrangement for Ebbers where he could draw down amounts on his own without reporting mechanism to the Board and for subsequent approval as amounts rose beyond reasonable levels, and they did not check on the specific use of the money and the value of that usage as collateral. They trusted Ebbers who had built the company up from its early roots. They did allow him to borrow money for the purpose of buying the largest ranch in Canada, which was also unusual.

6. *How can a Board ensure that whistleblowers will come forward to tell them about questionable activities?*

A protected whistle-blower mechanism is vital, and its use must be encouraged by top management. Even then, there is no guaranty. In the end, an ethical corporate culture is essential to the promotion of whistle blowing and ethical behavior in general. This topic is discussed further in Chapter 3.

Useful Links, Videos, and Films

WorldCom Fraud Info Center <http://www.worldcomfraudinfocenter.com/information.php>

The CNBC news show, "The Big Lie: Inside the Rise and Fraud of WorldCom," January 2007
<http://video.google.com/videoplay?docid=6560803301631269691#>

- This 55 minute CNBC news documentary exposes the extent of the WorldCom fraud. Viewers will gain insight into the actions, decisions, and deception of several key participants, including the then-chairmen of AT&T and Sprint as well as the WorldCom capacity planner who constructed the growth model.

"WorldCom Chief Guilty" CBS Video March 16, 2005
<http://www.cbsnews.com/video/watch/?id=680422n>

Bayot, Jennifer and Roben Farzad (2005) "Ex-World Com Officer Sentenced to 5 Years in Accounting Fraud" The New York Times August 12

<http://www.nytimes.com/2005/08/12/business/12worldcom.html>

4. Bernie Madoff Scandal – The King of the Ponzi Schemes

What this case has to offer

Bernie Madoff's investment scandal is the most recent high-profile corporate fraud in the U.S. As stated in the case, the story of how Mr. Madoff began his scheme, what he actually did, who suspected he was a fraudster and warned the SEC, why the SEC failed to find wrongdoing, who knew, and who did nothing is a fascinating story of ethical misbehavior, greed, innocence, incompetence, and misunderstanding of duty. As in previous scandals (Enron, WorldCom, etc.), managers, auditors, regulators, and other stakeholders failed to stop the fraud that went on for a long time.

This case raises questions about the role of the SEC in regulating and overseeing hedge funds, as well as the effectiveness of currently existing legislation in protecting investors of hedge funds.

Teaching suggestions

I start this case by asking students what a Ponzi scheme is. According to the SEC:

“A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.”

I continue explaining students that this is one of the oldest known forms of securities fraud. Following, I ask students what are the potential red flags to identify a Ponzi scheme and whether or not these flags were evident in Madoff's operation, for example:

- High investment returns with little or no risk (i.e. “guaranteed” returns).
- Overly consistent returns regardless of overall market conditions.
- Unregistered investments.
- Unlicensed sellers or a network of investment companies.
- Secretive and/or complex strategies.
- Poor disclosure or obscure account statements.
- Difficulty receiving payments.

Finally, I close the case highlighting that, as it was the case with other corporate scandals, several parties failed to detect and act on the potential signs of fraud.

Discussion of ethical issues

1. Is Madoff's sentence too long?

The 150 years sentence was the maximum possible penalty for Bernie Madoff's crimes. A week before the sentencing took place, Judge Denny Chin received a letter from Mr. Madoff's lawyer, Ira Lee Sorkin,

asking for a prison term substantially below the 150-year maximum. The lawyer listed several reasons, including Mr. Madoff's confessing to his sons, knowing he would be turned in, his "full acceptance" of responsibility for his crimes, and his efforts to assist in the recovery of lost assets. Furthermore, the lawyer asked a chance for Mr. Madoff to be free before his death.

In response, Judge Chin stated that he understood Mr. Sorkin's plea. "It's a fair argument that you want to give someone some possibility of seeing the light of day," the judge said in an interview, "so that they have some hope, and something to live for." Nevertheless, Judge Chin's reasoned that "In the end, I just thought he didn't deserve it," he said. "The benefits of giving him hope were far outweighed by all of the other considerations."

Judge Chin explained in a series of interviews that 20 or 25 years would have effectively been a life sentence, and that any additional years would have been purely symbolic. Yet symbolism was important, given the enormity of Mr. Madoff's crimes. The judge weighted the fraud's unprecedented scale, its duration over two decades and its thousands of victims. At that point, the judge said, symbolism "carried more weight."

The Judge decided that 150 years would send a loud, decisive message. He felt that Mr. Madoff's "conduct was so egregious," he said, "that I should do everything I possibly could to punish him." Moreover, any sentence of less than 150 years could be seen as showing him mercy. "Frankly, that was not the message I wanted to be sent," the judge said.

Following the Judge's criteria, the sentence was not too long but just tough in accordance to the U.S. laws.

2. Some SEC personnel were derelict in their duty. What should happen to them?

Arguably, the SEC personnel that failed in their duties should be punished; however, it is difficult to determine the extent of the SEC's negligence in investigating this fraud.

SEC Chairman Christopher Cox stated that the agency would follow up on its own failure to investigate this case. The SEC had been tipped as early as 1999 that Madoff was running a Ponzi scheme. The SEC sent examiners to the firm twice, including an enforcement team, but came up with nothing. Moreover, since no subpoena power was requested, the SEC conducted its investigations with documents provided by Madoff, and he kept providing false records.

After an extensive investigation, the Office of Investigation (OIG) of the SEC concluded:

"The OIG did not find that the failure of the SEC to uncover Madoff's Ponzi scheme was related to the misconduct of a particular individual or individuals, and found no inappropriate influence from senior-level officials. We also did not find that any improper professional, social or financial relationship on the part of any former or current SEC employee impacted the examinations or investigations."

Overall, the investigation uncovered that this case was a failure of the SEC's policies, procedures and internal controls but, according to the OIG, it appears not to be the direct result of professional negligence of the investigators. The fact that most investigators were lawyers, fresh out of law school

without a sufficient understanding of the capital markets seems to bear this assessment out. As well, the failure to have a central registry/oversight of complaints by a senior, fully-knowledgeable person points to a systemic failure. Moreover, the failure to check on Madoff's answers to interview questions demonstrates a ridiculous lack of appreciation for sound evidence-gathering and verification. On the other hand, Markopolos' testimony before members of the U.S. Congress seems to indicate that some individuals within the agency choose not to investigate the fraud in depth.

3. Are the reforms undertaken by the SEC (<http://www.sec.gov/spotlight/secpostmadoffreforms.htm>) tough enough, and sufficiently encompassing?

The reforms undertaken by the SEC include:

- Revitalizing the Enforcement Division
- Revamping the handling of complaints and tips
- Encouraging greater cooperation by 'insiders'
- Enhancing safeguards for investors' assets
- Improving risk assessment capabilities
- Conducting risk-based examinations of financial firms
- Improving fraud detection procedures for examiners
- Recruiting staff with specialized experience
- Expanding and targeting training
- Improving internal controls
- Advocating for a whistleblower program
- Seeking more resources
- Integrating broker-dealer and investment adviser examinations
- Enhancing the licensing, education and oversight regime for 'back-office' personnel

These reforms seem to address some of the biggest problems uncovered after Madoff's scandal; nevertheless, only time will tell if these measures are effective in preventing similar frauds.

4. Does it matter that Madoff's auditor, Frierling, was his brother-in-law?

It matters because it is a clear conflict of interest. Auditing Standards and professional accountants Codes of Ethics require auditors to be free of conflicts of interests in order to be objective. In the case of an audit engagement, it is in the public interest that the auditor be independent of the entity subject to the audit. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

Independence issues were central to prior corporate scandals and were addressed in the independence rules included in the *Sarbanes Oxley Act of 2002*; however, these rules would not necessarily apply to the audit of Madoff's funds as these companies were not a public company. Investors should be mindful of the potential problems of a lack of proper audit by a qualified auditor, and they should always make sure their interests are properly protected. In this case, investors failed to inquire.

5. Does it matter that Frierling did no audit work?

Not conducting any audit work was in clear violation of the auditing standards that require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit. Moreover, it is the auditor's responsibility to:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control;
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks; and,
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

As a result of the fraud, the PCAOB has been given the additional responsibility to supervise the audits of registered securities dealers in the U.S.

6. Comment on the efficacy of self-regulation in the form of FINRA, and in respect of the audit profession. What are the possible solutions to this?

Professional self-regulation is the regulation of a profession by its members. A central purpose of professional self-regulation is protection of the public from harm. Professional self-regulation should encourage professional conduct and competence, fairness, transparency, accountability, and public participation. Individual members are personally accountable for their practice through adherence to codes and standards.

A fundamental problem with self-regulation is maintaining independence from the interest of individuals or firms influencing the decisions of professional standard setters and enforcers. FINRA was not strong enough or sufficiently independent from Bernie Madoff to investigate the fraud.

The self-regulation of the accounting profession, and particularly in regard to audit standards, was put to test after the scandals that led to the passage of the *Sarbanes Oxley Act of 2002*. In essence, the US government decided that self-regulation was not enough to protect the public interest and created the Public Company Accounting Oversight Board (PCAOB), this organization is"

"a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection."

7. Answer Markopolos' questions: "How can we go forward without assurance that others will not shirk their civic duty? We can ask ourselves would the result have been different if those others had raised their voices and what does that say about self-regulated markets?"

There is no straight forward answer to these questions. In principle, it is an individual decision to act in accordance to ethical principles. In this case, it seems that there were many people who could have

raised the flag about the fraud, for example Madoff's employees and auditors, the SEC investigators, and a number of investment professionals that did not believe in Madoff's investment strategy. If these individuals had raised their voices earlier, the fraud could have been uncovered sooner. Of course, the regulator (the SEC) would have to be ready and able to investigate thoroughly, diligently and with proper professional scepticism.

8. How could Markopolos and the other whistleblowers have gotten action on their concerns earlier than they did?

Being a whistleblower is not an easy task. In this case, Markopolos contacted the SEC, which is the top authority in charge of investor protection in the U.S. Moreover, Markopolos had strong suggestive evidence to back up his claims. Beyond going to the SEC, he and other whistleblowers could have "gone public", talking to the media about these issues.

Media attention can help to direct the public's attention towards fraud cases; however, it can encounter fierce criticisms, for example, Bethany McLean, a 31-year-old Fortune magazine reporter challenged Enron's accounting practices, asking how the company made its money. Enron's CEO, Jeffrey Skilling, called McLean unethical and hung up on her. The chairman, Kenneth Lay, called Fortune's managing editor to complain. The CFO, Andrew Fastow, flew to New York to tell McLean and her editors that Enron was in great shape.

9. Did Markopolos act ethically at all times?

Arguably, Markopolos was driven not only by the public interest, but also by its personal interest as Madoff's competitor. Markopolos was a former chief investment officer at Rampart Investment Management in Boston. His investigation began in 1999, when a colleague learned of Madoff's investment returns and urged Markopolos to replicate his strategy. Markopolos soon concluded that the numbers did not add up. Markopolos confronted bosses who urged him to match Madoff's results, investors who did not want to hear the truth, and SEC's officials who either did not listen or could not understand his arguments. Moreover, Markopolos initially thought he might be eligible for a sizable reward if the fraud involved insider trading, but that turned out not to be the case. Nevertheless, it seems like Markopolos acted ethically in blowing the whistle about the fraud.

10. What were the most surprising aspects of Markopolos' verbal testimony on YouTube at http://www.youtube.com/watch?v=uw_Tqu0txS0?

Markopolos' statement highlights that:

- The SEC repeatedly ignored Markopolos' detailed warnings.
- The SEC's personnel appear to be incapable of understanding the financial transactions involved.
- The SEC is staffed by people without professional investigative or audit experience.
- The fraud could have been stopped earlier when Madoff's investments reached \$7 billion.
- SEC officials at the Boston office were ignored by their superiors and their colleagues at the New York office.
- The SEC appears to be afraid of investigating high-level cases.

11. Did those who invested with Madoff have a responsibility to ensure that he was a legitimate and registered investment advisor? If not, what did they base their investment decision on?

It seems like the decision to invest in Madoff's fund was a result of affinity, greed and trust in other investment advisors recommending Madoff's fund. Individuals should do some research before investing in public or private firms. Furthermore, if an individual relies on an investment advisor, the advisor should perform a more thorough examination before issuing a recommendation involving, for example, analysis of portfolio composition, portfolio stress testing, risk management, and asset verification.

An article by CBS News on the Madoff scandal, also featured in the Show 60 Minutes, cites Markopolos explaining that "Bernie was Jewish, so he ran it on the Jewish community in the United States. But that wouldn't get him enough customers, 'cause he always needed new money to keep the scheme going."

Madoff extended his reach from New York to Palm Beach, Fla., where he enlisted hundreds of wealthy clients, many of them recruited from his own country clubs. And he also made connections that gave him entree to Europe, and the hedge funds capital of America, Greenwich, Conn.

It was in Greenwich that Bernie Madoff made some of his biggest deals with large investment firms that were willing to feed him billions of dollars of their clients' money to manage. And in return, Bernie Madoff agreed to pay the so-called feeder funds a fortune in annual fees. The largest of the feeder funds was the Fairfield Greenwich Group.

Boies, Schiller & Flexner LLP, one of the most prominent law firms in the US, is representing Fairfield Greenwich investors, who lost nearly \$7 billion when Madoff went under. They are suing the firm for gross negligence, claiming it failed to investigate Madoff thoroughly or monitor his activities as it promised to do in its marketing materials.

12. Should investors who make a lot of money (1% per month while markets are falling) say "Thank you very much", or should they query the unusually large rate of return they are receiving?

The SEC guidance recommends that when individuals consider their next investment opportunity, they should start with these five questions:

- Is the seller licensed?
- Is the investment registered?
- How do the risks compare with the potential rewards?
- Do I understand the investment?
- Where can I turn for help?

Also, the SEC explains in its guidance to be aware of red flags such as:

"High investment returns with little or no risk. Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any "guaranteed" investment opportunity.

“Overly consistent returns. Investments tend to go up and down over time, especially those seeking high returns. Be suspect of an investment that continues to generate regular, positive returns regardless of overall market conditions.”

13. Should investors who made money from “investing” with Madoff be forced to give up their gains to compensate those who lost monies?

US bankruptcy laws authorize a trustee to recover money that was distributed as part of a fraud and share it among the victims. The purpose of these provisions is to balance the losses among the various investors, but how that balance is supposed to be struck is not clear. Under New York State law, which can be invoked for Madoff recoveries, a trustee can seek redemptions going back six years.

In practice, it will be very difficult to force investors to return any money made from their investments with Madoff. Investors may wind up suing each other, as well as the hedge funds and banks that brought them into Mr. Madoff’s funds and the auditors who worked for those hedge funds.

14. Is this simply a case of “buyer beware”?

This is a case involving a massive fraud and negligence of various government agencies in charge of investor protection. It is not just a case of “buyer beware” it should be a clear call for reforms targeted to avoid similar cases.

Several people lost their life savings and some even lost their lives in connection with this fraud. A man that invested his savings with Madoff, mentioned by Judge Denny Chin, died of a heart attack two weeks after the fraud was uncovered. Thierry de la Villehuchet, CEO of Access International Advisors, a money-management operation who placed investors' funds in Madoff’s investments, stabbed himself to death with a box cutter after taking sleeping pills after losing \$1.4 billion in the scheme. Mark Madoff, Bernie Madoff’s eldest son and defendant in a number of lawsuits launched by the trustees of his father’s investors, hanged himself two years after the fraud by a dog leash on a metal ceiling beam in his Manhattan loft apartment.

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