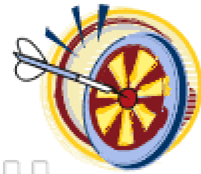
Objectives

after completing this lesson, YOU will be able to



» Gain insight into the **hows and whys of corporate fraud;**

» Discuss *Enron's "business model"* and subsequent collapse; and

» Discuss other *frauds and Sarbanes-Oxley*

For this lesson, please read:

» Rosoff, Pontell and Tillman, *White-collar Crime*:

- **Chapter 7. Corporate Fraud**

» Fortune Magazine piece (handout).

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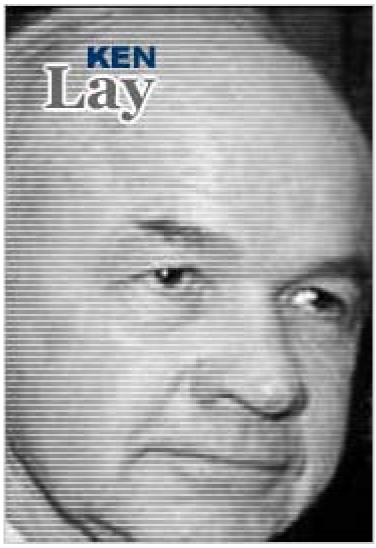
In late 2001, a new wave of corporate and accounting scandals hit Wall Street, beginning with the meltdown of Enron. ***Enron's complicated business model turned out to be nothing but a house of cards, as major losses were hidden through accounting schemes and insider fraud.***



Ken Lay (who had very close ties to the **Bush Administration**) was publicly touting the company, bolstering its stock price, and selling his own shares as the company continued to lose money and get closer to bankruptcy.

The first major officer of the company, Andrew ("Fast Andy") Fastow, cut a deal with prosecutors and will be serving prison time. Former CEO **Jeffrey Skilling,** who testified before Congress that he didn't really know what was going on within the company, has been indicted. He faces more than 300 years in prison if convicted on all counts brought against him.

The Enron debacle has resulted in the loss of thousands of jobs and retirement savings of its employees. Because Enron was one of the world's largest companies, its crash caused major shockwaves and the acknowledgment that similar accounting abuses and frauds were occurring in other major companies at that time.

» The effects of these disclosures battered the world's economies, and investor confidence fell to the lowest levels since the Great Depression.

The story of Enron, retold and explained in the reading, is somewhat complicated. We can make three major points about the case.

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First, it is hard to imagine a company as large as Enron, and with so much legal and political clout (it virtually designed the laws and regulations in its own business environment) not being able to turn a legal profit — unless it was incredibly mismanaged or was simply engaging in fraud.

"

That is, what other business has ever created its own environment and not been able to succeed?

A second issue involves **Wall Street** and the financial media.

» *During the company's heyday, it was touted by analysts and the media as a "**model company.**" Given its complicated and seemingly successful business model (largely built on phony accounting), the financial press and others were completely taken in, failed to adequately examine exactly what the company was actually doing, and ended up essentially reprinting Enron's press releases.*

This leads to our third and final point: ***Exactly how was Enron making money, other than by hyping the value of its own stock?*** This question has not been adequately addressed outside the white-collar crime literature, and certainly not by economists and business types.

The answer seems to be that it wasn't making any real profits.

In fact, ***Enron was hiding its losses in a scheme that involved "limited partnerships."*** In this sense it resembled a giant Ponzi scheme run by controlling insiders with the help of a major accounting firm, Arthur Andersen.

As the *New York Times* later put it: "Enron was not much of a company, but it was one hell of a stock."

Forum *discussion*

"to post your reply, select OUTLINE from the TOOLS menu and enter the FORUMS area"

What are your thoughts regarding the **Enron** case (based on the reading)? *How does this case relate to some of the major points we have discussed regarding white-collar crime?*

» Write two paragraphs on these topics.

Enron's record as the world's largest corporate bankruptcy was soon eclipsed by the fall of Worldcom, which had cooked its books by classifying ordinary expenses as capital expenditures.

While Worldcom was experiencing huge losses, ***it made it appear as a $1.4 billion profit. Worldcom executives earned $104 million in salaries and bonuses based on theses phony earnings***. As in the Enron case, the CEO pointed the finger at the CFO, and claimed that he didn't know this was going on.

If nothing else, the fall of Worldcom demonstrated that Enron was no anomaly.

A number of other major corporations collapsed in scandal in the early years of this century. The roster includes:

- Global Crossing, a voice and data carrier, and the fourth largest bankruptcy in history;
- Qwest Communications, the fourth largest long-distance carrier;
- Xerox, the photocopy giant;
- Adelphia Communications, of Rigas family "fame" and the sixth largest cable company in the United States;
- Tyco, whose former CEO Dennis Koslowski reportedly spent $135 million of his company's money to finance his ultra-lavish lifestyle;
- Rite Aid, one of the largest pharmaceutical chains; and
- Halliburton, whose accounting abuses occurred mostly during the watch of former CEO Dick Cheney, the current vice president of the United States.

Sarbanes-Oxley and the Future of Corporate Fraud

In response to the unprecedented scale of fraud in America's corporations during this time period, **Congress passed the Sarbanes-Oxley Act of 2002.**

» This law represents the toughest piece of corporate governance legislation ever enacted, and imposes new duties on public corporations and executives, directors, auditors, attorneys, and securities analysts. Among the major provisions of the Act is the requirement that CEOs assume responsibility for the validity of their company's financial statements.

Given this start to the new millennium, it appears that corporate morality still has a long way to go in the United States. **A healthy economy was pushed to the brink of a major crash**. Executives looted their companies and became astonishingly wealthy, while employees lost their jobs and retirement savings and shareholders lost their investments.

> » ***Investor confidence fell to lows not seen since the Great Depression. "Infectious greed," as Alan Greenspan termed it, had threatened our very way of life.***

If nothing else, this unfortunate chapter in American history proves that white-collar crime cannot simply be dismissed as the "other" crime problem. As a US Attorney investigating allegations of corporate crime put it, **"Corporate fraud has emerged as one of our top priorities, second only to fighting terrorism."**

Summary

a brief overview of what you learned

» In late 2001, a new wave of corporate and accounting scandals hit Wall Street, beginning with the meltdown of Enron. **Enron's complicated business model turned out to be nothing but a house of cards, as major losses were hidden through accounting schemes and insider fraud.**

» Enron's record as the world's largest corporate bankruptcy was soon eclipsed by the fall of Worldcom, **followed by the collapse of a number of other major corporations .**

» In response to the unprecedented scale of fraud in America's corporations during this time period, **Congress passed the Sarbanes-Oxley Act of 2002,** which imposes new duties on public corporations and executives, directors, auditors, attorneys, and securities analysts. **Among the major provisions of the Act is the requirement that CEOs assume responsibility for the validity of their company's financial statements.**

» **Corporate greed pushed a healthy economy to the brink of a major crash.** This unfortunate chapter in American history proves that white-collar crime cannot simply be dismissed as the "other" crime problem.