

# Major Corporate Governance Failures

## 1. Enron corporation(USA)

Enron Corporation was an American energy company based in Houston, Texas. It was founded in 1985 following the merger of two small regional energy companies, Houston Natural Gas and Inter North. Over the years, Enron expanded its business plan to increase profitability. Now acting more like a hedge fund, Enron dealt in commodities and services including natural gas, electricity, paper, freight, water, and communication technology. Enron was praised for its innovative business model; the company was named "America's Most Innovative Company" by Fortune magazine every year between 1996 and 2001.

Enron's stock price reached a high of US\$90.75 per share in mid-2000. After it was revealed that the company had been engaging in accounting fraud - had, in fact, been hiding billions of dollars in debt via various accounting loopholes - the company's shareholders filed a \$40 billion lawsuit. Enron's stock price plunged to less than \$1 per share by the end of November 2001. On December 2, 2001, Enron filed for bankruptcy. At the time, Enron's meteoric fall marked the largest corporate bankruptcy in US history. [1]

### The Fall of Enron

Enron engaged in mark to market (MTM) accounting, for which the company received official US Securities and Exchange Commission (SEC) approval in 1992. This accounting method allows companies to value their financial situation based on the "fair value" of the company's assets, which may change as market conditions change. Enron used this accounting method to overinflate the company's estimated profits and mislead investors. To hide its mounting debt, Enron used special purpose vehicles (SPVs: shell companies capitalized entirely by Enron stock) to borrow money on Enron's behalf. By 2001, Enron had used hundreds of SPVs to hide its debt.

By the end of 2001, investor confidence in Enron had started to decline. Jeffrey Skilling took over the role of CEO after Kenneth Lay retired in February. Skilling resigned for "personal reasons" in August. Analysts began to downgrade Enron's stock rating. On October 16, Enron reported the company's first quarterly loss. Shortly

thereafter, the SEC announced it was opening an investigation into Enron and its SPVs. Enron restated the company's earnings (or lack thereof) and revealed that the company had \$628 million in debt and \$591 million in losses. [2] After Dynegy, a company that had previously stated plans to merge with Enron, backed out of the deal, Enron filed for bankruptcy.

## **Conclusion**

In the end, many of Enron's executives were charged for insider trading, securities fraud, and conspiracy. Former CEO Kenneth Lay was convicted of six counts of fraud and conspiracy and four counts of bank fraud, but he died of a heart attack before he could be sentenced. Jeffrey Skilling was convicted of insider trading, fraud, and conspiracy. Skilling was finally released from prison in 2018.

Enron's collapse prompted President George W. Bush to sign into law the Sarbanes-Oxley Act, a law designed to protect investors from corporations' fraudulent accounting activities. At the time, Enron's collapse was the biggest to ever hit the US financial world. It was soon surpassed, however, by WorldCom, in 2002.

## **2. World Com (USA)**

### **Introduction**

WorldCom which was at one time the second-largest telecommunication company in the U.S is perhaps best known for a massive accounting scandal that led to the company filing for bankruptcy protection in 2002. WorldCom executives effectively fudged the company's accounting numbers, inflating the company's assets by around \$12.8 billion dollars. The swift bankruptcy that followed led to massive losses not only for investors but also for retailers and employees. The WorldCom scandal is regarded as one of the worst corporate crimes in history, and several former executives involved in the fraud were held responsible for their involvement.

WorldCom inflated assets by as much as \$11-12.8 billion, leading to 30,000 lost jobs and \$180 billion in losses for investors.

## **Responsible WorldCom personnel**

Former CEO of WorldCom Bernie Ebbers was the main culprit and he did it by capitalizing inflated revenues with fake accounting entries and he is sentenced to 25 years for fraud, conspiracy and filing false documents with regulators.

Former CFO of WorldCom, Scott Sullivan received a five-year jail sentence after pleading guilty and testifying against Ebbers.

David Myers, former director of General Accounting of WorldCom was sentenced to one year in prison after the fraud incident .

Cynthia Cooper formerly served as the Vice President of Internal Audit at WorldCom. She and her team were the first people who uncovered the major fraud at WorldCom.

## **Pressures that lead the managers to commit Fraud**

Due to the low demand at the onset of the economic recession and the aftermath of The dot-com bubble collapse and also as a result of high competition the telecommunication industry began to fall. This also leads the price to fall. So, WorldCom also forced to increase their revenue. They thought that they would not be attracted by the investors anymore. Also, Ebbers, the CEO, forced the managers to improve the revenue condition to remain in their jobs.

## **Fraud Committed by WorldCom**

The fraud committed by WorldCom was characterized mainly by the improper reduction of line costs and false adjustments to report revenue growth. Line cost is the cost that WorldCom had to pay to other telecommunication companies due to using their phone calls. If WorldCom customer made a phone call from New York to London, then the call would first go through the local telephone company's line in New York to WorldCom's long distance and finally to London's local telephone companies. This process was very costly for WorldCom; in fact this was half of the cost that they had incurred in a particular time period. WorldCom had to reduce those costs to make them profitable. Especially after 2000 it became crucial for them to manage those costs in a way that would help them to show shareholders that WorldCom was profitable. WorldCom's competitors such as Sprint and AT&T had

line costs that were 52% of revenues. WorldCom reported line costs of about 42% of revenues, in reality these costs were 50%-52% of revenues. WorldCom had made inappropriate accrual releases both in the domestic and international divisions that amounted to about \$3.3 billion (Beresford, Katzenbach, & Rogers, 2003).

These are some of the ways through which they committed fraud:

### **Releasing Accruals:**

According to Breeden (2003), the end of each month, during the fraud period at WorldCom, was characterized by the estimation of costs that were associated with using the phone lines of other companies. The actual bill for the services was usually not received for several months. This meant that some of the entries they had made to the payables were overestimated or underestimated. As result liability was overestimated, and when the actual bill was received it would have had a surplus in liability.

WorldCom adjusted its accruals in three ways; some accruals were released without even confirming any accruals. Secondly, they didn't release the accruals in proper time; instead they kept them as "rainy days" future fund. Lastly, some of the accruals were released not establishing any accruals.

### **Capitalizing Line Costs:**

- WorldCom committed major fraud in capitalizing leased property as well.
- They paid 4% utilization periodically of fiber optics cable which didn't generate any revenue.
- WorldCom had leased fiber optics line for 2-5 years agreement that could not be canceled. Then they showed it as a capital lease in the records with an estimated life of 20-30years. This increased the amount of fixed asset, which wasn't authentic according to GAAP.
- By the time the fraud was discovered, Sullivan had managed to improperly reduce the line costs by approximately \$3.883 billion (Beresford, Katzenbach, & Rogers 2003).

## **Revenue:**

- WorldCom initiated a process called ‘close the gap’ to falsify the information in company records.
- There were meetings after every accounting period between top management who helped to change the records of the company. They would receive a report called ‘MonRev’ report which showed the actual image of the company.
- These records were heavily guarded by the company’s securities.
- Top executives would then make up and correct the gaps between the major journal entries and financial statements. This way they prepared the company’s records for public presentation.
- A total of approximately \$958 million in revenue was improperly recorded by WorldCom during 1999 – 2002 (Beresford, Katzenbach, & Rogers (2003)).

## **Conviction**

Total 6 people were convicted for playing key roles in the fraud. The 63-year-old former CEO of WorldCom Mr. Bernard Ebbers was sentenced for 25 years of prison time for orchestrating the \$11 billion fraud that sank the company in 2002, the biggest corporate fraud and bankruptcy in U.S. history. His chief financial officer Scott D. Sullivan was sentenced of five years, a reduced prison time for cooperating the investigation and acknowledging his own crimes. Another four members of WorldCom including Buford Yates Jr, David Myers were also convicted from 5 months to 3 years of prison

## **Conclusion**

The internal problems at WorldCom were its lack of a competitive strategy, weak internal controls, an aggressive culture that demanded high returns, and the failure to look out for what was best for the stock holder as well as the stake holder of the company. The competitive culture at WorldCom was characterized by loyalty to management with no regards to ethics, honesty, or integrity.

### **3. Tyco International – Corporate Scandal**

#### **Introduction**

Tyco international operated in over 100 different countries and was a large producer of electrical components. They designed and produced underwater telecommunications systems, fire protection, plastics and adhesives, electronic security services, specialty valves and have a big market share of disposable medical products.

In 1992, Dennis Kozlowski was appointed as CEO of Tyco International. During the years 2002 and 2003, two cases were brought towards Kozlowski along with the CFO for Tyco, Mark H. Swartz. The results came out in 2005, Kozlowski and Swartz were convicted of counts of grand larceny, conspiracy, securities fraud, and falsifying business records.

#### **Ethical Scandal**

Kozlowski was the main person that influenced and persuaded other senior Tyco employees to get involved or conceal about his operations in exchange for financial benefits. The CEO and CFO started to commingle the assets and started to use capital from the company for personal expenses. An example of commingling is: when Kozlowski made Tyco to pay \$30 million for his apartment and \$14,7 million for an artistic painting. All of this became easier to manipulate since the company had already programs allowing this kind of misuse of the company's assets.

According to (Romero, 2017), the Tyco scandal wasn't just mere stealing of funds. It was an exploitation of financial loopholes in the firm policies. (Romero, 2017) The fraud was executed through the CEO and CFO who provided themselves with loans containing very low interest sometimes even disguised as bonuses that weren't approved by the board and never paid back.

Some of these "loans" were part of "Key Employee Loan" a program that the company offered. Further they were accused of selling the company's stocks without informing investors, which is a requirement under SEC regulations.

Up to 40 loans were later "forgiven" as part of Tyco's loan-forgiveness program. Something to keep in mind is that many didn't know they were doing something wrong. Money had also been paid out purchasing their silence about Kozlowski's actions in the company through the company programs. This led to further corruption of the top branch of leaders in Tyco making Kozlowski bolder as time passed. (U.S. Securities and Exchange Commission, 2002)

**Accounting scandal**

Tyco took an advantage of the financial term “acquisition” and implemented accounting loopholes to mislead investors. To grab the admiration market watchers with remarkable and incredible financial performance Tyco followed a special path of acquisitions. Throughout that it concentrated solely on showing outstanding results avoiding the weak organic growth it really had. It acquired several companies and insisted on pursuing that scheme for few years playing a wicked gimmick to hide the slow organic growth by taking advantage of the accounting techniques of acquisitions and disposals to inflate the CFFO.

The trick that Tyco played focused on shifting between two sections of the cash flow statement: the operating and the investing cash flows, particularly, the acquisitions accounts. Rather than having an outflow through the operating section Tyco tricked and carried it through the investing one. This affects the CFFO positively by showing strong numbers on quarterly basis.

Tyco was a professional gimmick master in doing so by taking advantage through loopholes. When it acquired another company, of course, this can be done through two ways: either by offering stocks in exchange, which there is no cash outflow, or through paying out cash, which falls as an investing outflow under accounting regulations. When Tyco now owns the company, this makes it benefit from the new inflows of the acquired company, in that case, all the revenues of the acquired are recorded as sales on Tyco financial statements and the same for all the other accounts, falling under one company.

This affected and showed a strong performance of CFFO by adding new sales streams from new companies boosting the operating section. This can indubitably be enormously affective if you do this repeatedly within few years. Between 1999 and 2002 (the scandal period), Tyco spent around \$29 billion on acquiring and including companies under its wing, which obtained over 700 new companies (Shcilit & Perler, 2010). During these years Tyco generated the following CFFO:

Table 12-1

(\$ millions)	2002	2001	2000	1999
Cash flow from operations	5,696	6,926	5,275	3,550

Source: (Shcilit & Perler, 2010)

Tyco used malicious accounting methods to inflate its profits significantly. During the scandal period, Tyco's home security monitoring division, ADT, was booming in the 1990s becoming a well-known desirable brand. To increase a company's profits, it is important to have higher number of contracts with new customers. In a normal case, a firm can implement this through its sales department or it could be through dealerships, which are considered an external network in that example. Tyco, though, used both methods but relied heavily on the last one.

The gimmick that Tyco benefited significantly from was that it used several sales forces from dealers as an outsourcing service; thus, not including them in the expenses ledger as a payroll, but as they are selling security contracts. In return, Tyco purchased each new client contract an amount of \$800. The main problem was in recording these into financial statements, Tyco manipulated accounts by considering these payments amounts as "acquisition to contracts".

Hence, shifting this from an expense to an investing outflows in the cashflow statement. Of course, doing so and playing this card would overstate the cash flow from operations (CFFO). However, it appeared that Tyco enjoyed the game and exaggerated this action by going further into another shenanigan.

Tyco invented a special bogus charge that plugged millions into its firm. It created a fee calling it "dealer connection fee" which represents a \$200 payment paid by the dealer for every contract Tyco buys in. In this case it benefits from a \$200 operating inflow into its cashflow. Well, doing so will defiantly upset the dealers as its going to decline the net profit of a contract to \$600 down from \$800. But then again, Tyco already thought of that and just raised the purchasing payment to the dealers from \$800 to \$1000. In this case, everyone was happy except that Tyco would benefit from it as an operating inflow by the \$200 bogus "dealer connection fee" which generated in total of \$719 million in CFFO during those years. (Shcilit & Perler, 2010)

## **Results**

In 2006, SEC has filed a complaint alleging the Tyco violated the law of federal securities by engaging in several improper practices. The complaint stated that Tyco distorted its financials by overstating the results through misusing acquisition accounting standards by misrepresenting its operating income and boosting it by around \$500 million. Not only that, but Tyco, also, misled investors by hiding considerable party transactions and excessive compensations and bonuses to senior executives. (U.S. Securities and Exchange Commission, 2006)

In addition, the commission has ruled out that Tyco misused the accounting regulations by aiming in spreading fraudulent information to investors using the contract purchases method. It

discovered that a huge duplicitous amount has been pumped to the CFFO and other \$567 million were deceitfully generated to operating income.

Tyco was ordered to pay out around \$50 million into a special fund to compensate affected investors from its fraudulent actions during the period of 1996 – 2002. (SEC v. Tyco International Ltd., 2006)





