

## Collegiate Case Study

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### Case Study Expert: John D. Martin, Ph.D.

Professor of Finance, Baylor University

### USA TODAY Snapshots®

#### Greed is still good

MBA Jungle magazine recently conducted a survey about the business ethics of MBA students. Some of the results:

Would buy stock on inside information received from a friend  
**52%**

Would reveal corporate secrets to a spouse or family member  
**50%**

Would pay someone off to help close a business deal  
**13%**

Would let a gift sway a company purchasing decision  
**26%**

Source: MBA Jungle survey of 445 business students

By Darryl Haralson and Adrienne Lewis, USA TODAY

# Accounting fraud

## Part I: The problems

"Creative accounting" is not a new technique, but it can certainly be a costly one. Businesses feel the pressure to appear profitable in order to attract investors and resources, but deceptive or fraudulent accounting practices often lead to drastic consequences. Are these so-called creative practices always illegal or can they ever be justified? This case study will present examples of companies who have used inappropriate accounting practices, the results of their deceptions and the government's plan to avoid future incidents.

### Cover story

# Capitalizing on oldest trick in book

## How WorldCom, and others, fudged results

By Matt Krantz  
USA TODAY

WorldCom's accounting game is stunning investors who thought the loophole the telecom firm used was sewn shut years ago.

Showing that accounting gimmicks may fade but never really go away, WorldCom acknowledged it improperly "capitalized" costs. This shenanigan was believed to be one that is quickly detected by analysts and, if not, used to fudge books by much smaller amounts.

"This had been a huge problem at one time, but it has receded over the years," says Robert Willens of Lehman

Bros. "How was this overlooked by people who are supposed to be looking at it?" he asks.

WorldCom used the gimmick to a level never before seen. The company showed a \$1.4 billion profit in 2001, rather than a loss, by using what's essentially the oldest trick in the book.

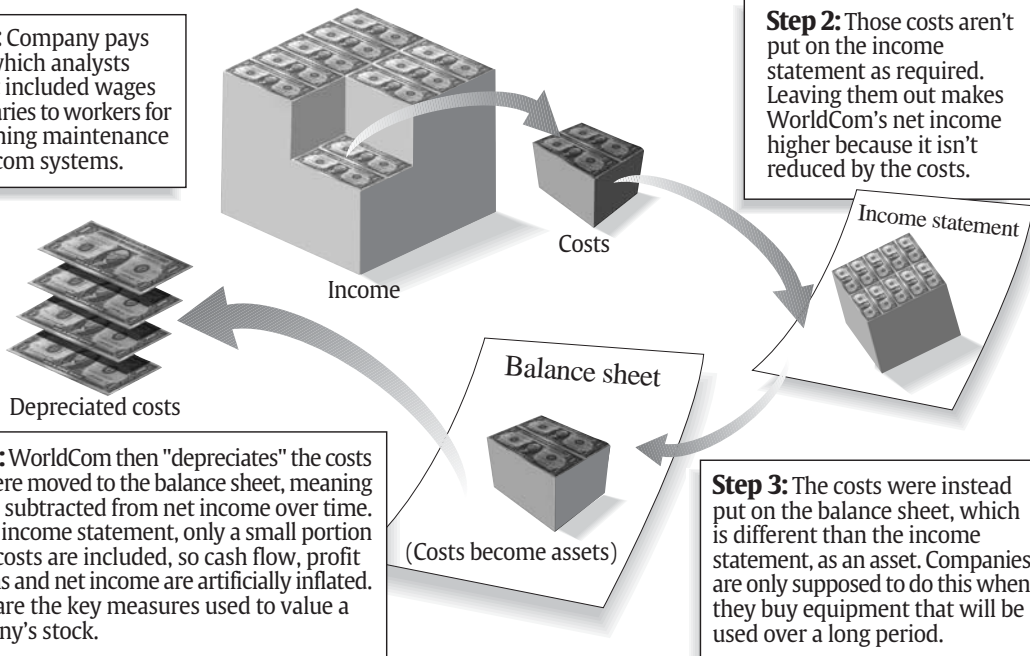
Rather than subtracting certain costs – which analysts think were for maintaining telecom systems – from profit, it called them long-term investments. Doing this allowed WorldCom to inflate earnings because the costs of long-term investments are subtracted from earnings over time, rather than all at once up front.

AS SEEN IN USA TODAY MONEY SECTION, THURSDAY, JUNE 27, 2002

## How WorldCom might have mishandled expenses

WorldCom says it improperly handled \$3.9 billion in expenses, which inflated the bottom line. It improperly "capitalized" costs, meaning it attempted to spread them over many years rather than taking the hit at one time. Here's how analysts suspect it was done:

**Step 1:** Company pays costs, which analysts suspect included wages and salaries to workers for performing maintenance on telecom systems.



**Step 4:** WorldCom then "depreciates" the costs that were moved to the balance sheet, meaning they're subtracted from net income over time. On the income statement, only a small portion of the costs are included, so cash flow, profit margins and net income are artificially inflated. These are the key measures used to value a company's stock.

**Step 2:** Those costs aren't put on the income statement as required. Leaving them out makes WorldCom's net income higher because it isn't reduced by the costs.

**Step 3:** The costs were instead put on the balance sheet, which is different than the income statement, as an asset. Companies are only supposed to do this when they buy equipment that will be used over a long period.

Source: USA TODAY research

By Karl Gelles, USA TODAY

WorldCom wouldn't say which costs were incorrectly recorded.

Things to keep in mind about improper capitalization:

- High-profile companies have pulled it off before. It's an easy way for high-growth companies to delay recording costs, says Howard Schilit, president of the Center for Financial Research & Analysis.

For instance, America Online paid a \$3.5 million fine to the Securities and Exchange Commission in 2000 to settle charges it capitalized the costs of mailing out thousands of trial diskettes in the mid-'90s.

The SEC found that by not charging the expense right away, AOL reported a profit instead of a loss for three years. AOL says it stopped capitalizing the costs in October 1996 because it changed its business model. "This was completely different, as AOL's accounting was always fully disclosed and AOL did not admit any wrongdoing in its settlement agreement," says spokeswoman Ann Brackbill.

- Any company in any industry can use the tactic. Some accounting tricks become favored by certain industries. Internet companies had their barter revenue. Telecom firms

had their swaps. But any company can use this one. In 1992, garbage hauler Chambers Development was forced to restate earnings when the company said it capitalized \$50 million in landfill development costs, Schilit says.

Investors, though, should be extra suspicious of companies that stress financial results measured as earnings before interest, taxes, depreciation and amortization, says Carol Levenson, director of research at Gimme Credit, a credit-rating firm. That's because such companies, usually in the media and cable businesses, have more to gain by using the trick.

- It can be hard to detect by looking only at the financial statements of the company in question. Detecting the trick requires investors to hold companies' financial statements next to rivals' and question capitalized costs that are out of line, says Brett Trueman, professor of accounting at the University of California at Berkeley.

It's unclear how many other companies are abusing the rule. But investors should be cautious, because WorldCom proves the accounting rule has enough "gray areas" for dishonest companies to take advantage of, says Patricia Fairfield, an accounting professor at Georgetown University. y Matt Krantz

AS SEEN IN USA TODAY MONEY SECTION, WEDNESDAY, JANUARY 16, 2002

# Enron law firm called accounting practices 'creative'

## Enron directors waived code of ethics in 1999

By Greg Farrell  
USA TODAY

Even though it was not permitted to question Enron's accounting practices, Enron's own law firm described Enron's accounting methods as "creative and aggressive."

The findings by law firm Vinson & Elkins came just days before Enron's mid-October report that it was reducing its shareholder equity by \$1.2 billion.

According to Vinson & Elkins' findings, now in the hands of the House Committee on Energy and Commerce, many Enron employees, such as Sherron Watkins, were concerned about some of the limited partnerships that Enron established under the control of former CFO Andrew

Fastow. Citing client-attorney privilege, the firm declined to comment on the report, obtained by USA TODAY.

Watkins, a financial executive who worked with Fastow, told Enron CEO Kenneth Lay in August that she feared Enron would "implode in a wave of accounting scandals."

After receiving the letter, Lay commissioned Vinson & Elkins to investigate Watkins' concerns. But Lay told the firm not to "second-guess" decisions by Enron's auditor, accounting firm Arthur Andersen.

Tuesday, Andersen fired David Duncan, the lead Houston-based partner auditing Enron, for destroying documents related to the case that were sought by regulators. But the Vinson & Elkins document says the Houston office had received approval for some of its judgments relating to Enron from company headquarters. Among other document revelations:

- ▶ Enron's directors waived the company's code of ethics in June 1999 to allow Fastow to run an investment partnership that traded with Enron. The board audit committee, which included Wendy Gramm, wife of Sen. Phil Gramm, R-Texas, reviewed all LJM transactions.

- ▶ The existence of the partnerships, and the fact that they were run by Fastow and another Enron employee, Michael Koppers, created "awkwardness."

"Within Enron, there appeared to be an air of secrecy regarding the LJM partnerships and suspicion that Enron employees acting for LJM (got) special or additional compensation."

The report says the situation bred conflicts of interest. Lawyers were told that some employees were concerned that when negotiating transactions with the LJM partnerships, they were mindful that their performances would ultimately be evaluated by Fastow in his capacity as CFO.

Another area of conflict concerned outside investors. "Investors in LJM may have perceived that their investment was required to establish or maintain other business relationships with Enron," the report says.

Separately Tuesday, the New York Stock Exchange delisted Enron for trading below \$1 for the past 30 trading sessions. The stock, which traded for as much as \$83 last year, will now trade as an over-the-counter "pink sheet" stock.

AS SEEN IN USA TODAY MONEY SECTION, TUESDAY, JULY 23, 2002

# Did banks play role in Enron scandal?

## J.P. Morgan Chase, Citigroup execs face questions

By Edward Iwata  
USA TODAY

WASHINGTON -- Congressional investigators are expected to disclose today that Wall Street bank executives knew their deals with Enron were designed to hide billions of dollars in debt from investors.

The Senate Permanent Subcommittee on Investigations, which has been looking at Enron's collapse since December, will grill executives from Citigroup and J.P. Morgan Chase about the roles of their firms in the Enron scandal. Civil lawsuits allege that banks helped Enron defraud investors.

The Wall Street firms and Enron used "accounting tricks" and overseas "sham companies" to misstate Enron debt, keep its credit rating high and polish its financial statements for investors, according to congressional investigators.

"The maze of financial transactions that Enron constructed makes Rube Goldberg look like a slacker," said Sen.

Carl Levin, D-Mich., the subcommittee chairman. "They couldn't have done it without Wall Street."

Enron received \$8.5 billion in financing from Citigroup and J.P. Morgan Chase in 26 deals from 1992 to 2001, according to congressional investigators. Enron engaged in similar, smaller deals totaling \$1 billion with several other investment banks.

Citigroup made at least \$167 million from Enron in fees and other business over the past few years, congressional investigators say. It's unclear how much J.P. Morgan Chase received from Enron-related deals.

Many of the complex deals, called "pre-pays," were recorded by Enron as energy trades and contracts that strengthened Enron's cash flow, congressional investigators allege. But the transactions were really disguised loans that should have been accounted for as debt, they say.

For instance, if Enron had properly recorded the deals in fiscal 2000, its total debt would have been \$14.4

billion — not the \$10.2 billion it posted, according to congressional investigators.

In one e-mail to be released today by the subcommittee, a J.P. Morgan Chase employee wrote: "Enron loves these deals as they are able to hide funded debt from their equity analysts."

Levin, whose subcommittee will hold another hearing next Tuesday on Enron, said that if the deals "had been true, pre-paid energy trades, they would have been legitimate transactions. But they weren't pre-pays. They were loans. The banks knew it, and Enron knew it."

Enron did not return calls for comment.

Citigroup said it relied on assurances that Enron's auditors approved the transactions' accounting. J.P. Morgan Chase said its accounting of transactions with Enron conformed with generally accepted accounting principles.

AS SEEN IN USA TODAY MONEY SECTION, WEDNESDAY, JULY 24, 2002

# Banks face accusations in Enron case

## Senate panel slams J.P. Morgan Chase, Citigroup

By Edward Iwata  
USA TODAY

WASHINGTON -- Lawmakers and Senate investigators charged Tuesday that J.P. Morgan Chase and Citigroup helped Enron engage in financial fraud before the energy-trading firm's collapse last fall.

"The financial institutions were aware that Enron was using questionable accounting," said Robert Roach, chief investigator for the Senate Permanent Subcommittee on Investigations, which is scrutinizing the role of Wall Street firms in the Enron scandal. "They actively aided Enron in return for fees and favorable consideration in other business dealings."

In a jammed hearing room, lawmakers blasted J.P. Morgan Chase and Citigroup, calling their behavior "a charade" and "a cancer" on the financial markets.

During the 10-hour hearing, the committee revealed document after document appearing to show the banks and their overseas law firms set up and ran secretive, offshore "shell" companies that funneled billions of dollars in financing to Enron over the past decade.

The 26 transactions, designed to look like legitimate energy-contract trades, were accounting trickery that served no business purpose, the senators said.

Lynn Turner, former chief accountant for the Securities and Exchange Commission, testified that the banks and Enron clearly set up the complex deals to disguise the debt from investors.

Heavier debt on Enron's balance sheet would have seriously hurt its credit ratings and hastened its meltdown, executives from Standard & Poor's and Moody's Investors Service testified.

Sen. Carl Levin, D-Mich., the subcommittee's chairman, said its findings would be turned over to the SEC and the Justice Department. The SEC reportedly is investigating the transactions.

Outside the hearing, Kristin Lemkau, a J.P. Morgan Chase spokeswoman, said Enron deceived the firm.

"It defies logic to say that we colluded with Enron to defraud ourselves," Lemkau said.

Lemkau also said the bank's use of an offshore company called Mahonia was legal and followed generally accepted accounting principles.

Citigroup spokeswoman Arda Nazerian said "the transactions (with Enron) were entirely appropriate at the time, based on what we were told by Enron."

Lawmakers said the suspect dealmaking would lead to even more public distrust of Wall Street. Stronger accounting disclosures and harsher sanctions against executives are needed, they said, pointing to reform bills moving through congressional committee this week.

The banks' stocks slid for the second straight day because of the committee's investigation. Citigroup fell 15.7%, to \$27, while J.P. Morgan lost 18.1%, to \$20.08.

AS SEEN IN USA TODAY MONEY SECTION, WEDNESDAY, JULY 24, 2002

# Banks defend e-mail about Enron

## Executives call exchanges 'inaccurate'

By Edward Iwata  
USA TODAY

WASHINGTON -- Call it a public bushwhacking. Seemingly with each denial of wrongdoing by Wall Street bankers at a congressional hearing Tuesday on Enron, lawmakers revealed damning documents to hammer home their point.

J.P. Morgan Chase and Citigroup executives deny any questionable or illegal behavior in at least 26 financial transactions with Enron from 1992 through 2001.

But a long trail of e-mails, letters and other documents disclosed by congressional investigators seems to show that the banks worked closely with Enron to help it hide more than \$8 billion of debt.

"It appears Enron was not alone in its shady financial dealings," said Sen. Jim Bunning, R-Ky.

The Senate Permanent Subcommittee on Investigations believes that hundreds of pages of documents indicate the banks knowingly used secretive, overseas "shell" companies, with names such as Mahonia and Yosemite, to engage in the deals with Enron.

The subcommittee's seven-month investigation found e-mails showing that Enron and the banks set up complex financial transactions, known as "pre-pays," that appeared to be energy commodities trades but were really loans.

Lawmakers charge that the transactions should have been clearly recorded by Enron as debt, rather than cash flow from operations, on its balance sheet.

One e-mail, from J.P. Morgan Chase executive George Serice to another bank executive in November 1998, reads: "Enron loves these deals as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred rev (revenue) or (better yet) bury it in their trading liabilities."

Another e-mail, from a J.P. Morgan Chase employee to Serice and dated October 2001, reads: "\$5 (billion) in prepays!!!!!!"

The e-mailed reply from Serice: "Shutup and delete this email."

Sen. Carl Levin, D-Mich., the subcommittee's chairman, said the documents show clearly that "Enron saw (the deals) as a way to get cash without reporting liabilities." He also said, "Chase is clearly aware that one of Enron's motives is to classify the (financing from the banks) as liabilities."

J.P. Morgan Chase bankers who testified Tuesday said they were baffled by the e-mail exchanges. They called the e-mails "inaccurate" or "casual comments" that did not reflect the true nature of the deals between J.P. Morgan Chase and Enron.

"(The executives) were not fully informed as to Enron's interest or the full structure of the Mahonia transactions," said Donald McCree, managing director at J.P. Morgan Securities in New York. "I think it's an unfortunate statement."

Levin fired back, "Does that embarrass you?"

Replied Jeffrey Dellapina, a managing director at J.P. Morgan Chase: "It confuses me as well. I believe it to be inaccurate."

The lawmakers also grilled Citigroup executives about their questionable transactions with Enron.

Levin repeatedly asked Citigroup officials why they needed to design the Enron deals using an offshore entity, Yosemite, and a law firm, Maples and Calder, in the Cayman Islands.

"Why are you forming these in a secrecy jurisdiction?" he asked. "Why not do it in the daylight?"

Citigroup executives replied repeatedly that they believe they complied with accounting rules and that the use of offshore companies for financial deals was a common practice of many U.S. corporations.

"I don't think there's anything nefarious with doing it in the Cayman Islands," said Citigroup managing director Richard Caplan.

AS SEEN IN USA TODAY MONEY SECTION, WEDNESDAY, JUNE 26, 2002

# WorldCom finds accounting fraud

## CFO fired; audit reveals cash flow was overstated by \$3.9B

By Andrew Backover, Thor Valdmanis,  
Matt Krantz and Michelle Kessler  
USA TODAY

WorldCom has engaged in what could be one of the biggest financial frauds in history and will restate earnings for the past five quarters.

The news, released Tuesday, is bound to shake already low investor confidence and increases chances that the No. 2 long-distance company may have to seek bankruptcy-court protection.

WorldCom fired Chief Financial Officer Scott Sullivan. It said it overstated cash flow by \$3.9 billion for 2001 and the first quarter of 2002 by booking ordinary expenses as capital expenditures — which dressed up the books. Otherwise, WorldCom says, it would have posted a loss last year instead of net income of \$1.4 billion, and a loss for the first quarter of 2002 instead of net income of \$130 million. Telecom analyst Tom Lauria estimates WorldCom's loss for 2001 could top \$1.5 billion.

The Securities and Exchange Commission, already reviewing WorldCom's accounting, has launched a high-level probe. Executives found guilty could face civil and criminal penalties, say people familiar with the situation. "Our senior management team is shocked by these discoveries," said CEO John Sidgmore in a statement. He replaced ousted CEO Bernard Ebbers in April.

The news, first reported by CNBC, sent WorldCom shares down 76% to 20 cents in after-hours trading. The fraud could result in an earnings restatement rivaling the biggest yet: Rite Aid's \$1.6 billion net-income restatement in 2000.

Analysts were likewise shocked. "I couldn't believe it. This is mind-boggling if it's true," says Patrick Comack, analyst at

Guzman & Co.

WorldCom has 20 million customers and serves some of the world's largest businesses. It was among the best-performing stocks in the 1990s, peaking at \$64.50 in 1999. It used dozens of acquisitions to grow from a start-up to big-time player. In 1998, it acquired MCI in what was then the biggest merger ever. Sullivan was Ebbers' key dealmaking partner. They could not be reached.

Analysts say a filing for bankruptcy protection is a real possibility. It would be the biggest in U.S. history, dwarfing Enron. Debt-holders are on the hook for some \$30 billion in WorldCom debt.

Now uncertain of how much cash WorldCom is generating, banks are unlikely to provide the \$5 billion credit line it needs to continue, Comack says. Without that, it faces "substantial questions" about whether it has enough cash to get through 2003, says Rick Black, analyst at Blaylock & Partners.

Even if WorldCom goes bankrupt, consumers will be hurt but not left hanging, analysts say. Most likely, WorldCom's assets would be bought by a competitor, possibly a regional Bell company. Businesses, which rely on data networks, could suffer the most. But they likely would have time to switch services if needed, analysts say.

Sidgmore said customers won't be hurt and that WorldCom has no debt due in the next two quarters.

WorldCom also confirmed that Friday it will start cutting 17,000 jobs, or 21% of its workforce. It also said its auditor, KPMG, will conduct a "comprehensive" audit. Arthur Andersen, Enron's former auditor, audited WorldCom in 2001 and reviewed the 2002 statement. It says Sullivan failed to inform it about the cost transfers.

AS SEEN IN USA TODAY MONEY SECTION, TUESDAY, JULY 16, 2002

# Former controller comes up more often

By Andrew Backover and Chris Woodyard  
USA TODAY

Former WorldCom controller David Myers is beginning to emerge from the shadows of the company's accounting scandal.

On Monday, WorldCom sued Myers, who resigned June 25 in connection with his alleged role, for the return of a \$795,000 retention bonus. And lawmakers investigating the misdeeds are bringing his name up more often:

\* E-mail released Monday by the House Energy and Commerce Committee show that Myers knew as far back as July 2000 that WorldCom couldn't account for costs in the way it eventually did.

Other documents show that Myers last month told internal auditors who uncovered the misdeeds that there were no accounting standards to support them. He also said he hoped it wouldn't have to be explained to the Securities and Exchange Commission.

Documents released Sunday show Myers expressed displeasure in 2000 to Steven Brabbs, a London-based WorldCom executive, after Brabbs asked audit firm Arthur Andersen about an accounting move that inexplicably reduced his unit's expenses by \$33.6 million.

\* WorldCom CEO John Sidgmore has said that Myers was an accomplice to fired chief financial officer Scott Sullivan, whom WorldCom fingers as the main culprit. "He knew about it, didn't report it, (and) was involved in the middle of

it," Sidgmore says. "It wasn't his idea. He just did what he was told."

\* Myers has cooperated with WorldCom in the probe of its accounting. "The company is grateful for his cooperation," says his attorney, Larry Barcella of Paul Hastings Janofsky & Walker.

Myers, 44, a well-liked senior vice president, lives in a sprawling lakeside house with his wife and son near WorldCom's headquarters in Jackson, Miss. He could not be reached for comment.

Myers, as controller of the company's chief accountant, has been silent. Barcella says, "It's way premature to make any kind of judgments on how a particular employee's activities are viewed." Barcella adds that selective leaks from politicians trying to get re-elected are "not the guidance one ought to take when trying to decipher complex accounting issues."

Myers missed a congressional hearing on WorldCom July 8 because federal marshals couldn't serve him with a subpoena. Myers wasn't hiding but was on vacation, Barcella says.

Myers came to WorldCom from insurance company Lamar Life. He loves golf and dresses so fashionably that one former employee says he used to call him "Mr. GQ."

Myers had been a WorldCom cheerleader. "He thought the world of WorldCom," says Kimberly Spencer, who worked in accounts payable. Myers quit after WorldCom gave him and Sullivan the option to resign or be fired.



AS SEEN IN USA TODAY MONEY SECTION, TUESDAY, JULY 16, 2002

# WorldCom's bad math may date back to 1999

## Lawmakers dive into e-mails from former CFO and controller

By Jayne O'Donnell and Andrew Backover  
USA TODAY

WorldCom's accounting woes may go back to 1999 and were inspired by desires to keep profit margins up, lawmakers charged Monday.

Also Monday, WorldCom moved closer to a debtor-in-possession funding pact worth \$2 billion to \$3 billion that will give it money to operate under a possible bankruptcy reorganization, people familiar with the situation said. WorldCom is negotiating the deal with lead bank lenders Citigroup, J.P. Morgan Chase and GE Capital.

While WorldCom looks to its future, lawmakers are digging through its past. In e-mails dating to mid-2000, WorldCom's former CFO, Scott Sullivan, and ex-controller David Myers discussed with colleagues the accounting for excess network capacity as long-term investments rather than immediate expenses, say documents released by the House Energy and Commerce Committee.

WorldCom used such accounting methods to hide \$3.9 billion in costs in 2001 and early 2002.

By early 2001, Myers and Sullivan were pressuring others to do something about declining profit margins. In an e-mail dated March 5, 2001, Myers refers to a recent dinner in which Sullivan and executive Tom Bosley discussed the need to "do whatever necessary to get Telco/Margins back in line." Ex-CEO Bernie Ebbers and COO Ron Beaumont were at the dinner.

WorldCom spokesman Brad Burns declined comment on the documents, saying: "We're providing documentation to all investigative bodies as we uncover it."

Rep. Billy Tauzin, R-La., says the committee will continue interviewing whistle-blowers in hopes of learning more. He says the panel may hold a hearing or report its findings to the Justice Department, which is also probing WorldCom.

Excerpts:

\* An e-mail from WorldCom accounting executive Buford Yates in July 2000 confirmed the lack of accounting justifications for how WorldCom eventually treated the costs. That e-mail did not go to Sullivan but did go to Myers. "The bottom line is, people inside this company were trying to tell its leaders you can't do what you want to do, and these leaders were telling them they had to," Tauzin says.

WorldCom's Tony Minert, in a 2000 e-mail, floated the idea of capitalizing excess network capacity to Myers and others.

\* Myers last month told auditors that capitalizing the line costs in the inappropriate matter was first done in the second quarter of 2001. While he said he was uncomfortable with the deeds, he added it was hard to stop them in subsequent quarters.

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Contributing: Thor Valdmanis

AS SEEN IN USA TODAY MONEY SECTION, TUESDAY, JULY 16, 2002

# CFOs join their bosses on the hot seat

## WorldCom shows power has shifted

By Jim Hopkins  
USA TODAY

SAN FRANCISCO -- As more WorldCom documents pour into offices of congressional investigators, one question looms larger each day: What did ousted CEO Bernie Ebbers know about his chief financial officer's alleged financial shenanigans?

Many corporate governance experts now say it's unlikely Ebbers could be clueless about CFO Scott Sullivan's actions, as Ebbers claims.

"It's just not plausible," says Warren Bennis, a management professor at the University of Southern California.

Last week, the first link between Ebbers and Sullivan was disclosed. A lawyer working with WorldCom told investigators that Ebbers knew about the improper accounting of \$3.9 billion in expenses. The lawyer, who was not identified by the House Energy and Commerce Committee, said Sullivan implicated Ebbers during an internal company inquiry.

But much is in dispute. Ebbers' attorney, Reid Weingarten, says his client was in the dark. "Sullivan has not incriminated Mr. Ebbers," Weingarten says.

In fact, Weingarten says, Sullivan told WorldCom's internal investigators just the opposite — that Ebbers knew nothing about the accounting strategy.

But corporate governance experts question Ebbers' contention, because Sullivan was his right-hand man in many acquisitions, as well as in decisions to spend heavily to build telecom networks and plan for the revenue later.

### Joined at the hip

Sullivan, in Securities and Exchange Commission

documents, says it was that decision -- which he says "management" made — that inspired him to move expenses around because the revenue never materialized.

Ebbers rarely spoke with investors without having Sullivan on hand to answer questions. The two appeared joined at the hip, sometimes ending each other's sentences. "It was tough to tell where one started and the other stopped," says Patrick McGurn, vice president at Institutional Shareholder Services, which represents big investors.

If Ebbers was clueless about Sullivan's alleged transactions, he should not have been CEO, Bennis says. "I don't think he's qualified, or is so mindless that it's a case of malfeasance," says Bennis.

But other experts say it's impossible for CEOs to know everything, especially if CFOs aren't being truthful.

"It is absolutely plausible — probably likely — that there are good CEOs out there that could be hoodwinked by their CFOs," says Sarah Teslik, director of the Council of Institutional Investors.

### CFOs at the core

Other CFOs are on the hot seat.

Enron CFO Andrew Fastow devised the accounting schemes that drove Enron's collapse. And Dan Cohrs, the CFO of Global Crossing, which filed the fourth-biggest bankruptcy case ever, has been accused by a former Global executive of financial high jinks.

More than ever, experts say, CFOs have become the CEO's closest partner because of:

- **Changed roles.** CEOs are coming to the office with resumes heavy on sales and marketing experience but light on finance.

That's been especially true in the past two decades, as boards put more emphasis on CEOs drumming up deals, customers and investors, and serving as the corporation's public face, says Jeff Christian of executive search firm Christian & Timbers.

That means CEOs give more finance responsibility to their CFOs, elevating them to superstar status of their own, McGurn says.

► **Complex dealmaking.** As at WorldCom, acquisitions have been more critical to growth – making finance even more complicated. Also, more companies are using head-spinning financial instruments, such as futures contracts.

That means CFOs are an even more critical player in strategy, Bennis says. And they are more likely to report directly to the CEO – instead of to the chief operating officer, as was once more common.

Sullivan was involved in the more than 60 acquisitions that made WorldCom a giant. He became famous for his role in grabbing MCI from suitor British Telecom in 1998. Sullivan reportedly persuaded Ebberts to make an unsolicited bid for MCI after BT reduced its offer.

At Tyco International, both CFO Mark Swartz and ousted CEO Dennis Kozlowski reportedly signed off on each of the scores of deals Tyco made since 1999. Kozlowski has been indicted on charges of sales tax evasion, and the company is investigating whether he used Tyco

## The moves of a CFO:

WorldCom says former CFO Scott Sullivan was fired because he improperly accounted for the costs of leasing network capacity that WorldCom hoped to resell to customers. Instead of accounting for the cost as an expense, which would reduce net income, he accounted for it as an asset that could be deferred and amortized over time. His reasoning: The cost could be considered an asset because it embodied a probable future benefit.

## This would be the same as if you:

1. Lease a house.
2. Plan to rent it out because you believe you can make more money than what you pay for it.
3. Make payments to the owner of the house, which adversely affects your overall financial position.
4. But, you don't get a renter. In fact you find there is little possibility of getting one.
5. You consider your lease payment as an "asset" because it'll help you someday get rental income.
6. You go to a bank to get a loan to buy a car and present the lease payments as "assets."

money for personal expenses.

► **Investor demands.** Wall Street is so unforgiving about missed earnings that a 1-cent drop in quarterly results can send stock prices tumbling. That means "earnings management" is more important than ever. In a recent CFO magazine survey, 17% of CFOs at public corporations said they felt pressure from CEOs to misrepresent financial results.

At Global Crossing, Cohrs wanted to lower financial guidance to analysts last year, says ex-finance vice president Roy Olofson. He did not, Olofson says, because Chairman Gary Winnick had just sold about \$124 million in Global stock – which might look bad if Global gave guidance that sent shares down. Global denies the allegation.

## Behind the Story: A Reporter's Notebook



Andrew Backover  
Telecommunications reporter,  
Money section  
USA TODAY

The failure of energy trader Enron and long-distance phone giant WorldCom taught investors a painful lesson: financial results can easily be doctored. Each company masked its ailing financial condition through creative accounting.

Had shareholders known sooner that WorldCom and Enron were struggling, they could have sold their shares rather than watch them become worthless.

As USA TODAY's telecommunications reporter, WorldCom's meltdown fell squarely on my beat.

WorldCom, for example, used a number of accounting tricks to hide expenses and inflate profits, thus boosting its share price. Its disclosure of improper accounting, which totals \$9 billion so far, led to its filing of the biggest bankruptcy-protection case in history. WorldCom's collapse has cost investors tens of billions of dollars, caused jitters among many of its 20 million long-distance phone customers and inflicted pain across the telecom sector.

The collapse of WorldCom and Enron forced, investors, lawmakers, executives and regulators to look hard at the system that allowed such disasters to occur. This led to new scrutiny of the relationships between corporate officers, auditors, investment bankers and Wall Street analysts. Investors learned that conflicts of interest among these groups often prevented them from getting the information they need to make smart investment choices. What's more, the havoc wreaked by Enron and WorldCom showed the need for tougher laws, penalties and oversight to protect investors in the future.

Andrew Backover has covered the telecommunications industry for USA TODAY since 2000. For the past year, he has covered accounting problems at WorldCom, Global Crossing and Qwest Communications. Andy also covered technology and telecom for The Denver Post, and business news for the Fort Worth Star-Telegram. Andy graduated from the University of Michigan in 1990; he earned a master's degree from Northwestern University's Medill School of Journalism in 1994.

# For discussion

## **CAPITALIZING ONE OF THE OLDEST TRICKS IN THE BOOK (KRANTZ); WORLDCOM FINDS ACCOUNTING FRAUD (BACKOVER, VALDMANIS, KRANTZ AND KESSLER); FORMER CONTROLLER COMES UP MORE OFTEN (BACKOVER AND WODYARD); WORLDCOM'S BAD MATH MAY DATE BACK TO 1999 (O'DONNELL AND BACKOVER); AND CFOS JOIN THEIR BOSSES ON THE HOT SEAT (HOPKINS)**

1. WorldCom reported profits for 2001 of \$1.4 billion that later proved to be grossly overstated. How did this huge swing in profits happen and why was it so controversial?
2. WorldCom used managerial discretion to manage reported earnings to an extreme; however, many companies regularly manage their reported earnings in an effort to smooth out the ups and downs of their year-to-year reported profits. Why do you think managers feel they need to smooth out company profits? Should something be done to stop this practice and if so what?
3. Where does the buck stop in assessing responsibility for corporate financial fraud? Sarah Teslik, director of the Council of Institutional Investors, says that "It is absolutely plausible—probably likely—that there are good CEOs out there that could be hoodwinked by their CFOs." Do you think that the firm's CEO should be held responsible for the actions of his CFO when financial fraud is committed? How deep into the organization does the CEO's responsibility go?
4. The deal-making at WorldCom and Enron was often extremely complex, especially with respect to finance issues. However, CEOs often come to their position through marketing or operations and have only limited knowledge of new and innovative financing methods. How much should a CEO know about the details of the firm's complex financial dealings? How about the board of directors, should they be required to be financially savvy too?

## **ENRON LAW FIRM CALLED ACCOUNTING PRACTICES 'CREATIVE'—ENRON DIRECTORS WAIVED CODE OF ETHICS IN 1999 (FARRELL)**

1. Enron Corp declared bankruptcy in December 2001 after news of its aggressive financial reporting practices revealed that the firm was unable to meet its financial obligations to its creditors. One of the most troubling things that Enron had done was to set up partnerships that were run by its own employees (including CFO Andrew Fastow) to acquire assets from Enron. Although the practice of selling company assets to partnerships and corporations is not unusual (in fact it's done all the time in the mortgage banking industry and it's called "asset securitization"), selling them to an entity that is run by a company employee is highly unusual. What types of concerns does this practice raise for investors and the general public?
2. When firms and individuals prepare their tax returns they often do so using every possible opportunity to reduce their tax liability while following the rules of the Internal Revenue Service. This practice is generally viewed as good business. Why isn't pushing the limits of the accounting rules regarding the reporting of accounting profits "good business", or is it?

## **DID BANKS PLAY A ROLE IN THE ENRON SCANDAL?; BANKS FACE ACCUSATIONS IN ENRON CASE; BANKS DEFEND E-MAIL ABOUT ENRON (IWATA)**

1. Senator Carl Levin, D-Mich., said "The maze of financial transactions that Enron constructed makes Rube Goldberg look like a slacker." Furthermore, he charged that "They couldn't have done it without Wall Street." Specifically, Enron has been accused of engaging in highly complex business transactions designed to confuse and hide the truth about the firm's financial condition. These transactions often involved setting up new business organizations to own assets that Enron essentially controlled and overseas companies that could help Enron avoid paying taxes. If Enron's bankers (J.P. Morgan Chase and Citigroup) were aware of why Enron was engaging in these transactions, is it their responsibility to refuse to do the work and accept payment from Enron if they feel the motives are unethical?
2. Some have argued that even when Enron's questionable transactions did not break accounting rules, they certainly bent them. Isn't it the job of the firm's financial officer to reduce taxes and make the most profit she can for the company? Where did Enron go wrong?
3. Enron managed to disguise or otherwise hide a large portion of its debt in off-balance sheet entities called Special Purpose Entities or SPEs. These SPEs were simply partnerships of corporations set up presumably with outside capital to acquire assets from Enron. If Enron's accountant (Arthur Andersen) said that a particular business transaction is within accounting guidelines, should an investment banker question the legitimacy of the transaction before agreeing to help raise funds for it? Whose responsibility should it be to monitor Enron's use of these off-balance sheet entities: the government who oversees the sale of new securities by public firms through its watchdog agencies including the SEC, investors who buy the securities of the SPEs, Enron's accounting firm who helps Enron design the entities, Enron's attorneys who advise the firm on the legality of the structures, or Enron's investment banker who arranges for financing?

# Future implications

1. Firms that manipulate their expenses and revenues to manage reported earnings often do it in subtle ways that are hard to detect. However, the experts say that some careful "sleuth work" by the financially savvy investor can often ferret it out. How can you detect whether a company is following WorldCom's example and manipulating its expenses to manage corporate profits?
2. Perhaps the most troubling consequence of the financial fraud scandals reported over the last two years is the potential impact these scandals have had on the confidence of the investing public in the US capital markets. Why are the possible consequences of deterioration in public confidence in reported earnings?

## About The Expert



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From 1980 until 1998 John Martin taught at the University of Texas at Austin where he was the Margaret and Eugene McDermott Centennial Professor of Finance. Currently holding the Carr P. Collins Chair in Finance at Baylor University in Waco, Dr. Martin teaches corporate finance and financial modeling. His research interests are in corporate governance, the evaluation of firm performance, and the design of incentive compensation programs.

Dr. Martin publishes widely in both academic and professional journals. Included among his academic publications are papers in the Journal of Financial Economics, Journal of Finance, Journal of Monetary Economics, Journal of Financial and Quantitative Analysis, Financial Management, and Management Science. Professional publications include papers in Directors and Boards, Financial Analysts' Journal, Journal of Portfolio Management, and Bank of America Journal of Applied Corporate Finance.

- ▶ Dr. Martin co-authors several books including the following:
- ▶ Financial Management, 9th edition (Prentice Hall Publishing Company)
- ▶ Foundations of Finance, 4th Edition (Prentice Hall Publishing Company)
- ▶ Financial Analysis (McGraw Hill Publishing Company)
- ▶ The Theory of Finance (Dryden Press)

Dr. Martin consults with a number of firms including Citgo, Hewlett Packard, Shell Chemical, Shell E&P, Texas Instruments and The Associates.

## Additional resources

Working Paper Series – Financial Engineering, Corporate Governance, and the Collapse of Enron

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