In the public eye, Enron’s mission was nothing more than the cover story for a massive fraud.
—Bethany McLean and Peter Elkind

CORPORATE FRAUD, BANKRUPTCIES, AND VARIOUS ILLEGAL ACTS HAVE always been part of the business environment. Every time fiascos erupt there is a shock, but business history records dozens of major failures, frauds, and other measures of massive corruption each decade. The big ones often hit during recessions or periods of other economic problems, as expected. The high-risk firms are the most vulnerable to economic shocks. The recent scandals are no exceptions. The most important scandals are the focus of this paper and are summarized in table 1.

Although the problems that exist are diverse, a few common characteristics stand out. The first is the obvious backdrop of corporate greed. Presumably, senior executives expect to get away with it. They also fit the financial-corporate culture described above. And earnings manipulation is part of (and usually central to) most of the scandals. Some of them used brazen and unsophisticated approaches (such as WorldCom), while others used new, sophisticated devices to defraud (like Enron). Determining the existence of criminal acts takes years.
<table>
<thead>
<tr>
<th>Company</th>
<th>Year</th>
<th>Description</th>
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<tr>
<td>Enron</td>
<td>2001</td>
<td>Declared bankruptcy on December 2, 2001 after restating earnings in the 3rd-quarter 10-Q, indicating major problems with special-purpose entities. Investigations by the SEC, Justice Department, and others; executives indicted and class-action lawsuits filed.</td>
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<tr>
<td>Global Crossing</td>
<td>2002</td>
<td>Overstated revenue and earnings over network capacity swaps and then declared bankruptcy; investigated by SEC and FBI.</td>
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<td>WorldCom</td>
<td>2002</td>
<td>Recorded improper expenses of $3.8 billion and then declared bankruptcy; under investigation for accounting fraud and other violations; the amount of improper expenses uncovered approached $10 billion.</td>
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<td>Qwest</td>
<td>2002</td>
<td>Subject to criminal investigation by Justice Department and accounting practice probe by the SEC, associated with &quot;hollow swaps.&quot;</td>
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<tr>
<td>Adelphia</td>
<td>2002</td>
<td>Cable TV operation charged with overstating earnings; former CEO John Rigas charged with looting the company, which went bankrupt.</td>
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<td>Imclone</td>
<td>2002</td>
<td>Insider trading charges against former CEO for selling stock after FDA rejected a new drug; alleged to have tipped off Martha Stewart and other friends and relatives.</td>
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<tr>
<td>Merrill Lynch, Salomon,</td>
<td>2002</td>
<td>Major investment banks settled with the New York attorney general, SEC, and other regulators on deceptive stock analysis and other brokerage-related practices, similar to Merrill Lynch earlier. The total fine was a combined $2 billion approximately, plus other sanctions and agreement to correct deceptive practices.</td>
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<td>Smith Barney, Credit Suisse, Goldman Sachs, J. P. Morgan, and others</td>
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<tr>
<td>HealthSouth</td>
<td>2003</td>
<td>Accused of accounting fraud involving $1.4 billion in earnings and $800 million in overstated assets. Former CFO and others pleaded guilty to fraud charges.</td>
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<td>The Mutual Funds Scandal</td>
<td>2003</td>
<td>The mutual funds have only limited SEC regulation requirements and often poor corporate governance, yet have been considered highly ethical. That changed when New York Attorney General Eliot Spitzer sued them on several counts. Some pundits consider the mutual fund scandal as egregious as Enron.</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>2004</td>
<td>Fraudulent accounting practices totaling $16 billion and extensive payouts to ousted executives; earnings restated and executives fired.</td>
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<tr>
<td>AIG</td>
<td>2005</td>
<td>Internal control weaknesses and poor corporate governance; CEO fired.</td>
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<tr>
<td>Stock Option</td>
<td>2006</td>
<td>Backdating options grant date to lower stock price; dozens of companies investigated by SEC.</td>
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<tr>
<td>Backdating</td>
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<tr>
<td>Subprime Loans</td>
<td>2007</td>
<td>Massive number of mortgage loans to subprime borrowers, often without documentation. Mortgages then repackaged through SPEs and sold as bonds. Huge losses taken at major financial institutions and many executives fired. An FBI investigation is ongoing.</td>
</tr>
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Two industries were particularly prominent in the scandals: the energy companies and telecommunications. Deregulation allowed the stodgy energy companies that carried out such basic operations as transmitting natural gas to become high-tech energy traders using sophisticated derivatives and structured-finance deals. The result was giant profits for the lenders. Continued big profits meant increasing risks and more complex deals. For Enron and others it also meant hiding the losses in controversial and often fraudulent off-balance-sheet schemes. The telecommunications industry transformed from monopolist AT&T in the 1970s to a group of dynamic and competitive high-tech giants, all trying to integrate and dominate with new telecommunications
methods. Overcapacity led to shady capacity-trading schemes booked as revenues and, despite the deceptive accounting, big losses and bankruptcies.

The various investment bank scandals are included because their deceptive practices encouraged earnings management and an environment of fraud. The recent mortgage-related scandals directly involve investment banks. Investment banking deals, especially those that were complicated and skirted the regulations, were very profitable. The banks would seemingly do any deal and locate it anywhere in the world for the right price. Rather than emphasizing financial and economic reality, analysts and brokers were encouraged to push stocks of companies doing investment-banking business with the parent company, irrespective of the underlying performance potential.

Enron and WorldCom were the largest scandals in American history in terms of the size of the companies (based on market capitalization). Both represent fraud on a large scale, although entirely different from one to the other. Enron used sophisticated fraud based on complex financial instruments, while WorldCom used an unsophisticated scheme of capitalizing operating expenses for several billion dollars. Many of the other corporate scandals around 2002 also involved relatively large companies. The shock of Enron led to congressional hearings and, after the fall of WorldCom some six months later, real financial reform with the passage of the Sarbanes-Oxley Act of 2002.

ENRON
Enron is the premier scandal, a “new economy” energy-trading company that seemed to succeed at everything it attempted. At its height, which occurred on August 23, 2000, Enron had a stock price over $90, which gave it a market value of almost $70 billion. Revenues for 2000 were over $100 billion, making it the seventh-largest American corporation (based on revenues); stated assets were $65.5 billion; earnings were $1.3 billion (if a $287 million write-off is ignored). Stock returns for Enron were large, 89 percent just for the year 2000 and 700 percent for the decade. This performance resulted in huge compensation payments to
Enron chairman Kenneth Lay (a base salary of $1.3 million, $7 million bonus, plus 782,000 stock options for the year; Lay also exercised 2.3 million options, for a gain of $123 million). Manipulation was paying off. The stock would trade for less than $1 later in 2001, the debt would be rated junk and the company declared bankruptcy December 2, 2001. Despite the total collapse, many of the executives would cash out their options and be paid additional millions, while thousands of Enron employees were fired and lost all of their retirement funds invested in Enron.

In terms of scandal, Enron had it all: gigantic executive compensation incentive packages; management dedicated to meeting all quarterly earnings forecasts to maintain the compensation—often by accounting manipulation; a rubber-stamping board of directors; a chief financial officer (CFO) enriching himself through related-party partnerships and hidden side agreements; an accommodating auditor in Arthur Andersen, and an equally accommodating law firm in Vinson and Elkins; investment bankers who would structure virtually any financial deal anywhere in the world for big fees, and whose financial analysts always seemed to rate Enron a strong buy, no matter the economic reality; and a political system that often stacked the deck in favor of Enron, thanks in part to large campaign contributions and massive lobbying. People who raised doubts, both inside and outside the company, were often fired. Otherwise, there seemed to be a complete lack of ethical standards by almost everyone involved. Enron can be considered a microcosm of the entire scandal environment.

There have been more books and articles written about Enron than any other scandal, many written by insiders and journalists following Enron for years. *Power Failure: The Inside Story of the Collapse of Enron* (2003) is coauthored by whistleblower hero Sherron Watkins (with journalist Mimi Swartz), an Enron vice president who attempted to convince CEO Kenneth Lay of the seriousness of the accounting manipulations. Kurt Eichenwald's *Conspiracy of Fools* (2005) is the last of the significant books and probably the best in detailing the Enron story. Other books include *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall*...

THE EARLY YEARS

Enron started as a big, stodgy gas transmission company when InterNorth Inc. and Houston Natural Gas merged in 1985. It had the largest gas transmission system in the United States: a 38,000-mile pipeline network. Kenneth Lay soon became CEO. The name Enron was adopted in 1986. One result for the merger was a load of debt, a continuing problem when Enron executives wanted to expand rapidly—and new junk bonds did not help the leverage ratios or investor confidence. (Enron bounced around between low investment grade and junk bond ratings.)

Enron’s first scandal was in 1987. The dubious response by Lay, Arthur Andersen, and others suggests their interest in profits over ethics and willingness to hide bad news. The company had a small energy-trading subsidiary in New York called Enron Oil. It was started and run by Louis Borget. Although profitable (important for a slumping Enron), it was fraudulent from the start. Part of the manipulation was moving profits from one period to the next, apparently based on orders from Houston.

Enron’s auditor, Arthur Andersen, investigated and discovered several unusual transactions and potentially fraudulent acts. They reported to Enron’s audit committee, but would not comment on the illegality of the acts. If material, Enron would have to disclose the impropriety to the Securities and Exchange Commission (SEC) and restate earnings. Rather than face these sanctions (and possible bankruptcy), Enron declared the problems immaterial and did not disclose the bogus transactions. Andersen went along with the decision. And, amazingly, Borget stayed on. A crooked operation seemed to be okay if profitable.
Unfortunately for Enron, Borget was still a crook. Some of the fraudulent acts benefited Enron, but Borget was interested in diverting cash for himself and accomplices. There were two sets of books, one real and one for the Houston office. There were sham transactions, kickbacks from brokers, phony companies, and various offshore accounts. Borget skimmed some $4 million from Enron. Borget speculated using cash vastly beyond the limit amounts stated by Enron, and later bet wrong on the price of oil. Trading losses approached $1 billion before he confessed. Enron ended up taking an $85 million loss (after taxes) in 1987. Despite the earlier indications of fraudulent activities, Lay denied responsibility and blamed only the rogue traders for the loss.

The SEC and U.S. attorney’s office investigated Enron, but the focus was on Borget and his cronies. Borget was sentenced to a year in jail. The trading operation was shut down. Enron restated earnings in 1988, but survived despite this lack of honesty. However, it seems the lesson that Lay and others drew from the episode was the importance of cover-ups and obfuscation. The basic internal controls and governance policies in place did not work but remained uncorrected.

GAS TRADING

Until the 1980s, natural gas was highly regulated and gas prices controlled. Gas contracts were mainly long term and relatively little risk was present for buyers and sellers. Pipeline profits were fairly low but dependable. That all changed with deregulation. With volatile gas prices subject to market conditions and the potential for lower prices, gas users moved from long-term contracts to the spot market (initially 30-day supply contracts). In this now unstable market, prices initially fell, supply dropped, and prices rose again.

This was not a profitable environment for a pipeline company. Lay’s business strategy shifted to the unregulated gas sales market, which lent to Enron’s gas-trading business. Enron bought and sold standard amounts of gas and became a market maker, initially from the standard spot market contracts. As their expertise increased, Enron traders moved to offering longer-term contracts, for which they could
charge a premium over spot prices. Enron would become the largest
gas trader in North America by the early 1990s.

Suppliers and users often want to hedge certain risks, such as
future rising or falling gas prices. As a market maker, Enron could
provide forward contracts (at stated future prices) to meet this risk.
As long as Enron had roughly an equal number of buyers and sellers,
both Enron and the customers could be fully hedged. The New York
Mercantile Exchange (NYMEX) would standardize these as gas futures
contracts. Enron would move into additional—and more complex—
derivatives, such as options and swaps. In a swap prices are exchanged,
usually fixed for variables (such as interest rates). Enron also started
swapping oil for natural gas (see Giroux, 2004, chap. 11, for a more
thorough discussion of derivatives).

In the new world of deregulated gas, finding and selling natural
gas became risky and banks were reluctant to loan money to produc-
ers, at least the smaller ones called wildcatters. To solve this problem,
Enron formed the Gas Bank in 1989, run by former Kinsey consultant
Jeffrey Skilling. The idea was to provide a more stable market, with
Enron in the profitable middle. The producers contracted to sell their
expected future natural gas to Enron. Enron would give them the cash
up front, the equivalent of a bank loan. The producers would then drill
for new gas and pay off Enron in gas rather than cash. Simultaneously,
Enron would contract to sell the gas to users in the future at a set price.
Since the future prices were now known (to Enron), the company could
“lend” more money to the producers. The result: relative stability.
The price and supply were now guaranteed, as was Enron’s expected
return.

Skilling had another innovative idea: trading these contracts.
His idea was to be an active trader rather than an owner of these
resources—his “asset-light” strategy. Of course, Enron always owned
substantial pipeline and other heavy assets and the massive debt to
fund these expensive assets. But Skilling would continue to promote
the asset-light strategy and seemed to successfully convince analysts
and investors.
When Skilling started at Enron, he demanded that his division use mark-to-market accounting; in other words, long-term gas delivery and other trading contracts would be valued at market or fair value rather than the more typical historical cost (where the income would be spread over the life of the contract and roughly match actual cash flows). Accounting standards have moved (somewhat slowly) from historical cost to market value for financial instruments (but generally not for physical assets). The current rules are based on the Financial Accounting Standards Board's Statement No. 157 (2006). Mark-to-market for gas contracts was a stretch at the time, but was approved by Enron's board of directors and the SEC. Enron would expand the use of mark-to-market and the technique became a generator of huge earnings and a major mechanism for quarterly earnings manipulation. (The later subprime mortgage scandals also relied on mark-to-market accounting for earnings manipulation.)

Mark-to-market is an appropriate technique for financial instruments where a well-developed market exists (such as the stock market) and specific closing prices are obvious. Fair values are recorded on the balance sheet and gains and losses immediately recognized, usually on the income statement. Thus, profits are "front-loaded" (that is, reported immediately). The essential logic is that it the actual trade contract that determines profitability, while actually fulfilling the contract (and generating cash) becomes secondary.

At the end of every accounting period the financial instruments are revalued to the new market value. Consequently, earnings volatility is common. However, Enron was recording relatively long-term contracts using mark-to-market. Reliable market values really did not exist on gas prices one to ten years out. Pricing became an exercise in "mark-to-model," with math models predicting values. Because of this, big gains could be recorded before any gas (or cash) changed hands. Since trader incentives were based on the value of the trades and not on actual gas deliveries, predictions were optimistic. On a quarterly basis, if Enron was desperate for additional income, these contracts could
be recalculated on an even more optimistic basis. When income was greater than expected, large reserves (called cookie jar reserves) could be set up for potential future trading losses (for more on revenue recognition and the use of fair value, see Giroux, 2006, chaps. 8 and 14).

Actual cash flows depend on fulfilling the long-term contracts, with actual profit based primarily on current gas prices. Based on mark-to-market, income was taken from trading and expected long-term return and was independent of actual cash flows. Thus, the gain on a 10-year contract to deliver a set amount of gas each month would be booked immediately (and, at least theoretically, revalued quarterly), but actual cash flows would be spread out over the 10-year delivery period. Since Enron did not have a long-term operating perspective, this was a strategy for disaster.

A basic technique to record cash as a “cash from operations” item (suggesting that earnings are tied closely to cash performance) rather than “cash from financing” (primarily borrowing) was the use of prepayments (prepays). Enron was loaning money to gas producers through the Gas Bank and then using mark-to-market to record the expected earnings; however, no cash was generated (cash would come several years later when the gas was delivered). Enron would “contract” with offshore entities to deliver natural gas in the future and be paid cash (recorded as cash from operations). But these contracting entities were actually set up by Chase Manhattan and other Enron bankers to appear as legitimate sales when in fact they were disguised loans. These prepays could amount to billions of dollars and camouflaged the actual negative cash flows when Enron was reporting large earnings (a signal of manipulation to most analysts). They also did not report the obligation for cash received as a liability on the balance sheet.

It should be pointed out that Enron traders were experts at gas prices and innovative at developing new gas-related derivatives instruments. Commodities trading (Enron expanded to electricity and other commodities trading) became Enron’s most profitable business. However, that profitability was overstated using mark-to-market and included the obvious valuation problems. Various Enron groups also
speculated on commodities prices, usually profitable but not always. Enron was relatively successful at camouflaging the losses associated with volatility and wrong predictions.

**STRUCTURED FINANCING AND SPECIAL PURPOSE ENTITIES**

Enron is particularly infamous for its use of structured financing, especially special purpose entities (SPEs). Structured financing and SPEs have been an increasingly common set of financial arrangements used predominately by banking and other financing organizations and would play a major role in the later subprime mortgage scandals. Banks started moving mortgage and loan receivables into SPEs beginning in the 1980s and would then “securitize” them for resale as bonded debt instruments. The SPE places assets and corresponding liabilities in a separate legal structure (perhaps a partnership). The SPE must have at least one independent equity investor contributing assets of at least 3 percent of the fair value of assets (this was raised to 10 percent after Enron’s collapse). To be independent, the investor must be an outsider and assume the risk of the transaction(s) involved. Independence would become a major flaw in Enron’s schemes.

The rationale of the SPE is to perform specific tasks and isolate financial risks. All the technical details must be met (for example, the independent investor and the equity investment at risk) or the SPE must be consolidated into the financial statements of the parent, Enron. (Accounting procedures for SPEs are complex and are governed primarily by Financial Accounting Standards Board (FASB) Statement 94 and 140 and FASB Interpretation 46R. See Giroux, 2006, chap. 12).

The basic idea of securitization is to convert assets (either financial or physical) to securities based on the future cash flows, sell these to investors, and record cash. The liabilities are transferred to a separate entity, cash is received (that may be recorded as cash from operations—which Enron needed to convince analysts that profits were real), and the whole package priced at market value, usually for a nice gain recorded on the income statement. When an active market exists,
such as the stock market, pricing is straightforward (generally the most recent closing price). When an active market does not exist, pricing is usually based on mathematical models, which can be manipulated.

A big problem with Enron’s potential growth was its massive debt load and junk bond rating (later raised to low investment grade and back to junk status before the final collapse). To continue to grow, the company turned more and more to SPEs. Skilling hired Andrew Fastow as an SPE specialist, who combined various energy-related assets that were then sold to institutional investors. Fastow created Enron’s first SPE in 1991, called Cactus, to fund long-term contracts with oil and gas producers. The Gas Bank required cash payment to producers, to be later paid back in gas. Some $900 million of these contracts were bundled together and sold as packages to General Electric and other investors. Enron received the investor cash equivalent to what was paid to the producers (using borrowed money) and moved the debt to the SPE. Cash was generated and the debt moved off the balance sheet.

The basic purpose of Enron’s use of SPEs and other structured financing techniques was to “keep fresh debt off the books, camouflage existing debt, book earnings, or create operating cash flow” (McLean and Elkind, 2003: 155). Under Fastow, they became bigger, more complex, and more deceptive. Increasingly, the focus became manipulation rather than legitimate financial purposes. As SPEs grew more deceptive, independent investors became harder to locate and the structure then emphasized what was the bare minimum that the auditors, lawyers, and regulators would allow. The investments (plus a sizable return) were often guaranteed by Enron, another violation of the intent of the SPE. Then Fastow and his employees became the so-called independent investors, making a travesty of the concept of independence and economic reality.

In 1993, Enron formed a 50-50 partnership (a joint venture) with California Public Employees’ Retirement System (CalPERS) to invest in natural gas project called JEDI. The use of joint ventures requires the equity method (see Giroux, 2006, chap. 14), which effectively hides debt, since the net amount invested is recorded as a single line-item called
“Investments” on the balance sheet. CalPERS invested $250 million in cash, Enron an equivalent amount in Enron stock. Therefore, the value of JEDI would go up and down with Enron’s stock. JEDI acquired a number of production companies (it also was allowed to loan money, form partnerships, and carry out other investment techniques), which provided added opportunities for Enron and was reasonably profitable.

Enron bought out CalPERS’ JEDI share in 1997 for $383 million, a sizable profit over the original $250 million investment. To keep the debt off-balance-sheet, Enron created an SPE called Chewco (set up as a separate corporation). Enron’s banks would provide the 97 percent debt; it was the 3 percent equity interest that was difficult to find. Fastow wanted to be the “independent investor,” a clear violation rejected by Skilling and law firm Vinson and Elkins. Instead, Fastow’s employee Michael Kopper became the investor (with some funding by additional relatives and friends). This was allowed for some reason; the explanation was that Kopper was not an officer of Enron. This is a related-party-transaction, at best a questionable practice. Most of the so-called 3 percent investment was actually borrowed, another violation of the rules. It was later determined (in the Powers Report, 2002) that Chewco was formed improperly. The stage was set: Enron was moving from aggressive to fraudulent accounting. It is likely that beginning with Chewco, Fastow and his crew were making side deals for self-enrichment and hiding relevant details from the board and auditors.

MEETING QUARTERLY EARNINGS TARGETS
Richard Kinder’s job as chief operating officer (until he left in 1996, and Skilling after that) included making sure Enron met its quarterly earnings forecasts, initially through cost savings, then more gimmicks. The incentives were clear: the compensation packages for Kinder, Skilling, Lay and others were aimed at earnings and stock price performance. Kinder and Lay would receive options for hundred of thousands of shares, but most would not vest for several years—unless the company met its earnings targets (typically 15 percent growth a year). Missing
these earnings targets, even by a few cents a share, would result in greatly reduced executive compensation.

Enron had many volatile operations and missing quarterly budget targets or generating huge losses was not uncommon. Instead of issuing warnings to analyst, the rush was on to “find” additional earnings. When shortfalls were small, deals were closed early to generate revenues in the current quarter or the recording of losses was delayed. For big “loss recovery” periods, two interrelated schemes were used. The first was to revalue physical assets using “fair value” models, based on FASB Statement No. 125 (this standard, now superseded, was designed to be used only for financial assets)—that is, front-load profit streams on major project such as large power plants. The second was to use SPEs in virtually any complex context to record earnings.

In the summer of 1996, Enron traders were speculating on gas prices and lost $90 million instead of expected gains of a $100 million or so. To make up for this loss, the investments in JEDI were revalued using mark-to-market. This was an allowed accounting procedure only if these investments were held for resale, which Enron then claimed. This worked so well that mark-to-market was extended even further, eventually being used on about 35 percent of Enron assets (according to McLean and Elkind, 2003).

In 1998 Enron made a $10 million investment in a small Internet company called Rhythms NetConnections. Rhythms NetConnections went public through an initial public offering (IPO) in 1999 and that day the stock increased to $69 a share. Enron recorded the entire $290 million gain. To lock in that gain, Fastow set up a complex set of SPEs and other relationships through a partnership called LJM. LJM would prove to be fraudulent.

An example of a sham sale was the unloading of power plants floating on barges off the coast of Nigeria. Since Enron could find no real buyers in 1999 (and the company needed more profit and cash flow), a deal was reached with Merrill Lynch as a sale and (informal) buyback. This was really a loan that would allow Enron to book a gain of $12 million and create operating cash flow of $28 million. Thanks to
the barge deal, Enron was able to match analysts' expectations of $1.17 a share. The buyer next year was Fastow's LJM2 (see below), providing Merrill the expected profit of $775,000.

Long-term contracts could be reevaluated to make them appear profitable and then book the newfound earnings in the current quarter. Since mark-to-model was often used, the models could be rerun with more optimistic assumptions. And long-term contracts could be renegotiated or restructured to book more profits.

MANIPULATIONS AND FRAUD
Enron acquired other companies to move into electric utilities, finance, risk management, and, toward the end, a telecommunications company. Why is not easily explained; Enron had not any experience in any of these areas. Based on economic reality, most of these new enterprises were not successful. Enron expanded into Enron Development to build power plants around the world and into Enron Broadband, timing the entrance into telecommunications just before the collapse of that industry. Some projects were marginally profitable, other disasters, but the same SPE manipulations were used to set up complex deals so Enron could hide the losses and book nonexistent profits instead.

Trading profits increased with volatility and opportunities expanded when California deregulated energy. Enron used every trading trick to overcharge California buyers; giant electric utilities California Edison and Pacific Gas and Electric declared bankruptcy in 2001. Enron traders developed specific strategies such as Fat Boy, Death Star, Get Shorty, and Ricochet specifically to disrupt California power and increase electricity prices. These trading practices were improper and some (based on later litigation) proved to be illegal.

Fastow was general partner in LJM beginning in 1999 and later LJM2. These were separate partnerships, each using SPEs. The idea was to have a vehicle to quickly provide accounting benefits (that is, no real economic benefits) in the form of increased profits, hiding losses, moving debt off-balance-sheet, and showing operating cash flows. They also enriched Fastow and his partners. The board of directors was required
to waive its conflict-of-interest requirements. Andersen audit partner David Duncan agreed to go along only if the board approved, which it did. Fastow did not make it clear that he would generate substantial profits for himself or that many of the schemes would skirt the law (at best) and be subject to substantial future risk. At a minimum, these should have been disclosed as related-party-transactions and, in many cases, SPEs consolidated in the Enron financial statements. The degree to which the SPEs were mishandled and Fastow was allowed to manipulate them through the audit committee, auditor Arthur Andersen, and various law firms is quite remarkable.

The first LJM deal was the Rhythms NetConnections hedge to lock in the gain recorded in 1999. LJM set up a subsidiary called LJM Swap Sub, which would sell a put option on Enron's Rhythms NetConnections stock (a put option requires the seller, in this case Enron, to sell the stock at a certain price if the buyer exercises the option). Enron would transfer 3.4 million shares of its own stock to LJM to serve as a hedge. This transaction had no economic substance, but was an accounting artifact to benefit Enron (and Fastow). Astonishingly, nobody objected. This transaction was, in fact, extremely complex and involved bankers at Credit Suisse First Boston and Greenwich NatWest, a British bank. The plan to unwind this transaction was even more complex and three bankers from NatWest became the first people indicted in the Enron scandal for wire fraud. The buyer was a new partnership called Southampton Place, controlled by Michael Kopper. Fastow, Kopper, and the bankers greatly enriched themselves. Naturally, the details were unknown to the board or the auditors.

Flush from the profit from LJM, Fastow set up an even larger partnership with LJM2. Within LJM2 four new SPEs, called Raptor I-IV, were formed. The primary asset was Enron stock. This was an accounting artifact, set up to provide hedges against the decline in value of various stocks and other assets, but the real purpose was manipulation. Fastow was the so-called independent investor and, in effect, negotiated with himself between Enron and LJM2. Over 50 investor groups were found
to invest some $400 million in LJM2. According to McLean and Elkind (2003), the LJM partnerships contributed almost $230 million in earnings and more than $2 billion in cash flow to Enron. For example, LJM2 invested $30 million in a Polish power plant, on which Enron booked a $16 million gain for the December 1999 quarter. Because of problems, no outside buyer could be found, so the investment was bought back for $32 million using other subsidiaries.

An idea used in Raptor I was the total return swap. Raptor was required to pay Enron for any losses on its investments, but kept all the gains. One investment was Avici systems, a maker of networking equipment. When Avici went public, its share price hit over $160 a share on August 3. The “hedge” in Raptor I for Avici was made in September, but was backdated to August 3 to lock in the maximum price. Enron booked a $75 million gain. A major problem with the Raptors was the use of Enron stock as the primary capital. Unfortunately, the price of Enron stock started falling in 2000 and the result was that some of the Raptors were in trouble. Rather than make the necessary charges to earnings in 2000, the Raptors were restructured to cross-collateralize them (meaning that the guarantees were provided by all the Raptors for each other).

There were over 20 deals made through LJM2, all complex, all deceptive, and all designed to provide accounting benefits to Enron and millions of dollars to Fastow and his accomplices. According to Swartz and Watkins (2003: 310), Fastow “earned” $58.9 million from LJM and LJM2.

**POLITICAL PRESSURE**

As an S&P 500 company willing to bully anyone, Enron applied pressure to the auditors, investment bankers and analysts, and politicians at the federal and state levels. In most cases, the main reason for influence was cash—the funds Enron was willing to spend on investment banking deals, consulting contracts to the auditors, political contributions, and so on. In fact, Enron really did not have that much real political clout.
(it needed the banking deals more than any of the banks did; the $52 million Andersen received in audit and consulting fees was a small part of total firm revenues), but was quite successful in persuading these groups to step over the line. The lack of obvious ethical constraints on any one’s part demonstrates a major facilitator for Enron’s fraud.

Hype also was important, especially to the financial analysts to maintain those “strong buy” ratings. Since most of the analysts worked for the investment banks that received millions for Enron deals, this was much easier (see Gasparino, 2005). In fact, most analysts seemed to believe the hype that Enron was a great company primed to make billions and undervalued. Enron actually was good at energy trading and Enron Online was a real Internet innovation. But the overall business strategy made little sense, with Enron spending billions on a multitude of poor investments, always hidden from public view.

Analysts who maintained some independence and had negative comments about Enron did it at their own peril. John Olson, an analyst for Credit Suisse First Boston, covered Enron from the 1980s. He recommended “hold” (not sell, but not strong buy either) and was generally less than enthusiastic about Enron. Lay complained to Credit Suisse executives and Olson left Credit Suisse for Goldman Sachs, then Merrill Lynch—where Olson was fired after Merrill was left out of significant Enron investment banking offerings. Apparently, this was punishment for Olson’s ratings—flawed research according to Enron (Gasparino, 2005: 233).

Enron was a political contributor to both parties from the start. The cash involved kept getting bigger and totaled some $6 million to politicians and political parties. Lay and his wife also contributed almost another $1 million. They were major supporters of Texans Tom Delay (Republican House whip) and Senator Phil Gramm. Lay developed many direct political connections, especially with President George H. W. Bush and Vice President Dick Cheney. Lay also chaired the 1992 Republican Convention in Houston. Of course, he supported George W. Bush for president (earning the nickname “Kenny Boy”). He was named a Pioneer,
the term used for people raising at least $100,000 for Bush. Lay was influential in determining certain political appointments, such as commissioners at the Federal Energy Regulatory Commission (FERC) and Enron executive Thomas White joined the Bush administration as secretary of the Army. Lay also was influential in Cheney’s analysis of energy policy as a member of his task force. Former FERC commissioner Wendy Gramm (wife of then-Senator Phil Gramm) was an Enron board member.

What did Enron get for its money and influence? Enron received billions of dollars in loans and other benefits for a multitude of international projects. Between 1989 and 2001, 20 or so government agencies such as the Export-Import Bank and the World Bank loaned some $7.2 billion for 38 Enron project around the world (McLean and Elkind, 2003). When a huge power plant being built in Dabhol, India ran into political trouble, US Secretary of State Colin Powell talked to the Indian foreign minister, as did ambassadors and other high officials supporting Enron.

When Enron was floundering in late 2001, Lay still had access to top officials. He called Federal Reserve Board chairman Alan Greenspan, Treasury Secretary Paul O’Neill, and Commerce Secretary Donald Evans. O’Neill asked Undersecretary for Domestic Finance Peter Fisher to follow up on Enron, but the federal government ultimately did not respond. There are limits to access.

RESTATEMENTS AND COLLAPSE
Other companies gained expertise in energy trading, driving down Enron’s profitability and pushing it to assume greater risks and to venture into trading areas it had no expertise in. The end result was obvious. Losses, side deals gone bad, and other shady practices caught up with Enron. Complex fraudulent transactions using SPEs, however, hid the problems for quite a while.

The tech bubble burst in the spring of 2000; tech and telecom stocks tumbled. Enron was trying to make itself into both a tech/telecom company with Enron Broadband and an Interest company with...
Enron Online. Even if Enron Broadband and other ventures had been hugely successful (which they were not), Enron could hardly have maintained its premium stock price. The stock price peaked at $90 in August 2000, then dropped sporadically. Enron executives were bailing out of their options, including Lay and Skilling. Hedge fund managers such as Jim Chanos investigated Enron’s reporting and took a dim view of the mysterious disclosers and difficulty of figuring out how Enron made money. All of Enron’s shenanigans could be camouflaged, but not completely hidden. Chanos and other hedge funds started selling short. Some big institutions started selling their Enron shares.

The Raptor SPEs were funded with Enron stock and, therefore “with no skin” (that is, no hard assets), could not be kept off the balance sheet (even with accommodating attorneys, auditors, and board members). The Raptors were underwater some $700 million. The decision was made to terminate the Raptors and take the loss. At the same time, chaos reigned at several Enron businesses, from Enron Broadband to the Dabhol power plant. At the same time, Lay was publicly proclaiming that Enron was doing great.

Enron reported big third-quarter 2001 losses. Andersen also discovered an accounting error on closing the Raptors when a decrease in equity was recorded as a write-down in notes receivable. The third-quarter report also included a $1.2 billion write-down in equity to correct this error. Enron’s earnings release reported: “Recurring third-quarter earnings of $0.43 per diluted share; reports nonrecurring charges of $1.01 billion after tax; reaffirms recurring earnings estimate of $1.80 for 2001 and $2.15 for 2002.” No mention was made of the billion-dollar write-down of equity. In other words, Enron was still being deceptive. The stock dropped to $33 a share.

Fastow was soon fired, but the company did not realize the extent of the damage to its credibility—essential to its stock price and borrowing capacity from the banks. The news grew worse. The SEC announced it was conducting a formal investigation of Enron. The bond rating-agencies were scrutinizing Enron closely. The auditors reevaluated the
SPES. Chewco did not have enough equity to be a separate SPE and other problems were discovered with LJM. Andersen wanted the company to restate it earnings by $1.2 billion from 1997-2000, which it did on November 8, 2001.

With a complete lack of credibility, Enron had no bank or other commercial credit. It could not roll over its commercial paper (very short-term unsecured loans). Banks were unwilling to lend any additional money beyond what was required in outstanding letters of credit and traders were unwilling to trade with Enron except for cash. (Most trading transactions are on credit, since the parties usually have superlative credit; the potential for default is called counterparty risk (see Giroux, 2003, chaps. 11-12). In desperation, Enron tried to be acquired by gas competitor Dynegy. With new revelations of problems, Dynegy backed out. Enron’s bond rating, which had eventually reached minimum investment grade at BBB-, was downgraded to junk status. With no chance of a bailout and no last-minute shenanigans possible, Enron declared bankruptcy on December 2, 2001. Just prior to failure, Enron gave $55 million in bonuses to key executives while firing 4,500 employees.


Over several years, over 30 Enron executives and employees were indicted by the Justice Department. Fastow was indicted on 78 criminal counts for defrauding Enron. He agreed to a 10-year prison sentence, one of the few crooks to get serious jail time. Both Skilling and Lay were indicted in 2004, convicted, and sentenced to long jail terms. Several other have also pled guilty, including Kopper and Fastow’s wife, Lea.
The Enron story is a useful microcosm of all that could go wrong with high-tech business and the motivations for the stock market bubble of the late 1990s. This includes executive greed, ruthlessness, a lack of ethical standards, accommodating auditors, law firms, and investment bankers, lack of proper regulatory oversight, substantial political contributions used to acquire influence in Washington, and a derelict board of directors. The stodgy gas transmission company remade itself as a high-tech conglomerate and, despite obvious high leverage and extreme financial risks, was able to mislead investors on its true value for years.

OTHER MAJOR SCANDALS
The Enron scandal came after the market collapse in 2000 and during the developing recession. As the largest bankruptcy, it resulted in headlines, instant media analysis, and congressional hearings. The call for immediate congressional reform (the original Sarbanes-Oxley) was starting to diminish when new scandals erupted, beginning with WorldCom, which replaced Enron as the largest bankruptcy ever. Real reform was inevitable.

WorldCom
By the middle of 2002, the financial and political worlds stopped hyperventilating about Enron and business as usual was returning. Then came the announced bankruptcy of WorldCom on July 22, 2002 after the discovery of almost $4 billion in accounting irregularities in June (later to rise to $11 billion), replacing Enron as the largest failure in American history. WorldCom listed assets of $107 billion (and a market value that peaked at $115 billion in 1999), compared with Enron's $63 billion. Business as usual was no longer possible. Serious reform resurfaced, including Sarbanes-Oxley in a slightly watered-down version of the original bill. Former WorldCom chief financial officer (CFO) Scott Sullivan was charged in the multibillion dollar accounting fraud;
former controller David Myers and three others pleaded guilty to securities fraud.

Bernard Ebbers and others started Long Distance Discount Service in 1983. The name was changed to WorldCom in 1995. Growth came mainly through over 70 mergers, with the big one the $42 billion acquisition of telecom giant MCI in 1998—much larger than WorldCom at the time. Ebbers was a master at using the board of directors to his advantage. As described by Haddad:

Through the 1990s, the then-nine-member board was composed of insiders and execs from acquired companies. [The board] collected plenty of perks—from use of a corporate jet to financial support from Ebbers—in their pet projects. And they piled up loads of WorldCom stock—as many as 10,000 stock options per year. [T]he board O.K.'d mega loans to Ebbers. They backed him through the stupendous expansion of WorldCom—to the brink of its collapse (2002: 138).

At first glance WorldCom looked solid, based on the 2001 10-K. Total assets were $104 billion and stockholders' equity $58 billion, resulting in a debt-to-equity ratio of 79.3 percent. Not bad for a telecom. However, almost $51 billion of the assets were goodwill and other intangibles, while cash totaled less than $1.5 billion. This indicates the significance of acquisitions, but who knows to what extent the goodwill represents real assets or just overpaying for the acquired companies. In bankruptcy, goodwill is not a real asset and the $30 billion in long-term debt was huge. According to the 10-K, earnings were off for 2001, with net income of $1.5 billion compared with $4.1 billion the previous year. Revenues were down and operating expenses up. Net income for the first quarter of 2002 was a less than stellar $172 million, down from $610 for the same quarter in 2001. But even this lousy performance was not correct.
Early in 2002, an internal audit found operating expenses charged as capital expenditures, double counting of revenues and undisclosed debt. New auditor KPMG reviewed the books; old auditor Arthur Andersen was fired. Ebbers resigned in April. On June 25, 2002, WorldCom announced $3.8 billion in accounting errors ($3.1 billion for 2001 and $800 million for first quarter 2002), mainly by capitalizing "line costs," which are fees to other telecom companies for network access rights. These are operating expenses. With the required restatements, net losses were now reported for both 2001 and first quarter 2002. CFO Scott Sullivan was fired on the same day. Further review found over $10 billion in operating expenses that were fraudulently capitalized. WorldCom filed for bankruptcy in July 2002.

CFO Sullivan pleaded guilty of securities fraud and agreed to cooperate with prosecutors. Ebbers was indicted on securities fraud and making false statements to the SEC and convicted. WorldCom emerged from bankruptcy in 2004 as MCI, with debt reduced to less than $6 billion and about that much cash. Debtors ultimately received about 35 cents on the dollar in new bonds and stock; the original stockholders received nothing. MCI agreed to pay the SEC some $750 million to repay investors wiped out by the scandal.

Tyco

Tyco started as a research lab in 1960, only to be transformed into a conglomerate through acquisitions. Dennis Kozlowski became president and chief operating officer (COO) in 1989, then CEO in 1992. He earned his "Deal-a-Day Dennis" nickname with 750 acquisitions, with up to 200 in some years. Earnings magic based on business combination accounting gave the impression of substantial growth and rising earnings. Revenues rose almost 50 percent a year from 1997 to 2001. With the $6 billion acquisition of ADT Security Services, the acquisition was structured as a reverse takeover so that Tyco could use ADT's Bermuda registration to shelter foreign earnings. The SEC started an
investigation into Tyco’s acquisition accounting in 1999, but did not charge Tyco with wrongdoing.

Tyco’s acquisition of CIT Group, the biggest independent commercial financial company in the United States, for $9.2 billion in 2001 was a disaster. Deceptive techniques used by Tyco became public with this acquisition (CIT continued to issue financial statements after the acquisition to continue to maintain a high credit rating). Apparently, Tyco specialized in “spring loading,” notifying the acquired company to modify accounting policies before the acquisition and making various write-offs and adjustments, with the intent of improving the perceived performance of the parent immediately after the acquisition. Before the acquisition date, CIT disposed of $5 billion in poorly performing loans, made downward adjustments of $221.6 million, increased the credit-loss provisions, and took a $54 million charge to acquisition costs (apparently “pushed down” from Tyco). Revenues for CIT were extremely low just before the deal and dramatically increased after the deal. The result, according to Symonds (2002), was a net loss reported by CIT just before the acquisition date.

After the acquisition, CIT reported net income of $71.2 million. That increased Tyco’s earnings for the September 2001 quarter, but luck ran out. Tyco Capital (CIT’s new name) had extreme problems with credit, since it was now tied to Tyco. Ultimately, this new business segment was sold. Tyco recorded this as a discontinued operation (recording an after-tax loss of $6.3 billion). For the year ended September 30, 2002, Tyco had a total net loss of $9.4 billion. The company had goodwill and other intangibles of nearly $33 billion, liabilities of almost $42 billion, and equity of less than $25 billion.

In 2002, Dennis Kozlowski was charged with evading $1 million in New York sales tax on paintings he bought (apparently using noninterest loans from Tyco). He resigned in June. In September 2002, he and former Tyco CFO Mark Swartz were charged with 38 felonies that ranged from “enterprise corruption and grand larceny” for raiding Tyco of some $600 million. A mistrial was declared in May 2004 and a retrial
scheduled for 2005. What’s not clear is if Tyco actually engaged in criminal acts. There is no doubt they were manipulative and deceptive, but illegality can be hard to prove. Unlike most of the scandal-plagued companies, Tyco did not go bankrupt.

**Adelphia**

John Rigas turned a local cable franchise into a communications empire, including high-speed Internet, cable, and long-distance phone service. In May 2002, Adelphia announced the earnings restatement for 2000 and 2001, including billions of dollars in off-balance-sheet liabilities associated with “co-borrowing agreements.” The company filed for bankruptcy in June 2002, following an SEC suit charging Adelphia and several executives with extensive financial fraud: “Adelphia, at the direction of the individual defendants: (1) fraudulently excluded billions of dollars of liabilities from its consolidated financial statements by hiding them in off-balance-sheet affiliates; (2) falsified operation statistics and inflated Adelphia’s earnings to meet Wall Street expectations; and (3) concealed rampant self-dealing by the Rigas family” (GAO, 2002: 122).

Adelphia also created sham transactions and false documents indicating that debts were repaid, rather than shifted to affiliates. Self-dealing by the Rigas family included using Adelphia funds to purchase stock for the Rigas family, timber rights, construct a golf club, pay off margin loans of various family members, and purchase several condominiums.

The financial statements of Adelphia indicated a company with problems. The last 10-K filed (for the fiscal year ended December 31, 2000) showed a net loss of $548 million, with losses also in 1998 and 1999. The last 10-Q (for the September 2001 quarter) also showed continuing losses. Of $21.5 billion in total assets, $14.1 billion were intangibles (primarily goodwill). Liabilities totaled $16.3, while equity was only $4.2 billion. And that is after they cooked the books!

Adelphia indicates the importance of corporate governance. Included on Adelphia’s nine-member board of directors were five Rigas
family members: John as chairman and CEO, three sons, and a son-in-law. Son Timothy also was CFO and son Michael was an executive vice president. Rigas, two sons, and two former Adelphia executives were indicted on criminal charges for conspiracy, bank fraud, and securities fraud. John Rigas and son Timothy were convicted of conspiracy and fraud in 2004.

**REGULATIONS AND THE IMPACT ON LATER SCANDALS**

The Sarbanes-Oxley Act was passed in 2002 basically to eliminate future scandals. Funding was substantially increased for SEC review and enforcement and rules improved at stock exchanges, audit firms (including a new federal audit regulator, the Public Company Accounting Oversight Board), accounting standards, and so on. Expanded regulations, improved funding for oversight bodies, expanded auditor responsibilities, and chastised companies meant scandals were expected to stop. Unfortunately, the incentive structure of high executive compensation tied to earnings and stock price performance did not change.

Corporate scandals continued, although at a slower pace: HealthSouth in 2003; a major mutual funds scandal in 2003-2004; AIG corporate governance and internal control weaknesses in 2005; derivative deceptiveness at semi-government mortgage buyers Fannie Mae and Freddie Mac in 2005-2006; major stock options deceptiveness at dozens of companies discovered in 2006; and the major subprime mortgage loan crisis in 2007. An insider trading investigation was started, but did not develop into a scandal; investment bankers and others with insider knowledge have the ability to enrich themselves with this information. This is a gray area for illegal acts.

HealthSouth operates outpatient surgical centers. The SEC, related to deals with MedCenterDirect and Source Medical, charged the company and senior executives with accounting fraud. The stock was downgraded by S&P to a CCC rating, and the New York Stock Exchange suspended trading following an SEC order to halt trading. CEO and founder Richard Scrushy and several other senior executives were
fired, as was auditor Ernst and Young. Scrushy was later indicted by the federal government on 85 counts, including money laundering and mail fraud. The mutual funds scandal involved market-timing issues, essentially allowing individuals and groups to trade after hours, when new information was available at end-of-session prices.

Fannie Mae used fraudulent accounting practices reported to total $16 billion. Fannie paid a $400 million penalty in 2006 for financial statement misstatements from 1998 to 2004. A basic problem is political connections to Congress, with Fannie (and Freddie Mac) supplying campaign contributions (both directly and from housing industry beneficiaries) and jobs for politicians staying in Washington. In 2006 Fannie Mae restated earnings through 2004. Its total retained earnings were cut $6.3 billion, the net of some dozen accounting rules violations (the usual reasons: income smoothing and maximizing executive bonuses).

**Stock Option Scandals**

Stock options, as described above, were a major factor in the earlier scandals, because executives with large options packages (the ability to buy shares of the company stock as a set price) could make millions as stock prices went up. Beginning in 2006 companies are now required to expense options, which should make this almost a nonissue. Stock option issues do not want to go away. The latest scandals are backdating and spring-loading—how companies can give options to executives that illegally give them additional gains. Backdating sets the grant date to an earlier day with a lower stock price. Spring-loading is when companies give options just before good news, which is expected to boost the stock price. The *Wall Street Journal* reported that many companies were handing out millions of options to executives right after 9/11 stock price drops: 511 execs at 186 companies, including about 90 big companies that usually did not grant options in September. By the end of 2006 some 130 companies were under investigations by the SEC and other federal authorities for backdating and other option manipulations.
A new wrinkle is exercise backdating: to backdate when the options are exercised—this time to a low stock price. The idea is the executives will hold the options for at least one year (note that most options are exercised and immediately sold). They are then eligible for capital gains treatment and a much lower tax rate. That is, the tax on the ordinary gain (exercise price minus option grant, or strike, price) is minimized and the capital gains portion maximized. The tax angle means that in addition to the SEC, the Internal Revenue Service is interested (as is the Justice Department in cases of fraud).

Subprime Mortgage Loan Scandal
The subprime loan area is related to the housing crisis of 2007, associated with huge drops in demand and price in key housing markets. Subprime loans are made to low-credit borrowers at higher interest rates, often with little or no down payment. When housing prices drop, the mortgagees soon have negative equity and are likely to just walk away from the house. The mortgage holder is stuck with the loan and the property. The mortgages are packaged as structured debt (often called collateralized debt obligations or CDOs) and sold through special purpose entities (made infamous from the Enron scandal). The losses on these CDOs are the primary cause of the large bank write-offs. These losses are continuing, getting larger, and dragging down stock prices especially for financials.

As of mid-2008, financial write-downs of mortgage-backed securities are expected to total over $200 billion. As of April 2008, UBS had the dubious lead, with write-downs of $38.3 billion, followed by Merrill Lynch at $25.1 billion, Citigroup at $21.7 billion, AIG at $17.2 billion, and Morgan Stanley, $13.1 billion. Many other banks also had multi-billion-dollar write-offs. Bank managers and others were arrested and charged with securities fraud in June 2008 and the FBI announced that some 300 real estate executives were charged with mortgage fraud (Hays, 2008).

The subprime loan scandal is primarily an investment banking scandal rather than an accounting scandal. The subprime loan scandal
seems a special case of a unique bubble, exacerbated by low interest rates and new structured financing instruments where controls were not well developed. The evidence of fraud suggests that it occurred mainly at relatively low levels associated primarily with mortgage origination. The major problem is that the large banks and other institutional players badly misjudged the risks involved and actually increased risky behavior as an obvious housing bubble developed. At the corporate level, this suggests incompetence rather than fraudulent intent.

CONCLUSIONS
This paper described the major twenty-first-century business scandals, with particular focus on Enron. Enron was a case of sophisticated fraud over an extended period, specifically to manipulate, quarterly earnings to maintain the vast compensation of key executives. WorldCom was a big company with a case of simple fraud (capitalizing operating expenses), with the same result: bankruptcy. Combined with other corporate scandals, the result was the Sarbanes-Oxley Act of 2002 to improve regulation and oversight, a quick and broad-based federal response to these problems.

The early twenty-first century has proved that the business cycle still exists and corporate scandals are not a thing of the past. Greed and hubris are recurring themes in these as in earlier scandals. There are obvious differences. Considerable oversight and regulations exist—they just were not effective when not adequately enforced. Somewhat unusual were the scandals at really big companies and the fraudulent schemes coming from the executive offices. Most frauds are at smaller companies and at lower levels in big companies.

The incentives were somewhat different. Two interrelated problems are relatively new: executive compensation and meeting analysts' forecasts. It has always been the money, but the compensation levels beginning in the 1990s became huge and driven especially by stock options. To make that work, quarterly earnings targets had to be met. The result was higher stock prices. As stock prices peaked in the 1990s,
the temptations for fraud increased. Apparently, too many executives making millions of dollars in base pay and bonuses could not pass up additional millions in options even though fraud was required. The basic problem today is the executive compensation structure essentially remains the same; the result is senior management still has incentives to cheat. On the other hand, the executives are more likely to get caught.

Will the business fraud problems subside? I am modestly hopeful. There seem to be fewer accounting-related scandals, suggesting the post-Sarbanes-Oxley oversight and regulatory environment is working reasonably well. (This assumes that the subprime loan debacle is a special case and not representative of accounting fraud.) New regulations will likely be put into place (starting with investment banking and mortgages) to reduce the occurrence of future fraud. Most executives and other players are reasonably honest, but it does not take that many ethically challenged players to create the next scandal. As long as the oversight authorities continue due diligence and adequate regulatory funding continues, accounting scandals should be fewer and less severe.

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