

CRIME IN THE SUITES

Corporate crime – any illegal act by a corporation or top officials: fraud, tax evasion, price fixing, embezzlement, unsafe products, government bribery, environmental damage, occupational disease & accidents (= 56,000 employees deaths vs 16,000 murders annually).



Accounting Fraud (“Cooking the Books”): Falsifying financial information, including false accounting entries; bogus trades to inflate profits or hide losses; false transactions to evade regulatory oversight

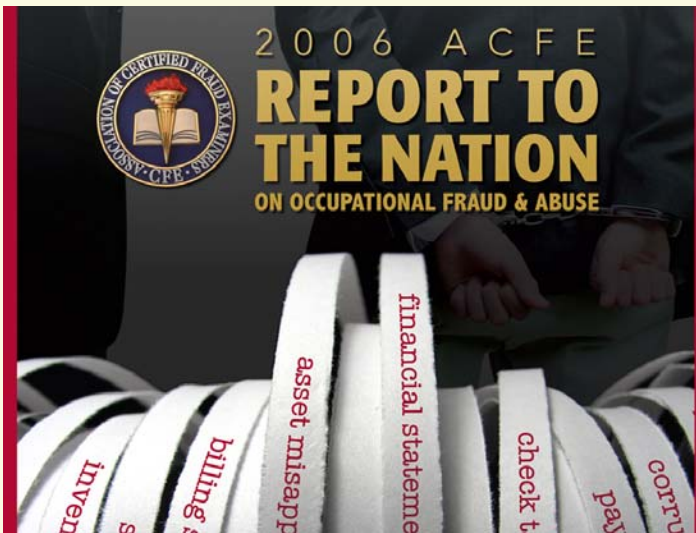
Self-Dealing by Corporate Insiders (“Me First”): including: insider trading; kickbacks; misuse of corporate property for personal gain; individual tax violations related to self-dealing

Obstruction of Justice (“The Cover-Up”): concealing criminal conduct, particularly when that obstruction impedes the regulatory inquiries of the Securities and Exchange Commission (SEC) or other agencies

Doing the perp walk: Enron CEO “Kenny Boy” Lay & Adelphia Communications CEO John Rigas

Occupational Fraud & Abuse

Assn of Certified Fraud Examiners estimated that U.S. organizations lost 5% of annual revenues to occupational fraud and abuse. Based on \$13T economy in 2006, total losses = \$653B. Others estimate annual cost of corporate crimes might exceed 10 times that of “street crimes.”

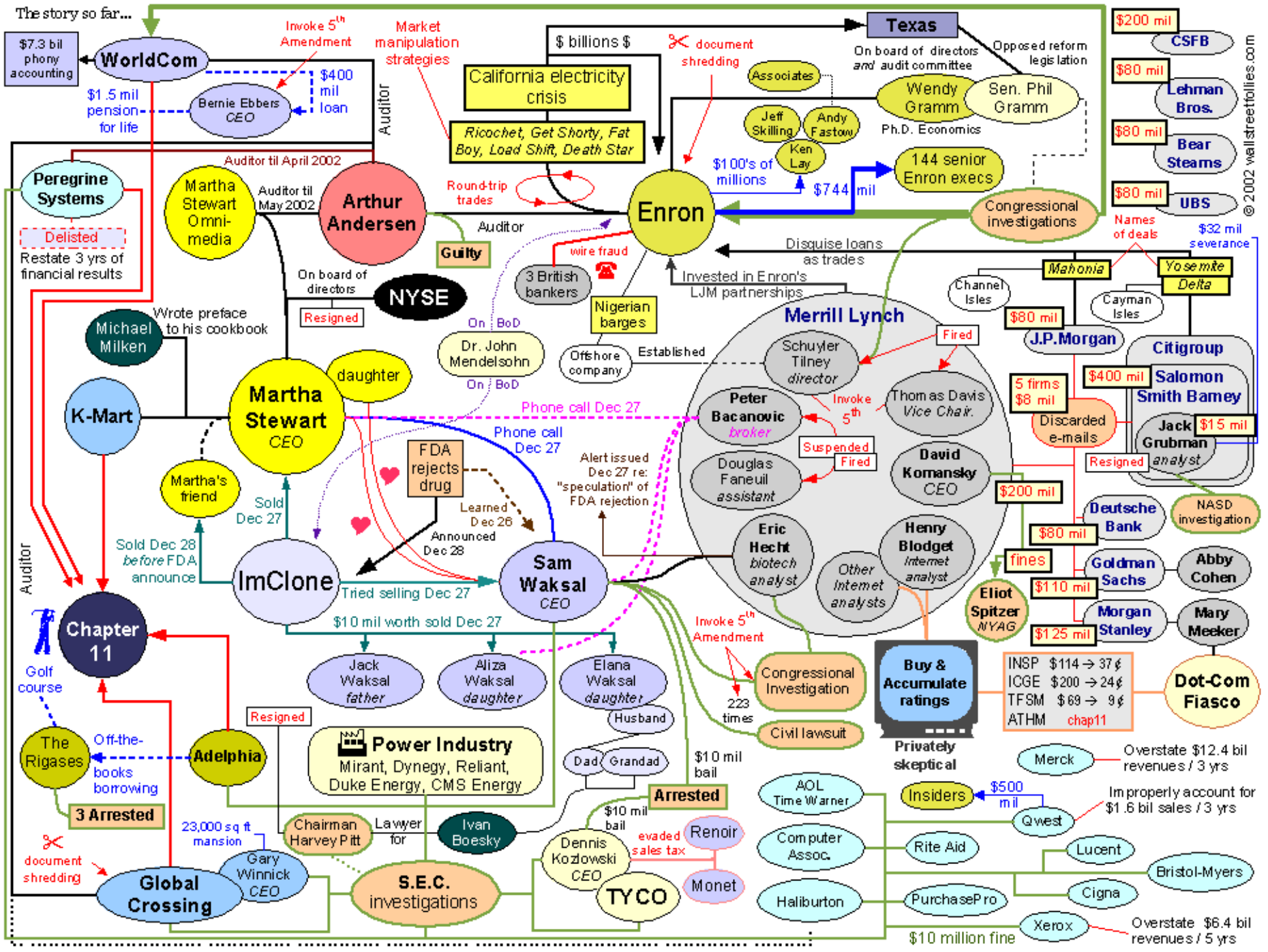


Based on 1,134 fraud case from 1/04 to 1/06:

- Median corporate loss = \$159,000
- Small business loss median = \$190,000
- 25% of fraud & abuse cases \geq \$1,000,000
- Nine cases had losses of \$1 billion or more!
- Most common: employees writing fraudulent company checks, skimming revenues, and processing fraudulent invoices

Frauds are very difficult to detect: average 18 months from start of scheme to detection. Orgs with anonymous fraud hotlines lost median = \$100K versus \$200K loss for orgs without tip. Tips uncovered 44% of \$1M+ frauds, 22% by internal audits, and 15% by external audits.

Did a U.S. corporate crime wave erupt in 2002? See the map →



More Than a Few Bad Apples?

In July 2002, President Bush created a Corporate Fraud Task Force. Through 2006, FBI reported 2,569 convictions in 459 cases, including: 200 CEO/Presidents, 53 CFOs, 23 lawyers; with \$149B in restitutions.



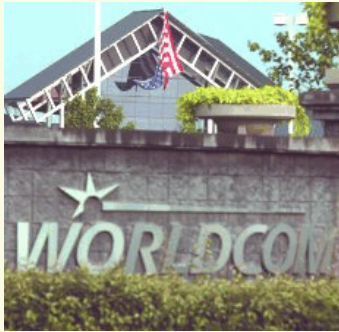
Which conditions spawned a “perfect storm,” resulting in laid-off workers, defrauded investors, empty pension funds, and weakened public faith & global confidence in U.S. capitalism?



- o Is “moral decay” running rampant in modern American society?
- o Excessive greed by leaders of corporations, banks, investors?
- o Market deregulation reduced governmental oversight of industries?
- o Spineless auditors pressured into certifying accounts in good order?
- o Securities & Exchange Comm’s lacked enforcement powers?
- o Too few prosecutions resulting in serious fines & executive jailings?
- o Politicians too dependent on corporations for campaign donations?
- o Business schools failed to teach students about ethical standards?

The Wall Street Fix

Bernie Ebbers, former WorldCom CEO, was convicted of fraud in March 2005 and sentenced to 25 years. Watch Frontline's *Wall Street Fix*.



This \$11B accounting fraud involved questionable loans & stock price manipulations for personal gain by Ebbers, involvement of Citigroup's CEO Sanford Weill and Salomon star stock-picker, Jack Grubman.

How did Congress' 1999 repeal of the 1933 Glass-Steagall Act – which separated investment banks & government-insured commercial banks – create opportunities for illegal collusion between brokers and bankers?



Were WorldCom-CitiCorp crimes & misdemeanors the fault of just a few individuals (“rotten apples”) or did they originate from structural flaws in the banking and investment system? How can new policies best detect & prevent future crimes?

As self-policing & securities industry regulations failed to stop corporate misconduct, are serious criminal prosecutions the only effective solution?

Board of Directors

Corporations are not federally chartered. Under state statutes, a Board is elected by shareholders & legally supervises the firm.



Delaware's General Corporation Law was institutionalized nationally through American Bar Assn's Model Business Corporation Act, adopted by 35 states.

The Model Business Corporation Act obligates a Board to supervise company managers' activities, applying **norms** of:

- **Duty to Manage:** to monitor the top executives' performances
- **Duty of Loyalty:** to make decisions in the company's best interests; unethical for board members to self-deal (e.g., sell or buy from firm)
- **Duty of Care:** obtain accurate information before making decisions
- **Business Judgment Rule:** board members not personally liable for bad outcomes if they act using independence, due care, & good faith

Debate about Independent Directors

A corporate board of directors has a duty, imposed by state laws and upheld by courts, to oversee top managers and to safeguard the interests of shareholders, who elected them.



“.... much that was wrong with Enron was known to the board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-book activity and excessive executive compensation.” U.S. Senate Gov Affairs Comm

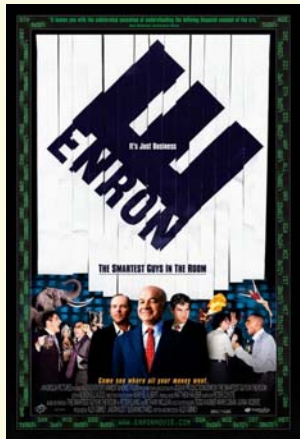
Since 2004, New York Stock Exchange (NYSE) & NASDAQ standards require the majority of a board of listed companies to be **independent directors**. They must have no material relationship (\$\$\$) with the firm.

Class divides into opposing sides & debates these two propositions:

- A) Directors with no material stake in a firm are more likely to act in the best interests of the company and its shareholders
- B) Directors who are company insiders (CEOs, VPs) are highly motivated to learn about & act on behalf of a firm's best interests

Enron: The Smartest Guys in the Room

Before its 2001 bankruptcy, Enron Corporation was one of the world's leading electricity, natural gas, and communications companies, with 21,000 employees. Claiming revenues of \$101B in 2000, Enron was the seventh largest U.S. corporation. *Fortune* magazine named it “America's Most Innovative Company” for six consecutive years.



Watch *Enron: The Smartest Guys in the Room* (2005) an R-rated, Oscar-nominated documentary based on Bethany McLean and Peter Elkind's 2003 best-seller.

It reveals how top executives – including CEOs Ken Lay and Jeffrey Skilling, and CFO Andrew Fastow – covered up a \$\$\$ billion systematic accounting fraud.

Enron's bankruptcy filing left banks, pension plans, and other lenders with at least \$5 billion at risk. More than 4,000 Enron employees lost their jobs and 401(k) savings. Its accounting firm, Arthur Andersen LLP, was convicted of obstruction of justice for shredding documents and forced to surrender its license (overturned by Supreme Court – too late). Fastow & 12 execs pled guilty; Skilling convicted; Lay died before trial.

The Sarbanes-Oxley Act of 2002

Reacting to the scandals, Congress passed and Pres. Bush signed the 2002 Sarbanes-Oxley Act, designed to restore **investor confidence** by limiting corporate self-regulation and by mandating **strong punishments** for violators. “Sarbox” applies only to publicly traded U.S. companies.



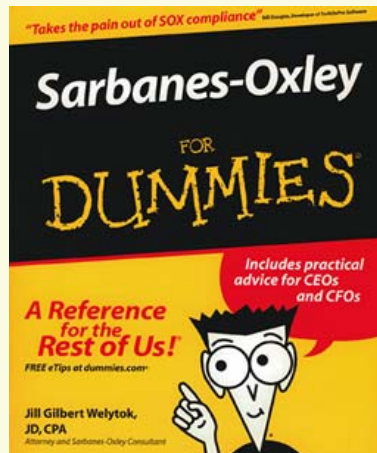
- SOX made the CEOs and CFOs personally responsible for false regulatory filings, with stiffer jail sentences for fraud and cover-ups
- They must file annual Statement of Certification attesting that financial reports fairly and accurately represents their company’s economic conditions
- Auditors (public accountants) must retain their paperwork for five years, or face criminal charges

SOX created a quasi-public agency, the Public Company Accounting Oversight Board, charged with overseeing, regulating, inspecting, and disciplining accounting firms in their roles as public company auditors.

Despite its good intentions, how well did Sarbox work in past 5 years?

Five Years Under the Thumb

Executives complain that SOX compliance is too costly, creating a real drag on firm & stock market performances. Small firms in particular feel burdened. But, what evidence backs these claims?



Economist reports academic cost-benefit analyses of costs:

- U.S. firms lost \$1.4T in market value after SOX
- They reduced their R&D and capital investments
- Small firms more likely sold to private-equity buyers
- Foreign firms avoided listing on U.S. stock markets

On the benefits side of SOX:

Restoration of business public image

Auditors “licensed to print money”

More employee whistle-blowing

Increased fraud detection

Compliance costs fell with new guidelines on Section 404 implementation

Can SOX really reform corporate misconduct or only treat symptoms?

Legislated Ethics

Rocknesses document 100 years of corporate wrongs, arguing that punitive laws & IT controls alone can't stem temptation to misconduct. Their solution also requires a deep transformation of corporate cultures.



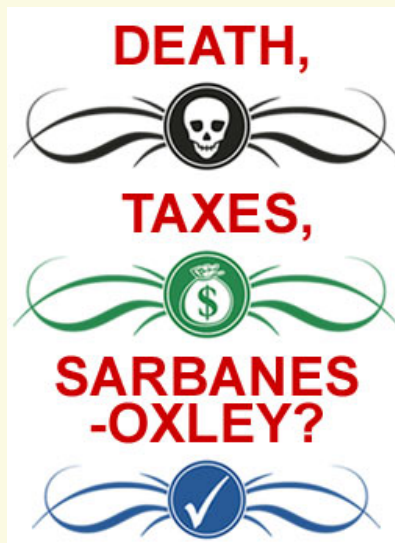
“None, taken alone, have stood the test of time in guaranteeing appropriate corporate ethical behavior. Sarbanes ... does not address the relationship between management behavior and rewards. ... It is the combination of a **strong ethical corporate culture** (beginning with the Board of Directors), controls, laws, rewards, and penalties that provide a context for obtaining ethical and transparent financial reporting.”

Premise 3: A strong corporate culture as the context and imbedded in corporate ethical values as the driver of behavior are a necessary condition for “fixing” financial management and reporting.

How can companies build stronger cultures that “reflect caring deeply about their customers, employees, and stockholders, a deep commitment to leadership... that can help firms adapt to a changing environment”?

Shorter Writing #7

The Sarbanes-Oxley Act of 2002 was intended to restore public confidence in American business after the scandals of WorldCom, Enron & many others. Yet, just five years later its critics charge that it instead weakened businesses.



Drawing from the Rockness article, videos, & AVAS model of organizational culture:

- (1) identify one AVAS element that tolerated, even encouraged, the fraudulent behaviors at Enron and other companies; **and**
- (2) discuss what changes in that cultural element might be more effective than the SOX regulations at creating real barriers to corporate fraud and abuse.

DUE in class Thursday, December 6

PAPER SPECS: **Maximum word limit = 500**, typed double-spaced with one-inch margins, 12-point Times Roman font. Include your name and student ID, Assignment #, and “Word Count = 000”