Incorporating Discussions of Fraud at Enron, WorldCom, Tyco and Adelphia into the Accounting Curriculum

Enron Capitalism: You have two cows. You sell three of them to your publicly listed company, using letters of credit opened by your brother-in-law at the bank, then execute a debt-equity swap with an option so that you get all four cows back, with a tax exemption for five cows. The milk rights of the six cows are transferred through an intermediary to a Cayman Island company secretly owned by the majority shareholder who sells the rights to all seven cows back to your listed company. The Enron annual report says the company owns eight cows, with an option on one more. (From: Swartz, M., and S. Watkins. *Power Failure: The Inside Story of the Collapse of Enron,* pp. 350-351.)

BACKGROUND

The post-Enron period of accounting reflects a greater awareness of the possible existence of fraud in financial statements. The 2002 *Report to the Nation on Occupational Fraud and Abuse* issued by the Association of Certified Fraud Examiners (ACFE) notes that the average organization loses $4,500 per employee to fraud. While the majority of cases (85.7 percent) indicate that asset misappropriation is the primary cause of fraud, the highest median cost ($4,250,000) results from fraudulent financial statement schemes.

A record number of shareholder fraud lawsuits were filed against corporations in 2002. According to the Stanford Law School Securities Class Action Clearinghouse, 260 companies were sued for securities fraud in 2002 including WorldCom Inc., Tyco and Adelphia. This represents a 54 percent increase over the record number of lawsuits (169) filed in 2001 including the Enron lawsuit.

The purpose of this paper is to examine three types of fraud and suggest where discussions might best fit into the accounting curriculum: (1) misappropriation of assets; (2) fraudulent financial reporting; and (3) disclosure fraud. Each type of fraud raises questions about the quality of financial report information. Examples of fraud are drawn from accounting scandals at Enron, WorldCom, Tyco and Adelphia.

CHARACTERISTICS OF FRAUD

Fraud involves a deliberate action to gain an advantage over another party. Fraud is never unintentional. It involves a knowing intent. In the context of the financial statements, fraud results from a material misstatement in earnings (revenues and expenses), misstated balance sheet amounts (assets and liabilities), and improper cash flow classifications (operating, investing and financing). In addition, fraud can exist in disclosure information or the lack thereof.

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit," (AICPA 2002, 7) defines the misappropriation of assets as misstatements involving the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP. The misappropriation of assets occurs in a variety of ways including embezzling receipts, stealing assets, or causing an entity to pay for goods not received.

A company should have a system of internal controls to prevent or detect the misappropriation of assets and related falsification of documents, records and financial statements. However, problems can arise even with a strong system of controls if they are circumvented or management overrides the controls.

SAS No. 99 defines fraudulent financial reporting as material misstatements that are intentional or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the statements not to be presented, in all material respects, in conformity with GAAP.

The statement identifies three ways that financial reports may be fraudulent: (1) Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared; (2) Misrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information; and (3) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

The Sarbanes-Oxley Act of 2002 (HR 3763) was passed by Congress and signed into law by President Bush in August 2002 in response to corporate accounting scandals. The Act establishes several provisions to enhance the quality of financial reports. These include the requirement that a public accounting firm must report to the audit committee: (1) all critical accounting policies and practices to be used, (2) all alternative treatments of financial information within GAAP that have been discussed with management, and (3) the possible effects of the use of such alternative disclosures and treatments on the financial statements as well as the treatment preferred by the firm.

The frauds at Enron, WorldCom, Tyco and Adelphia are due, at least in part, to pressures that existed to achieve financial analysts' estimates of earnings, compensation bonuses tied to earnings and stock price levels, and stock option incentives that infected the culture of these companies. Top officials made decisions that emphasized personal greed over their stewardship responsibility.

ENRON

The scandal at Enron appears to have set in motion a series of fraud disclosures at companies and significant earnings restatements that have led to a variety of SEC investigations. The four companies chosen engaged in a variety of fraudulent practices and sufficient information is publicly available because of on-going SEC investigations.

Enron reduced its shareholders' equity by $1.2 billion in the third quarter of 2001 because three of the special purpose entities (SPEs) kept separate from the company, JEDI, Chewco and LJM1, did not meet GAAP rules for non-consolidation of SPEs from sponsoring company's financial statements.

In the case of another SPE, Chewco, Enron and the California Public Employees' Retirement System (CalPERS) were joint venture partners in an off-balance sheet investment vehicle called Joint Energy Development Limited Partnership (JEDI). When CalPERS wanted to cash out its $383 million investment in JEDI prior to investing in a larger Enron venture, Fastow and others at Enron formed another special purpose entity called Chewco to buy CalPERS' interest in JEDI thereby allowing Enron to continue accounting for JEDI as an off-balance sheet entity.

The financing arrangement involved a $250 million subordinated loan, guaranteed by Enron, to Chewco from a bank; a $132 million advance to Chewco from JEDI under a revolving credit agreement; and $11 million in "equity" contributed by Chewco's owners–the 3 percent at-risk money required by the accounting rules.

The SEC complaint alleges that Fastow secretly controlled Chewco through Kopper and siphoned funds from Enron and gave it to Chewco. That enabled Fastow to get larger shares of the profits as kickbacks from Kopper. The two worked together to keep Chewco off Enron's balance sheet but their involvement meant that the SPE was improperly kept off the balance sheet because Chewco did not have third-party equity at risk required by accounting rules. The result was that both JEDI and Chewco were improperly kept off Enron's books.

The company's earnings were overstated by almost $400 million and its debt was understated by almost $2.6 billion.

In another project (Nigerian Barges), Enron and Merrill Lynch entered into a sham "sale" transaction in December 1999 that enabled Enron to book approximately $12 million in earnings prior to year-end. Merrill agreed to "buy" from Enron an interest in power-producing barges in Nigeria based on an express oral promise from Fastow that Enron would arrange to buy out that interest within six months. Enron also agreed to a specified profit for Merrill's "investment." Fastow fulfilled his promise by arranging to have a partnership he controlled, LJM2, to purchase Merrill's interest in the previously-agreed terms.

WORLDCOM

Unlike Enron the fraud at WorldCom was deceptively simple. In an Amended Complaint dated November 5, 2002 (SEC 2002d), the SEC alleges that from at least as early as 1999 through the first quarter of 2002, the company materially overstated the income it reported in its financial statements by approximately $9 billion. An internal review of WorldCom's previous financial statements indicated that the final misstatement may be as high as $11 billion.

WorldCom allegedly manipulated its financial results in two ways: (1) releasing reserves into income; (2) improperly classifying operating expenses as capital costs.

The company reduced its operating expenses by improperly releasing reserves carried on its balance sheet for various future payments including goods and services and offsetting these amounts against operating expenses. As a result, income from operations increased making it appear that the company was more profitable from its core operations.

WorldCom also improperly reduced its operating expenses by recharacterizing certain expenses as capital assets. These "line costs" represented the various fees the company paid to third-party telecommunications carriers for WorldCom's right to access the third party's network facilities in order to serve customers.

WorldCom employees initially recorded the payments as operating expenses. When the company's growth rate slowed and earnings declined, a substantial risk arose that WorldCom's publicly reported income would fail to meet the expectations of Wall Street analysts and that the market price of WorldCom's securities would therefore decline.

The company, under the direction of senior management, began to falsely reduce reported line cost expenses by first offsetting them against recorded reserves and then reclassifying them as capital assets. These actions inflated WorldCom's assets and earnings. Also, the company treated the expenditures as investment outflows thereby understating cash flow from investments and overstating cash flow from operations. The latter is closely watched by financial analysts as an indicator of true profitability under a cash basis approach to earnings.

WorldCom's former CFO Scott Sullivan tried to justify the changes by stating that the excess leased network capacity acquired represented marketing costs to obtain future customers that could be deferred and amortized over the revenue stream associated with future revenues. Under the matching concept, costs can be capitalized and amortized over future periods when there is a discernible benefit that can be verifiably measured. GAAP allows marketing expense to be capitalized and amortized only when it can be linked directly to specific revenue. Moreover, the leases entered into by WorldCom for "marketing-related" activities did not meet the capital lease criteria.

TYCO

The distinguishing characteristic of the frauds at Tyco and Adelphia is the misappropriation of assets by top management. In both cases top executives used company assets for personal purposes without proper authorization or disclosure. Both companies also engaged in fraudulent accounting schemes. The SEC alleges charges against top officers of Tyco as follows:

1. From 1997 to 2002, former CEO, Dennis Kozlowski, loaned $270 million from the company's corporate loan program that was designed to encourage employees to buy Tyco stock by helping to pay taxes due as a result of the vesting of ownership of shares. Kozlowski used only about $29 million for this purpose and the remaining $242 for personal expenses, including yachts, fine arts, estate jewelry, luxury apartments and vacation estates, personal business ventures and investments, all unrelated to Tyco. These loans were not disclosed to shareholders as required by federal securities laws.
2. During the same period, foremer CFO, Mark Swartz, took an aggregate of approximately $85 million but used only $13 million for taxes. The rest was spent on personal investments, business ventures, real estate holdings and trusts. These loans were not properly disclosed.
3. Tyco's former chief legal officer, Mark Belnick, allegedly took approximately $14 million in undisclosed, interest-free relocation loans that were designed to assist Tyco employees who had to relocate from New Hampshire to New York City when Tyco moved its corporate offices. Belnick took these loans even though he never worked in New Hampshire and already owned an apartment in New York City on Central Park West.
4. During the period from August 1999 to September 2000, Kozlowski authorized and Swartz caused to be recorded in Tyco's books and records $25 million loan forgiveness against Kozlowki's outstanding balance and a $12.5 million credit against Swartz's outstanding balance. The executive compensation was never properly disclosed.
5. Kozlowski and Swartz engaged in undisclosed real estate transactions with Tyco and its subsidiaries including Kozlowski's purchase from Tyco with funds borrowed under the loan program a $7 million Park Avenue apartment for his wife and a subsidiary of Tyco's purchase of Swartz's New Hampshire property for more than its fair market value. These related-party transactions were not properly disclosed.

Tyco's earnings restatement for fiscal year 2002 should amount to between $3 and $4 billion when the SEC investigation is complete. The accounting practice at issue involves the company's ADT alarm-system unit. ADT purchases security-alarm contracts from dealers that sell them to homeowners. The homeowners agree to pay $30 a month for ADT monitoring services for three years. After installing the system in the customer's home, the dealer then sells the monitoring contract to ADT. Under its typical arrangement with dealers, ADT would agree to pay about $1,000 per contract, but would deduct a $200 "connection fee," so that dealers would receive only $800. ADT would then record a $1,000 capital expenditure, which it wrote off over 10 years (perhaps because that may have been the average length of a monitoring contract including renewal periods). Also, the $200 "fee" was recorded on the income statement as a reduction of operating expenses.

ADT's "creative accounting" violates the matching concept. The company should have expensed the net $800 payment to dealers since it resembles a commission payment for products sold to customers and provides no future benefit. Any costs to service the contract during the monitoring period should have been used to offset the $30 monthly fee. By failing to match expenses with revenues, the company not only overstated net income in the early years of the contract but also overstated cash flow from operations.

ADELPHIA

On July 24, 2002 the SEC charged five former and one current executive at Adelphia, including four members of the founding Rigas Family, with directing a fraud that included: (1) fraudulently excluding billions of dollars in liabilities from its consolidated financial statements by hiding them in off-balance sheet affiliates; (2) falsifying operating statistics and inflating earnings to meet Wall Street's expectations; (3) concealing rampant self-dealing by the Rigas Family including the undisclosed use of corporate funds for Rigas Family stock purchases and the acquisition of luxury condominiums in New York and elsewhere. A summary of the charges follows:

- Made fraudulent misrepresentations and omissions of material facts to conceal extensive self-dealing by the Family.
- Using Adelphia funds to finance undisclosed open market stock purchases by the Family, purchase timber rights to land in Pennsylvania, construct a golf course for \$12.8 million, pay off personal margin loans and other Rigas Family debts, and purchase luxury condominiums in Colorado, Mexico, and New York City.
- The company also set aside a pool of corporate funds ("cash management system") that the Rigases used as their personal bank account, withdrawing hundreds of millions of dollars.

RECOMMENDATIONS

Recommendations to incorporate coverage of the frauds into the curriculum include:

1. Assign a term paper and require students to research one of the companies and write a paper about earnings management and the quality of financial reporting.
2. Divide the class into groups and have each group make a presentation about fraudulent activities at one of the companies. If more than four groups are formed, additional companies can be added such as Global Crossing and Qwest.
3. Integrate discussions of the various techniques used at the four companies to commit fraud throughout the curriculum.

EXHIBIT 1
Integration of Fraud Cases and Topics into the Intermediate Accounting Curriculum

Intermediate Topic	Fraud Issue	Companies
Conceptual framework	Asset valuation; matching	WorldCom, Tyco
Cash & internal controls	Unauthorized use of assets	Tyco, Adelphia
Receivables & reserves	Estimates; smoothing net income	WorldCom
Investments	Mark-to-market; derivatives	Enron
Property, plant & equipment	Capital vs. revenue expenditures	WorldCom, Tyco
Liabilities	Off-balance sheet entities	Enron, Adelphia
Lease transactions	Allocating lease costs to proper time periods	WorldCom
Revenue recognition	Unrealized gains on investments	Enron
Cash flow	Classification	WorldCom
Disclosure	Related parties; public release of information about company	Enron, Adelphia