



Corporate Frauds

Case Studies

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The Collapse of GTB

A Suryanarayana

Global Trust Bank (GTB), the first among the new generation private banks, collapsed under the weight of non-performing assets. Oriental Bank of Commerce (OBC) is acquiring it, and is promising to take care of the interests of the depositors as well as the employees. It is, however, difficult to tell whether this acquisition is in the interest of the OBC.

Reach of trust. This is what appears to have happened to the customers of the Global Trust Bank (GTB), the pioneer among the new generation of private banks. "Global Trust Bank Loses its Middle Name" said *The Financial Express*, in the heading of its story on the collapse of the bank on July 25, 2004, which earlier in 2001 had rated the bank as the first in its survey of India's best banks. The statement was fully justified, given that the Reserve Bank of India (RBI), on July 24, 2004, imposed a moratorium on the operations of the bank for a period of three months. The moratorium came into effect at the close of working hours on July 24, 2004, and is effective until October 23, 2004. As per the moratorium, depositors can withdraw only an amount of Rs.10,000 from their accounts (of any type) during the period. Amounts in excess of Rs.10,000 would only be permitted based on the merits of each case. All the ATMs of the

Source: ICFAI Reader, September 2004. © ICFAI University Press. All rights reserved. This article was originally published as "Proposed OBC-GTB Merger: A Pre-merger Appraisal".

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bank have been made non-operational. This is the third instance of a bank being placed under moratorium in the last two years – the other two were public sector banks, namely, Benaras State Bank and Nedungadi Bank.

Background

GTB was established in late 1994, and was among the first private banks to be established, after the RBI decided to permit more private players in the banking sector. The bank expanded quickly, setting up over a hundred branches and acquiring close to a million customers in less than a decade (by December 2003).

The bank also achieved several milestones in its brief history. It has been able to rope in two multilateral financial institutions, International Finance Corporation (IFC) and the Daiwa Securities Group. IFC invested in the equity of the bank. Its maiden public offering was a huge success, with an oversubscription of over 60 times. It also won several awards for its customer-friendly services.

However, all was not well with the bank. It got entangled in several controversies. Its attempt to merge with the UTI Bank in 2000-01 failed. The role of its then Chairman and Managing Director, Ramesh Gelli, was widely criticized and he had to finally resign. Sebi banned the promoters from accessing the capital markets earlier, in December 2002, for their role in manipulating the bank's stock price.

The Recent Crisis

The current crisis, which reached a flashpoint now, has been simmering for quite some time now. The bank has been under investigation for the last couple of years, as the RBI found irregularities in its financial statements. According to news reports, the RBI first found discrepancies in the financial statement of the

Exhibit I: Growth of Global Trust Bank				
	FY00	FY01	FY02	Dec 03
Branches	74	79	101	104
ATM	36	101	240	275
Customers	NA	660,000	807,000	902,000

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bank for the year 2001-02. While the bank showed a net worth of Rs.400 cr for the year, the RBI found the net worth to be negative. The net worth of the bank is said to have been wiped out due to bad loans made by it. The bank has been an aggressive lender to stock brokers and thus had a lot of exposure to the vagaries of the stock markets. Added to this, the reckless lending practices have resulted in the accumulation of non-performing assets. The bank, in its accounts, did not make enough provisions for the NPAs and could thus show some profits and substantial net worth. When the RBI made adjustments for the same, the net worth turned negative (Exhibit II).

Exhibit II: Key Financials of Global Trust Bank					
	March 99	March 00	March 01	March 02	March 03
Interest Earned	491.36	646.41	897.50	724.22	539.60
Total Income	637.94	879.48	1062.15	955.95	732.18
Interest Expended	438.46	507.19	697.17	635.85	517.41
Provisions & Contingencies	33.70	139.41	120.44	110.16	309.21
Total Expenses	567.08	770.86	981.82	915.69	1004.88
Net Profit	70.86	108.62	80.33	40.26	-272.70
Total Share Capital	104.00	121.36	121.36	121.36	121.36
Reserves	186.25	406.78	467.05	272.96	-118.92
Net Worth	290.25	528.14	588.41	394.32	2.44
Deposits	4096.80	6198.85	7734.23	6443.08	6920.92
Total Liabilities	5200.33	7542.10	9471.97	7346.13	7436.52
Advances	2118.44	3219.02	4099.69	3435.18	3276.11
Investments	1961.87	2928.71	3864.92	2554.20	2498.74
Net Fixed Assets	325.41	338.29	379.44	221.39	210.34
Total Assets	5200.33	7542.10	9471.97	7247.32	7439.06
Contingent Liabilities	4632.38	7018.20	6067.62	2579.16	3578.32

Source: www.moneycontrol.com

Another consequence of the net worth turning negative is that the capital to risk-weighted assets ratio of the bank also turned negative, while the stipulated norm by the RBI is 9%. The RBI started inspecting the books of the bank on a monthly basis and advised the bank to change its auditors, who allowed the bank to present false financial statements. Though the bank claimed to have a positive net worth for the year ending March 31, 2003, the RBI again found that the net

worth of the bank had eroded further. In November 2003, the bank was asked to bring in fresh equity funds to improve its capital to risk-weighted assets ratio.

The bank then started scouting around for fresh equity funds and approached several institutional investors. A US-based private equity firm, Newbridge Capital, agreed to provide the required capital through equity participation. Its offer to buy equity at Rs.9 per share was accepted by the board of the bank. However, the conditions imposed by Newbridge were not acceptable to RBI. Thus, GTB's efforts to bring in fresh capital collapsed and the RBI initiated action on the bank.

The RBI, according to its order, imposed the moratorium on the transactions of GTB "in public interest, in the interest of the depositors and the banking system" and during the period of the moratorium, the RBI would "consider various options, including amalgamation of the GTB with any other bank and finalize plans in public interest and with a view to ensuring that the public deposits are protected".

The Solution

The solution to the crisis at the GTB that finally emerged is to merge the bank with another bank in the public sector. OBC agreed to acquire the GTB. Merger with another bank is the solution that was given to the other two failed banks mentioned earlier also.

As already mentioned, the net worth of the bank is zero. So, the question that arises is what should the OBC acquire GTB for? There are indications that the acquisitions will not be through a share swap deal. From the draft scheme of amalgamation, the following can be understood:

- All investments in government securities will be valued at their market rates, while investments like post office savings deposits will be valued at face value.
- Assets like premises will be valued at market value.
- Advances will be categorized into two categories, namely, "advances considered good and readily realizable" and "advances considered not readily realizable and/or bad or doubtful of recovery".

Exhibit III: Key Financials of Oriental Bank of Commerce

(Rs. cr)

	FY 2003	FY2004
Total Interest Revenue	3288.88	3265.73
Total Interest Expense	2089.93	1844.74
Total Non-Interest Expense	544.68	775.81
Net Income	572.01	774.06
Earnings Per Share (Rs.)	29.71	40.20
Loans, Net	15240.43	19201.93
Securities Available for Sale	17002.07	19123.95
Total Assets	35768.17	42863.91
Total Deposits	29807.82	35678.55
Total Liabilities	32399.47	38657.87
Total Shareholders' Equity	3368.70	4206.04
Total Liabilities and Shareholders' Equity	35768.17	42863.91

Source: www.obcindia.com

- All assets will be credited to an asset account and liabilities will be reduced from it.
- OBC will assume all liabilities of GTB, subject to some minor conditions.
- The shortfall between the assets and liabilities is to be treated as an expenditure made by OBC.
- The value of the equity capital and reserves currently outstanding in the books of GTB will be treated as provision for doubtful and bad debts in the books of OBC.
- OBC will continue to pursue recovery of advances and other assets that are not readily realizable, and any amount realized, after meeting the expenses of realization, will be used towards meeting the deficit of assets compared to liabilities being assumed by OBC.
- If there is still any surplus, it will be used to pay or provide for any contingent liabilities being assumed by OBC.

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- Further surplus, if any, will be paid to the shareholders of GTB on a *pro rata* basis.
- In the mean time, if there are any uncalled amounts relating to the equity shares issued by the bank, they will be called and collected from the shareholders.

Based on the above details relating to the scheme of amalgamation, there exist a few crucial points that determine whether OBC is going to gain or lose from this transaction. First, it is going to assume all liabilities, while recovery of advances is uncertain. So, whether OBC will be able to complete this acquisition or not, without any loss would depend on what part of the advances can be recovered. Assets like premises are being acquired at market value, which means that the appreciation in the value of real estate is going to offset the shortfall of assets compared to liabilities. Hence, the difference between the book value of the real estate and the market value (capital gains made) will play an important role. Finally, the shortfall being treated as expenditure and the provision required to the extent of the equity capital and reserves are likely to have some impact on the profits and the capital adequacy of OBC.

However, as of now, OBC appears to be in a strong position. Its capital to risk-weighted assets ratio is at 14.5%, and may at the worst come down to 13% after the acquisition. This is still higher than the 11% stipulated by the RBI for banks planning to pay dividends without its approval. The total business of OBC during 2003-04 was Rs.56,286 cr, on which the bank earned a profit of Rs.686 cr. Its EPS is Rs.35.63, while return on assets is 1.7%. The profit for the current year is higher than the previous year by 50%.

How Good is the Solution?

RBI found a good solution to the GTB crisis, as far as the depositors and employees of GTB are concerned. But, is the solution beneficial for the acquirer too? We have noted earlier that the capital adequacy of the latter bank is likely to decrease due to the acquisition. Some researchers have shown that acquiring failed banks is not all that good for the acquirer.

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Exhibit IV: How the Current Crisis Developed

- The accounts of GTB show a profit of Rs.40 cr for the year ending March 31, 2002 and a net worth of Rs.400 cr as on that day.
- Inspection by the RBI reveals that net worth is negative.
- The report of an independent chartered accountant appointed to reconcile the two confirms RBI's stand.
- RBI starts monitoring GTB on a monthly basis and advises it to change its statutory auditors.
- In September 2003, the RBI issued a press release appreciating the efforts of GTB to clean up its balance sheet.
- For the year ending March 31, 2003, the bank reported a slightly positive net worth, but again, RBI found that the net worth eroded further and the capital adequacy ratio of the bank is negative.
- RBI advised the bank to bring in capital to improve the net worth and restore the capital adequacy ratio to the required 9% level.
- In July 2004, the bank made a proposal for infusion of capital and restructuring, which the RBI rejected.
- On July 24, 2004, the Central Government placed the bank under a 3-month moratorium, on the request of the RBI.

Source: The Financial Express, July 25, 2004.

Kevin Jacques and Peter Nigro (1995) have shown that the Recycled Assets Theory is valid in the US market. According to the theory, banks generally hold capital a little in excess of the minimum required to meet regulatory obligations. This is because raising funds at short notice, if there is a shortfall, is costly for them. When a healthy bank acquires a failed bank, the healthy bank should have enough capital to absorb the assets of the failed bank, without itself becoming under-capitalized. The acquisition of the failed bank's assets will call for additional capital to meet the requirements of capital adequacy. As raising new equity immediately after acquisition of a failed bank may not be possible and may also be costly for the healthy bank, it will not raise fresh equity capital for some time after the acquisition of the failed bank. This will force the healthy bank to slowdown lending, as the available regulatory capital will not be sufficient for absorbing the assets of the failed bank and to lend further at the normal pace. Thus, "recycling of assets" between failed and healthy banks results in slowing down the growth of loans of the healthy bank. Kevin Jacques and Peter Nigro

have used a sample of 70 US banks that failed during the period from 1988 to 1991. They excluded banks that acquired failed banks in consecutive years and banks that acquired both healthy and failed banks, to isolate the effect of the acquisition of failed banks. The results of their study have shown that acquisition of failed banks not only brings down the regulatory capital available with the acquiring bank, but also slows down its lending growth.

According to George G Kaufman (2004), there are two issues to be considered by the regulators, while handling the failure of a bank. The first one is whether it is desirable to provide immediate liquidity. The institution that insured them may pay insured deposits immediately. For the uninsured portion, based on a conservative estimate of the recovery of the assets, a certain part (called dividend) can be considered payable. This portion may be made available to the depositors immediately, without waiting for the realization of the assets, in the form of deposit certificates of the acquiring bank. However, enabling the depositors to withdraw even the uninsured portion (the part that can be paid) may lead to financial indiscipline, as the pinch of having to wait for funds will be absent. But, not restoring liquidity quickly, even if some part of the uninsured deposit is lost, is likely to result in intense political pressure to bail out the bank, and may result in costs relating to the bailing out. Regulators thus have to do a balancing act between the two and trade off between restoring the liquidity to the investors and the political pressure for a bail out.

Conclusion

In the context of the acquisition of GTB by OBC, reduction of regulatory capital is evident, in the form of decrease in the capital adequacy. Whether the growth of lending of OBC also slows down, remains to be seen. The RBI has virtually taken the bail out route in this issue, using the services of a public sector bank, which absorbs the shortfall that arises after meeting all the liabilities of GTB. This route for the resolution of this issue takes care of the interests of the depositors and restores their confidence in the financial system. But, whether this is the most desirable way to resolve the crisis would still remain a question of debate.

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The Parmalat Collapse

*Siva Rama Krishna Pusa**

Little did the European business community guess what was to come when Parmalat first hit newspapers for defaulting on a bond buyback. In response to allegations and media reports, Parmalat's Founder and Chairman Calisto Tanzi brushed aside the issue saying the money was safe in a high-yielding fund. But in reality, the issue was the first among a string of financial scandals that eventually led to the downfall of Parmalat. As one scandal led to another, Parmalat's reputation took a beating with its being dubbed as 'Europe's Enron'. While the US regulator, Securities and Exchange Commission, described the fraud as "one of the largest and most brazen corporate financial frauds in history", journalists at BusinessWeek saw the case as "globalization gone wrong".

The case of Parmalat is of much interest to an academician as it became clear that the debate on accounting practices was far from over. The case also provides a history of Parmalat and the company's fast-paced expansion, while still keeping its investors in dark.

* This case was written by Siva Rama Krishna Pusa, under the direction of N Rajshekar, ICFAI Business School Case Development Centre. It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from published sources.

The Parmalat Collapse

*"Parmalat was a symbol of pride for us. It represented prosperity, success, for us, for Parma. It was a worldwide symbol and then, suddenly – boom – all gone. No one believed this was possible."*¹

– Aldo Pesci, a resident of Parma, home town of Parmalat.

In December 2003, as the Italian government was preparing for one of the country's biggest bankruptcies, parallels were drawn between Italy's dairy giant Parmalat Finanziaria SpA (Parmalat) and American Enron, a failed US energy giant that became the leading example of bad accounting and financial irregularity. According to the US stock market regulator Securities and Exchange Commission (SEC), the accounting scandal at Parmalat that led to its downfall was "one of the largest and most brazen corporate financial frauds in history."² The collapse of Parmalat was largely attributed to its runaway expansion, which was fuelled by heavy debts. During the expansion, Parmalat built an international structure of perplex complexity, in part to reduce its taxes and hide its losses [Annexure 1].

Founded in 1963, Parmalat grew to success as a family run business and became one of the symbols of Italy's business community. Prior to its demise, Parmalat was Italy's eighth largest industrial group with a market capitalization of €1.8 billion³. It was a global rival to food companies like Nestle, Danone and Kraft Foods, selling its products worldwide including US.

Background – The Founding of Parmalat

In 1961, an innovative young entrepreneur, Calisto Tanzi (Tanzi) dropped out of university to concentrate on turning around his family's salami and cured meat business in the village of Collecchio outside Parma, Italy. After the death of his father, Melchiorre, 22-year old Tanzi took over the business and decided to produce new range of products that would achieve excellence through a strongly distinctive brand. He started with dairy products and opened a small dairy plant near Collecchio to supply milk to the city of Parma and surrounding areas. He named the company Parmalat, after the city Parma, adding the word "latte" (the

¹ Peter S Goodman, "Parma's Knight No More", www.washingtonpost.com, January 10, 2004

² "Parmalat bosses play blame game", www.bbc.com, January 5, 2004

³ Tony Barber, "Bondi to focus on Parmalat's bondholders", www.FT.com, December 26, 2003

Italian for milk). Parmalat was created with the idea that milk could be transformed from a local farm commodity into a big international business.

In 1963, a Swedish company developed a new technology called Ultra Heat Treatment (UHT) that allowed dairy processors to produce milk with longer shelf life than any other milk in the market. When Tanzi noted this new technology, he decided to bring this idea to Italy, where most of the milk was home delivered in glass bottles. Unlike the bottled milk, the carton milk allowed Parmalat to put the company's name on the product. The name Parmalat was given to the milk produced, and its tetrahedron shaped paper packaging was known, as Tetra Pak. Parmalat became the country's first producer of branded milk, and later went on to become the world's largest producer of UHT milk. Parmalat's 'Milk Box' became an instant success and rapidly attained a prominent place on store shelves around the world.

From the beginning, Tanzi's approach was swift and aggressive. He used door-to-door advertisement, displayed company ads on vans that supplied milk, and developed new products from time to time. New dairy shops were opened and the popularity of the product not only spread in the region of Parma, but also to the wealthier areas like Genoa, Florence and Rome, where the Centrali del Latte (Municipal Milk-distributing centers) held the whole milk commerce monopoly. However, the expansion of Parmalat was hindered by various distribution laws in the country, which prevented it from selling products other than milk. Despite the impediments to growth, the company released new brands of milk such as, Parmalat Vita C (pasteurized milk enriched with vitamin C) and Parmalat Indemne (certified Tuberculosis free milk) in the mid 1960s. In the first nine years of its founding, the firm's sales increased by 30% each year and in 1970 its earnings surpassed €3 million⁴.

Parmalat – Internationalization & Brand Building

In 1970, new milk legislation was passed in Italy, which allowed milk producers to sell their products not only in specialized milk shops but also in every grocery store. Parmalat was quick to react, and used new technologies to modify and start

⁴ "Italy's missing milk billions", www.telegraph.co.uk, December 12, 2003

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new plants, thus leaving behind all its competitors. In 1973, it launched special milk called Parmalat Vita7 (enriched with 7 vitamins). In the same year, when the milk sales monopoly of 'Municipal Milk-distributing centers' was broken in Italy, Parmalat began to sell its products all over the country. Until the mid 1970s, milk represented 80% of Parmalat revenues, but it began to branch out into other innovative products like yogurt, long-life cream and milk substitutes.

In 1974, as a part of internationalization, Parmalat setup its first overseas business in Brazil to produce yogurt, UHT milk and other products. In spite of the high inflation experienced by the South American economies, Parmalat managed to survive, and its operations in Brazil began with the installation of a UHT milk plant in the state of Minas Gerais, a traditional producer of milk in that country. In the same period the Italian company also expanded into France and Germany.

With Parmalat's business going global, Tanzi realized that he had to build Parmalat as a brand. Hence he started using sports sponsorships to spread the company's name. In March 1975, Parmalat paid 150 million Italian lire to sponsor the Italian team in the Skiing World Cup held in Val Gardena (Italian Dolomites). The company sponsored all the players and the grounds involved in the tournament. The company became famous in a single day, as the tournament was telecasted live throughout the world. "That got us two hours of advertising. Immediately we became an internationally known brand,"⁵ said Domenico Barili, Parmalat's general manager.

After Skiing, Parmalat moved to the most popular sport at that time – Formula One motor racing, which gave them more mileage. It signed agreements with Ferrari, which required its drivers – the Austrian world champion Niki Lauda and Clay Regazzoni to sport Parmalat's name on their overalls and helmets and so to take part in TV ads for the company. It was believed that Parmalat revolutionized sports sponsorship by making it mandatory to inscribe its name everywhere. Soon, the company's popularity reached new heights and its milk is called the "milk of champions". At the end of the 1970s, it had 242 agents

⁵"A small town's big cheeses", www.economist.com, May 29, 1997

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with warehouses, 1000 supply vehicles, 1500 sales people and 150,000 served point of sales in Italy alone⁶. According to the company reports, it secured 55% of the Italian milk market by 1980⁷.

Parmalat's spending on sports did not stop with racing and skiing. In 1987, it bought 25% stake in a lesser-known Italian football club 'Parma AC', and after the death of the club's main shareholder, it took over completely. The company poured in money to bring the world's leading players into the club, which helped them win four top trophies. With the success of Parma AC, it ventured into buying other football clubs.

Parmalat's expansion gained impetus in the early 1980s, when Italy began to privatize public companies. Until 1980, 75% of noticeable market was state-owned in Italy. Tanzi acted swiftly and transformed Parmalat into a national power, when the Italian government privatized its local dairies. Tanzi acquired them one after the other, leaving many who witnessed the process speculating about the sources of his financing.

As Parmalat business expanded, so did Tanzi's ties with bankers and politicians to an extent that his helicopter was nicknamed 'the helicopter of God' for frequently transporting the politicians and priests. "Christian and moral values are important, not money,"⁸ said Tanzi. Tanzi transformed Parmalat into a food giant with new products like fruit juices, vegetable sauces, baking products, soups, yogurt, cream and mineral water. "The entrepreneurial skills that had transformed a family business into one of the largest food companies in the world were never based on waiting for things to happen,"⁹ said the company on its rapid expansion.

As the company grew so did its debts. The bankers suggested Tanzi to sell his \$717 million company to the US food giant Kraft Foods Inc., in 1988. However, Tanzi's political associates arranged an \$80 million financial bail-out from seven-bank consortium that led to the Tanzi family company, 'Coloniale SpA', giving up 49% of its control. However, the turning point for Parmalat

* www.shibuimarkets.com/parmalat.html

* Peter S Goodman, "Parma's Knight No More", www.washingtonpost.com, January 10, 2004

* Svetlana Kovalyona, "Tanzi goes from food magnate to fraud suspect", biz.yahoo.com, December 27, 2003

* Mark Tran, "The milk sheik whose dream curdled", www.guardian.co.uk, December 31, 2003

1990, when for the first time it was listed on the Milan Stock Exchange. After its listing, the company again returned to the acquisitions spree in the 1990s. In 1993 alone, Parmalat made more than 20 acquisitions in Europe and America.

at – North America & Latin America

Parmalat opened its first overseas unit, called Yolat, in Brazil in the 1990s. Its presence in that country was felt only in the 1990s. It acquired small food-processing plants that had strong market presence in several states – significant ones being the purchase of 51% stock of the country's dairy, Cooperativa Central de Laticínios do Paraná and a \$160 million acquire Batavia, a major dairy cooperative. While making acquisitions, Brazil also emphasized on offering a wide range of products to its Brazilian market. Hence, it manufactured more than 400 products that were grouped in divisions – dairy (milk), fresh (yogurt, cheese, butter and deserts), (juice and tomato byproducts) and baked items (pastas, cookies and

Parmalat Brasil initially struggled to compete with traditional Brazilian companies, it rose to the second place in the Brazilian dairy industry. Analysts attributed Parmalat's success to marketing and advertising. To promote its products, Parmalat Brasil launched a \$5 million campaign, which proved to be one of the most successful campaigns in the Brazilian market. It distributed swanky animal dolls to consumers in exchange for 8 dollars and packs of any of the Parmalat's products. This campaign was an success as the company sold more than one million dolls.

How passionate the Brazilians were for soccer, Parmalat co-administered the soccer club 'Palmeiras'. In order to put its name on 'Palmeiras' t-shirts, it spent about \$5 million a year and spent about \$5 million a year to sign talented players to pay their remunerations. Thanks to Parmalat, the club won the championship after 17 years without a trophy. Parmalat's soccer fervor was evident there. It bought clubs in Russia, Mexico and Uruguay as well. In the 1990s, Parmalat opened several business units in Latin American countries

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including Argentina, Uruguay, Paraguay, Chile, Colombia, Ecuador, Mexico and Venezuela.

It also expanded into the very lucrative North American market. Parmalat's acquisition of the first US plant was that of the Georgia-based Atlanta Dairies in 1992. Initially, Parmalat faced difficulties to establish its name as a fresh milk producer, as its move to replace the name of Atlanta Dairies with its own didn't go well with the consumers. So they renamed the company as Parmalat Atlanta Dairies. "People are confused about who we were. We had to reinvent both names"¹⁰, said Eric Dailey, president of Parmalat Atlanta Dairies.

Headquartered in New Jersey, Parmalat USA also acquired dairies in Michigan (White Knight and Grand Rapids) and Pennsylvania (West Dairies), in 1993. It spent \$25 million as a part of its advertising campaign in the US¹¹. To launch its product in New York alone, it spent \$2 million to sponsor a free concert in Central Park. Parmalat acquired six more businesses, most of them in New Jersey and eastern parts of US, between 1998 and 1999 [exhibit 1]. And in 1999, it bought Mothers Cake & Cookie Company and Archway Cookies for \$250 million¹², which made Parmalat the third largest cookie maker in the US.

Exhibit 1: Parmalat's Acquisitions in the US (1998-99)

Company	Takeover Date	Sales (in million \$)
Farmland Dairies Inc.	March 1999	200
Peeler Jersey Farms Inc.	October 1998	22
Clinton Milk Co.	August 1998	21
Welsh Farms Inc.	August 1998	45
Kinneth Dairies Inc.	July 1998	60
Sunnydale Farms Inc.	February 1998	120

Source: Gerry Clark, "Walk, don't run: Parmalat USA is set on conquering the continent, but its legions are proceeding at a leisurely pace", www.findarticles.com. May 1999

¹⁰ Cheryl Crabb, "Can Parmalat cream its rivals", atlanta.bizjournals.com, January 27, 1997

¹¹ ibid

¹² Deborah Orr, "Who Gets Parmalat's Milk and Cookies", www.forbes.com, December 24, 2003

Exhibit 2: Parmalat's Four Principle Activities

Milk Division (57%) – Milk is Parmalat's largest division. Products include pasteurised milk, UHT milk, flavoured milk, milk powder, condensed milk, pasteurised cream, UHT cream and Bechamel sauce. Products are sold throughout the world including Europe, South America, Central America, North America, Africa, Asia and Australia.

Fresh Products Division (10%) – The fresh products division includes yogurt, fermented milk, ice cream, desserts, butter and cheese. Parmalat manufactures fresh food products in most countries in which it has operations.

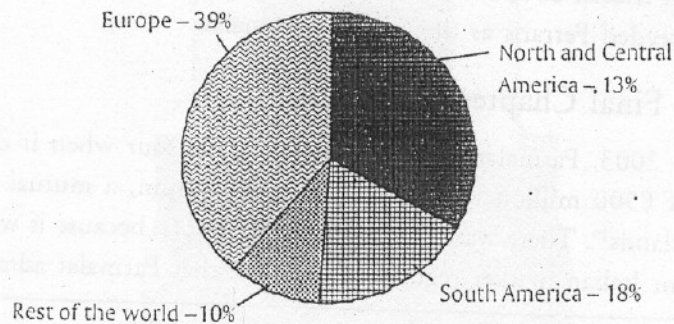
Vegetable Division (10%) – Parmalat's vegetable division includes fruit juices and nectars, fruit derivatives, tomato derivatives, iced tea and beverages and vegetable soups.

Bakery Division (23%) – Bakery products include snacks, biscuits, pastries, pizza, focaccia, bread and pasta.

Source: www.parmalat-asia.com

By the turn of the century, Parmalat was operating in 31 countries with more than 35,000 staff in 139 plants. Parmalat's core business activities were divided into four business divisions [exhibit 2], and its operations grouped into four geographical areas [exhibit 3].

Exhibit 3: Parmalat Operations in Four Geographical Areas



Source: <http://bankrupt.com/parmalat.txt>

CORPORATE FRAUDS – TRENDS AND LESSONS

In 2002, Parmalat reported a turnover of €7.6 billion, which represented about 0.8% of Italy's GDP¹³ [Annexure 2]. Parmalat was listed on half-a-dozen stock exchanges, and according to the 2002 consolidated balance sheet, Parmalat had some \$7 billion in debts and \$5.4 billion in assets¹⁴ [Annexure 3]. Its rapid growth was largely due to the banks like Chase Manhattan, Bank of Boston, Deutsche Bank, Barclays and Merrill Lynch, who sold billions of dollars of Parmalat's bonds. Between 1990 and 2003, it issued 37 bond issues and raised \$8 billion¹⁵ out of which Bank of America (BoFA) alone arranged \$743 million in debt sales¹⁶.

Many investment bankers wondered why Parmalat was issuing billions of bonds, when it had cash in its accounts. When asked about Parmalat's opaque finances, its then CEO, Fausto Tonna (Tonna), said, "The Company was on an acquisitions spree and needed cash – and the liquid funds were earning good returns, 3.5% after taxes in 2003."¹⁷ However in early 2003, many analysts became more cynical about Parmalat's finances. "The actual size of Parmalat's net financial debt is, in our view, much higher than the \$2.3 billion reported by the company,"¹⁸ said an analyst at Auerbach Grayson & Co. Faced with mounting criticism about the company's finances, Tanzi appointed Alberto Ferraris (Ferraris) as the CFO in March 2003. However, in November 2003, Luciano Del Soldato (Soldato) succeeded Ferraris as the CFO of Parmalat.

Parmalat – Final Chapter

In November 2003, Parmalat's success began to turn sour when it disclosed an investment of €500 million (\$619 million) in Epicurum, a mutual fund based in Cayman Islands¹⁹. There was a furor among investors, because it was not until a request from Italian market regulator 'Consob', that Parmalat admitted about

¹³ Sophie Arie, "Parmalat dream goes sour", www.guardian.co.uk, January 4, 2004

¹⁴ <http://bankrupt.com/parmalat.txt>

¹⁵ Alessandra Galloni and David Reilly, "How Success Story at Parmalat Got a Very Sour Final Chapter", www.wsj.com, December 22, 2003

¹⁶ Gail Edmondson, David Fairclamb, Nanette Byrnes, "The Milk Just Keeps On Spilling At Parmalat", www.businessweek.com, January 26, 2004

¹⁷ *ibid*

¹⁸ *ibid*

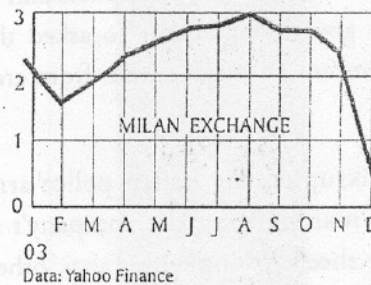
¹⁹ John Tagliabue, "Irregularities Push Parmalat Closer to Insolvency", www.nytimes.com, December 20, 2003

the holding. Parmalat tried to pacify its investor by stating that it would recover the money within 15 days. But, unfortunately when Parmalat tried to recover its funds, Epicurum was flooded by redemption requests from its other investors, and as a result it had to freeze all redemptions and liquidate.

However, on December 8, 2003, Parmalat faced worst cash crisis in its 40-year history, when it defaulted on a €150 million (\$108 million) bond, leaving many analysts wondering why the redemption was a problem for a company with €4.0 billion of reported cash and short-term assets²⁰. Parmalat stated that it was not able to buy back the bond because it was not able to liquidate €500 million (\$619 million) investment from Epicurum. But as rumors spread that Parmalat's claimed liquidity was not there, on December 9, Standard and Poor's downgraded Parmalat's bonds to junk status and in the next few days, its stocks fell by 40% [Exhibit 4]. Since then, things started to get out of Parmalat's control.

Exhibit 4: Parmalat's Share Chart (January 2003 to December 2003)*

(Monthly close in Dollars)



* After Parmalat shares plunged to near zero trading was suspended

Source: www.businessweek.com, January 12, 2004

On December 10, 2003 after an emergency board meeting, Enrico Bondi (Bondi), a turnaround expert was appointed as a consultant to sort out things at Parmalat. On December 15, Tanzi was ousted as the Chairman and chief executive by Parmalat's main banks, and Bondi was appointed as the CEO. As a first move

²⁰ "Milking lessons", www.economist.com, December 29, 2003

to overhaul the company, Bondi ordered a complete review of Parmalat's accounts and from then on, as the 'Economist' magazine put it 'a bad story got much worse'²¹.

On December 19, 2003, BofA shocked Parmalat's investors when it revealed that it was not holding about €3.95 billion (\$ 4.9 billion) of Parmalat funds, as reported by the company in September 2003. The money was supposedly in BofA account held by Bonlat, a Parmalat subsidiary, based in Cayman Islands. "What is most incredible, is to find out that a company you thought was so great was really a castle of cards,"²² said Gianni Alviti, a union leader at Parmalat.

On December 24, 2003, amidst an escalating scandal, Parmalat filed for bankruptcy protection, after the Italian government amended its bankruptcy laws to allow quick bankruptcy procedures for Parmalat. "The government couldn't sit still," said Italy's prime minister, Silvio Berlusconi, adding that the amendment was designed to protect jobs at Parmalat²³. As per the new legislation the government appointed Bondi as a special commissioner with additional powers to restructure the dairy company within 180 days. This new law also allowed Parmalat to use its working capital to pay for the suppliers and workers by enjoying protection from creditors. The government had also asked the European Union to waive rules on state aid to prevent Parmalat's woes from creating a wider dairy sector crisis in Italy²⁴.

A week after Parmalat's bankruptcy, the Italian police arrested Tanzi on the charges of market rigging and manipulating the company's accounts to hide a multi-billion hole in its balance sheets. Along with Tanzi, other Parmalat officials were also arrested including former chief financial officers Tonna and Soldato and also the two officials from auditor Grant Thornton's Italian division that audited Parmalat's Bonlat division. During the interrogations, more breath-taking details had emerged, which suggested that the company did not buy back \$3.5 billion

²¹ Op.cit. "Milking lessons", www.economist.com, December 29, 2003

²² Alessandra Galloni and David Reilly, "Italian Food Giant Nears Bankruptcy Amid Scandal; Billions of Dollars Missing", www.wsj.com, December 22, 2003

²³ "Parmalat files for bankruptcy", www.guardian.co.uk, December 24, 2003

²⁴ "Parmalat to seek administration", www.bbc.com, December 22, 2003

in bonds it said it had in the past several years. And also more than \$12 billion might be missing from Parmalat's balance sheets.

After Parmalat's rapid descent from glory to disgrace, many questions were raised about what might have happened to a company that was once regarded as Europe's biggest success story in modern history. The biggest question of all, according to a 'Wall Street Journal' reporter was – "What was the ultimate motive? Did someone abscond with the money? Or was it simply an effort to pump up balance sheet to help Parmalat sell 37 bond issues over the past 10 years involving billions of dollars?"²⁵

Parmalat – The Plot

According to BusinessWeek magazine²⁶, Parmalat was a story of globalization gone wrong. The roots of Parmalat scandal, according to investigators dated back to 1989, before it became a public company. It was believed that Parmalat began to create a web of offshore finance companies in Dutch Antilles to hide its liabilities from investors prior to being listed on the Milan Stock Exchange²⁷. At the time, Grant Thornton audited Parmalat's accounts including the offshore finance companies.

After Parmalat became public, Tanzi family expanded Parmalat into 31 countries. With the expansion, came a borrowing spree, and its finances became more opaque. It was believed that Parmalat's troubles started after a costly international expansion, during the late 1990s, into the US and Latin American countries. During the interrogation, Tanzi revealed that the accounting scandal was partly driven by the need to hide huge losses at the company's South American operations²⁸.

In the 1990s, Parmalat went on a buying spree in Brazil, which, according to a former finance director of Parmalat, was done at inflated prices, partly to pay

²⁵ Alessandra Galloni and David Reilly, "Italian Food Giant Nears Bankruptcy Amid Scandal; Billions of Dollars Missing", *www.wsj.com*, December 22, 2003

²⁶ Gail Edmondson, David Fairlamb and Nanette Byrnes, "The Milk Just Keeps On Spilling At Parmalat", *www.businessweek.com*, January 26, 2003

²⁷ *ibid*

²⁸ Tony Smith, "Parmalat's South American units aren't seen as culprits", *www.iht.com*, January 13, 2004

bribes. Within a short period, the company grew to 17 plants across the country. However, such acquisitions, instead of bringing profits, started to bring in losses every year since 1998, partly due to the economic and currency crises in the Latin American countries. Therefore, with losses mounting from its core business activities, Parmalat started to create opaque subsidiaries in tax havens such as the Cayman Islands, to hide the true state of its finances²⁹.

In the mid 1990s, the Italian government, in an effort to overhaul its financial system, made it mandatory for publicly trading companies to change their auditors every nine years. In 1999, Parmalat bought in Deloitte & Touche as a replacement for Grant Thornton. But, before that had happened Parmalat closed down its Antilles-based companies and replaced them with Bonlat, a subsidiary based in the Cayman Islands. Parmalat also made sure that the supervision of the new division remained under its old auditor, Grant Thornton. Parmalat stated that Bonlat possessed its assets including \$4.9 billion, supposedly held in BofA. However, it was later found that the money was non-existent, and by using a photocopier and a fax machine a few Parmalat financial officers forged the document that authenticated the funds.

"If the auditors are dishonest, negligent or incompetent, if they sign off false accounts, then the fraud isn't going to emerge until it's too late. I can't think of any reason why that couldn't happen here,"³⁰ said one UK regulatory source.

Along with Tanzi and other Parmalat officials, police also arrested two Grant Thornton executives – branch president Lorenzo Penca and partner Maurizio Bianchi. The Milan magistrate accused them of falsely certifying Parmalat's balance sheets³¹. In December 2002, as a part of the audit, Parmalat sent a letter to Grant Thornton that permitted them to verify with BofA, the details of the €3.95 billion (\$4.9 billion) bank account held by Bonlat. During the investigations, it was revealed that the letter, which authenticated that Bonlat held €3.95 billion (\$4.9 billion) in cash and securities in BofA, was signed by the then CFO Tonna.

²⁹ Peter Gumbel, "Autumn of The Patriarch", *www.time.com*, January 12, 2004

³⁰ Conal Walsh and Oliver Morgan, "Parmalat: could it happen here?" *www.guardian.co.uk*, January 11, 2003

³¹ Sophie Arie, "Parmalat's auditors and former finance chiefs arrested", *www.theage.com*, January 2, 2004

Later, when asked if he signed that letter, he said, "It's possible. I may or may not have. I used to sign a lot of letter."³²

In March 2003, Grant Thornton received a letter on BofA's letterhead confirming the Bonlat account. However, it was later found that the letter was forged, as reported by 'Wall Street Journal', by scanning BofA's logo onto a computer, printing it out and then passing it through a fax machine several times to make it look more authentic.³³ Though Grant Thornton stated that it was a victim of the fraud, investigators believed that there were many such documents. And much to the astonishment of investors, "The auditors used Parmalat's internal mail to request financial information, rather than dealing with banks or other parties directly," as reported in *The Economist*³⁴.

During its headlong international expansion, Parmalat was a prolific issuer of bonds, leaving many investment bankers wondering, why Parmalat did not use its cash pile to clear its debts, instead, replacing the old bonds with the new ones. "Things have been strange at Parmalat since the mid-1980s. It smelled bad,"³⁵ said an investment banker. However, to some banks including Citigroup, BofA and JP Morgan, Parmalat was fast growing and a sound business, with its books audited by one of the top auditors. These banks were the largest placers of Parmalat bonds and rated them as financially sound papers³⁶.

Parmalat Basks in the Spotlight

Many questions were raised about the role of the banks in the Parmalat debacle. "What's appalling is that the mistakes were made by many banks all over the world. Parmalat was a totally international affair,"³⁷ said Valter Lazzari, a professor of banking and finance at Bocconi University in Milan. The three banks under

³² Alessandra Galloni and David Reilly, "Italian Food Giant Nears Bankruptcy Amid Scandal; Billions of Dollars Missing", *www.wsj.com*, December 22, 2003

³³ *ibid*

³⁴ "Milking lessons", *www.economist.com*, December 29, 2003

³⁵ Gail Edmondson, David Fairlamb and Nanette Byrnes, "The Milk Just Keeps On Spilling At Parmalat", *www.businessweek.com*, January 26, 2003

³⁶ Claudio Celani, "The Story Behind Parmalat's Bankruptcy", *www.larouchepub.com*, January 16, 2004

³⁷ Gail Edmondson, David Fairlamb and Nanette Byrnes, "The Milk Just Keeps On Spilling At Parmalat", *www.businessweek.com*, January 26, 2003

the spotlight were Citigroup, BofA and Merrill Lynch – all three of them setup Special Purpose Vehicles (SPVs), which were designed to hold Parmalat's offshore assets, in a most tax-efficient way³⁸. The most talked deal was the one made by Citigroup, under which the bank arranged an offshore financing worth €117 million to Parmalat, through an SPV called Buconero, known as 'black hole' in Italian language, in 1999³⁹. But, this deal was not registered on Parmalat's books. Reacting to the widespread criticism, Citigroup said, "Regrettably, the legal vehicle associated with this transaction was called Buconero. Today we would only do this transaction if a client agreed to provide greater disclosure."⁴⁰

In January 2004, the US market watchdog, Securities and Exchange Commission (SEC) filed a lawsuit against Tanzi and his son, Stefano, for allegedly selling \$1.5 billion worth of bonds to American investors. SEC also began to probe, whether the American banks, which placed the bonds, were intentionally unaware of Parmalat's complex finances. South Alaskan Miners' Pension Fund also filed a lawsuit against Parmalat, its auditors, BofA and Citicorp, the main focus being on Buconero SPV. "We believe that Citigroup, by creating instruments like the sadly famous 'Buconero', has played a fundamental role in helping Parmalat to fake their balance sheets and hide their real financial situation,"⁴¹ said Darren Robbins, a lawyer.

Aftermath

As much of the scandal was still unfolding and leaving thousands of jobs at stake, many questions were raised as to why it took so long to detect the possible fraud, in spite of Parmalat's reputation for lack of transparency. And also as the Economist reported⁴², why did respected institutional investors continue to buy Parmalat's shares and bonds? As for the banks, why did they continue lending and arranging questioning derivative deals?

³⁸ Caroline Merrell, "Enron banks are back in the spotlight", www.timesonline.co.uk, December 23, 2003

³⁹ *ibid*

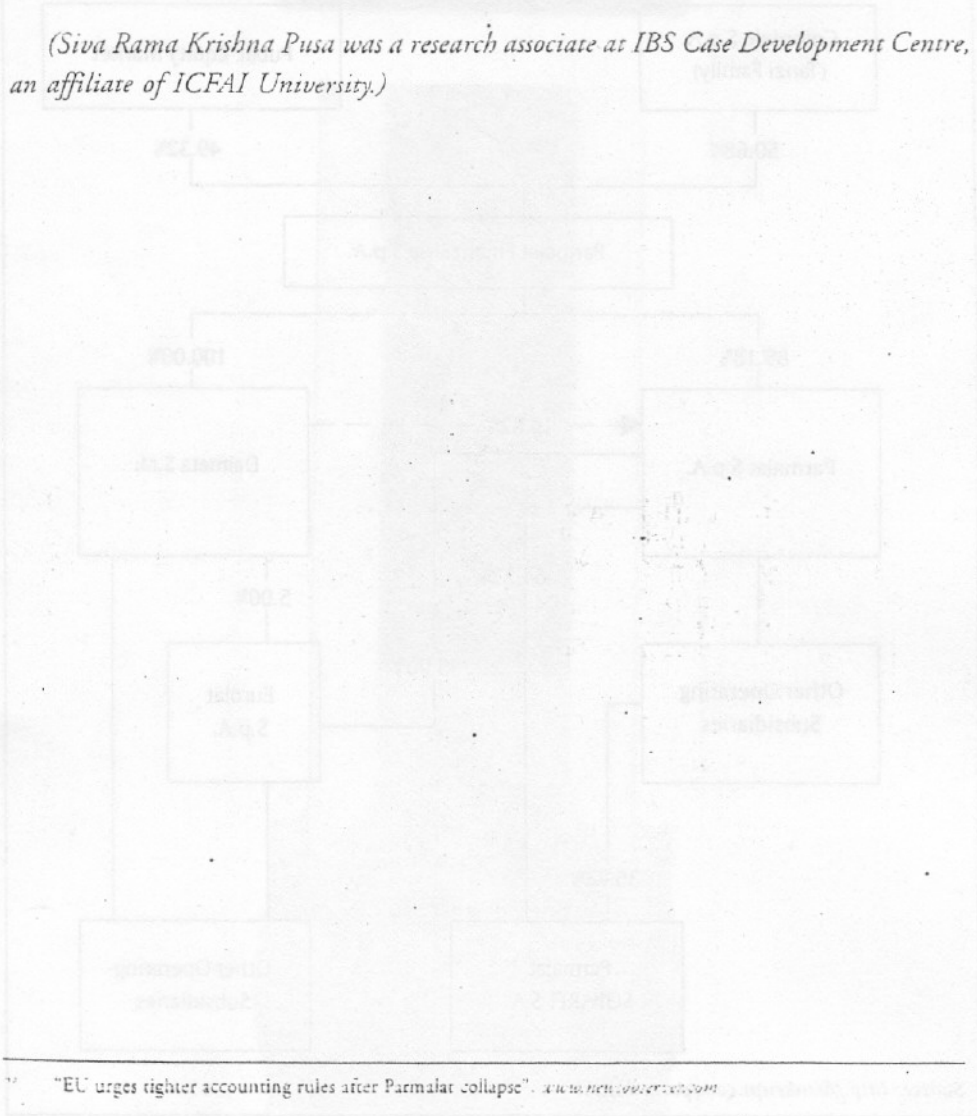
⁴⁰ *ibid*

⁴¹ Claudio Celani, "The Story Behind Parmalat's Bankruptcy", www.larouchepub.com, January 16, 2004

⁴² "Déjà vu all over again?" www.economist.com, December 18, 2003

Following the Parmalat scandal, the European Union (EU) had announced plans to tighten accounting standards, as it was believed that the use of two auditors by Parmalat helped them to manipulate their accounts. According to EU internal market commissioner, Frits Bolkestein, the plans would include – close scrutiny of auditors by national authorities; rules on the independence and ethics of auditing companies; tougher penalties for malpractice; and greater international cooperation between monitoring bodies⁴³.

(Siva Rama Krishna Pusa was a research associate at IBS Case Development Centre, an affiliate of ICAI University.)

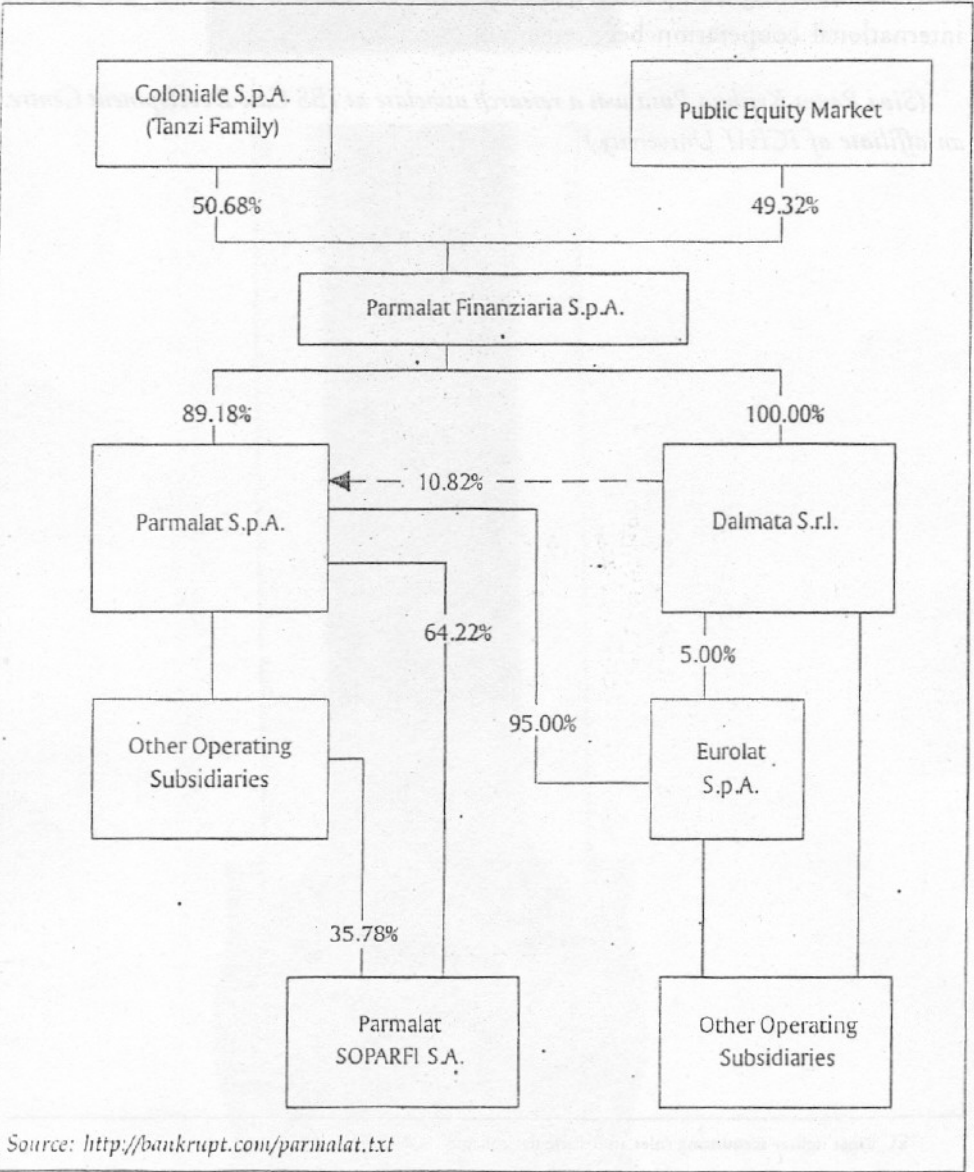


⁴³ "EU urges tighter accounting rules after Parmalat collapse". www.bbc.co.uk/1/health/2003/03/030315_eu_accounting.shtml

Annexure 1

Parmalat – Corporate Structure

Parmalat's corporate structure involved hundreds of entities. A simplified version of the companies' relationships nearest to the ultimate parent company shows:



The Parmalat Collapse

Annexure 2

Consolidated Balance Sheet

Assets	December 31, 2002 (thousands of euros)	December 31, 2001 (thousands of euros)
A. Unpaid Share Capital		
Called-up	53	53
B. Fixed Assets		
<i>I. Intangible fixed assets</i>		
Start-up and expansion costs	30,918	51,059
Research, development and advertising costs	6,047	13,205
Industrial patents and intellectual property rights	19,340	19,038
Concessions, licences, trademarks and similar rights	398,056	439,194
Goodwill	517,279	619,840
Intangible assets in process and prepayments	24,242	6,094
Other assets	328,172	319,442
Goodwill arising from consolidation	838,975	908,953
Total intangible fixed assets	2,163,029	2,376,825
<i>II. Tangible fixed assets</i>		
Land and buildings	520,991	651,982
Plant and machinery	1,051,067	1,292,254
Industrial and commercial equipment	84,798	98,435
Other assets	109,343	128,471
Work in progress and prepayments	51,263	71,969
Total tangible fixed assets	1,817,462	2,243,111
<i>III. Long-term financial assets</i>		
Investments in:		
- Unconsolidated subsidiaries	6,395	6,693
- Associated companies	74,083	41,822
- Other companies	23,309	35,883
Accounts receivable:		
- Others within 12 months	34,972	35,074
- Others beyond 12 months	374,526	344,622
Other securities	210,134	44,275
Total long-term financial assets	723,419	508,369
Total fixed assets	4,703,910	5,128,305

Contd...

CORPORATE FRAUDS - TRENDS AND LESSONS

<i>Contd...</i>		
C. Current Assets		
<i>I. Inventory</i>		
Raw, ancillary and consumable materials	198,422	237,241
Work-in-progress and semi-finished products	10,051	7,178
Contract work in progress	8,965	8,206
Finished products and goods for resale	303,423	385,045
Prepayments	27,006	81,423
Total inventory	547,867	719,093
<i>II. Accounts receivable</i>		
Customers within 12 months	1,143,720	1,257,244
Customers beyond 12 months	41,907	18,744
Subsidiaries within 12 months	262	264
Subsidiaries beyond 12 months	25	25
Associated companies within 12 months	5,317	8,751
Others within 12 months	224,931	246,994
Other beyond 12 months	72,388	7,524
Less provisions for doubtful accounts	(68,009)	(77,716)
Total accounts receivable	1,420,541	1,461,830
Assets		
<i>III. Current asset investments</i>		
Other investments	4	4
Other securities	2,412,941	1,459,646
Total current asset investments	2,412,945	1,459,650
<i>IV. Cash on hand and at banks</i>		
Bank and post office deposits	828,152	1,359,216
Cheques	117,206	100,395
Cash on hand	5,262	5,166
Total cash on hand and at banks	950,620	1,464,777
Total current assets	5,331,973	5,105,350
D. Accrued Income and Prepaid Expenses		
Accrued income and prepaid expenses	245,948	306,297
Total assets	10,281,884	10,540,005
<i>Contd...</i>		

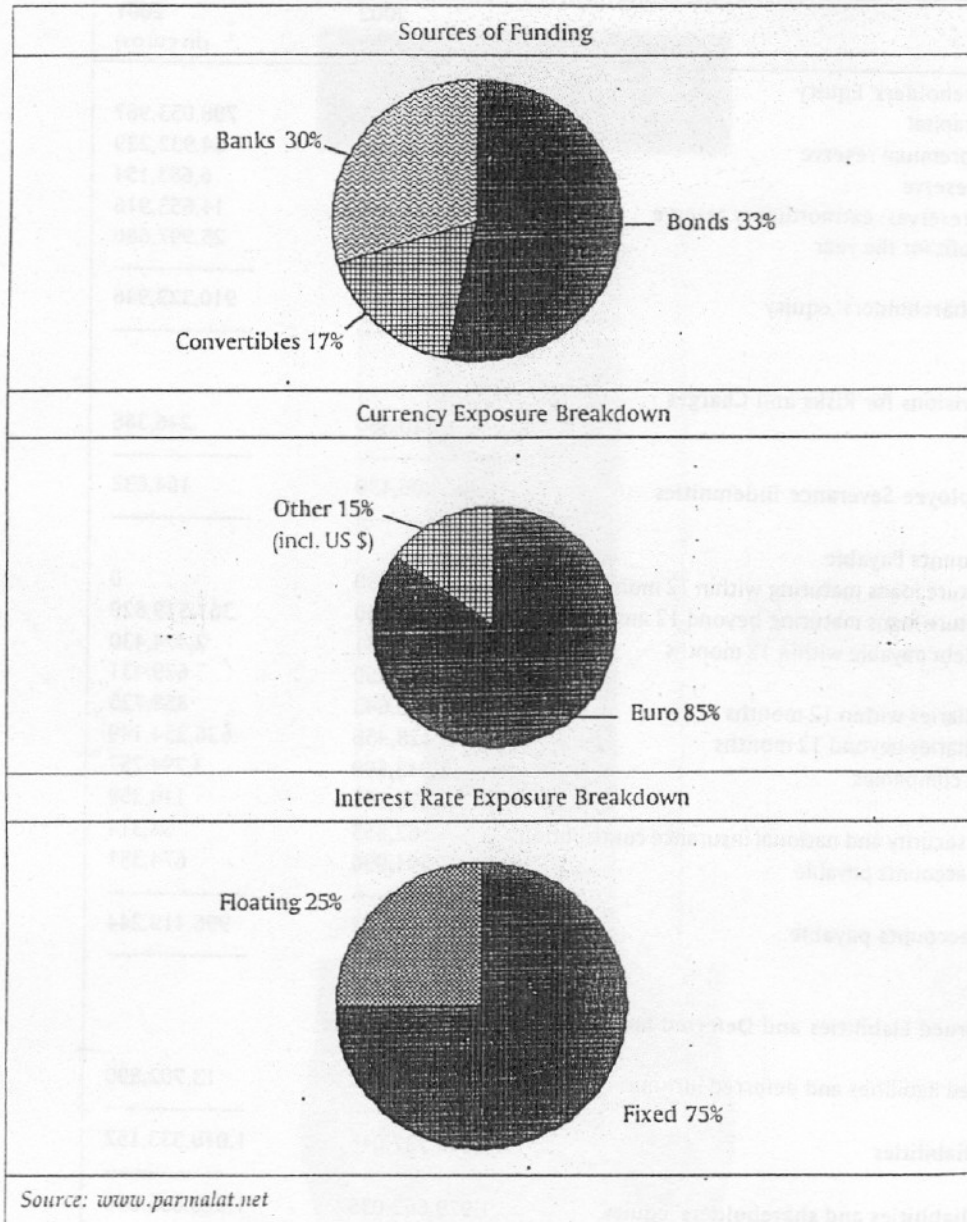
The Parmalat Collapse

<i>Contd...</i>		
Liabilities and Shareholders' Equity	December 31, 2002 (In euros)	December 31, 2001 (In euros)
A. Shareholders' Equity		
Share capital	804,926,547	798,053,967
Share premium reserve	67,642,980	64,932,229
Legal reserve	7,983,038	6,683,154
Other reserves: extraordinary reserve	23,322,998	14,655,916
Net profit for the year	27,449,426	25,997,680
Total shareholders' equity	931,324,989	910,322,946
B. Provisions for Risks and Charges		
Other	246,386	246,386
C. Employee Severance Indemnities	206,130	164,632
D. Accounts Payable		
Debenture loans maturing within 12 months	103,291,380	0
Debenture loans maturing beyond 12 months	258,228,450	361,519,829
Bank debt payable within 12 months	8,207,351	2,474,430
Trade	656,250	679,431
Subsidiaries within 12 months	608,528,643	858,725
Subsidiaries beyond 12 months	56,328,456	626,254,149
Parent companies	3,913,699	3,794,757
Taxes	278,562	110,258
Social security and national insurance contributions	62,455	53,314
Other accounts payable	591,096	674,351
Total accounts payable	1,040,086,342	996,419,244
E. Accrued Liabilities and Deferred Income		
Accrued liabilities and deferred income	7,798,188	13,702,890
Total liabilities	1,048,337,046	1,010,533,152
Total liabilities and shareholders' equity	1,979,662,035	1,920,856,098
<i>Source: www.parmalat.net</i>		

Annexure 3

Debt Details (as per 31-12-2002)

Average Cost of Debt: 5.8% pre-tax (as per end of FYE 2002)



The WorldCom Accounting Scandal

*Hari Prasad Sharma**

The case discusses the accounting frauds committed by the leading US telecommunications giant, WorldCom during the 1990s that led to its eventual bankruptcy. It provides a detailed description of the growth of WorldCom over the years through its policy of mergers and acquisitions. The case explains the nature of the US telecommunications market, highlighting the circumstances that put immense pressure on companies to project a healthy financial position at all times. The case provides an insight into the ways by which WorldCom manipulated its financial statements. It also describes the events that caused the company to file for reorganization under Chapter 11 of the US Bankruptcy Code in 2002. Finally, the case explores the initiatives being taken by the company to change its management structure, improve its performance and restore investor confidence.

This case was written by H Prasad Sharma, under the direction of A Neela Radhika & A Mukund, ICAI Center for Management Research (ICMR). It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from published sources.

ce: ICAI Center for Management Research (ICMR). © 2003, ICAI University Press. All rights reserved.

"Corrupt corporate executives are no better than common thieves when they betray their employees and steal from their investors."

– John Ashcroft (US Attorney General), in August 2002.

*"WorldCom put extraordinary pressure on itself to meet the expectations of securities analysts."*¹

– A report filed with the bankruptcy court, November 2002.

WorldCom 2002: Yet Another Corporate Scam

On June 26, 2002, the US-based telecommunications major WorldCom received unprecedented media coverage all over the world. Not for good reasons though. The company had earned the dubious distinction of being involved in the largest accounting scandal ever to hit the US corporate history. WorldCom had reportedly misrepresented its financial statements to an extent of around \$ 4 billion. The company admitted that it had resorted to fraudulent accounting practices for five quarters (four quarters of 2001 and the first quarter of 2002).

Soon after, WorldCom terminated the services of some of its top executives including Scott Sullivan (Sullivan), the Chief Financial Officer and David Myers, the Senior Vice President and Controller. The company's auditors held Sullivan responsible for the accounting mess and Sullivan was soon arrested on charges of fraud and misrepresentation.

Adding fuel to the fire was the fact that Arthur Andersen was WorldCom's auditor while the inappropriate accounting was taking place.² However, Arthur Andersen tried to wash its hands off the crisis stating that it was not aware of the accounting discrepancies. They accused Sullivan for withholding crucial information about book-keeping practices followed at WorldCom.

With the sudden appearance of a \$ 4 billion hole in its balance sheet, WorldCom was in an acute financial crisis. A severe cash crunch forced the company to layoff 17000 workers, which constituted 20% of its global workforce. Eventually, the

¹ www.guardian.co.uk.

² Arthur Andersen was also found guilty on charges of 'Obstruction of Justice' in the government investigation of another infamous client, Enron, which was embroiled in a major financial scandal as well.

The WorldCom Accounting Scandal

financial crisis forced WorldCom to file for reorganization under chapter 11³ of the Bankruptcy Code in July 2002.

In August 2002, WorldCom shocked company observers and stakeholders yet again by reporting an additional improper reporting in its financial statements. This time around, the amount involved was \$ 3.3 billion, carried out by manipulating the EBITDA⁴ during 1999-2001, and the first quarter of 2002. By late 2002, the extent of misappropriation by WorldCom was estimated to be well over \$ 9 billion.

From being one of the world's most valuable companies (valued over \$ 100 billion at its peak), WorldCom came to be known as one of the biggest instances of the 'fraud wave' sweeping the global corporate world since the late 1990s. The company's downfall from WorldCom to 'WorldCon' is a story of a corporate feeding its greed through financial and accounting manipulations.

WorldCom: The Company

WorldCom was started by Bill Fields in Hattiesburg, Mississippi, in 1983 under the name 'Long Distance Discount Services' (LDDS), providing long distance telecommunication (telecom) services. The venture was profitable right from the start. In 1985, Bernie Ebbers (Ebbers) became the company's CEO. Ebbers reportedly played a major role in the success of LDDS in the following years. The company went public in 1989 when it acquired Advantage Companies Inc., a publicly traded long distance telecom services company.

Throughout the 1990s, the company continued to grow by acquiring various companies and expanding its operations across the world (Refer Table 1 for the major acquisitions). In 1992, LDDS acquired Advanced Telecommunications Corp. In 1995, LDDS changed its name to WorldCom, as the management

Chapter 11 of the US Bankruptcy Code provides debtors a vehicle for operating their business under protection from the creditors while developing a plan for resolving their financial problems. The debtors can then develop a 'plan of reorganization' that enables them to operate successfully in the future, free from the burdens that precipitated the Chapter 11 filing in the first place.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) refer to a company's reported profit before the charges of depreciation and amortization (non-cash) interest and taxes (cash). It is calculated by deducting total expenses from the revenues in the period under consideration excluding the four expenses mentioned. Often used as a measure of a company's financial performance, EBITDA has many critics as well who state that unlike cash flows, it can be very easily manipulated to please investors.

CORPORATE FRAUDS – TRENDS AND LESSONS

Table 1: Key Mergers/Acquisitions of Worldcom

Year	Acquisitions/Mergers	Deal	Deal Value (Approx.)
1992	Advanced Telecommunications Corporation	Stock	\$ 850 million
1993	Metromedia Communications Corporation (MCC) & Resurgens	Stock & Cash	\$ 1.25 billion
1994	IDB Communication Group Inc.	Stock	\$ 936 million
1995	Williams Telecommunications Group, Inc. ('WilTel')	Cash	\$ 2.5 billion
1996	MFS Communications Company, Inc. ('MFS')	Stock	\$ 12 billion
1998	Brooks Fiber Properties	Stock	
1998	ANS Communications, Inc	Cash	\$ 500 million
1998	CompuServe Corporation	Stock	\$ 1.3 billion
1998	Embratel participacoes S.A	Cash	\$ 2.3 billion
1998	MCI Communication Corporation	Stock	\$ 40 billion

Source: ICMR

found the new name to be consistent with the company's future growth strategy of building a global presence through acquiring telecom-related companies across the world.

In 1998, WorldCom bought the network units of America Online and CompuServe. However, WorldCom's biggest deal was that of acquiring Microwave Communication Inc. (MCI)⁵ for an estimated \$ 40 billion in the same year. The company now operated under the name 'MCI WorldCom'. To complete the merger that year, MCI sold its Internet access business to Cable & Wireless plc (a leading communication company), and British Telecommunications (BT) ended its partnership with the company and bought MCI's Concert Communication⁶ stake. Bert Roberts (Roberts), CEO-MCI was made the Chairman of MCI WorldCom, and Ebbers, the CEO.

This was reportedly one of the largest deals in the world till then; and the credit for clinching the MCI deal went to Ebbers, following which, his influence

⁵ Microwave Communications, Inc. (MCI) was formed in 1963 by John Goeken to offer long-distance phone services. In 1993, British Telecommunication (BT) acquired a 20% stake in MCI and formed a global joint venture called Concert Communication.

⁶ Concert Communications was a joint venture between BT and MCI.

and reputation in the business circles began to grow. In February 1999, MCI WorldCom transferred its computer and software operations to Electronic Data Systems (EDS), one of the world's leading information technology (IT) service companies, in exchange for EDS's networking operations. In the same year, MCI WorldCom re-entered the consumer Internet access business by entering into an alliance with CompuServe and began delivering high-speed Internet access.

In October 1999, MCI WorldCom bought SkyTel, a wireless messaging firm. In the same year, it also tried to acquire Nextel (Nextel Communications, based in Reston, VA, a leading provider of fully integrated, wireless communications services) by bidding for it. However, it dropped the idea later as Nextel was reported to have accumulated huge debts. Continuing its acquisition spree, MCI WorldCom announced its decision to acquire its long-distance telecom-rival, Sprint for approximately \$ 120 billion. But the regulators in Europe and the US objected to the deal, following which the company dropped the idea.

By 1999, WorldCom had emerged as one of the world's biggest 'backbone' networks⁷ for Internet traffic and electronic commerce. Data, Internet and international services accounted for an estimated 70% (\$ 15.8 billion) of WorldCom's total revenues of \$ 22.8 billion in 1999.

In 2000, the company dropped MCI from its name and was called WorldCom once again. By 2001, WorldCom had acquired nearly 75 companies, most of the deals having been funded through stock with a marginal contribution of cash on the company's part. The decision to fund the deals primarily with stock served the company well since it did not have to incur heavy cash outflows. Creditors also found WorldCom a credible venture and invested around \$ 30 billion in the company.

By 2002, WorldCom had emerged as a leading global communication services provider, with operations in more than 65 countries. It had one of the most expansive, wholly owned IP⁸ networks in the world and provided innovative data

The generic term for LAN or WAN connectivity between subnetworks across an enterprise. Generally a conduit for traffic between multiple networks, which must operate at greater speed and capacity than the networks it connects. Backbones are generally bordered by either switches which consult routers or routers.

The Internet Protocol (IP) is the most widely-used method for transporting data within and between communication networks. IP telephony is also known as Voice over IP or Internet Telephony and it represents the technology, which uses IP-based data networks to transmit telephone calls.

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and sophisticated Internet services for businesses to communicate. Due to the sheer size and the range of services it offered, WorldCom marched ahead of most of its rivals in the telecom sector. In 2002, WorldCom employed more than 60,000 people and served over 20 million residential and business customers (Refer Exhibits I, II and III for the company's financial statements).

The developments in June 2002 came as a major shock to all the parties concerned because the company had shown impressive growth and had an excellent performance record. As the story of WorldCom's frauds unfolded in the media, the factors that had led to the crisis soon started becoming common knowledge. It was soon evident that the accounting malpractices that had begun in the late 1990s were rooted in the company's desperate attempts to face the challenges and problems that had cropped up due to the changing economic and business scenario.

WorldCom: Genesis of the Frauds

In the early 1990s, the US economy went through a phase of consolidation, in which many major companies acquired or merged with weaker companies to strengthen their own position in the market (as seen earlier, WorldCom happened to be one of the key acquirers in this phase). The share prices of companies play a vital role during mergers and acquisitions. Therefore companies try to 'maintain' the prices of their shares (that is, keep them sufficiently high). If they fail to do so, they can easily become targets for takeover/acquisition.

Moreover, if a company wishes to raise capital from the market, its performance on the stock exchange is considered to be very important. The companies are generally valued on the basis of cash flows they could generate in future. As the financial performance of a company is one of the most important (and direct) factors affecting its share price, companies were under constant pressure to show positive revenue streams.

However, this was easier said than done. Not only was the US economy facing a slowdown during the late 1990s, industries such as IT and telecommunications were going through one of the worst downturns ever. As a result of the dotcom bust, many big companies lost millions of dollars in a short span of time. The old-economy industries were not faring very well either. In these conditions,

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many companies resorted to a process called 'backing in'⁹ to project increased profits despite low growth rates.

WorldCom was also among one of these companies that were trying to take an 'easy way out' to project healthy financial growth despite the adverse market conditions. To provide Internet access to customers, the company had built up a huge infrastructure, anticipating that the demand for services on broadband¹⁰ networks would grow significantly. However, by 2000, the Internet infrastructure had lost much of its attractiveness and the demand for broadband services was lower than expected.

Moreover, the long distance telecom sector was severely hit by growing competition from local phone companies. Prices fell drastically. With the introduction of mobile telephony, customers were increasingly relying on email and mobile phones for long distance communication. As a result of the above factors, by late 2000, WorldCom was struggling to retain its position in the market. In spite of the tough competition from mobile telephony, WorldCom decided to stick to basic telephony only.

WorldCom responded to the changing business conditions and 'earnings pressure' by resorting to illegal measures. The objectives behind these adjustments was to illegally inflate the reported earnings and meet the expectations of security analysts, thereby concealing the company's actual financial position.

In a scheme that had reportedly been accepted by its senior management, WorldCom covered its true operating performance through improper accounting that overstated its income during 1999-2002. Ordinary operating costs (telecommunications system maintenance expenses) were characterized as capital expenditure. The company also reclassified certain line cost expenses¹¹ (operational

⁹ In this procedure, instead of the profit figure emerging as the end result of accounting procedures, it becomes the starting point. Beginning with a level of profit necessary to meet 'market expectations' and maintain or increase the share price, companies worked backwards to manipulate the financial statements to attain that goal.

¹⁰ Broadband refers to a high-speed interactive data transmission service, wherein the technique used is such that several data channels can be carried over a common wire using a wide band of frequencies. Information can be sent on many different frequencies or channels within the band concurrently, allowing more information to be transmitted in a given amount of time.

¹¹ Line costs represented the fees WorldCom paid to third-party telecommunication carriers for accessing their network facilities. As per the accounting standards followed in the US, the Generally Accepted Accounting Principles (GAAP), the fees has to be reported as an expense by the paying company.

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costs) as capital expenditure. As a result of understating the revenue expenditure, the company was able to overstate its operating cash flows and overall profits.¹² (Refer Table 2 for details). The amount involved in such reclassification was \$ 3.055 billion for 2001 and \$ 797 million for the first quarter of 2002.

Table 2: Accounting Discrepancies at WorldCom

(in \$ billion)

Quarter (Q)	Line Cost Expenses Reported (1)	Line Cost Expenses Actual (2)	Variance 3 = (2-1)	Reported Income before Taxes (4)	Actual Income before Taxes (5)	Variance 6 = (4-5)
3rd Q. 2000	3.867	4.695	0.828	1.736	0.908	0.828
2000	15.462	16.697	1.235	7.568	6.333	1.235
1st Q. 2001	4.108	4.879	0.771	0.988	0.217	0.771
2nd Q. 2001	3.730	4.290	0.560	0.159	(0.401)	0.560
3rd Q. 2001	3.745	4.488	0.743	0.845	0.102	0.743
2001	14.739	17.754	3.015	2.393	(0.622)	3.015
1st Q. 2002	3.479	4.297	0.818	0.240	(0.578)	0.818

Source: Adapted from filings with SEC in Forms 10Q and 10K.

Meddling with expenses was just one aspect of the company's accounting manipulations. During 1999-2001, the company took out money from reserve accounts¹³ and showed it as revenue from operations. As the pressure to show profits increased, the frequency of these adjustments also increased. Had there been no such transfers, EBITDA would have been reduced to \$ 6.339 billion for 2001 and \$ 1.368 billion for the first quarter of 2002 and the company would have posted huge losses.

Similar to the expenses reclassification exercise, the above exercise was also against the accounting policies specified under GAAP. GAAP rules stated that 'expenses should be recognized in the period when the revenue generated by them was recognized.' In situations where the value of expense was difficult to

¹² Operating expenses are charged to a company's income statement and subtracted from revenues in the period in which the expense is incurred or paid, resulting in the company's net income for that period. Capital expenditures, on the other hand, are not subtracted from revenues and are not reflected on the income statement. They are reported as capital assets in the balance sheet.

¹³ Reserves are special accounts set up to pay for potential losses from a specific predictable event, such as a legal verdict.

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define, or was spread out over multiple accounting practices, 'industry practices' were to be adopted. However, WorldCom had devised a convenient way of dealing with its problems.

It was reported that some WorldCom officials expressed concern over the happenings during this period but they were not taken seriously. Sullivan justified his actions in an interview by saying that during the boom of 1999 and 2000, the demand for telecommunications seemed excessively high. To cater to this high demand, WorldCom took long-term leases from local telecommunication companies for providing more local phone-line connections than were actually needed.

Since lease costs are operating in nature for telecommunication companies, they have to be directly debited to the profit and loss statement at the time of their occurrence. However, WorldCom re-classified them as capital investments, to charge them off over many years. Sullivan justified this by saying that 'costs associated with obtaining a customer may be deferred and amortized over the revenue stream associated with that contract.'

Accounting Principles state that for an expense to be classified for amortization, it has to be directly linked to the revenue. However, Sullivan justified his stand stating that the amortization of expenses would apply to revenue actually contracted, not to the marketers' projections of what customers might buy. Since WorldCom did not have the corresponding revenue to justify the amortization of the expense, the remaining portion of the re-classified line costs was decided to be charged off by restating earnings for the previous quarters. Sullivan's plan apparently was to make a one-time charge in the quarter of June 2002 and take care of the problem.

However, this became impossible after MCI internal auditors discovered the accounting irregularities during a review of WorldCom books in early 2002. The auditing not only revealed the issue of inflated earnings, it also drew attention to another regular practice at the company – the massive loans given to Ebberts over the years.

WorldCom: The Ebbers Angle

During the 1990s, Ebbers borrowed more than \$ 1 billion for personal purposes from various banks. He pledged his WorldCom stock as collateral. When the prices of the WorldCom stock began declining in the early 21st century, Ebbers' lenders began pressurizing him to sell the stock and raise cash to support his loans. Reportedly, Ebbers decided to sell some of his shares in the company to meet these personal liabilities. However, fearing that the sale would result in a further drop in WorldCom's share prices, the company board decided to authorize loans to Ebbers so that he could pay off his debts. The company gave him loans to the extent of \$ 408 million between 2000 and 2002. The company justified this by stating that it had to stop Ebbers from selling his stock in order to prevent a fall in the share prices of WorldCom.

Ebbers appropriated these loans for various personal purposes. For instance, around \$ 36.5 million was donated to his alma mater Mississippi College under an arrangement. According to this, the school sold bonds that Ebbers pledged to pay off at maturity. As a collateral for the bonds, Ebbers pledged WorldCom stock to the Bank of America (BoA). The arrangement allowed the school to get the money instantly. It also allowed Ebbers to hold his stock under the impression that he would be able to earn enough to pay back the bonds over time. However, after the prices of WorldCom's stock began declining in 2000 and 2001, Ebbers' shares were no longer sufficient as collateral for BoA. As the bank started demanding money for the collateral, Ebbers did not have any option but to sell his stock. To prevent him from selling shares, WorldCom paid off BoA on Ebbers' behalf. Besides this, Ebbers spent nearly \$ 28 million on personal business ventures and \$ 1.8 million on buying a residential property for himself.

However, once the auditors discovered the accounting discrepancies, they reported them to the Securities and Exchange Commission (SEC)¹⁴ and an official probe began. In April 2002, Ebbers resigned, all the while denying having any knowledge of the frauds or accounting 'mistakes'. He also commented that no one would find him to have knowingly committed the fraud. However, Sullivan told lawyers that Ebbers knew about the misrepresentations all along. He said,

¹⁴ The primary objective of the US Securities and Exchange Commission (SEC) is to protect investors and maintain the integrity of the securities markets.

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"When all of the activities at WorldCom are fully aired, I believe that no one will conclude that I engaged in any criminal or fraudulent conduct during my tenure."

During the course of the probe, it was revealed that, Ebbers had entered into a loan arrangement with Citibank, wherein Citibank provided Ebbers with a loan of roughly \$ 400 million in August 1999 using the WorldCom stock as collateral. Citibank thus clearly had an 'investor interest' in the company. During this period, Jack Grubman (Grubman), Salomon Smith Barney's (Citigroup's investment division) former telecommunications analyst predicted a substantial rise in WorldCom stock.

On August 20, 1999, when WorldCom shares were trading at \$ 75.75, Grubman recommended the stock and predicted that its price would reach to \$ 130. Though the price never reached the predicted levels, he continued to rate it a 'buy' until April 2002. According to analysts, the recommendations of a renowned analyst like Grubman also contributed to the general feeling of 'everything being well' at WorldCom among the investors.

WorldCom: The Final Countdown

As media, legal and investor unrest intensified against WorldCom, there was little hope left for the company. The company was required to pay \$ 172 million in interest and debt in 2002, which was to increase further to \$ 1.7 billion and \$ 2.6 billion as a part of the repayment schedule in 2003 and 2004. Analysts remarked that the company, which had a negative cash flow of \$ 871 million in 2001, would be able to generate only \$ 564 million in free cash flow in 2002 and \$ 1 billion in 2003. Considering the situation, many company observers predicted that the company would soon declare itself bankrupt.

On April 19, 2002, the company revised its financial predictions for the year 2002, citing a downturn in the long distance consumer business. WorldCom announced that its revenues would range between \$ 21 billion to \$ 21.5 billion, as against the earlier projection of \$ 22 billion. The overall revenues were supposed to drop by 5%. Similarly, the net income was expected to fall by 40% (to \$ 1.6 billion approximately). Firms including Merrill Lynch, A G Edwards and Credit Suisse First Boston downgraded WorldCom to 'sell'. Standard & Poor's and

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Moody's Investor Service cut the rating to 'Baa2' (two notches above junk bond status)¹⁵. The company's stock dropped by 43% in the next two days to \$ 3.41 a share. Following this, in May 2002, WorldCom replaced Andersen with KPMG.

After the company admitted to the fraud in June 2002, the SEC stated in its civil lawsuit that the scheme was 'directed and approved by WorldCom's senior management. In 2001, WorldCom fraudulently reported \$ 2.393 billion in income before taxes rather than its actual loss of \$ 662 million.' According to SEC, in the first quarter of 2002 also, WorldCom incorrectly reported income before taxes of \$ 240 million, rather than a loss of \$ 578 million. The scandal generated so much media backlash that the US President, George W Bush had to intervene and promise to safeguard the interests of the investors.

In the first week of July 2002, John Sidgmore (former President) was appointed as the company's new CEO. In early July 2002, both Ebbers and Sullivan refused to testify to a US Congressional Committee saying that such testimony may lead to self incrimination. They asserted their right of not testifying and declined to answer any questions. Following this, Sullivan and David Myers (Controller) were arrested in the first week of August 2002 and were charged with conspiring to commit securities fraud and filing false statements with the SEC. They surrendered and were taken into custody by the Federal Bureau of Investigation (FBI) officials. Later, they were freed on bail. Interestingly, Ebbers was not charged with any wrongdoing related to WorldCom's accounting frauds and was thus not prosecuted.

Given the above circumstances, the July 2002 filing of Chapter 11 protection by the company was inevitable. However, these events did not have much impact on the bourses, as by now WorldCom's stock was already a penny stock¹⁶. While the Dow Jones Industrial Average lost only six points and the S&P 500 less than three, the Nasdaq Composite Index actually gained a bit; all three indices rose on

¹⁵ Rating downgrade occurs when a company is at high risk of defaulting on its obligations. Bonds are generally classified into two groups, 'investment grade' bonds and 'junk' bonds. The term 'junk' refers to all bonds with Standard & Poor's ratings below BBB and/or Moody's ratings below Baa. While investment grade bonds are generally legal for purchase by banks, junk bonds are not.

¹⁶ A stock which sells for less than one dollar per share or in some cases, less than five dollars per share.

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the days that followed the Chapter 11 filing announcement¹⁷. Soon after, the Nasdaq listing qualification panel decided that WorldCom's WorldCom Group Common Stock, MCI Group Common Stock and the 8% Cumulative Quarterly Income Preferred Securities, Series A, would be delisted. Soon, the stocks were delisted from other US stock exchanges as well.

WorldCom: Lessons from the Saga

WorldCom had an audit committee consisting of 11 directors (refer Exhibit V for the board's composition), eight of whom were independent. The objective of the audit committee was to review the company's financial statements, monitor internal accounting control activities, communicate with the company's external auditors and review internal accounting control activities. However, media reports claimed that WorldCom's board of directors failed to fulfill their basic responsibilities.

Analysts also felt that apart from inefficient corporate governance practices followed by the company, the naivety of the investors was also equally responsible for the crisis. They felt that the investors should have demanded for more transparency in the accounting systems. At the same time, they held the market forces responsible for expecting companies to deliver positive results, without considering the prevailing economic conditions. They said that such expectations were one of the major reasons which compelled companies like WorldCom to adopt such deceptive accounting procedures.

The WorldCom debacle prompted analysts to comment that the increasing trend of external auditors being a party to corporate scams was rather disturbing. Since external auditors had begun performing various roles for their clients (in terms of consultancy for instance), their relationship with these companies had become 'too close'. This seemed to have made them forget their fundamental duty of informing the investors about the company's true financial position. The above issue was at the core of the new corporate governance rules released by the

¹⁷ As per the semi strong form of efficient market theory, the share prices reflect and adjust all publicly available information. This suggests that shares had already taken into account the effect of financial conditions of WorldCom and investors had no expectation from this stock. WorldCom's stock reached a high of almost \$ 65 a share in 1999. It had been dropping precipitously thereafter, and then, due to market fears of a bankruptcy, dropped below \$1 even before the company revealed in June 2002 that it had inappropriately accounted for \$3.85 billion in costs.

SEC regarding issues related to auditing, accounting and corporate governance (Refer Exhibit VI).

WorldCom: The Aftermath

In November 2002, Michael D Capellas (Capellas, Former President, Hewlett-Packard) was appointed as the Chairman and CEO of WorldCom. Despite the bankruptcy proceedings and the legal troubles, WorldCom officials seemed rather positive about the company's future. John Sidgmore (Retiring CEO) said that the company's focus would be on reorganizing, regaining financial strength, and operating with the highest integrity. He also said that the company would emerge from chapter 11 as quickly as possible and with their competitive spirit intact. At the time of his appointment, Capellas said, "Today we are launching a new company, one that will reclaim the strengths of its past and focus on a promising future."

In December 2002, a majority of the board members of WorldCom offered their resignation to Capellas, who accepted the same. This was done so as to enable the company to start afresh and put in place substantive reforms and adopt the best corporate governance practices. In January 2003, Capellas announced extensive plans for the next 100 days to bring the company back to normal. In a presentation to the WorldCom employees, he outlined various plans which included the launching of new products and services, putting in place additional corporate integrity initiatives. He also planned to develop a new corporate leadership structure.

Within three weeks of these announcements, the company laid out a \$ 2.5 billion cost reduction plan aimed at reducing line costs by 12.5% and sales, general and administrative expenses by 13%. WorldCom also planned to consolidate its facilities and reduce its workforce (primarily from corporate and administrative functions).

While the legal proceedings continued and the company struggled to get back on the tracks, the credibility of US corporate citizens seemed to have reached a nadir. Companies such as Enron, K-Mart and WorldCom had proven beyond doubt that unethical business practices could not be covered forever behind glitzy corporate offices and mega marketing campaigns. However, this fact would perhaps be of little consequence when seen in the backdrop of the billions of dollars that were lost in these scandals.

Exhibit 1*: WorldCom & Subsidiaries – Consolidated Balance Sheets

(in million, except share data)

	December 31	1997	1998	1999	2000	2001
ASSETS						
Current assets:						
Cash and cash equivalents		\$ 155	\$ 1,710	\$ 876	\$ 761	\$ 1,416
Marketable securities		54	-	6		
Accounts receivable, (net of allowance for bad debts)		1,241	5,226	5,746	6,815	5,308
Deferred tax assets		-	2,523	2,565	172	251
Other current assets		424	1,180	1,131	2,007	2,230
Total current assets		1,874	10,639	10,324	9,755	9,205
Property and equipment:						
Transmission equipment		3,688	12,052	14,689	20,288	23,814
Communications equipment		2,493	5,256	6,218	8,100	7,878
Furniture, fixtures and other		920	5,986	7,424	9,342	11,263
Construction in progress		468	3,080	5,397	6,897	5,706
		7,569	26,374	33,728	44,627	48,661
Accumulated depreciation		(855)	(2,067)	(5,110)	(7,204)	(9,852)
		6,714	24,307	28,618	37,423	38,809
Goodwill and other intangible assets		13,882	47,018	47,308	46,594	50,537
Deferred tax assets		405				
Other assets		4,437	721	4,822	5,131	5,363
		\$ 23,596	\$ 86,401	91,072	\$ 98,903	\$ 103,914
LIABILITIES AND SHAREHOLDERS INVESTMENTS						
Current Liabilities:						
Short-term debt and current maturities of long-term debt		\$ 11	\$ 4,756	\$ 5,015	\$ 7,200	\$ 172
Accrued interest		119	505		446	618
Accounts payable and accrued line costs		1338	5,640	6,278	6,022	4,844
Other current liabilities		606	5,128	5,916	4,005	3,576
Total current liabilities		2,074	16,029	17,209	17,673	9,210
Long-term liabilities, less current portion:						
Long-term debt		7,413	16,083	13,128	17,696	30,038

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Deferred tax liability	-	2,960	4,877	3,611	4,066
Other liabilities	308	1,852	1,223	1,124	576
Total long-term liabilities	7,721	20,895	19,228	22,431	34,680
Commitments and contingencies					
Minority interests	-	3,676	2,599	2,592	101
Company obligated mandatory redeemable and other preferred securities	-	798	798	798	1,993
Shareholders' investment:					
Series B preferred stock, par value \$.01 per share; authorized, issued and outstanding: 10,693,437 shares in 2000 and none in 2001 (liquidation preference of \$1.00 per share plus unpaid dividends)	-	-	-	-	-
Preferred stock par value \$.01 per share; authorized: 31,155,088 shares in 2000 and 30,967,637 shares in 2001; none issued	-	-	-	-	-
Common stock:	10	18	28		
WorldCom group common stock, par value \$.01 per share; authorized: 5,000,000,000 shares in 2000 and none in 2001; issued and outstanding 2,887,960,378 shares in 2000 and none in 2001				29	-
WorldCom group common stock, par value \$.01 per share; authorized: none in 2000 and 4,850,000,000 shares in 2001; issued and outstanding: none in 2000 and 2,967,436,680 shares in 2001				-	30
MCI group common stock par value \$.01 per share; authorized: none in 2000 and 150,000,000 shares in 2001; issued and outstanding: none in 2000 and 118,595,711 in 2001				-	1
Additional paid-in capital	15,530	49,521	52,108	52,877	54,297
Retained earnings	(1,773)	(4,473)	(928)	3,160	4,400
Unrealized holding gain (loss) on marketable equity securities	34	122	575	345	4,400
Cumulative foreign currency translation adjustment			(360)	(817)	(562)
Treasury stock, at cost, 6,765,316 shares of WorldCom, Inc. in 2000, 6,765,316 shares of WorldCom group stock and 270,613 shares of MCI group stock in 2001		(185)	(185)	(185)	(185)
Total shareholders' investment	13,801	45,003	51,238	55,409	57,930
	\$ 23,596	\$ 86,401	\$ 91,072	\$ 98,903	\$ 103,914

Source: www.WorldCom.com

*: The statements depict the financial position before the misrepresentations mentioned by the company were taken into account.

Exhibit II*: WorldCom & Subsidiaries – Consolidated Statements of Operations

(in millions, except share data)

For the years ended December 31	1996	1997	1998	1999	2000	2001
Revenues	\$ 4,449	\$ 7,384	\$ 17,678	\$ 35,908	\$39,090	\$35,179
Operating expenses:						
Line costs	2,397	3,764	8,416	14,739	15,462	14,739
Selling, general and administrative	867	1,626	4,312	8,935	10,597	11,046
Depreciation and amortization	320	976	2,200	4,354	4,878	5,880
Other charges	2,740	-	3,725	(8)	-	-
Total	6,324	6,366	18,653	28,020	30,937	31,655
Operating income	(1,875)	1,018	(975)	7,888	8,153	3,514
Other income (expense):						
Interest expense	(253)	(395)	(637)	(966)	(970)	(1,533)
Miscellaneous	25	40	41	242	385	412
Income before income taxes, minority interests and cumulative effect of accounting change	(2,103)	663	(1,571)	7,164	7,568	2,393
Provision for income taxes	130	416	876	2,965	3,025	927
Income before min. interests and cumulative effect of accounting change	(2,233)	247	(2,447)	4,199	4,543	1,466
Minority interests	-	-	(93)	(186)	(305)	35
Income before cumulative effect of accounting change	(2,233)	247	(2,540)	4,013	4,238	1,501
Extraordinary items (net of income taxes \$16, \$0 and \$78 respectively)	(24)	(3)	(129)	-	(85)	-
Cumulative effect of accounting change (net of income tax of \$50 in 2000)	(2,257)	244	(2,66)	4,013	4,153	1,501
Net income						
Distributions on mandatory redeemable preferred securities and other preferred dividend requirements			18	72	65	117
Preferred dividend requirement		26	13			
Net income applicable to common shareholders	\$ (2,258)	\$ 218	\$ (2,700)	\$ 3,941	\$ 4,088	\$ 1,384
Net income attributed to WorldCom group before cumulative effect of accounting change				\$ 2,294	\$ 2,608	\$ 1,407
Cumulative effect of accounting change				\$ -	\$ (75)	\$ -

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Net income attributed to WorldCom group				\$ 2,294	\$ 2,533	\$ 1,407
Net income (loss) attributed to MCI group before cumulative effect of accounting change				\$ 1,647	\$ 1,565	\$ (23)
Cumulative effect of accounting change				\$ -	\$ (10)	\$ -
Net income (loss) attributed to MCI group				\$ 1,647	\$ 1,555	\$ (23)
Earnings (loss) per common share						
Net income loss applicable to common shareholders before extraordinary items						
Basic	\$(5.02)	\$ 0.23	\$ (2.02)			
Diluted	(5.02)	0.22	(2.02)			
Extraordinary items	(0.05)		(0.10)			
Net income (loss) applicable to common shareholders:						
Basic	(5.07)	0.23	(2.12)			
Diluted	(5.07)	0.22	(2.12)			
World Com group:						
Net income attributed to WorldCom group before cumulative effect of accounting change:						
Basic				\$ 0.81	\$ 0.91	\$ 0.48
Diluted				\$ 0.78	\$ 0.90	\$ 0.48
Cumulative effect of accounting change				\$ -	\$ (0.03)	\$ -
Net income attributed to WorldCom group:						
Basic				\$ 0.81	\$ 0.88	\$ 0.48
Diluted				\$ 0.78	0.87	\$ 0.48
MCI group:						
Net income (loss) attributed to MCI group before cumulative effect of accounting change:						
Basic				\$ 14.32	\$ 13.61	\$ (0.20)
Diluted				\$ 14.32	\$ 13.61	\$ (0.20)
Cumulative effect of accounting change				\$ -	\$ (0.09)	\$ -
Net income (loss) attributed to MCI group:						
Basic				\$ 14.32	\$ 13.52	\$ (0.20)
Diluted				\$ 14.32	\$ 13.52	\$ (0.20)

Source: www.WorldCom.com

* : The statements depict the financial position before the misrepresentations mentioned by the company were taken into account.

Exhibit III*: WorldCom & Subsidiaries – Consolidated Statements of Cash Flows

(in millions, except share data)

For the Years ended December 31	1996	1997	1998	1999	2000	2001
Cash flows from operating activities:						
Net income	\$ (2,257)	\$ 244	\$ (2,669)	\$ 4,013	\$ 4,153	\$ 1,501
Adjustments to reconcile net income to net cash provided by operating activities:						
Extraordinary items	24	3	129			
In-process research and development and other charges	2,740	-	3,725			
Provision for losses on accounts receivable	58	111	374			
Cumulative effect of accounting change					85	-
Minority interests	-	-	93	186	305	(35)
Other charges				(8)	-	-
Depreciation and amortization	320	976	2,200	4,354	4,878	5,880
Provision for deferred income taxes	59	368	787	2,903	1,649	1,104
Accreted interest on debt	30	122	25			
Change in assets and liabilities, net of effect of business combinations:	(216)	(453)	(698)			
Accounts receivable, net	(216)	(453)	(698)	(875)	(1,126)	281
Other current assets	(54)	(174)	(248)	143	(797)	164
Accounts payable and other current liabilities	79	(25)	741	692	(1,050)	(1,154)
All other operating activities	(1)	(9)	(44)	(403)	(431)	253
Net cash provided by operating activities	781	1,260	4,085	11,005	7,666	7,994
Cash flows from investing activities:						
Capital expenditures	(875)	(3,066)	(5,418)	(8,716)	(11,484)	(7,886)
Acquisitions and related costs	112	(1,144)	(3,400)	(1,078)	(14)	(206)

Contd...

The WorldCom Accounting Scandal

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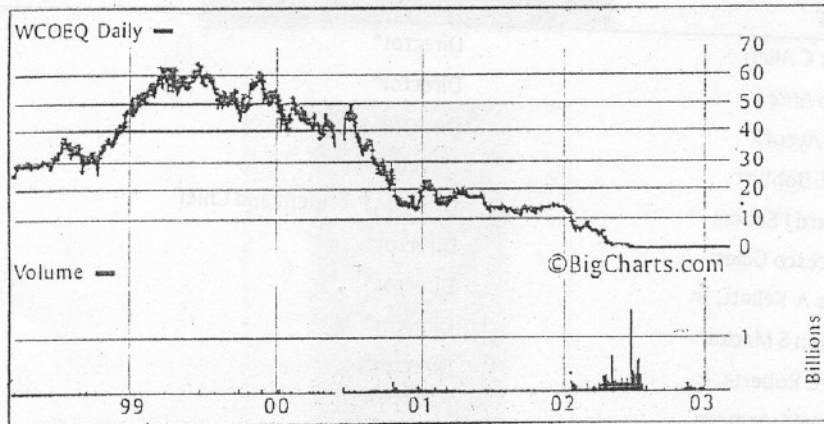
Sale (purchase) of short-term investments net	(182)	890	54			
Increase in intangible assets	(71)	(141)	(351)	(743)	(938)	(694)
Proceeds from disposition of long-term assets	22	93	146			
Increase in other assets	(152)	(291)	(320)			
Decrease in other liabilities	(42)	(42)	(144)	(650)	(839)	(480)
All other investing activities				1,632	(1,110)	(424)
Net cash used in investing activities	(1,188)	(3,701)	(9,433)	(9,555)	(14,385)	(9,690)
Cash flows from financing activities:						
Principal borrowings (repayments) on debt, net	568	1,978	6,424	(2,894)	6,377	3,031
Common stock issuance	233	164	463	886	585	124
Distributions on mandatory redeemable and other preferred securities and dividends paid on other equity securities	-	-	(18)	(72)	(65)	(154)
Dividends paid on preferred stock	(1)	(26)	(13)			
Redemptions of preferred stock				-	(190)	(200)
All other financing activities	(10)	(5)	47	-	(84)	(272)
Net cash provided by (used in) financing activities	790	2,111	6,903	(2,080)	6,623	2,529
Effect of exchange rate changes on cash				(221)	(19)	38
Net increase (decrease) in cash and cash equivalents	383	(330)	1,555	(851)	(115)	871
Cash and cash equivalents at the beginning of the period	102	485	155	1,727	876	761
Deconsolidation of Embratel				-	-	(216)
Cash and cash equivalents at the end of the period	\$ 485	\$ 155	\$ 1,710	\$ 876	\$ 761	\$ 1,416

Source: www.WorldCom.com

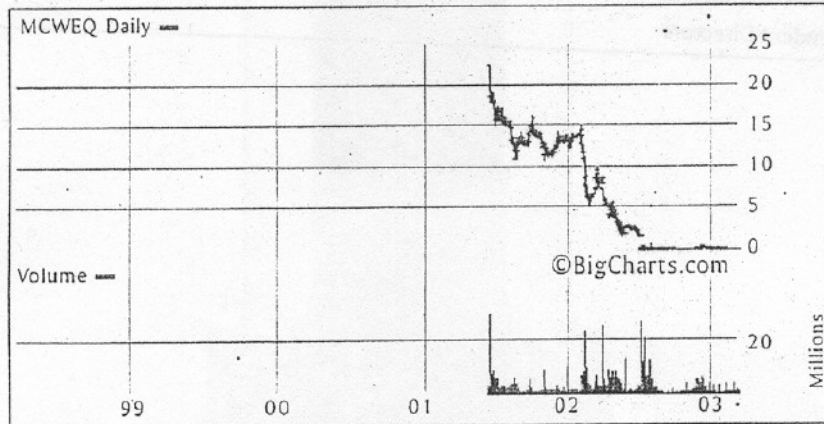
*: The statements depict the financial position before the misrepresentations mentioned by the company were taken into account.

Exhibit IV
WorldCom & MCI – Stock Price Movements

WCOEQ*



MCWEQ*



* On June 7, 2001 WorldCom announced that it would have two tracking stocks; while the WorldCom group stock (Nasdaq: WCOEQ) would reflect the performance of the high-growth data, the internet and international operations, and commercial voice services, the MCI group stock (Nasdaq: MCWEQ) would reflect the performance of its high-cash flow consumer, small business, wholesale long distance, wireless messaging and dial-up Internet access operations. In May 2002, the company announced that it had decided to eliminate the above structure. However, after the bankruptcy and the subsequent delisting from the bourses, the stock was trading over the counter in March 2003. On March 11, 2003, the WCOEQ stock closed at 0.124, while the MCOEQ stock closed at 0.125.

Source: www.worldcom.com

CORPORATE FRAUDS – TRENDS AND LESSONS

Exhibit V
WorldCom's Board of Directors prior to the Scam

NAME	TITLE
James C Allen	Director*
Judith Areen	Director*
Carl J Aycock	Director*
Max E Bobbitt	Director*
Bernard J Ebbers	Director, President and Chief
Francesco Galesi	Director*
Stiles A Kellett, Jr.	Director*
Gordon S Macklin	Director*
Bert C Roberts, Jr	Director*
John W Sidgmore	Director*
Scott D Sullivan	Director and Chief Financial Officer.

Source: www.worldcom.com

* Independent Directors

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Exhibit VI: New Corporate Governance Rules by the SEC and the New York Stock Exchange (NYSE)		
FROM THE SEC:		
Area	Tough new rules...	Though not tough as some
Accounting	Tight restrictions on Enron-style off-balance-sheet vehicles	Definition of expert widened; level of liability too low for some Chairman yet to be appointed
Audit committees	Must state if it contains a 'financial expert'	
Audit standards	To be overseen by the new Public Company Accounting Oversight Board, ending industry self-regulation	
Auditors	Barred from much non-audit work, such as consulting Lead partners to be rotated every five years	
Financial disclosure	Accounts to be filed faster CEOs and CFOs to attest to accuracy of accounts Use of 'proforma' accounts limited	Still allowed to advise on tax Allowed to do non-audit work for client immediately after stepping down as auditor Definition of 'audit' widened to cover some work that was previously 'non-audit'
Executive behavior	Share sales to be disclosed sooner Executives barred from selling if employees cannot sell	
Lawyers	Have to ensure client senior-managers and board informed of security-law violation	
Mutual funds	Funds to disclose how they use 'proxy' votes	
FROM THE NYSE:		
Board composition	Must be a majority of non-executive (independent) directors	
Non-executive power	Non-executives must meet regularly without executives Lead non-executive must be named	
Scrutiny of decision-making	Compensation, nominating and audit committees to be entirely non-executives	
Public accountability	Must publish corporate governance guidelines setting out for example, provision for annual evaluation of the board and the boss	
Source: SEC, NYSE, The Economist.		

CORPORATE FRAUDS – TRENDS AND LESSONS

(Hari Prasad Sharma was an MBA from ICAI University. He has done his project with ICMR, an affiliate of ICAI University.)

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Power Failure

Mimi Swartz and Sherron Watkins

(Summarized by Sharath Jutur)

Power Failure is the inside story of the rise of Enron, its culture of corruption and its fall. It chronicles the linkages between the cultural deterioration and the excessive emphasis on performance – irrespective of the mechanisms used – that have first created the semblance of a flourishing organization and then revealed the fraud to the world.

Although it ended as a tragic story, the name Enron was always synonymous with innovation. Enron had its roots in Houston. Like any Houston-dweller who thrives on innovation and experimenting, this citizen of Houston also made innovation a weapon to smother its competitors and grow. Enron, initially known as Kirby Oil Company established by John Henry Kirby, the father of Industrial Texas. The oil company after a series of mergers was christened as Enron. Enron and its employees dwelled on innovation for its success. Those who were smart and innovative turned out to be winners and those who were not were losers.

Star Search

The story of Enron was surrounded with mystery since its inception in 1985. Five years after its inception, Ken Lay, the then CEO unveiled a new vision for

Source: ICAFI Reader, September 2003. © ICAFI University Press. All rights reserved. This article is a summary of the book "Power Failure: The Inside Story of the Collapse of ENRON" by Mimi Swartz and Sherron Watkins.

Enron – to be world's first natural gas major and the most innovative and reliable provider of clean energy. To achieve this, Lay knew that he had to have the brightest and the best talent who should be allowed to develop to their immense potential.

This marked his ambition and desire to place talented people in key positions of Enron. The most prominent among them were John Wing, Rebecca Mark, Jeff Skilling. John Wing got Enron's first biggest power plant in line in Texas, and Rebecca Mark as CEO of Enron Development Corporation, got many large deals and helped Enron to spread its reach. Jeff Skilling shared Lay's aspirations of creating Enron as a new business model that would change American capitalism forever. He headed Gas Services Department and his sound finance knowledge helped Enron survive uncertainties created by the deregulation regime. As the economy improved, Enron's business also improved. In 1990s, gas business became so popular that New York Mercantile Exchange (NYMEX) established a new market for gas futures. Since Enron was a major gas company, it was a dominant player in the futures market. As futures contracts do not require one to actually get into business of gas buying and selling, trading in futures increased and Enron's traders were the major players. Due to this the company could effectively set the prices in the market and control them.

Then in 1991, a newly hired controller at the SEC, Rick Causey introduced 'mark to market accounting' to Enron. Mark to market method determined the value of future deals that Enron entered into at current market prices. This helped Enron reap huge profits. When Enron was enjoying the feast of success given by mark to market accounting, it failed to recognize the risks involved in using this method. Nor did its auditors Arthur Andersen and Wall Street's investment banks who continued to rate Enron as a "very attractive" stock.

Smart Enron

Though Enron was growing, it was not at the pace at which, Lay wanted it to grow. With an objective to achieve robust growth, a new division, the Joint Energy Development Investments (JEDI) was established. The mission of JEDI was to invest in diversified businesses in natural gas that would benefit Enron's Gas Services' core businesses strategically. After JEDI was created, though the company was growing, it could not make further investments, as this would lead to an

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increased debt burden on the company. The HNG/Internorth merger resulted in excess debt burden on Enron and taking further debt was ruled out. Enron had no other option but to rely on off-balance sheet deals using the Special Purpose Entities (SPEs) to hide its debt. These innovative instruments allowed companies to expand without increasing debt. Enron also used innovative products like Volumetric Production Payments (VPP).

Enron's first off-balance sheet SPE was called the cactus. This SPE funded Enron's VPP business and also jump started its trading operations. Another division that was offering real money to Enron was the partnership between Enron and the California Public Employees' Retirement System (CalPERS).

The Monkey House

Lay saw his dreams being fulfilled through Jeff Skilling's skills who banked on his creation, the Enron Capital and Trade (ECT) division. As the commodity markets grew Enron's traders were able to make more successful financial trades. ECT's business model was such that it purchased natural gas and oil from its suppliers and sold to its consumers at a margin and it made profits out of the spreads in the purchase price and selling price of the raw material. In December 1995, due to some rumors that Enron had made losses on its contracts on the NYMEX its stock price dropped by from \$37 to \$34. Enron reacted to it swiftly and said that these rumors were baseless. Enron's auditor, Arthur Andersen too said that everything is fine at Enron after thoroughly checking the internal controls and various other aspects at ECT. But ECT made a mistake in 1996, when it made a wrong bet on the price of gas and had to lose \$90 mn. Consequently, ECT was \$190 mn short of its earnings target but Enron never missed its target. Enron's top performers were looking for ways to meet the earnings targets.

In this process they realized that Enron's equity investment was in trouble as banks recovered from the 1980s oil crash. Consequently those who approached Enron for their funding through VPPs were loath to approach any more.

The Portfolio Advisory Committee was set up to assess and manage the company's new equity risk portfolio. The Committee headed by Sherron Watkins realized that it was not possible to hedge the equity deals. However, Skilling was

Power Failure

not convinced. He advised Sherron to arrive at some techniques just to prove that they can be hedged, irrespective of their real hedging capabilities.

Skilling set up a Risk Assessment Control (RAC) group, which was responsible for developing innovative mathematical models to arrive at the risk of every Enron Capital and Trade deal using the metric Risk Adjusted Return on Capital that helped Enron to close any deal. As a result, the importance of the RAC group increased in Enron as it helped them in arriving at a fair value of each asset in Enron's portfolio of assets. This group could generate income for the ECT division by setting a higher valuation for the assets. Thus, any mathematical model could be adjusted to come up with virtually any desired calculation: What was needed was only Andersen's approval. Enron had a long-standing relationship with Andersen. With billings of \$1 bn a week for Andersen, Enron ensured that the audit firm would not come in its way of the innovative technique of fair value accounting. However, some knew the risks that Enron was inviting by using this technique. Sherron was one of them.

Andy's World

Andy Fastow is the man behind the complicated off-balance sheet deals and innovative SPEs that saved Enron in short-term but led to its destruction in the later years. His first successful off-balance sheet deal was at the time of acquisition of Portland General Electric utility. After the merger, Enron was to be considered as an electric utility. Till then though Enron owned four plants, local regulators gave Enron a special permission to operate in other utilities regulated market area. Once Enron got this status as an electric utility, its debt on all the four utilities would be immediately repayable. Since sale of these utilities was impossible in such a short time, the only visible option for Enron was creating an SPE. Fastow along with Michel Kopper, worked on rescue efforts and created Alpine Investors Fund. Blinded by the success of the SPE, no one at Enron cared about how the new SPE was financed. They also did not recognize the numerous self-interests that Fastow and Kopper had in this SPE.

In 1997, Skilling wanted to sell a part of Enron Energy Services and CalPERS signed to do so on the condition that Enron would buy out their current position in JEDI that was worth \$383 mn. To make this deal possible Fastow created a

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new SPE called the Chewco, which was formed as a Delaware Corporation. These innovative deals made Fastow a prominent figure on the Wall Street. The new CFO of Enron was called the "The Finest in Finance" and "One of the best CFOs in the Country" by the *CFO Magazine*.

Despite the fact that Skilling was not interested in tech investments one particular deal interested him. This was of a small Internet company called the RhythmsNet Connections. In 1998, Enron invested \$10 mn in RhythmsNet and when the company went public Enron's investment in the company shot up to \$300 mn. Enron marked the entire \$290 mn gain immediately as profit. However, Skilling was skeptical about the company's future performance and wanted to hedge the risk so that Enron could retain \$300 mn value on its books despite RhythmsNet's actual performance. Fastow came to the rescue and designed LJM partnership that was basically to hedge against the risk of investments in RhythmsNet. The partnership would invest in energy, communications and related businesses and assets.

Smoke Screen

Napster's IPO lured Skilling into the lucrative world of information technology. Soon it acquired First Point and renamed it Enron Broadband Services. It adopted its old strategy of acquiring companies and expanding in new markets. Soon it repositioned itself as an Internet company. In his meeting with the analysts, Skilling announced about his plans. The company would enter into a partnership with Sun Microsystems to offer online services to its customers. This news of Enron moving into the tech world caused a 25% rise in Enron's stock. To further enhance its capabilities Enron acquired other companies in different markets. One such acquisition was of Blockbuster Group, a pioneer in video rentals. Their strategy was to develop technology that they would use to telecast Blockbuster's movies to homes using Internet. As usual Enron made huge payments than what is required to acquire IT companies. By the end of 2000 they realized that the new broadband unit was investing more and had not made adequate profits.

Dancing on the Edge

While everything looked fine from outside at Enron, it was actually not the case. While Enron was growing exponentially, so were Enron's overheads in terms of

salaries, benefits and start up costs of Enron Broadband Services, etc. Soon Skilling realized that no other department was generating the revenues comparable with the costs being incurred on those departments. Slowly the board members also raised questions about these expenses.

While this was the scenario with respect to the internal operations, Enron had to face a new set of problems that were supposed to be strategic maneuvers. Enron's deal with Blockbuster Group failed; by this time Enron had already sold Enron's future earnings of Enron Broadband Services to Toronto-based Imperial Bank of Commerce. Enron's power project at Dabhol, India also had to be terminated. Amidst these circumstances, Skilling in a meeting claimed that Enron's stock would climb from \$84 to \$124. This was possible because the telecom industry that declined in spring of 2000 has slowly started gaining momentum. Soon Lay announced his intentions of resigning. He announced that Jeff Skilling would takeover as CEO from February 2001.

No Harm, No Foul

As Skilling was struggling to transform Enron into Internet company, Fastow hit the road with his LJM2 fund. The fund was connected to all investments made by Enron. He gained momentum on the grounds that he being the CFO, had insider information and that LJM2 would certainly benefit from it. With this he finalized the deal with Merrill Lynch. Finally, LJM2 fund was a success. To deal with the risk on RythmsNet, Fastow created a subsidiary of LJM, Swap Sub to issue a put on RythmsNet stocks. By the first quarter of 2000, stocks of RythmsNet, LJM and Swap Sub were performing well.

Internally, things were not going well. Though Enron was closing deal after deal on their SPEs, no one understood what exactly was taking place. The most popular of these was the Raptors SPE that was created to hedge Enron's equity investments. The Enron Board did not know all the details about this project. They only knew that Raptors transferred the P&L volatility and not the economic risk. Not only the board, Enron's accountant Andersen was not clear about Enron's accounting practices. They were not sure especially of the risky accounting practices followed by Enron.

Meanwhile, Arthur Andersen was getting increasingly concerned about Enron's use of SPEs particularly with the LJM2 deal, the debt that Enron was putting off its balance sheet using the SPEs, Fastow's conflicts of interests in the SPEs and the disclosures made by the company in its footnotes about these SPEs.

Flakes vs. Cowboys

Meanwhile, California deregulated the wholesale side of its energy market keeping the price caps on the retail front. Enron joined the deregulation fight early and promised to deliver power more efficiently and to build more effective plants that were operated using cleaner and cheaper fuels. Enron realized that to keep up these words and to make money they required volatile and not stable conditions. Because it is during volatile supply conditions that users would become ready to pay any price. By fall of 2000, electricity generators were facing power shortages and they could not buy power from companies that sold on spot prices, as the deregulation required them to do so. When they tried to increase prices, regulators denied it and they had to resort to power cuts. When Federal Energy Regulatory Commission installed price caps so as to buy whatever was available, out-of-state suppliers vanished from the scene. By December 2000, California was nearly out of power supply.

By late winter and early spring of 2001, investigators from various governmental agencies probed into the situation and discovered that during the energy crisis, demand for energy never exceeded the generation capacity of plants and Californians used less energy than they used during the same period in 1999.

Suspicious Minds

During first quarter of 2001, Enron's stock for the first time in three years, took a U-turn. Enron's employees became more concerned of this U-turn. Not only employees, several outsiders became suspicious about Enron. This happened because of the Californian energy crisis and the 2000 second-quarter report. The report had a note, which stated that a transaction of LJM2 provided \$53 mn of gross margin to Enron Broadband, allowing Enron Corp to make its earnings target by 2 cents. This was just the beginning. People started raising questions about various deals that Enron went into and Enron's reporting practices were

under scrutiny. As a whole, the question how Enron made money was a mystery for analysts, investors and for those who followed the stock keenly. Several journals published concerns about Enron's mark-to-market accounting practices stating that the profits of Enron constitute unrealized, non-cash gains that are made depending on numerous assumptions and estimates. And Enron did not provide details about these assumptions and it was quite possible that the company could go wrong.

Trapped

In early 2001, Sherron was ambivalent about her job. She was assigned with the responsibility of installing cost controls at Enron Broadband Services (EBS). She found that there was situation not in order at EBS. Whenever Sherron tried to implement cost control plans, she faced opposition from EBS employees. In reality, no one was selling anything at EBS. In the second quarter of 2001, EBS spent around \$102 mn to record revenues of \$16 mn. Failure of EBS was crystal clear.

Enron reported earnings of \$425 mn at the end of first quarter of 2001. However, things were going wrong in the Indian project and at Broadband.

Coming back to the California energy crisis, in April 2001, Federal Energy Regulatory Commission declared price controls and cautioned of many more controls. These had a devastating effect on Enron's revenues. In May, California filed lawsuits against Enron and other power companies alleging conspiracy and price fixing. It affected the stock price badly and the stock price was thrown to \$50.

On 13th June California Attorney General announced investigations into energy prices and FERC, out of regulatory pressures expanded price caps to other parts of Western region and this controlled prices and the crisis ended. Skilling started selling Enron's stock and when employees at Enron Energy Services questioned this, his reply was that he wanted to invest in real estate. The situation worsened when three employees died in an explosion at Teesside plant. Unable to bear the pressure of being the CEO of the company and sliding stock price he decided to quit Enron and declared his intention to Lay.

Aboard the Titanic

After hearing the news of Skilling's resignation, everyone was shocked. The employees, who thought that Skilling was an effective hedge for all the risk they were taking, saw themselves at the crossroads.

Sherron decided that it was time the top management at Enron knew about what was actually happening.

Sherron met Lay in person and spoke about her fears. She said that it was inappropriate for a company to use its own stock to affect its income statement and that was what Enron was doing. However, Lay brushed off everything.

In August 2001, Andersen realized that it had done an accounting blunder by approving an entry of transaction related to Raptors. When Raptors were restructured in the first quarter of 2001, Enron contributed \$1.2 bn of contingent common stock of the company in exchange of \$1.2 bn note. Andersen booked the entry as a receivable rather than as a charge against equity. No one had caught the mistake for two quarters.

In the third-quarter of 2001, Enron was already facing a charge of reversing the shareholder's equity. And coping with the accounting problem was a tough task as the prices were already on a downward spiral. The September 11 attacks further caused the stock to fall to a new low of \$25. Andersen that was already facing charges of cooking the books with Waste Management and Sunbeam now pressurized Enron to clean up its practices. On Sherron's advice, Lay hired Vinson & Elkins, a law firm to conduct an investigation about the company.

While Lay was not ready to admit the mistakes done by Enron, Vince Kaminski admitted the mistakes and expressed that the only option available for Enron was to come clean and restate its earnings.

The Death Spiral

On November 8, 2001, Enron filed an 8K report with SEC, in which it restated its earnings. But analysts were skeptical about these earnings as it accounted for

losses with LJM1 and not LJM2. Enron was close to losing its investment-grade rating. If that happened, all the debt-acceleration clauses on the off-balance sheet deals would mature. With Enron's shares already being traded like junk it was not long before the rating agencies would downgrade Enron. In these circumstances, bankruptcy was inevitable as Enron was cash starved and investors were not ready to invest in Enron.

The only option available for Enron was to be acquired by Dynegy. Lay was successful in convincing Chuck Watson of Dynegy for the deal. According to the agreement, Lay would step down and Dynegy would buy Enron. This was a win-win deal, jobs would be saved and Lay could save his honor. On November 7, both the boards tentatively agreed for the merger. But Enron was running short of cash of about \$2 bn and it managed to conceal this from Dynegy. Moody's was threatening another downgrade. But it did not do so and instead all investment bankers and rating agencies wanted Watson to bring in more cash. Watson agreed and put in \$1.5 bn but in exchange wanted to take away, Natural Gas Pipeline, Enron's crown jewel, in the event the merger did not go as planned.

Meanwhile the rating agencies were continuously downgrading Enron and the company therefore had to put up with more collateral in order to continue trading. Enron had to make many upfront payments to convince its customers of its credibility. With huge losses at Enron, Watson grew apprehensive about the deal and finally called off the merger. Immediately Moody's and S&P downgraded Enron. This immediately triggered the debt on the off-balance sheet deals. The stock price fell to 27 cents. Enron had no other option except to file for bankruptcy.

Wages of Greed

Enron had to suffer for whatever it has done to the public. It spent the last two quarters of 2001 in attending the congressional summons and investigations by various regulators. By early 2002, Enron's story shifted from a mere accounting scandal to a grand deception. It exhibited how the greedy executives enriched their wealth at the cost of their employees' interests and shareholders' interests.

CORPORATE FRAUDS – TRENDS AND LESSONS

(Mimi Swartz is an Executive Editor at Texas Monthly and won the National Magazine Award in the public interest category in 1996. She has been a staff writer for the New Yorker and Talk. She has also contributed for New York Times, Vanity Fair and Esquire.

Sherron Watkins is a former Arthur Andersen accountant and joined Enron in 1993. At Enron she worked at Enron's finance group, and its broadband division. She also worked for Enron's CFO Andy Fastow as Vice-President, Corporate Development. With her memos to Ken Lay urging him to change the accounting practices at Enron, she became Enron's whistle-blower. She also testified before the House and Senate in hearings investigating Enron's business practices in February 2002. She was named along with two others as Time Magazine's 2002 Person of the Year.)

(Sharath Jutur is an associate consultant at ICFAI University Press.)

The Fall of Arthur Andersen: Organizational and Cultural Issues

*A Neela Radhika**

Arthur Andersen's culture, popularly known as the 'Andersen Way', made it one of the leading consulting firms in the world. The 'Andersen Way' represented a culture of integrity and ethics in business. The case discusses the evolution of this culture and also its deterioration (over the decades) due to internal conflicts (between the audit and consulting groups) and changing business dynamics during the 1990s. It examines how and why one of the world's most respected auditing firms got entangled in a web of controversies and accounting scandals by the early 2000, which eventually led to its end.

"This is an American tragedy. For decades Andersen was renowned as the company that could say no to a client, but somewhere along the way, Andersen became a firm that could not say no to a client, and in fact said, 'how can we help you do it'."

— An article on <http://news.bbc.co.uk>, July 2002.

This case was written by A Neela Radhika, under the direction of A Mukund, ICAI Center for Management Research (ICMR). It is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from published sources.

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"This growing split was one of the key elements transforming the firm's tight-knit, proud culture, into one filled with paranoia, jealousy and rage."

– Barbara Ley Toffler (Toffler), former Arthur Andersen partner, commenting on the animosity between the auditing and consulting groups in her book, 'Final Accounting'.

A Shamed Company.

In March 2002, one of the world's leading auditing firms, Andersen (previously Arthur Andersen), was indicted by the US Department of Justice (DOJ) on charges of obstructing the course of justice. The company was blamed for hampering DOJ's investigations in the on-going Enron case.¹ Andersen was accused of deliberately destroying evidence (by shredding many Enron-related documents), while the US Securities and Exchange Commission (SEC) was investigating the numerous charges.

Ever since DOJ had begun a criminal investigation of Andersen in early January 2002, the firms' employees and partners expected the firm to reach an outside settlement with DOJ. The firm had even roped in Paul Volcker, a former Federal Reserve Chairman, to set things right and restore its reputation. Thus, the indictment came as an unexpected and severe blow to the firm. DOJ's investigation revealed that Andersen had indeed shredded Enron-related documents during October 2001 and early November 2001, even as SEC's probe at Enron was underway.

Andersen accepted DOJ's charges, but passed on the blame to David Duncan, the partner² in-charge for Enron's auditing, and fired him. And Enron severed ties with Andersen for destroying the documents wanted by SEC. The repercussions of the indictment were soon felt by Andersen. There was an exodus of clients from Andersen to other firms in early 2002: between January 2002 to March 2002, Andersen lost 690 clients (public limited companies) against a client base of 2,311 in December 2001.

¹ One of the largest companies in the US, Enron was primarily involved in the trading businesses of energy and natural gas. The company lied about its profits and concealed debts so as to show a healthy financial position for many years. As investors and creditors abandoned the company, it had to file for bankruptcy in December 2001. Andersen had been the internal and external auditor of Enron since the mid-1990s.

² All Andersen auditors were referred to as partners.

Andersen also saw many partners joining rival firms. Since it had also laid-off employees in huge numbers across the world and traded partners to other leading accounting firms during the period of the trial, its US employee base had come down from 27,000 to a little over 10,000 during the period. The remaining employees literally took to the streets (in Boston and Philadelphia), protesting the indictment. They accused DOJ of attempting to punish the whole firm and its thousands of employees for the misdeeds of a handful of corrupt partners.

The DOJ, which had begun proceedings in early June 2002 and concluded them in mid-June 2002, found Andersen guilty of obstructing SEC's proceedings. The SEC revoked Andersen's license to audit public limited companies and ordered the firm to pay a fine of \$1,000 for obstructing state investigation (this was the highest fine that a state board could charge). Andersen accepted the revocation and the fine, and declared that it would cease auditing corporate clients by the end of August 2002. After taking the above decision, Andersen laid-off its remaining employees and closed its offices across the US by the end of August 2002.

Andersen was once known as one of the 'Big Five' accounting and consulting firms in the US that had prospered for nearly a century (Refer Table 1). Considering the fact that the firm had itself set the standards for honest and law-abiding accounting ever since its inception, its shameful descent into becoming one of the 'Big Corporate Frauds' was even more painful and humiliating. According to industry observers, Andersen's fall can be seen as a perfect example of how even great institutions founded on integrity, value, stewardship and personal growth, could collapse in the absence of internal controls, a good work culture and sound values.

Background Note

Arthur Andersen (Arthur) and Clarence Delaney founded Andersen in Chicago, in 1913. Andersen was essentially a partnership firm, with all the chief auditors having a share in the firm. Arthur was one of the youngest Certified Public Accountants (CPA) in the US. He was invited to be the first salaried president of the New York Stock Exchange on account of his knowledge and expertise in the field of finance. However, he declined the offer so that he would be free to

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Table 1: The 'Big Five' Audit and Consulting Firms in the US (2001)

Firm	US Revenues (in \$ million)
PricewaterhouseCoopers	8,298.6
Deloitte & Touche	5,312.6
KPMG	4,804.0
Ernst & Young	3,781.0
Arthur Andersen	3,545.5

Source: Bowman's Accounting Report.

concentrate fully on Andersen. The firm, initially named Andersen, Delaney & Co., was engaged in the business of offering accounting services to companies. The firm's name was changed to Arthur Andersen in 1918.

Arthur gave a lot of importance to ethics and insisted on honest accounting, and the elimination of conflicts of interest that arose when accounting various companies. According to him, 'public accountants should be answerable to only the investing public and not to the companies they audit.'³ Reportedly, Arthur believed so much in his value system that (during the firm's initial years) he refused to endorse an accounting misrepresentation by one of the firm's most lucrative clients. Even the fact that Arthur Andersen had very few clients then and was offered an astronomical sum in return, did not convince Arthur. He said, "There is not enough money in the city of Chicago to induce me to change that report."⁴

Though Arthur Andersen lost a big client, it gained a reputation as a firm with high values. Within a few months of the above incident, the said client filed for bankruptcy, underscoring Arthur Andersen's reputation as a firm with integrity. During the late 1920s, because of depression in the US economy, many investors lost faith in companies. Reportedly, Arthur Andersen, under the leadership and guidance of Arthur, was instrumental in restoring the faith of US investors in companies, based on its integrity and professional values.

³ 'Final Accounting' by Barbara Ley Toffler, with Jennifer Reingold.

⁴ *ibid.*

The Fall of Arthur Andersen – Organizational and Cultural Issues

Arthur strictly followed his principle of 'Think straight. Talk straight' when dealing with clients. This principle was followed by partners throughout the firm and was taught to every new recruit. Arthur also developed business standards for his firm. His emphasis on 'Arthur Andersen specific' business standards evolved into the concept of 'One Firm' over the years. This concept ensured that all Arthur Andersen clients across the world received the same quality of work, the same kind of approach to work and the same caliber people trained in the same way. Such consistency in offering services and quality was achieved by imparting rigorous training to all new recruits. The training was sought to make new recruits imbibe the Arthur Andersen culture, popularly known as the 'Andersen Way'.

Analysts referred to Arthur Andersen partners as 'androids' who were proud to be working at the firm and who vowed that integrity mattered more than fees. These androids believed that to stand up for what they believed in was a virtue and that it was better to do the right thing rather than do "the easy thing". Reportedly, Arthur Andersen generally recruited fresh graduates as it would be easy for the firm to infuse them with the Arthur Andersen culture.

The firm gave a lot of importance to the training of new partners (termed the 'making of androids' by analysts). Arthur Andersen also required its existing employees to attend training sessions annually to ensure that they remained committed to the firm's philosophy and values. All employees received an average of 135 hours training every year. Arthur Andersen invested approximately 6% of its total revenues on training to ensure that its new hires would take the same approach to a problem in every office of Arthur Andersen and to implement the concept of 'one firm'.

The firm launched a centralized training program in 1940, which required new recruits and existing employees from all its offices to be trained at one specific center. Apart from conveying the Arthur Andersen culture to the trainees, the training also covered aspects of their job such as their duties, responsibilities, ethics and personal investment restrictions in their client companies.

After Arthur's death in 1947, Leonard Spacek (Spacek), a partner in the firm, became the CEO. During the early 1950s, Spacek realized that Arthur Andersen

needed a logo that could create a unique identity for the firm and symbolize its values. He chose the image of 'Mahogany Doors' (such doors could be seen at the entrance at all Arthur Andersen's offices) as the firm's logo. Spacek said, "To me, those doors represented confidentiality, privacy, security and orderliness. And it struck me that those thoughts epitomized the common vision I wanted all of our people to share."⁵

According to sources at the firm, the logo was meant to assure the client and the public that Arthur Andersen could be trusted; that the job assigned to it would be kept confidential and secure. This logo (two closed mahogany doors), with Arthur Andersen printed on it in gold, was used by Arthur Andersen on annual reports, stationery, binders, T-shirts and many other items. Reportedly, the logo became quite popular across the world and even contributed to establishing Arthur Andersen's concept of 'one firm'. Since these doors were the first thing clients saw at every Arthur Andersen's office, across the world, they felt assured of receiving the same treatment anywhere in the world, once inside those doors.

During the same period, the firm promoted a computer project under its Industrial Engineering Group. This project, led by Joe Gilckauf (Gilckauf), changed the firm's growth pattern in a major way over the next few decades. In 1951, Gilckauf designed a small computer named 'Glickiac', which processed business information. Gilckauf convinced the Arthur Andersen board of 'Glickiac's' ability to perform accounting calculations quickly and process information that could be of great help to companies and auditors. Following this, Arthur Andersen's board decided to invest in the new technology. In 1953, the firm funded a computer training school for its young auditors.

By the early 1950s, the culture of ethics and honesty was so deeply ingrained in the firm that the firm was elected to the Accounting Hall of Fame of Ohio State University in 1953. By the mid-1950s, Arthur Andersen also became famous for its knowledge of the field of computers, which was at that time in its initial stage of evolution. Companies like GE, which wanted to install computers, turned to Arthur Andersen for guidance and help. Thus, Arthur Andersen realized a new business opportunity in the form of Consultation and Installation services. It set

⁵ *ibid.*

up a new division, 'Administrative Services Division', and began offering these services during the mid-1950s.

Though the business of the new division did not pick up over the next few years, Arthur Andersen decided to continue investing in it. Commenting on this, Spacek said, "I must say, though, that I will forever be grateful to the partners. I allotted one-third of all our income to what I called the extracurricular things. It was a lot of money to the partners."⁶ During this period, the firm also went in for overseas expansion. The first office outside the US was set up in Mexico in 1955.

By the late 1950s, it seemed to have become a matter of 'honor' for every accountant in the US to join Arthur Andersen. This was primarily because more than a job, Arthur Andersen offered its employees 'a way of life'. The reputation Arthur Andersen gained over the decades made people regard Arthur Andersen as a wonderful place to work in. The media often referred to it as an extraordinary organization, a great American Brand.

During the early 1960s, both the auditing and consulting services businesses grew rapidly. According to sources at the firm, all employees were required to spend their first two years of service in audit practice, before moving on to the consulting group. This was to ensure that the employees of the consulting group also followed the 'Andersen way' in their business as a part of the 'one firm' concept. The consulting group's activities soon expanded from technology to other areas of management. During the early 1960s, the consulting group was renamed the 'Management Information Consulting Division' (MICD) to reflect the wider scope of its activities.

By 1964, the auditing business was experiencing a boom phase. Since the auditing group now required more auditors to meet the growing demand, Arthur Andersen began restricting the number of accountants the consulting group could recruit. By the late 1960s, Arthur Andersen removed the rule that required all partners to work for two years in the audit group. Reportedly, the firm felt that this rule mandated audit training for people who were going to leave the practice after two years to join the consulting group.

⁶ ibid.

The above development changed the very philosophy of the organization that had been carefully built over the decades. It marked the beginning of a series of internal conflicts within the firm and contributed to the crisis that Arthur Andersen landed in at the end of the century.

Changing the Organizational Philosophy

According to former Arthur Andersen partners, the decision to remove the two-year audit practice rule was the first step in developing a generation of future leaders at Andersen who did not share a deep bond with the audit group or its values. According to Victor Miller (Miller), the head of the consulting group, "The real bitterness emerged when we began pulling people [into the leadership circle] with no background and no personal relationships with the auditors."⁷

During the late 1960s, Arthur Andersen's consulting group continued to grow, and began competing with computer giants like IBM in computer consulting services. Meanwhile, the boom for auditing services gave way to a recession, leading to a decline in the audit business. At the same time, the demand for computers in the corporate world increased drastically, which in turn increased the demand for the services of the consulting group.

Consequently, the business of the auditing services division did not compare well with that of the consulting division. To make matters worse, the auditing division's recruitment spree in the 1950s (which continued for many years) had led to overstaffing. By the 1970s, the ratio of partners to staff was very high, putting financial pressure on Arthur Andersen. There was just not enough money for all partners and, reportedly, the firm was straining under the weight of so many partners. According to company sources, during that period, the consulting group with a low ratio of partners to staff naturally looked better in comparison.

In 1970, as Arthur Andersen struggled to deal with the problem of over-staffing, Harvey Kapnick (Kapnick) took over as the CEO. By the mid-1970s, the consulting group began registering more profits per partner than the auditing group. In the late 1970s, the consulting group accounted for 21% of the firm's \$546 million total revenues – and its revenues continued to grow rapidly. In

⁷ ibid.

1977, Arthur Andersen decided to create a new structure to integrate its various international offices. It established Arthur Andersen Worldwide, under Arthur Andersen & Co. Societe Cooperation, a Swiss umbrella organization.

During the late 1970s, many audit failures were reported in the US corporate world. As a result, there was growing concern over the practice of a single firm handling both the audit and the consultancy requirements of a given client. The SEC and the US Congress expressed concern over the potential conflicts between the audit business, which had to assure investors of the company's viability, and the consulting business, which advised the company on various organizational and business issues including financial consulting.

Though interest in this issue died down within a few months, Kapnick realized that it might generate public concern again at any point in the future. He thus proposed that the two groups be separated into two different firms (reportedly, he also harbored the dream of heading both these firms). However, in 1979, when he proposed this at the board meeting, his idea was rejected. The board (which was dominated by audit group partners) felt that such a move would place the audit firm at a disadvantage when competing with other firms. Commenting on their investment in the consulting group in the initial years, an audit partner said, "We still had not realized all of the fruits of that investment."⁸

The board's decision was not welcomed by the consulting group, as by then the consulting group was earning substantially higher revenues than the audit group. Under these circumstances, they resented that the consulting group employees still had to report to their audit partners.

Eventually, Kapnick lost the trust of both the groups and had to resign at the end of 1979. Duane Kullberg (Kullberg) took over as the CEO. Kullberg met the demands of the consulting group to a certain extent, as a result of which the consulting group gained more seats on the board. The remuneration system was also altered to ensure that consulting partners received increased remuneration. However, the status of the consulting group partners did not change much. Miller said, "The consulting partner was always number two."⁹

⁸ *ibid.*

⁹ *ibid.*

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The auditors, who took pride in their accounting abilities and their culture, did not have faith in the abilities of the consulting group partners. They feared that these partners would upset the delicate relationship they had built with their clients. Commenting on the intensifying fight for control between the audit and consulting partners, a former Arthur Andersen partner said, "The cohesiveness was unsustainable. We were like a teenager, who wants his own set of keys."¹⁰

As the demand for more power to the consulting group increased, Kullberg appointed a task force in 1986 to determine the firm's future focus. As the task force was dominated by auditing partners, it concluded that the future lied in auditing, and hence, power should remain with auditing partners. This infuriated the consulting group partners and the rift between the two groups increased further. While the consulting partners felt they were denied power even though they had earned high profits for the firm, the audit partners had come to see the consulting partners as 'a bunch of ungrateful upstarts who did not have any appreciation left for the sacrifices made by their audit colleagues during their initial years.'¹¹

In 1987, the consulting group changed its name to Andersen Consulting from MICD. Though the group stated that it had done this to leverage the Arthur Andersen brand, the auditing partners disagreed. To 'tighten' its control on Arthur Andersen, the board added a non-compete clause to the partnership agreement in 1987. This clause stated that no partner could work in the same industry for one year after leaving the firm. Commenting on this, Brebach, a renowned Andersen consultant during that period, said, "I knew it was there for a purpose, which was to inhibit the consulting partners from doing anything on their own. It was never ever talked about before. It was a threat."¹² When Brebach tried to gather support from other consulting partners against the inclusion of this clause, he was removed from his job.

¹⁰ *ibid.*

¹¹ *ibid.*

¹² *ibid.*

The Auditing/Consulting Divisions Fight It Out

In 1987, to end the animosity between the two groups, the audit group agreed to separate the groups and allow the consulting group to function as an independent division. However, this agreement included a clause, which stated that the group, which earned more would have to give 15% in the earnings of the other group. The agreement also stated that the consulting partners now would directly report to other consulting partners and not auditing partners. In 1989, consulting group revenues accounted for over 40% of the firm's total revenues of \$2.8 billion.

In early 1990, the audit group entered the consulting business by launching a Technology Consulting group. This group did not compete with Andersen Consulting and focused on offering technology related business consulting services to small companies, in which Andersen Consultancy had no interest. In relation to this, the audit division and the consulting division formally agreed that the audit group would confine itself to clients with revenues of \$175 million or less.

In 1990, with the retirement of Kullberg, Lawrence A Weinbach (Weinbach) took over as the CEO of Arthur Andersen. As Weinbach was an auditing partner, the consulting group viewed his election as yet another defeat. In light of the continuing hostility and mistrust between the two groups, Weinbach ensured that both operated as entirely separate divisions. According to reports, the two groups had everything separated: brands, recruiting processes, pay scales and even the floors on which they had their offices.

In 1994, Andersen Consulting's revenues equaled the total Arthur Andersen revenues for the first time, and continued to grow. By 1996, though both the audit and consulting groups were posting increased revenues, there was a vast difference between their growth rates. The audit business grew at 11% while the consulting business at 26%.

Following this, the consulting partners began to see their audit partners as a strain on their profits, as they were contributing 15% of their revenues to the audit group. Meanwhile, the audit business experienced a decline in its growth

¹² *ibid.*

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rate, causing the audit partners to 'envy' their prosperous consulting colleagues. Reportedly, though the audit partners needed money from the consulting group, they resented the consulting group.

By the mid-1990s, the technology consulting service division of the audit group was doing very well and was posting high margins. Inspired by this and seeing more potential in the market for business consulting services, the audit group began offering other business consulting services and changed the name of its consulting group to Business Consulting Group (BCG). This was seen as a desperate move on the audit group to get on par with Andersen Consulting, which was earning high profits. Moreover, the audit group felt that with the Fortune 500 companies going in for IT initiatives and business overhauls, there was a lot of money to be made by the BCG.

As a result, during the mid-1990s, the partners and employees of both Andersen Consulting and Business Consulting began vying for the same business. This naturally resulted in increased hostility and rage among partners from both the groups. In the mid-1996, to diffuse tensions, Weinbach recommended that Arthur Andersen's BCG merged with Andersen Consulting. This suggestion was declined by both the groups for different reasons. While the audit partners found the consulting business very profitable, Andersen Consulting felt that the BCG might distract them from their larger client projects.

During the same period, transfer payments from Andersen Consulting to Arthur Andersen as a part of their agreement increased to about \$170 million in 1997. In light of direct competition from the BCG and the increase in transfer payments, Andersen Consulting demanded more power in the firm. Distressed by the growing conflict between the two groups, Weinbach resigned and left the firm in mid-1997. As candidates for the CEO post nominated by both the audit group and the consulting group failed to attain a majority vote, W Robert Grafton (Grafton) was made the Interim CEO of Arthur Andersen Worldwide. Jim Wadia (Wadia) was made the head of the audit and tax division and George Shaheen (Shaheen) was made the head of Andersen Consulting.

With the rift increasing, in late-1997, Shaheen called a meeting of the Andersen Consulting group to discuss whether it should file for separation from Arthur Andersen as a whole. Following this, Wadia and Grafton met Shaheen to resolve the differences and offered an independent board within the firm. They also offered to stop the transfer payments and made it clear that they did not want a breakup. This infuriated Andersen Consulting partners and supported their belief that the audit partners would never allow them to get what they thought they deserved. Following this, Andersen Consulting (with the unanimous approval of its partners), filed for arbitration¹³ in December 1997 to separate from Arthur Andersen Worldwide. Andersen Consulting sought a breakup on the grounds that the audit group violated the partnership agreement which restricted the consulting services of the audit group to only companies that earned upto \$175 million.

The arbitration proceedings continued till mid-2000. In August 2000, the independent arbitrator, Guillermo Gamba,¹⁴ ruled that Andersen Consulting be made independent of Arthur Andersen Worldwide. He stated that the audit group had violated the partnership agreement. As per the arbitration ruling, Andersen Consulting had to pay \$1 billion to Arthur Andersen Worldwide as compensation for its freedom and had to remove 'Andersen' from its name. Following this, Andersen Consulting was renamed Accenture.

By 2000, Arthur Andersen had more than 100 partner firms across 83 countries and 77,000 employees. The services offered by the firm included Assurance and Business Advisory Services, Global Corporate Finance and Tax Services, Business Consulting and Business Advisory Services. In early 2001, Joseph Berardino (Berardino) took over as the CEO of Andersen Worldwide. In March 2001, the firm changed its name to Andersen from Arthur Andersen as per the court order to change its brand name after the post separation of the consulting group from the firm.

¹³ Arbitration is a process through which a dispute between two or more parties is resolved by an impartial individual or a group of individuals, called arbitrators, conjointly selected by the parties involved in the dispute. Arbitration is generally sought by companies to avoid costly and lengthy litigation.

¹⁴ Guillermo Gamba is a Harvard-trained lawyer practicing in Columbia. Arthur Andersen Worldwide and Andersen Consulting chose him as their arbitrator in March 1998.

A Change in Values – Why Andersen began Compromising

Arthur Andersen Worldwide had not only experienced internal conflict, it had also experienced an erosion of its culture. Various factors were responsible for this cultural decay. During the 1990s (especially in the mid and late-1990s), the auditing services business was at a low. Arthur Andersen had the slowest rate of growth (12.6%) among the Big Five auditing firms. Also, though its consulting group was making profits, it was still in the initial stages. The consulting groups of competitors such as KPMG and Ernst and Young were, however, making high margins on their consulting services.

Reportedly, the pressure to increase revenues and profits was unbearable on the auditing group given the increasing competition and the expanding partner base. The fact that the Andersen Consulting partners looked down on their audit partners (because of the high revenues generated by the consulting group) added to this pressure. Reportedly at that period, the audit partners could not afford to reject their clients even though the clients were involved in numerous illegal activities.

Another major factor that contributed to the erosion of Arthur Andersen's values was the changing dynamics of the US corporate world during the 1990s. As the markets became more competitive, companies cut costs to increase productivity and profitability. In times like these, auditors had to become client-driven to be successful. As a result, meeting customer requirements became more important than the reputation and integrity of the audit firms. This realization came as a big shock to Arthur Andersen auditors, who for decades had prided themselves on their principles.

Commenting on these changed business conditions, a former Arthur Andersen partner said, "In the old days the client did not tell us what to do, we told the clients what was right. And if they did not listen to us, we dropped them. In those days being dropped by the auditor was scary business, it usually meant that your stock price would drop as well. Not anymore. Now if the auditors tell the client something it does not like, the client drops the auditor and that means a few million dollars a year right down the drain."¹⁵

¹⁵ 'Final Accounting' by Barbara Ley Toffler, with Jennifer Reingold.

The 1990s also saw an astronomical rise in the remuneration of those executives of leading US companies who were instrumental in drastically increasing the profitability of their companies. Arthur Andersen partners interacted closely with many such executives as their companies were its clients. Reportedly, this created a lust for money in the audit partners of Arthur Andersen: "The Androids wanted to bask in that glow (money) as well."¹⁶

All the above factors contributed to a major transformation of Arthur Andersen's culture. The principles it had prided itself on were replaced by a focus on revenues. Toffler stated that the firm became a place where revenues mattered more than reputation or business ethics. She claimed that auditing partners forced her to increase her billings even when the increase was unjustified.

According to analysts, by the mid-1990s, Arthur Andersen was using its brand name to 'over bill' and 'under deliver'. Analysts remarked that the attitude of the partners during the 1990s could be summed up in one word – arrogant. Reportedly, words like "Relax, we are Arthur Andersen. They [clients] need us, they shall pay,"¹⁷ were commonly heard at Arthur Andersen offices. Toffler felt that it was very hard for clients to get their money's worth from Arthur Andersen.

By this time, the firm was also offering risk consultancy services. As it was difficult to overcharge only on the basis of audit services, the firm offered consulting services as part of the audit service and increased the total bill. According to a report, the firm provided 'good' services only to those clients who paid the quoted price. Clients who bargained over the fee received poor service as Arthur Andersen assigned their work to inexperienced, junior auditors.

According to Rich Lowe, a retired Arthur Andersen partner, "During the 1990s something changed. In my years of working at Andersen, I came to believe that the white-shoed accounting firm known for its legions of loyal and honest professionals – a place that once had the respect, envy and admiration of everyone in corporate America – had forgotten everything about its laid down ethics and culture."¹⁸ According to analysts, the firm was rudderless in the 1990s, with the

¹⁶ 'Final Accounting' by Barbara Ley Toffler, with Jennifer Reingold.

¹⁷ *ibid.*

¹⁸ *ibid.*

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leaders changing frequently. The firm reportedly forgot its basic values of integrity, responsibility and honest business practices and focused instead on increasing revenues.

During the late 1990s, as the consulting business of Arthur Andersen grew, the audit partners tried to turn consulting jobs into annuity jobs to thus ensuring increased and continuous revenues. Reportedly, the audit partners pushed their colleagues and staff to convince their clients to opt for other services of the firm by carefully expanding the scope of their project to create a growing dependency. According to reports, Arthur Andersen also offered both internal and external audit services to the same client.

Reportedly, during the late 1990s, the revenue targets for the partners were set so high that they were forced to use whatever means possible to achieve them. The increased pressure on the partners to generate revenues for the firm (and thus increase their remuneration) led to cut-throat competition between them. According to analysts, the changed culture at Arthur Andersen forced the partners to cut one another out of business as they tried to acquire the same client. Toffler said, "Andersen was a brutally cut-throat place, where I learned to try to screw someone else [other partners] before they screwed me up."¹⁹ Reportedly, the members of the firm hated each other's guts.

Analysts also blamed Arthur Andersen's remuneration system for the deterioration in the firm's values. At Andersen, the audit fees generated or given to audit partners was divided into 'generated fees' and 'supervised fees'. The fee generated by the individual overseeing the audit job went to the individual's office as that individual's generated fees. But if a partner used or supervised anyone from another office on a specific project, the home office of the supervised individual received the fees, called supervised fees.

This system discouraged the partners from using personnel from other offices as doing so had little impact on their remuneration though they were generating revenues for the firm. Under Arthur Andersen's remuneration system, supervised fees, which reflected the fees of every person involved on a partner's project, did

¹⁹ *ibid.*

not contribute much to the partner's units (the basis on which the partner's remuneration was calculated), if he used personnel from another office. So if a partner brought business to the firm but did not work on it personally, nor supervised the job at his office, he did not get any formal credit and still had to meet his personal target for that period.

In the late 1990s, some partners tried to convince the firm to change the billing system. Under the system they proposed, the partner received the total fees for a project, sometimes depriving staff (from other offices within the firm, whom they used) of any remuneration. This attracted even more opposition. Commenting on this, analysts said that the concept of 'one firm' did not seem to apply, when it came to sharing fees. This further increased internal competition, mistrust and a drive for success even at the cost of other Androids. According to Toffler, "Instead of seeing collaborators or colleagues, they saw rivals and fee suckers."

Andersen – Ready to Fall

In this vitiated environment, Arthur Andersen employees were not allowed to question the superiors and were forced to comply with improper orders. There was no transparency in the system. According to Toffler, most of the people did not want to be involved in unethical activities, and such activities took place only because 'decent people were' put under unbearable pressure to do their jobs and to meet the firm's ambitious goals with very limited resources to get the job done.²⁰ Thus, Arthur Andersen's changed organizational culture made its partners easy accomplices in many crimes committed by some of its clients.

Many of these clients had come into the firm's fold as a result of its implementation of a strategy called 'Emerging 10', including fast growing companies that were emerging as market leaders. Launched in 1999, this new strategy was aimed at focusing on fast-growing entrepreneurial companies. Under this strategy, the firm dropped its unprofitable clients and concentrated on attracting big, profitable clients. In early 2001, under Berardino's leadership, Arthur Andersen began taking on 'new economy' clients, which promised both

²⁰ *ibid.*

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high risk and high returns. Companies such as WorldCom and Global Crossings came into the firm's fold as a result of this initiative.

This move could be termed as the catalyst that triggered the firm's eventual demise. Not only were many of these clients working on unstable business models, they were also working in industries where the pressure to show good financial performance was tremendous. As a result, such companies like Enron, WorldCom, Sunbeam and Waste Management Inc. often resorted to accounting malpractices to hide losses and show profits. And the changed Arthur Andersen was prepared to play along.

(A Neela Radhika was a faculty associate at ICMR, an affiliate of ICAI University.)

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