Back to the Agency Problem

• How do you motivate the CEO to work hard?
  – Board of directors
  – Profit Sharing
  – Auditors

Board of Directors

• In theory supposed to Monitor the CEO, but they sometimes get “captured”.
• Make boards external.
• And how do you motivate persons to go on a board?
  – Time and effort
  – Risk
Profit Sharing

• Pay the CEO with generous profit sharing, and stock options. That way when you make money, he makes money. (Maybe)

Two issues
– If you don’t pay him, he will cheat you with inattention.
– If you do pay him, he may still cheat you with phony books.

The Basic Idea

• The Accountants were supposed to prevent fraud, like the bank supervising your Saturday employee from conspiring with the bank teller.
• Things did not work as planned.

So What Else is New

• “Behind every accounting standard there lies a fraud”
• The McKesson Robins fraud of the 1940’s

The Accountants

• Some cases
  – Enron
  – Global Crossing
  – World Com
  – Tycho
  – Xerox
  – Health South

Enron

• Enron would enter into a contract to sell power at (say) $50 a MWH.
Enron

- Enron would enter into a contract to sell power at (say) $50 a MWH.
  - If power went to $500 a MWH, Enron stood to lose a lot of money; good accounting required disclosure.
  - But Enron had contracts with other companies to cover this risk. Someone else was “naked”. No disclosure.

There were secret deals where Enron was responsible for the risk.

Taking in each other’s wash

- Global Crossing signed a contract to purchase $100 of services from another company.
- The other company signed a contract to purchase $100 of services from Global Crossing.

Thus net profits of $95 this year.

This seems curious.
Taking in each others wash

- Global crossing counted the $X of sales as revenue and expensed the $X it was to pay over time. (E.g., $100 of revenue now and $5 million of expenses a year for the next 20 years)
- So did the other company.

The two companies were audited by different accounting companies.

World Com

- Took $4 billion of expenses and treated them as capital expenses.
- That is $4,000,000,000

No one caught it.

Arthur Andersen
Securities Analysts

The Accountants

- Some cases
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End

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