Introduction

Like a minister at a church revival, Sherron Watkins channeled a message that caused heads to nod up and down in agreement among her congregation. The only thing missing in this hotel function room off Times Square crammed with 100 fraud investigators was a spontaneous shout of "Amen!"

"I didn't recognize how corrupt the culture had become," she said, describing the painful days after Enron entered bankruptcy protection in December of 2001. The company had laid off 5,000 employees, abandoning them just before Christmas with no severance or benefits, while 75 senior executives gorged themselves on $55 million in "retention" bonuses.

Watkins had delivered this sermon on numerous occasions, yet it still came across spontaneously, as though her thoughts on what went wrong at Enron, and the problems ailing corporate America, were occurring to her in that moment. Ethical problems seep through a company gradually, she explained.

"It is not one small step in the wrong direction," she told the American Society of Certified Fraud Examiners. "It's walking

down a slope that looks like an egg. At some point, you're over the edge."

Watkins, a no-nonsense blonde from Texas, was one of the few heroes to emerge from the scandalous fraud at Enron. In August of 2001, months before the investing public learned there was anything wrong with the company, she discovered the Houston energy giant's rotten secret: that it was using accounting tricks to fool investors.

In an anonymous letter to Enron chairman Ken Lay, she pointed out the problem and urged him to launch an outside investigation into the matter. Instead of following her advice, Lay resorted to a half-measure, asking lawyers who had already approved questionable business deals at Enron to conduct a limited review of Watkins' concerns. Not surprisingly, these lawyers found nothing wrong.

And so, instead of identifying the fraud internally and conducting a top-down house-cleaning, which might have preserved some credibility among investors and saved the company, Enron's managers blundered forward, unwilling to confront the truth. They maintained that the company's finances were healthy, despite growing signs that Enron's earnings were a sham.

In October of 2001, following a surprise announcement that the company had lost money for the quarter, reporters at the *Wall Street Journal* began to unravel the carefully wrapped package of fabrications that lay at the heart of Enron's overstated earnings. Once investors realized that most of the company's profits were bogus, they punished Enron mercilessly, driving its share price down to penny-stock territory and forcing the once mighty company into bankruptcy.

Enron's collapse vaporized $60 billion in shareholder value, and resulted in thousands of employees losing their jobs. Worse, it wiped out the life savings and retirement plans of an army of loyal employees and retirees who had placed their faith in Enron's promise that it would keep growing at a 15% clip.

Watkins watched this devastation helplessly. After a Congressional investigation discovered her warning letter to Lay and released it to the press, Watkins became a national hero, celebrated by *Time* magazine as one of three women of the year for 2002. She co-authored a book about Enron's collapse, and began a new career as a public speaker. She also launched her own consulting company, the purpose of which was to help corporations identify ethical problems and root them out before they festered into crises of Enron-like magnitude.

Her timing was perfect: in the wake of the Enron collapse and the subsequent exposure of a massive accounting fraud at WorldCom, Congress passed the Sarbanes-Oxley Act. This harsh new law, approved with record speed in the summer of 2002, was designed to close the loopholes that corporate criminals exploited to rob American investors.

Nearly every Senator and member of the House of Representatives bragged to constituents that he or she supported the new law. These lawmakers expressed outrage at each accounting blow-up. But few dared to admit the truth: the root causes of fraud at Enron, WorldCom, Tyco, and HealthSouth sprouted from seeds sown by Congress.

In all, fraudulent accounting practices at some of the country's most respected corporations destroyed an estimated $500 bil-

lion worth of investor funds during the recent era of corporate scandals, hurting almost every one of the 95 million Americans who own stock directly or through mutual funds. In all, the accounting frauds scared investors into removing $7 trillion from the U.S. stock markets. How did this happen? Congress never passed a law saying it was okay for companies to lie about their earnings. The nation's biggest auditing firms never openly endorsed a program to allow their clients to deceive investors.

And yet, in the late 1990s, business leaders, auditors and lawmakers turned a blind eye as a cancerous growth took hold among the nation's corporate elite. Publicly traded companies glossed over unpleasant financial realities and used accounting trickery to hit their quarterly earnings targets. A booming economy disguised financial weakness across the business landscape. Congress took no notice of the decline in accounting standards, since a healthy economy helped lawmakers get reelected. Auditing firms, instead of acting like watchdogs, boosted their revenues by morphing into advisers and consultants to their clients. Business leaders, who were paid in stock options, became fabulously wealthy folk heroes, their images plastered on the covers of magazines and the finance pages of newspapers.

Because things were going so well--for lawmakers, auditors and business leaders--no one wanted to rock the boat. The stock market was going up in the 1990s, after all, so even the Main Street investor was getting wealthy off the miracle economy. But when the Internet bubble burst in 2000, all the problems that had been ignored by Congress, patched over by accounting firms and denied by business leaders exploded into view.

These problems led to the exposure of a massive accounting fraud perpetrated on the public. These corporate meltdowns shook investor confidence in Wall Street and scared Americans out of putting their money in stocks. Only then did lawmakers see that their blind efforts to promote free enterprise and business growth had transformed the stock market into a casino where the roulette wheel was fixed.

This book is an attempt to explain what happened, to explore the root causes of these frauds. It is written not for the purpose of exposing new details about what happened at Enron, WorldCom and other companies, but to provide an overview of how the public got ripped off in these and other cases. Its goal is to give the average investor a greater understanding of how a bunch of greedy people--Wall Street investment bankers, auditors, corporate executives and their lawyers--defrauded the public on a scale not seen since the savings and loan crisis a generation ago.

Like that earlier crisis, this one was aided and abetted by the United States Congress. By passing a law that rewarded companies for paying their top executives in stock options, and by stripping the Securities and Exchange Commission of the resources necessary to police the stock markets, Congress allowed this $500 billion accounting scam to happen. The passage of the Sarbanes Oxley Act in 2002 should have changed things, but by 2004, observers like Sherron Watkins realized that the law would only be as good as the people it was intended to rein in.

After her speech to the American Society of Certified Fraud Examiners, Watkins and I shared a cab from Times Square to Central Park. She had another appearance that day in which

she would barnstorm on behalf of corporate governance. But on this sunny April afternoon, as tourists and shoppers teemed on the streets of midtown Manhattan, she talked about how difficult it was to change executive behavior. The Sarbanes-Oxley Act was supposed to clean up corporate America, but from what she could tell, it only had the effect of forcing lawyers and accountants to jump through a few extra hoops. Congress could change the rules by which public companies filed their earnings statements with the SEC, but it couldn't change the attitudes of the executives responsible for those statements.

"There's a big group of companies that want to continue their behavior," she said. "They're not used to change. They want to stay the same." In other words, if we're not careful, it could happen again.