Corporate Misinformation
Jordan Fettman, Vicki Riggs, Megan Touchton

Introduction
Overview
In the age of information, it is necessary to critically analyze how information is summarized and presented to stakeholders. Every public company has a duty to portray its financial position as accurately as possible to its stakeholders. According to industry standard practices, companies have to pare down their financial information in order to make it manageable to external users. The information that is included or excluded is regulated by government and private bodies, but there are also many gray areas for companies to misrepresent themselves, as portrayed by recent financial scandals. Omission of numerous financial details is necessary for simplicity and understandability; however, if used the wrong way, it can result in corporate lying and subsequent harm to stakeholders. A company that misrepresents its financial position violates the trust and jeopardizes the well-being of its stakeholders.

Definitions
A stakeholder is defined, for purposes of these cases, as employees, management, owners and creditors. Financial misrepresentation is defined as not giving an accurate portrait of the financial position of a company, whether the intent to mislead is present or not. In contrast, corporate lying is the intentional deception of stakeholders, usually to make a company’s financial position appear more favorable. Accurate information is both free from the intentional manipulation by corporate motives and objective for external stakeholders. How a company treats its financial statements is indicative of its degree of ethical responsibility. Ethics is not only conforming to accepted professional standards of conduct, but also involving moral approval or disapproval.

Corporate Culture
Every company has a different corporate culture with diverse values and ethics. Since accurate representation to stockholders is an important value, it is necessary to understand the inner workings of a company’s corporate culture and how it relates to its external representation. This chapter will analyze how a company’s corporate culture affects its degree of transparency in its financial statements and how it affects the company’s stakeholders.

Assumptions

All primary stakeholders in businesses have a right to know companies’ financial information as it pertains to them. Therefore, all corporations have a duty to supply accurate financial information to their stakeholders. The assumptions guiding this duty-based ethical framework are supported by the belief that businesses have a duty to respect their stakeholders by supplying honest and accurate information. While this framework underestimates the importance of happiness and social utility, business’ primary duty is to add value to the company for the benefit of stakeholders. Therefore, actions in businesses must be assessed relative to the impact they have on those with a vested interest in daily operations. The implication of this framework, then, is the proverbial “actions speak louder than words”; businesses should operate in consideration of the ways in which their actions help them maintain their duty with respect to their stakeholders.

Values

In conjunction with the stakeholders’ right to know and the companies’ duty to tell, some important values are financial transparency, honesty, and loyalty to stakeholders. In order to ensure these values and ethical duties are upheld, companies should show everything they possibly can without compromising their internal integrity. Reasonable disclosure is necessary to portray an accurate picture of the company’s financial position.

Background
Stakeholders rely heavily on information provided in financial statements by companies, so full financial disclosure may be the solution to deliberate misinformation, or corporate lying. There are numerous reasons, that not all information should be published. First, furnishing all financial information to the public means that a company is also releasing this information to its direct competitors. If competitors use this information for an unfair advantage, the detrimental effects the company suffers will trickle down to the stakeholders, namely the owners who lose money and the employees who lose jobs. Second, the cost of publishing all financial information, down to every transaction, is exponentially higher than the benefit of furnishing such information to the stakeholders. There would be so much information that stakeholders may be overwhelmed and lose sight of the overall picture. Finally, there are too many variables in the business climate that may have an effect on financial information. For instance, coupons that have not been redeemed, lawsuits not yet resolved, and potential mergers/acquisitions are uncertain events that can all have a substantial effect on a company’s financials. Even if all numbers were published, they still may not paint an accurate picture of a company’s financials.

Company generated forecasting within the financials is another piece of the information affecting stakeholders. Based on prior financial statements and the current business climate, upper management issues its predictions for the upcoming quarter or year. From these predictions, financial analysts make forecasts about the industry as well as each company within that industry. How a company performs relative to the forecasts has a direct correlation to its stock price, which is typically one of the main success measures of a company. Upper management feels substantial pressure to predict that the company will be at least as successful, if not more, than the prior period, and then to live up to that expectation. There are numerous factors influencing the accuracy of forecasts. Buyers’ behavior is unpredictable, as are competitor’s tactics, which may or may not be successful. External events such as war, politics, culture, and globalization can all have significant influence. Due to the unpredictable nature of future events, and the high pressure on upper level management to perform to expectations, the likelihood of intentional financial misrepresentation is ever increasing.
A good company should have an internal structure that assures proper execution of ethical standards, substantial oversight of practices, and a company culture supportive of personal responsibility for the whole is fostered. In order to develop a strategy for an ethical company profile, it is important to reflect on some problems that companies had with misinformation in the past. Through discussion of Fannie Mae and WorldCom, Inc. this chapter will present a framework for developing and sustaining an ethically responsible company.

**Fannie Mae**

Prior to 2004, Fannie Mae was one of the most respected companies in the United States. They had a AAA credit rating, were often thought of as a “low-risk and best in class institution,” and were sponsored by the US government. This firm primarily securitized home mortgages and sold them on the open market, making itself a key component of the US housing industry. However, in October of 2004, the OFHEO (The Office of Federal Housing Enterprise Oversight) began to investigate Fannie Mae’s accounting practices. Fannie Mae had been growing at an incredible rate each year, and had been reporting curiously smooth earnings growth which just happened to meet expectations quarter-after-quarter. The OFHEO found out that the company had actually been manipulating its accounting numbers in order to meet these estimates.

Fannie Mae is an example of a company that perpetuated intentional information manipulation and financial misrepresentation. Among other practices that are deemed illegal according to GAAP (Generally Accepted Accounting Principles), Fannie Mae downplayed their losses by classifying numerous investments as hedges when they were not eligible to be counted as such, which will be explained shortly. In addition, “they did not invest the proper time or money into their accounting systems, computer systems, other infrastructure and staffing needed to support a sound internal control system, proper accounting and GAAP-consistent financial reporting” (OFHEO Report). All of this resulted in Fannie Mae over-estimating earnings by about 10.6 billion dollars from 1998-2004.

**Fannie Mae’s Corporate Culture**
The massive misrepresentations perpetrated by Fannie Mae and World Com are not the result of accounting errors. The misrepresentations are affected by policy decisions made by senior management to mislead stakeholders for their own advantage. As the leaders of a company, upper management establishes the norms and values of that company. Therefore, a corporate culture that condones questionable business practices starts with upper management. These flexible morals are one reason that company scandals are often attributed to internal corporate culture. Relative to the scandals previously discussed, each company’s corporate culture is viewed in consideration of its causal relationship with ethical practices. Fannie Mae’s culture was mostly influenced by Franklin Raines, who called for doubling Fannie Mae’s earnings per share in five years. Raines changed the enterprise’s compensation program to make incentives higher to achieve that goal; he also gave financial executives extraordinary power and authority. (OFHEO 53)

The OFHEO, in charge of ensuring financial safety of government sponsored enterprises like Fannie Mae, says that the Board of Directors failed in its duty:

The Board refrained from demanding accountability from the Chairman and other senior executives in numerous ways. Specifically, the Board abandoned its checks-and-balances oversight responsibilities; acquiesced in allowing management unbridled authority over its agenda, materials, and minutes; did not adopt and impose policies requiring that all critical accounting policies and major transactions be vetted before it or its designated committee; and acquiesced in allowing the Chairman to concentrate power in the Chief Financial Officer and then to seat him on the Board, which enhanced the power and influence of executive Board members. In fact, the Board allowed management to determine with little opposition the information it received and missed many opportunities for meaningful oversight. (OFHEO 281)

According to OFHEO, the executive compensation system itself drove the wrongdoing. "Fannie Mae tied major portions of executive compensation to EPS [earnings per common share], a metric easily manipulated by management."(OFHEO 55)
The way the compensation program worked created an environment where it was best to "smooth" its earnings -- to ensure that it met its targets but did not exceed them so executives could maximize their compensation. Raines also extended the EPS compensation to managers of the internal audit group and the accounting department, encouraging them in this deception of stakeholders.

In an internal letter from the Office of Corporate compliance: “Barnes expressed concern that he had been asked to make manual changes related to the amortization process without an explanation as to why he should do so and without appropriate documentation. Barnes alleged that these changes seemed designed to achieve predetermined results. … That the environment in the Controllers office was such that it discouraged raising accounting concerns or issues to management and those that did were treated as “not members of the team” (OFHEO Appendix F). Forty-eight out of sixty employees working for Fannie Mae in accounting and internal audit reported discrepancies in how Fannie Mae kept their books and discouragement of anyone who questioned Fannie Mae’s practices.

When OFHEO and the independent investigators found that the allegations that Barnes and others had made about manual changes were true, (1202) they recommended Fannie Mae to change how its independent audit was documented to address the conflict of interest issues raised by employees.

Barnes’ reports verify that executives and directors structured the operations of the corporation in pursuit of manipulated outcomes. That is, they knowingly and intentionally engaged in an ongoing pattern of manipulation and wrongdoing, and did so in such a way as to advance their own interests and earnings. When a culture of faithful representation is not supported by ethical behavior from senior management, it’s not surprising that compliance to ethical standards can be overshadowed by the desire for personal gain. People model and follow what leaders do, even contradicting personal morals to do so. This conflict of interest provides a fertile environment for improper activity to take place, as it did at Fannie Mae.

**Fannie Mae Financial**
The OFHEO found that Franklin Raines (CEO of Fannie Mae) would inform the accounting department of what numbers the company had to meet for the upcoming quarter, and the department would then “make it happen.” There were several specific and complicated gimmicks the accountants used to create these illusions.

Fannie Mae held many interest rate swaps during the time period in question in order to mitigate interest rate risk. When companies hold derivatives or other securities in order to protect themselves from future risk, it is called a “hedge.” Although this is a very simple definition, in order to use “hedge accounting” a company’s hedging instruments must qualify for specific standard criteria established by the Financial Accounting Standards Board (FASB) in which Fannie Mae’s did not. Despite Fannie Mae’s derivatives not being qualified for hedge accounting, they decided to use hedge accounting anyway. Using hedge accounting involves not recognizing losses immediately, therefore giving an illusion of inflated earnings.

Most other violations performed by Fannie Mae relate to the “Revenue Recognition” or “Matching” Principles of accounting. These rules state that every company should report revenue when it is earned, not necessarily when money is received, and match the expenses associated with these revenues when the revenues are reported. In order to show smooth financial growth, Fannie Mae booked both revenues and expenses during periods in which they were not permitted to so. While this may sound complicated to the non-accountant, these are two of the most fundamental rules in all of accounting. The firm’s CPAs who performed these actions knew without a doubt they were violating GAAP.

When these serial violations were uncovered, not only did the stock price plummet to reflect the loss of 10.6 billion dollars in revenue, but it went down even further due to the new lack of trust associated with Fannie Mae company. The end result was that stakeholders lost a great deal of money due to Fannie Mae’s deceptive behavior. By violating its duty to supply representative accurate information to its stakeholders, Fannie Mae violated its duty to stakeholders as well as the accounting profession.

**Fannie Mae Culture Influence on Financials**
Prior to the revelation of the Fannie Mae accounting scandals, the company was thought of as trustworthy and reliable. Without such trust, they would not have been rewarded with such a high stock price and a AAA credit rating. However, much about the firm’s corporate culture was uncovered with the investigation into this scandal.

The culture created by upper management is self-reinforcing. Upper management that intentionally directs others to mismanage financial statements in order to trigger its own bonuses is inherently unethical. But why did lower management and employees cooperate with these violations for so long? It appears that most of the workers who “overlooked” such wrongdoings did so because they trusted their CEO and other upper managers, at least at first. They were pressured into a certain fiscal performance by upper management, and it took awhile for information regarding their unethical behavior to leak.

After much investigation, the OFHEO remarked that Fannie Mae was an “aggressive and unethical company…” (Roberts). Most strikingly, they reported that “…Fannie Mae used its tremendous power in Washington to lobby Congress with the aim of interfering with the OFHEO’s investigation.” It appears that in a futile attempt to cover up any wrong-doing, Fannie Mae tried to get the OFHEO in trouble with Congress during their investigation. Obviously the ploy didn’t work; it only made the corporate culture of Fannie Mae appear even more corrupt.

WorldCom

Another company that misrepresented itself was WorldCom, Inc. After growing from a small startup company in 1983 into a multi-billion dollar corporation by 2002, the executives at WorldCom began to believe they could manipulate earnings and not get caught. When it became apparent that actual performance would not match the forecasts, upper management manipulated financial data, hoping to make up for the misstatements in upcoming periods during the forecasted internet boom with corresponding demand for WorldCom services. After the second period of misstatements, these manipulations lost their efficacy. Realizing this boom was not forthcoming, upper management ordered that the classification of specific leases should be changed. The new classification would result in an increase of net income as well as an increase in the value of capital assets on
the company’s books. These misclassifications ultimately resulted in 11 billion dollars of inflated earnings over less than a year and a half (USA v. Sullivan and Yates).

**WorldCom’s Corporate Culture**

The theory that upper management affects both company culture and employee behaviors is further supported by the concept of “group think.” Group think is defined as a "mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members’ strivings for unanimity override their motivation to realistically appraise alternative courses of action" (Janis. 9). Group think played a primary role in perpetuating the fraudulent environment at WorldCom. For example, Scharff described WorldCom’s cultural environment as one in which “employees felt that they risked losing their jobs by disagreeing with executives or policies that were implemented” (109-119). Additionally, Morgan equated the type of behavior at WorldCom to the metaphor of employees being held in a prison of the mind. He associated this prison to “Plato's cave whereby individuals could only see the shadows, or illusions of reality, on the wall in front of them. Plato's cave dwellers, even when faced with a truth that their reality was flawed and only revealed the shadow of reality, would reject that paradigm change to the point of ostracizing the individual attempting to change their reality” (109-119).

Morgan explains that in a “group think” culture, any attempt to change organizational norms often creates "all kinds of opposition as individuals and groups defend the status quo in an attempt to defend their very selves" (245). The dangers of group think became reality at WorldCom, where unquestioned compliance to the norms of the group ultimately led to the downfall of the company. According to Janis, group think simultaneously has dangerous effects on morality. For example, Janis observed that “highly cohesive groups might rely unquestionably in the morality and self-righteousness of their group” (109-119). As a result, members consider loyalty to the group the highest form of morality” (Janis 11). If the company’s goals are of greatest importance to a business, personal values and societal norms could be ignored in favor of the company’s objectives, no matter how unethical the behavior is. Proposing that stakeholders have a right to know accurate information, a duty-based framework dictates that companies have
a duty to give accurate information to stakeholders. This system works when management is accurately representing stakeholders’ desire for accurate information. Creating this type of system that connects the wishes of stakeholders and upper management would require consistent goals as well as communication of those goals. Where problems occur is when upper management loses sight of its purpose and instead focuses on personal aspiration. WorldCom “lost its internal compass” (Scharff 109). Executives controlled everything from the top, and group think minimized dissent. WorldCom experienced difficulties because it was “running on a financial survival mentality” (Scharff 111). and did not have stakeholders’ best interests in mind. The infiltration of group think into WorldCom’s company culture and the perpetration of a solid yet unethical status quo created and managed by a select few was primarily responsible for its ethical decline.

**WorldCom Financial**

WorldCom was such a large player in the telecommunications industry by 1999 that there was a substantial amount of pressure to perform sequentially better each quarter. WorldCom provided service to its customers through its own vast networks and facilities; they had developed an extensive network in order to provide these services. Where WorldCom did not own the network, it either leased equipment or facilities from other telecommunications companies or paid a fee to use them. These costs, according to GAAP, should be considered operating expenses. That is, they should be counted as costs that will not render any future benefit to the company. The only time that leases should not be expensed is when a substantial portion of the benefits and risks of ownership are transferred to the company doing the leasing, in this case, WorldCom (Kieso 1089).

When ownership is transferred, the lease is capitalized, the costs remain the same, but the company is increasing its assets. With an operating lease, the money for lease payments is gone once it is paid; with a capital lease, the money for lease payments is counted towards acquiring the asset. If a lease is classified as a capital lease rather than an operating lease, the company’s operating expenses will be lower, which increases net income, and the capital assets are higher (USA v Sullivan and Yates). Due to the
potential to manipulate the financials simply by reclassification, the Financial Accounting Standard Board (FASB) has very specific guidelines for what leases qualify as capital leases and which qualify for operating leases. Since none of World Com’s leases qualified to meet the requirements for capital leases, payments should all have been expensed as they were made.

From its founding in 1983 to 2000, WorldCom did not classify its leases as capital leases. Costs to lease equipment from third parties were counted as expenses. In 1999, WorldCom entered into numerous long term leases in anticipation of an internet boom and subsequent rise in demand for WorldCom services (USA V Sullivan and Yates). Since these leases required payment regardless of the amount of usage, “WorldCom’s expenses as a percentage of its total revenues began to increase” (USA V Sullivan and Yates). This rise led to a slower rate of growth in WorldCom’s earnings, which would in turn substantially lower the value of WorldCom’s stock. For the third quarter of 2000, when the upper management realized the certainty of this situation, they moved money between various accounts and inflated reserves to make the costs of the leases appear less detrimental to WorldCom’s financials. For the fourth quarter of 2000, they used the falsified balance in their reserves to pay for the leases. By the first quarter of 2001, when it was apparent that the high costs of leasing could no longer be hidden, they decided to change the classification of their leases from operating to capital. They continued to lie to their stakeholders until June 25, 2002, when they were forced to admit that they had falsified their financial position for 2 years. In the end, they had inflated their earnings by 3.8 billion dollars.

**WorldCom Cultural Influence on Financials**

Scharff, an author featured in the Journal of Leadership & Organizational Studies, attests that WorldCom's organizational structure, group processes, and culture contributed to both its fraudulent financial reporting and the length of time over which it occurred. Since WorldCom’s upper management created a company culture that emphasized values such as bonuses for upper management and cutting costs in every possible way, employees were pressured to manipulate financial outcomes to meet these internal company values. An SEC filing implicates Bernie Ebbers, WorldCom’s then CEO, as the
initiator behind the culture and pressure that allowed the fraudulent reporting of financial outcomes to transpire. This pressure Ebbers created heavily influenced employees to concede to group think and to leave upper management’s status quo unquestioned.

**The “Good” Company**

Companies that honor their duty to provide accurate information to stakeholders should anticipate fluctuations in earnings and faithfully report those to stakeholders. They need to acknowledge the possibility of such fluctuations and report in full these setbacks as they occur. This disclosure enables stakeholders to make informed decisions and minimize their losses. Good companies should also value honesty, loyalty and trust between the company and its stakeholders more than executive job security, career interest and bonuses.

Information should be fully disclosed with a few exceptions. Such exceptions may include information that would be financially harmful if known by competitors, if the information is immaterial compared to the totality of information being provided, or if the cost of disclosure precludes the feasibility of such an undertaking. In addition, good companies will avoid dependency on forecasts, which are by nature uncertain. Relying on these forecasts makes stakeholders rely on information which may or may not be substantiated, and gives upper management substantial pressure to perform to those standards, even at the cost of ethics. A good company with its stakeholders’ interests in mind must make a concerted effort to create a corporate culture that fosters and encourages honesty, loyalty and trust. This, in turn, translates into accurate financial information being provided to stakeholders.

**Conclusions**

How does corporate culture influence the degree of truthfulness in financial representation? Representational faithfulness, that is, the degree to which financial statements accurately portray the company’s financial situation, is dependent on corporate culture; therefore some sort of framework is necessary to ensure the integrity of financial information being provided by the company.
Recommendations

Due to the close connection between a company’s corporate culture and its degree of financial accuracy, it becomes necessary to build a framework for businesses to encourage the ethical responsibility of employees. According to Falkenberg and Herremans “Organizations can influence the ethical behavior of members through both formal and informal systems” (415). Formal systems, as discussed by Ross & Robertson, include a corporate code of ethics and serve the purpose of directing employee behaviors. “Formal ethical codes may be considered essential by many to aid employees in ethical decision making within the organization (Sims), but they are not sufficient to guide behavior if supervisor expectations contradict these written guidelines (Sims).

WorldCom and Fannie Mae had corporate codes of ethics, but these codes were overshadowed by supervisory direction. Therefore, it is necessary to implant executives with high personal ethical standards who will add to the informal systems. Due to upper management’s large influence on both company culture and employee behavior, it is important for executives to facilitate ethical and effective management. Liebowitz describes effective management as a process that “involves continually soliciting feedback from employees, customers, and suppliers regarding how they view the firm and its practices, and then acting on that feedback to improve the organization and its culture” (p. 101). Possible solutions could include opening access to information, requiring numerous people to make important decisions, and implementing non-critical methods of communication.

The representational faithfulness of financial statements matter. When considering management and its dual effect on company culture and ethics, actions speak louder than words. No matter what type of motto or code of ethics management puts in place, employee behaviors will not correspond without a foundation of observable ethical behaviors from management itself. The idea of transparency in financial records has a multi-dimensional definition. Literally, it allows stakeholders the ability to see information that directly pertains to them. Theoretically, it allows stakeholders to assess the ethical integrity of a company’s cultural framework. Financial statements speak volumes about the moral clarity of upper management, starting with the CEO.
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