Comments on "Governance, Supervision and Market Discipline: Lessons from Enron" and the Author's Response

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Comment -1

N Balasubramanian*

At the outset, Professor Varma is to be complimented for the meticulously painstaking effort in putting together a comprehensive and very readable narrative of the Enron episode (and others of similar ilk around the same time), and the valuable analysis of the multi-dimensional ramifications of the actions and inactions of the players involved. Much of the available information (and of course there is no dearth of it, thanks to the American obsession with dissemination) is widely scattered over several resource sites, and the author's current effort to present the salient details in an organized format is to be strongly commended.

Undoubtedly, the failure of Enron has spelt disaster to several hundred thousands of people around the world. Employees of the corporation were affected not only in terms of job-losses but also of erosion of market value of their investments in the company and even more importantly in the form of significant dilution of their pension accumulations largely invested in Enron's own shares. The overall cost to the US economy has been placed at around $ 35 billion[1] in the first year, or roughly 0.34% off the US Gross Domestic Product.

Some would argue that overall, looking forward, the Enron collapse was a good thing to have happened, and the price was worth paying at least at the macro level, if only for the attention and corrective reaction that it had led to. Continental Europe would smugly enjoy the opportunity to savour the discomfort and disenchantment with the supremacy of the highly touted Anglo-Saxon governance model (notwithstanding its own halting progress towards it in the EU). Developing countries like India would promptly emulate the remedial measures adapted to their own circumstances.

As the Enron dust begins to settle down, more than a year after the disclosures, it is time to sift the relevant and the material from the rest. Professor Varma identifies three categories of lessons to be learnt and actions to be initiated: strengthening market discipline, swift dispensation of justice in case of fraudsters, and regulatory/ supervisory reforms. To these, I believe, should be added a fourth, strengthening the ethical and moral foundations of societies in general and, especially people entrusted with fiduciary and reputational responsibilities.

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Strengthening Market Discipline

While fully endorsing the author's call to strengthen market discipline, there are a few other prerequisites that need addressing concurrently, particularly in countries like India which are ready to play the catching-up game in these matters. First, we need to define the basic parameters necessary to qualify a "market" before it can be entrusted with the responsibility of enforcing its "discipline" on the players. A shallow market with little liquidity, very few investing players, high levels of retail shareholder indifference, a weak enforcement mechanism, a corporate legal framework that is dated by close to a century, are all factors that impair the robustness of a good "market"; even without some or all these deficiencies, markets in countries like the United States are struggling to keep pace with deviant behaviour evidenced in instances like Enron, WorldCom, and so on. A great deal of caution and preparatory work are therefore necessary in countries like India before market discipline can hope to succeed.

The suggestion to encourage free short selling is a measure in the right direction, and needs to be pursued.[2] Market imperfections are a source of concern. "Insiders" taking such positions, in either direction, will need to be curbed, though proving such instances is always a major issue.

The recommendation on "class-action" litigation is welcome in that it brings in a valuable judicial dimension to the actions and inactions of those entrusted with fiduciary or executive duties. An important prerequisite of course is an independent, efficient and effective judicial system or process that would address such issues expeditiously. The accumulated corpus of pending litigation in Indian courts does not augur well for successful implementation of this proposal; but the answer does not lie in rejecting this suggestion but hastening reforms in the judicial processes.

Measures suggested for promoting competition in the securities industry are unexceptionable, but the concern is about the readiness of our markets for such reforms. In the US, there are already instances like the Merryl Lynch where "independence" of two functions, despite professed "Chinese walls", has been in question. There is perhaps a case, in the context of developing countries, for strengthening and substantially up-sizing such organizations (through encouraged consolidations and mergers) before exposing them to the temptations and vulnerabilities of unbridled competition.

Much the same could apply to other reputational agents like the statutory auditors. Out of the close to 100000 members of the Institute of Chartered Accountants of India, reportedly less than 4000 are engaged in some aspects of auditing listed companies in the country. Opening up the profession to multiple bodies may just lead to their competing for the same pool of membership without any potential improvement in quality. It has been suggested elsewhere[3] that somewhat similar to the SEC Practice Section of the AICPA in the US, members of the CA Institute in India with listed company (and "large unlisted company") audits may be grouped together and subjected to tighter surveillance and tougher regulation. Happily, the profession in India is not at this time at the mercy of

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a few strong and large audit firms (like the big four elsewhere) except where the big four themselves are involved, directly or indirectly, but there may be a case for encouraging consolidation of smaller and/or geographically dispersed practices so that a pool of such reasonable-sized firms may evolve over a period of time.

Expeditious Dispensation of Justice

Professor Varma makes an important point when pleading for speedy investigation, prosecution, trial and punishment processes when default or deviant behaviour had been established.

The delays in exercising the disciplinary jurisdiction at the CA Institute are too well known to bear detailed recounting. The good news is that some of the contributing causes are likely to be removed if the Naresh Chandra recommendations in that regard were accepted and legislated.[4] But that would not automatically improve the Institute's Standard-Setting processes and track record (barring the most recent year or two when SEBI put some pressure in this regard), and it will be entirely up to the Institute to bring about greater urgency as well as proactive initiatives recognizing the dynamically changing business and related scenario.

Regulatory Reviews & Monitoring

A key component of ensuring good corporate governance standards is the effectiveness of the regulatory mechanism. While (very rightly) there is considerable stress on the accountability of corporate directors and independent auditors, there appears to be a different standard when it comes to expectations from the regulators, which is truly "a shortcoming and impediment to good governance."[5]

Competency-Building in Regulators

In his advocacy for strengthening market discipline, Professor Varma has chosen to "let off" the regulators lightly, with the forgiving observation that "regulators are poor at detecting fraud". Of course, experience supports his observation, but it is an essential part of regulation (as indeed of preemptive legislation) is the ability not only to detect such instances after the event but also to foreclose opportunities for potential fraudsters and criminals. The number and, hopefully, the quality of such people in regulatory agencies like SEC are presumably better than those in developing countries, but again the level of sophistication in perpetrating such frauds is also perhaps of a higher order. Time and again we have observed instances of prosecution initiatives being thrown out of court on technical (and not substantive) grounds, a sad commentary on the thoroughness with which our cases are built up. The need of the hour is to strengthen the resources and skill sets of regulators, such as the Securities and Exchange Board of India, major Stock Exchanges, the Department of Company Affairs and its extended offices, the Institute of Chartered Accountants, and so on. Ignorance of law, it is cited, is no excuse; neither can be incompetence or indifference in case of regulators. If they still fail, as in recent US

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cases, after due and diligent effort, society may have to accept it as an inherent hazard of any regulatory activity.

Another well-intentioned but completely dysfunctional example may be cited in furtherance of this argument. Naresh Chandra Committee recommends that company auditors be required to send to the Registrars of Companies, Stock Exchanges and SEBI communications highlighting any audit qualifications in their reports to shareholders.[6] One assumes it is the responsibility of these receiving regulatory bodies to review filings even if on a selective basis. To require other constituencies to send them executive alerts does seem to be stretching the point, and more importantly, condoning in advance any potential for defaults on the regulators' part!

It is appreciated that building specialized resources could be a time consuming and expensive exercise, and often may also lead to underutilization of such talent if different regulators were to do so; the answer may lie in engaging independent experts or consultants to assist the regulators. Quite rightly, Naresh Chandra Committee suggests such a course of action in the context of its recommendations on the setting up of a Corporate Serious Fraud Office.[7] The same logic could be extended to other regulators as well.

Building an Ethically Responsive Mindset

At the end of it all, one is left wondering whether there shouldn't be a limit to such supervision and surveillance in a civilized society. Corporations, legislators, regulators, and scores of other reputational agencies continue to oversee the actions and inactions of others so that (virtually) nothing unacceptable to society ever escapes its attention and where appropriate, its punishment. In efficient businesses, people are always exhorted to "do things right the first time," since multiple points of assurance or correction only add to the "costs" without any corresponding increase in the customers' value-perception of the goods or services delivered. How, if at all, can we minimize, if not altogether preempt, the costs to society of corporate mis-governance?

A rule-based model is one method of striving for good governance, a series of do's and don'ts, supported by a web of control, correction and/or punishment mechanisms. Much of the legislative, regulatory, reputational and judicial measures fall in this category. Clearly, exclusive application of this model is no guarantee of complete success, as has been demonstrated by several instances of corporate scams and failures. And this has been so for centuries; one has only to recall cases like the South Sea Bubble and the Mississippi Scheme of the early eighteenth century down to the Enrons and WorldComs of our own times. Besides, such measures most often tend to be reactive, seeking to plug the observed loopholes in extant structures,[8] in the ongoing "catch-me-if-you-can" struggle between the regulator and the regulated.

Corporate misdemenour has often be attributed to the inherent greed of humans to have more than their "due" at the expense of others, and an undivided focus on financial

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measures like shareholder wealth maximization closely tied to executive compensation.[9] May be there is something in our education and upbringing that contributes this streak of violence in people in aggressively expropriating what actually belongs to others. May be, the harsh realities of a bygone age fighting to stake a claim for a piece of property in a foreign land, rationalizing it on their own deprivations following religious persecutions back "home", have sown their seeds for continuing the game at least in the New World countries. May be, this is one of the fallouts of sweeping globalization in developing countries like India, that encourage the natives to emulate their (materially) more successful compatriots in the developed markets.

The short point is that as important as the rule-based governance model is, there is a strong case to revisit our value systems (of which countries like India have an immense store) that will help our corporate leaders to fight hard in global competition on quality and value of the offerings, but play well within the rules dictated by an ethical framework (and many companies do now boast of such codes) that responds to the requirements of triple-dimensions of economics, environment and society. If bringing this emphasis to the fore means getting back to the basics, may be that should be done. Inculcating good ethical values at home, in school and internalizing them in people can translate in course of time into good governance in corporations. This is possibly the greatest and the harshest lesson that the Enrons of this world have proffered to communities and societies around the globe.

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[1] *Cooking the Books: The Cost to the* Economy, Policy Brief # 106, (August 2002), The Brookings Institution

[2] The author's views have been recently endorsed in an international context as well, *Don't Shoot the Messenger*, The Economist, February 27, 2003

[3] In my Presentation to the Naresh Chandra Committee on Corporate Governance and Audit in Mumbai, on September 19, 2002

[4] An entire Chapter 3 in the Naresh Chandra Committee Report is devoted to this important subject

[5] *Corporate Governance and Accountability: What Role for the Regulator, Director, and Auditor?* , Dan A Bavly, (1999), Quorum Books

[6] Recommendation 2.6 of the Report.

[7] Recommendation 5.3 of the Report

[8] The Sarbanes-Oxley Act of 2002 has been labeled by some as an over-reaction to the Enron and other failures of recent times

[9] *Value Shift*, Lyn Sharp Paine, (2002), McGraw-Hill; *A Theory on Corporate Greed*, Jeff Madrick, (2003), New York Times, February 20

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Comment – 2

Ajay Shah[*]

Prof. Varma has written an outstanding, book-length piece. From 2000 onwards, as many of these stories were unfolding, I kept myself superficially aware of what each of them was about. This article was the first time that I got a coherent, well thought out piece which put these facts together with a unifying conceptual framework. I hope everyone connected with these questions in India - board members, auditors, regulators, policy makers - will take time off to read the article.

In my experience, this is the first time that I read a top quality piece about the United States economy, which could hold its own in the United States discourse that was written by a scholar located in India. This is an achievement in itself, and also heartening in showing the possibilities to the rest of the research community. A university in India with a fast leased line to the Internet now has more of a 'level playing field' when compared with the best universities in the world.

Concerns on investigative process

(i) My first comment is a note of caution on the 'evidence'. In my experience, the investigative process in finance is somewhat biased towards portraying many activities as tainted. Many times, we run the risk of misclassifying activities and transactions which are honest and well meaning.

A large finance company is a complex web of contracts and transactions. Many of these contracts and transactions are based on oral discussions and subtle trust relationships within the organisation, and between the management team and the board. When a crisis engulfs the organisation, there is a rush for the exits, most spoken discussions and trust relationships are ruptured, and each individual seeks to protect himself. Investigative teams are then reduced to written records, which are inherently imperfect, and to the oral statements of individuals (each of whom has a self-interest in portraying others as wrongdoers while protecting himself). Investigative teams, particularly in India, tend to be comprised of policemen, lawyers and accountants, and generally do not involve finance people. Hence, investigative teams tend to be under equipped with knowledge of finance when compared with the staff of the company under investigation. The investigators are under pressure to come up with guilty verdicts. This is not an environment conducive to discovering the truth. There is a risk of taking individual transactions, out of context, and portraying them as malpractice. Hence, as a general principle, I would argue that there is merit in being cautious in the consumption of reports of financial fraud.

(ii) There are three fragments in this paper where I felt slightly uncomfortable about interpretation:

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Enron On page 9: Prof. Varma argues that the Rhythms transaction was 'fraudulent in intent, fraudulent in execution and fraudulent in effect'. The term fraud pertains to promises which are not kept. The Rhythms transaction was cleared by the board, which presumably got disclosure about what this transaction was about. One can argue that the board did not correctly maximise the interests of shareholders in this decision. However, it is hard to argue that the transaction did not work 'as promised' (which is the essence of the term 'fraud'). The transaction may have always been programmed to be unfair to shareholders, but if that was correctly disclosed to the board, then this was a poor decision by the board, and not a case of fraud.

Email by analysts: Prof. Varma (and the investigators) argue that statements made by analysts in their private email conversations were fundamentally incompatible with the reports that the analysts were putting out at the same time. However, we need to exercise greater care in the evidentiary interpretation of email.

In any organisation, there is (and there should be) honest internal dissent. Every time the organisation says X in the public domain, it is normal and healthy for many insiders to strenuously argue that X is false, both before the organisation has spoken in public, and after. Such dissent is a necessary condition in any well run organisation. If an organisation arrives at X without some internal criticism, or if every staff member changes his mind and agrees with X once a public statement has come out, then this would reflect a highly stifled organisation. In particular, email has a certain illusion of privacy about it, which implies that many times the written text is exactly comparable to an informal conversation. When this is read as an official statement after a passage of time, it can often appear lurid.

Tata finance: In the extract from the A. F. Ferguson report, I was struck by the phrase Significant deployment of the funds of the company's subsidiaries and affiliates for funding stock market operations and excessive dealing in select scrips. How much is 'significant'? How much is 'excessive'? These are subtle questions of business judgment. My experience with the investigative process in India in these sorts of questions leads to concerns about the quality of judgments that the typical investigator, who is not a finance professional, would make.

There is a larger problem, and much more important problem, here. Modern finance is as complex as (say) modern electronics. However, the operations of the financial sector innately involve many more interactions with laymen in a highly technical field, as compared with a field like electronics where decision making and discussion is restricted to the cognoscenti. This is innately the source of a great deal of confusion, and difficulties in enforcement.

For example, to a finance professional, it appears obvious and reasonable that a hedge fund focused on arbitrage should have a gross position of Rs.10,000 crore even though the assets under management are Rs.100 crore.

However, this is something that most laymen find incomprehensible. Under normal circumstances, these gaps in knowledge hinder policy making, where we routinely face problems with limited knowledge amongst individuals directly or indirectly

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involved in the policy process. Under crisis circumstances, this generates Type 1 errors, where there is a bias towards guilty verdicts.

In particular, jury trials involve bringing a 'man on the street' to sit in judgment on complex transactions. Given the cultural biases in modern society against 'clever finance people', and the media onslaught surrounding each of these trials, it is hard to obtain sound verdicts out of juries. In India, while we do not have jury trials, we have seen several situations where judges who have started out without experience in finance have gradually improved the quality of their knowledge over the years through repeated interactions with finance in various cases. We need to recognise that the concept of bringing laymen in judgement, on activities which require technical competence, is fraught with difficulties.

Problems in accounting

Prof. Varma is on very important territory when he focuses on the limitations of accounting. The fundamental intuition of accounting is based on 'watching a cashbox', and arithmetic relationships between stocks and flows. If we know how much money there is in a cashbox at the start of a time period, and if we watch every transaction where money comes into the cashbox or leaves the cashbox, then we can cumulate up these deltas and have an accurate picture about the value of the cashbox at the end of the time period. The stock of value of the cashbox at time t2 is the stock of value at time t1 plus all the flows which took place between t1 and t2. This intuition works well for cash, and fails strongly when we put things into the cashbox which have an independent market price. As Prof. Varma emphasises, the fundamental gulf between accounting and marking to market has not yet been adequately resolved. Modern finance has given us anonymous, liquid financial markets where the position of a firm can be substantially transformed several times in a single day. Under these circumstances, our traditional notions of accounting are grossly out of touch with the goals of financial disclosure.

To the extent that firms trade on public, anonymous markets, there is a clear way forward, which consists of two rules. First, we should utilise 100% marking to market. Second, we should utilise daily disclosure, and move towards realtime disclosure. We will require considerable work in implementing these strategies. However, at the level of ideas, it is clear that if these two principles are applied, then the goals of disclosure are fully met. The real problems then arise with the transactions which are conducted in private, where the public market does not constrain the privately negotiated price, and does not reveal a reference price. In such situations, realtime transparency is a constant enforcement challenge. As Warren Buffet has reminded us in a recent article in Fortune, it is not easy to obtain sound reference prices for opaque, illiquid products. When the trader who did the transaction is given the job of setting its reference price, as is the case for most opaque products, there is an obvious conflict of interest there. From a public policy standpoint, the easiest way to deal with opaque markets is to find ways to not deal with them. It is possible for policy makers to steadfastly favour the growth of public, anonymous securities markets, which seek to be close to Walrasian markets. This will inevitably leave a residual set of situations where contracting will continue to be bilateral, with

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highly customised contracts, etc. These situations will require substantial inputs of corporate governance and sophisticated supervisory capacity. But it is possible to reduce the incidence of these situations.

This has important lessons in India's financial markets. On the equity market, SEBI has succeeded in mandating that all transactions, even those by 'wholesale' players, take place on the public, anonymous computerised markets. There is much merit in emulating this experience on the currency and bond markets, to move away from bilateral transactions towards transacting on public securities markets.

Market discipline

I fully agree with Prof. Varma when he argues that the way forward should emphasise strengthening market discipline. He underlines the elements:

- Short selling,
- Hostile takeovers,
- Class action lawsuits,
- Breaking oligopolies in credit rating, investment banking, accounting, etc.

In addition to the above, continual efforts on strengthening disclosure, and in producing market-based mechanisms for giving firms incentives for better disclosure (such as publicly released scores of disclosure quality), would also help improve market discipline.

The underlying world view is equally important, and more broadly applicable. Speculative markets are powerful tools for information processing and can exert considerable market discipline. However, they only work well when we create the enabling structures for them to work well. The goal of public policy should be to create the enabling environment which generates strong incentives for speculation, and gives tools to individuals to engage in speculation.

There are basically three levels at which speculative dynamics can be subverted: 1.The State can engage in outright prohibitions, such as bans on short selling, currency controls, etc. 2. The State can trade directly on markets, which can be an effective device for frustrating price discovery. 3. A market where many or most economic agents are not well motivated in terms of information processing and profits is unlikely to exhibit sound speculative dynamics.

This has come about on India's currency market and bond market through State ownership of three quarters of the banking system. This is also a serious problem with private firms through poor corporate governance, whereby the maximisation of the individuals in the firm often leads them into actions which are not in the interests of the owners of the firm. Given India's problems with corporate governance, this is a serious difficulty faced in the sound operation of finance companies. The bulwark of speculative dynamics in India have hence been individuals and small firms where

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there is a strong identity between owners and employees. This is the class of entities that has sound incentives to consume information, make forecasts about the future, and trade in financial markets. Their domination of the equity market has worked well for India in terms of producing informational efficiency on the equity market. This class of entities will easily exploit short selling mechanisms if they are permitted by regulators. We need new thought in finding ways for this class of entities to play a bigger role in the market for corporate control.

The equity derivatives market marks a milestone in India's history, by giving a set of stocks where leveraged long and short positions are attainable by this class of entities. We may expect this to have given a strong fillip to price discovery for the securities affected herein. This is an area which merits further research. Looking forward, this class of well motivated economic agents has a transformative potential which can also be applied to other markets such as the currency, commodity and bond markets.

Conclusion

Prof. Varma has written a powerful and important article that should get us all thinking about how to make the financial sector function better. His important insight is that our way forward should be based on the enabling mechanisms required to make speculative processes to function better, and that a reflexive retreat into a more intrusive State does not constitute the solution.

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Comment – 3

Ashok Desai*

Jayanth Varma's painstaking, detailed and perceptive research paper reaches broadly correct conclusions. The comments below are intended to supplement his work.

1. My experience as company director is that independent directors are dependent on company managers for information; it is easy to keep them in ignorance, and bent corporate managers will keep them in ignorance. Where those who control information have an incentive to keep it secret, it can come out only against their will.

2. Disclosure norms set down by regulators do help under two conditions: first, the institution that monitors disclosure is independent of the company, and second, it monitors information frequently. Of the two institutions that currently monitor information, the vigilance officer is an employee of the company and has neither statutory duties nor statutory protection, and the chartered accountant is paid by the company and can be suborned. There is a case for external auditors appointed by someone other than the company. It could be the regulator. SEBI does get mutual funds' accounts audited by auditors of its own choice. But its choice is often quite nepotistic, with the result that there is much incompetent auditing.

3. It is a pity that Varma did not have the benefit of reading *Power Failure*, the book written by Sherron Watkins, the Enron whistle blower. Her main point is that independent directors are only nominally independent. Their selection itself is generally orchestrated by the management; and even when it is not, relationships between them and the management develop which induce them not to probe or not to raise uncomfortable questions. In the circumstances, we need to think a bit about the definition of an independent director; his not having any pecuniary relationship with the company is not enough. Western institutional investors like independent directors to have a shareholding in the company, but a token stake does not make them any more mindful of shareholders' interests.

4. Legal protection for whistle blowers is essential, but not enough. Watkins was a Vice President of Enron. She only sent an e-mail to Kenneth Lay expressing doubt about certain financial practices; she was immediately deprived of authority and access to information. She was abused by other employees. So with the best of intent, employees will have a strong disincentive against blowing the whistle. Some arrangement for rewarding whistle blowers is necessary.

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5. In India, the libel law strongly discourages whistle-blowing. A corporation can easily file a libel case for hundreds of crores; it can make a reporter's life sheer hell for many years. This is the most important reason why the press does not expose corporate fraud more frequently.

6. Varma is absolutely right about the difference between public enquiries in the west and in India – in India they are invariably held in camera. This is quite wrong; whether it is a regulatory or a parliamentary committee, it is supposed to act in a judicial capacity. Like any court, it must function in the full glare of publicity. Its programme should be announced weeks in advance, and should be available to everyone. We in this country has entirely subverted the institution of public enquiry; it is not surprising that enquiries yield so little. Even when an enquiry is public, it is easily subverted by sabotage by the government, as has happened in the case of the Tehelka commission.

7. In the Tata Finance case, Varma sticks too closely to the Tata Finance annual report, and misses the essential point, that Tata Finance had borrowed from depositors at fixed interest and invested the money through Niskalp in equities. This could not have been done without the approval of the board of Tata Finance. This is irrespective of any fraud committed by Pendse.

8. The following statement on p 45 is not comprehensible in light of Varma's evidence: "The critical issue was not so much that of fair value accounting, but of revenue recognition in the context of fair value accounting. * The problem of mark to market accounting at Enron were more related to the implementation of the method than to its conceptual validity." It seems to me that the Enron case was a pretty damning indictment of mark-to-market valuation; the best that could be said is that mark-to-market accounting is appropriate to certain cases and not others. Varma should say what he considers it appropriate to.

9. Some matters of detail: P16: it would help to explain that fair value accounting is a common but misleading name for marking to market. There is nothing particularly fair about it. Accounts should distinguish between profits made by a business out of its own exertion and windfall profits or gains arising out of revaluation of assets. Mark-to-market accounting mixes up the two. And where real market prices are not available, the balance sheet and profit and loss account can become fictitious – as they have of the fixed-income funds in India.

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Reply to Comments

At the outset, I would like to thank the commentators for their insightful comments and for their compliments. I am also grateful to them for highlighting some important dimensions of corporate governance that were under-emphasized in my paper.

Dr. Balasubramaniam is quite right in saying that while regulatory failure may be an inherent hazard of regulatory activity, that should not be an excuse for regulatory incompetence or indifference. He has also brought out the importance of building an ethically responsive mindset. My paper avoided any discussion of this not because ethics is unimportant but because I did not see any easy and simple way of improving the ethical climate. Those who attempt this difficult and arduous task deserve our full support.

I agree completely with Dr. Ajay Shah when he says that the investigative process in finance is somewhat biased towards portraying many activities as tainted even though they might have been honest and well meaning at the time when they were undertaken. I may not agree with all the specific examples that he has highlighted (particularly the Rhythms transaction) but the fundamental point that he makes is absolutely correct. We must indeed be cautious in the consumption of reports of financial fraud. Dr Shah is also absolutely correct in arguing that policy makers must steadfastly favour the growth of public, anonymous securities markets, which seek to be close to Walrasian markets.

Dr Ashok Desai makes the important point that since independent directors are dependent on company managers for information, it is easy to keep them in ignorance, and bent corporate managers will keep them in ignorance. I agree that we must keep this in mind while evaluating the alleged failure of the boards to monitor what was going on. In this context, the paper quotes several passages from the testimony of the Chairman of the Audit Committee of the Board of Enron in defence of his role. Yet after reading the tens of thousands of words of the written and oral testimony of the directors[1], my considered judgement is that the Enron directors were not really in the dark about the risks involved in Enron's accounting practices. However, this is a matter on which alternative interpretations are possible.

Regarding Tata Finance, Dr Desai asserts that my paper "misses the essential point, that Tata Finance had borrowed from depositors at fixed interest and invested the money through Niskalp in equities". I distinguish between fraud and poor business judgement or imprudence. What Dr. Desai describes was certainly imprudent, but it is not per se a fraud unless it violates a prudential regulation or unless it was wrongly concealed from regulators or investors.

Dr. Desai also states that my paper sticks too closely to the Tata Finance Annual Report. The only reason for doing so is that this is the only official document that is publicly available. As I write in my paper: "The information collected by these agencies has not however been made public and there is a dearth of authentic information about the matter." The paper does refer to numerous press reports (in the aftermath of the Kale episode) which provide circumstantial evidence that the true

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facts are more damaging to Tata Finance than the annual report suggests. But in the absence of hard facts, it is difficult to say anything more. This also highlights an interesting contrast with the US experience where after the unearthing of the frauds, the official filings of the companies read like a *mea culpa*. We do not find this in India (Tata Finance) or in Europe (Vivendi). This in itself is a telling commentary on the far sharper teeth of the US class action law suit as compared to the Indian and European regulators.

My only serious disagreement with Dr. Desai is on mark to market accounting. Dr. Desai argues that "It seems to me that the Enron case was a pretty damning indictment of mark-to-market valuation; the best that could be said is that mark-to-market accounting is appropriate to certain cases and not others." I disagree completely and emphatically. I regard mark-to-market accounting as the most important revolution in accounting – a revolution that I would like to see sweep through the whole of accounting. Historical cost accounting produces balance sheets that bear no resemblance to reality. It is a fiction that needs to be abandoned wherever and whenever possible. In practice, that means mark-to-market accounting must be adopted wherever there is a liquid and efficient market.

Dr. Desai states that: "Accounts should distinguish between profits made by a business out of its own exertion and windfall profits or gains arising out of revaluation of assets. Mark-to-market accounting mixes up the two." This mixing up would not take place at all if the income statement is presented correctly. Correctly prepared accounts distinguish between operating income and non operating income. They also distinguish between a gain that flows through the income statement (and becomes part of the profits) and a gain that flows straight into retained earnings as "Other Comprehensive Income". It is in this context, that the paper states that "The critical issue was not so much that of fair value accounting, but of revenue recognition in the context of fair value accounting." Proper revenue recognition would have spread the gains of the contract over the life of the contract as it was earned instead of recognizing the whole amount as a profit at inception of the contract. At the same time, mark-to market accounting would have shown the assets and liabilities at fair values in the balance sheet.

Dr Desai goes on to state that "fair value accounting is a common but misleading name for marking to market. There is nothing particularly fair about it." I disagree completely. Market values are the closest that we can ever get to fair values and the sooner accounting theory recognizes and accepts the fact, the better it would be for all users of accounting information.

Let me also add that Worldcom, Adelphia and other companies did not need mark-to-market accounting to perpetrate their accounting frauds. Enron itself perpetrated greater frauds in its historic cost accounting than in its mark-to-market accounting as my paper explains in detail. If vulnerability to frauds is to be the benchmark, historic cost accounting has far more to answer for than mark-to-market accounting.

Dr. Desai also dwells at length on the Sharon Watkins episode and the light that it throws on the independence of directors and the protection of whistle blowers. The

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Watkins episode is indeed deeply distressing for those who count on a sprinkling of upright people in the management and in the board to guard against corporate greed and misdemeanour. My paper takes a different approach. I agree that it would be nice if there were more saintly people around, but even if there were, I find it difficult to believe that chairing audit committees or presiding over regulatory agencies is the best use of this very precious resource. The whole point of my paper is more cynical and pragmatic – that greed can be fought with greed itself. I argue that in a well functioning capitalist society, the greed of short sellers, corporate raiders and class action lawyers provides a strong and robust defence against the greed of corporate insiders.

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[1] Particularly a long exchange between Mr. Robert Jaedicke, Chairman of Audit and Compliance Committee, Enron Board of Directors and Senator Carl Levin in the hearing before Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, US House of Representatives, February 7, 2002. This exchange relates to a chart presented by the auditor to the Audit Committee describing the accounting judgements in relation to certain transactions as "high risk".