The recent demise of Enron company and of their audit firm Andersen and of a host of other companies in the United States of America which has the most elaborate public monitoring and regulatory institutions and laws relating to free market institutions, sounded an alarm bell for economies like India that entered into a liberalized capitalist phase of development a decade ago. We felt the need for review of the circumstances leading to these failures in order to draw appropriate lessons for India. Prof. Jayanth Varma readily agreed to undertake this task. The paper by him is published below in the expectation that it will inform all interested persons on the development and lead to meaningful discussion on the steps to be taken in India to forestall such possibilities. We publish three comments on Professor Varma's paper in this issue. Other comments, if and when received, will be printed in the subsequent issues.

Editor

Governance, Supervision and Market Discipline: Lessons from Enron

Jayanth R. Varma[*]

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This paper studies and documents the accounting scandals and corporate frauds that came to light during 2001 and 2002 at Enron and other companies in the United States and elsewhere. It then describes the failure of governance and supervision as well as the failure of market discipline that took place and goes on to analyse the lessons that can be drawn from these episodes.

The principal conclusion of this paper is that while the Enron and related scandals represent a massive regulatory failure, such failures are inherent in the regulatory process. Regulators are poor at detecting fraud, and therefore we must strengthen market discipline. This in turn calls for four important measures: encouraging hostile take-overs, allowing free short selling, permitting and facilitating class action lawsuits, and promoting competition in the securities industry.

The second important lesson is that the world must learn from the US to prosecute and punish wrong doers swiftly after they are caught.

Finally, changes in regulation and supervision could facilitate the process of market discipline. Measures proposed here include: drastic reform of the system for regulatory review of corporate accounting filings, vast improvements in accounting standards and a movement towards detailed real time disclosures going far beyond the traditional accounting statements.

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1 Introduction

Enron is the best known and most complex of a series of accounting scandals and corporate frauds (Enron, Tyco, Worldcom, ImClone, and Adelphia to name only a few) that have come to light in the United States during 2001 and 2002. These scandals have their counterparts in Europe – ABB, Vivendi, Lernout and Hauspie, and Kirch Media. In India too, there have been allegations of corporate frauds in the case of Tata Finance and also in the cases of several companies that are alleged to have played a role in the stock market crisis of 2001.

This paper attempts the following:

- document the frauds that have taken place (Accounting Frauds in Section 2, Looting the Company in Section 3, Securities Market Frauds in Section 4, and Crises at non US Companies in Section 5);

- describe the failures of governance and supervision at various levels – the Board of Directors, the auditors, the rating agencies, the accounting standard setters, and the stock market regulators – and the regulatory response to this failure (Section 6);

- analyse the failure of market discipline that happened and examine the ways in which market discipline can be strengthened to reduce the chances of such frauds in future (Section 7);

- examine the US experience in relation to the investigative process after the fraud has been unearthed (Section 8); and

- identify the lessons to be learned from these events (Section 9);

Much of the paper focuses on the developments in the United States not because corporate fraud is less rampant or less severe in other countries, but because there is a lot more authentic information on what happened in the United States. Thousands of pages of official documents are available in the United States giving detailed information about the frauds that took place. In addition to the official investigative reports published by the companies themselves, there have been several congressional committee reports. Moreover, the congressional committees have published complete transcripts of their hearings including the testimony of the Directors and bankers of Enron. By contrast, Indian parliamentary committees have held their hearings behind closed doors and neither the companies nor the regulators have chosen to publish the results of their investigations. In many cases, we have only press reports to go by as to what actually happened in India. This difference in transparency is itself a lesson to be learnt.

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2 Accounting Frauds

2.1 Enron's Concealment of debt and losses through off balance sheet vehicles

2.1.1 Motivation and Background

Enron's dramatic collapse was triggered by the discovery of very complex off balance sheet transactions that had been used to conceal debt and inflate profits. This section discusses the motivation, mechanics and consequences of these transactions.

In the late 1990s, Enron was telling its investors that it was pursuing an asset-light strategy to improve its profitability. The argument was that when markets are well developed, it is no longer necessary to own expensive assets. For example, it is not necessary to own a power plant and a transmission network to offer a long term contract to sell power to a customer. It is possible to sell that contract and buy the power from the market. More precisely, it is possible to break up the risks involved in the long term contract into a number of component risks (like energy price risk and transmission cost risk) and hedge the component risks in appropriate markets. Enron claimed that its competitive advantage would come from its deep understanding of these markets – both the underlying market and the various derivative markets that had come up on top of the underlying markets. This knowledge and the associated trading skills would allow Enron to offer the long term contract to a customer cheaper than a competitor that actually owned a power plant and a transmission network. If that could be achieved, Enron would earn very large profits with very little investment and the return on investment would be extremely large. It was this vision that propelled the Enron stock to high levels and gave Enron the image of being a highly innovative company. Enron described[1] this strategy as follows:

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> "[Enron] Wholesale Services manages its portfolio of contracts and assets in order to maximize value, minimize the associated risks and provide overall liquidity. In doing so, Wholesale Services uses portfolio and risk management disciplines, including offsetting or hedging transactions, to manage exposures to market price movements (commodities, interest rates, foreign currencies and equities). Additionally, Wholesale Services manages its liquidity and exposure to third-party credit risk through monetization of its contract portfolio or third-party insurance contracts. Wholesale Services also sells interests in certain investments and other assets to improve liquidity and overall return, the timing of which is dependent on market conditions and management's expectations of the investment's value.
>
> …
>
> With increased liquidity in the marketplace and the success of EnronOnline, Enron believes that it no longer needs to own the same level of physical assets, instead utilizing contracting and market-making activities."

However, Enron pursued this asset light strategy with a single minded focus only under Jeffrey Skilling[2]. Prior to that, Enron had combined an asset light strategy in the North American markets with a strategy of aggressive investment in physical assets in emerging markets:

> "In many markets outside of North America and Europe, a shortage of energy infrastructure exists, providing Enron significant opportunities to develop, construct, promote and operate natural gas pipelines, power plants and other energy infrastructure. … Enron has developed regional wholesale energy businesses around its international asset base in both South America and in India and continues to pursue a range of energy infrastructure opportunities outside of North America and Europe."[3]

Over time, Enron built up a portfolio of emerging market assets in India, Argentina, Brazil, Bolivia, Venezuela, Panama, several Caribbean countries, China, Philippines and Korea. The emerging market strategy, associated with Rebecca Mark[4,5] was predicated on the assumption that, by offering to make large investments in capital starved emerging markets, Enron would be able to negotiate very profitable contracts. In fact, Enron did succeed in negotiating contracts that appeared so profitable and one-sided in countries like India that critics in these countries accused the company of bribery and deception. However, economic difficulties in the host countries combined with problems of contract enforcement made these projects unprofitable. To pursue its asset light strategy, Enron needed to sell these assets and sell them quickly.

Selling these assets would produce two major benefits to Enron. On the balance sheet side, it would eliminate the assets as well as the associated debt. The reduction in debt would reduce the debt-equity ratio and improve the credit worthiness of Enron. Maintaining a high credit rating was critical in the trading business which Enron saw as

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its future[6]. The counterparties with whom Enron entered into long term contracts would worry about the ability of Enron to honour its obligations during the life of the contract. If its credit rating slipped, counterparties would be unwilling to trade with Enron and the trading business would grind to a halt. Therefore, debt reduction was a very important reason for selling physical assets. Another potential benefit would be on profitability. If an asset could be sold above its cost there would be an immediate profit. If a loss making asset were sold, the recurring future losses would be eliminated.

Unfortunately, some of the assets that Enron wanted to sell were assets that others were not keen to buy. Some assets were so entwined in legal and political difficulties that nobody would want to get involved in them. Other assets might have had potential buyers but only at prices that would produce large losses for Enron. Even in the case of better assets that might have had willing buyers, Enron's desire to sell the assets quickly (typically ahead of a reporting deadline) made a lengthy negotiation with third parties unattractive.

2.1.2 Special Purpose Entities

It was in this context that Enron began the practice of selling assets to special purpose entities (SPEs) set up by itself. Enron would gain nothing by selling assets to an SPE owned and controlled by Enron itself. Companies are required to produce consolidated balance sheets that show the aggregate assets and liabilities of the company as well as of all subsidiaries and other entities that it owns and controls. Thus if the buying SPE were owned by Enron, nothing would change on the consolidated balance sheet where the SPE would effectively be regarded as part of Enron itself. To achieve the benefit of an asset sale, the SPE would need to be owned by somebody else.

This is where matters start getting complex. It is not too difficult to have an outsider own the SPE if the outsider has to invest very little money[7]. If the SPE is financed with say 99.9% debt, the outsider's equity investment would be very tiny. The question is why would anybody lend the SPE say $1 million when the owner of the SPE has made an equity investment of only $1000? The solution to this problem is that Enron in some way provides a guarantee or other form of credit support to the lender. In this scheme of things, the SPE is notionally owned by an outsider, but it is in some sense financed and controlled by Enron.

Of course, accounting standards were not stupid enough to allow this kind of sham. In the United States, there was an accounting standard FAS 140 ("Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities") that dealt with SPEs. It stated that for an SPE to escape consolidation with Enron, it would need to have an outside owner who:

1. makes a substantive equity investment in the SPE
2. controls the SPE (typically by owning a majority of the equity)

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3. bears the first dollar of loss of the SPE

The term "substantive investment" came to be interpreted as at least 3% by analogy with a similar requirement imposed by the SEC staff in the context of leasing transactions[8]. After the collapse of Enron, a significant body of opinion has emerged that the 3% requirement was too low[9]. While this might well be so, it must be noted that the standard setters regarded 3% as the minimum acceptable investment; the circumstances of a particular transaction may require a larger investment. Moreover, as discussed below, Enron had great difficulty meeting the 3% requirement and its failure to do so forced the disclosures that led to its collapse. The difficulty of getting the 3% outside investment was increased by the "first dollar of loss" requirement which prevented imaginative derivative transactions by which the outside equity holder could be protected from the losses of the SPE.

FAS 140 meant that an SPE could not be set up with the 99.9% debt discussed above. At most, the debt could be 97% so that a $1 million asset sale would require an outsider putting up $30,000 of equity. Moreover, the "first dollar of loss" requirement meant that the outsider would have to take a significant risk of losing the entire $30,000 of equity investment if the asset declined in value.

In a situation where there were no external buyers for Enron's troubled assets, there were also no external investors willing to put up 3% equity exposed to "first dollar of loss". Even if external investors were available, it might not have been possible to close a deal with them as quickly as Enron might have desired given its desire to complete transactions ahead of the quarterly and annual accounting reporting dates. Many of Enron's complex frauds were ill fated attempts to circumvent the requirement of 3% outside equity at risk.

2.1.3 Enron's SPEs: The Chewco Transaction[10]

This section and the following section discuss in detail two examples of ingenious but fraudulent structures that Enron used to create the pretence of fulfilling the requirement that an outsider make a 3% equity investment in the SPE.

The Chewco transaction became necessary in November 1997 to allow an external investor (CalPERS) to exit from an Enron joint venture called JEDI (Joint Energy Development Initiative). To avoid consolidating JEDI into the Enron balance sheet, it was necessary to find another investor to take the place of CalPERS. Chewco was an SPE set up by Enron for this purpose. After an unsuccessful attempt to get a genuine outside investor into Chewco, Enron's CFO, Andrew Fastow, proposed that he be allowed to be the external investor in this SPE. At that time, Enron wished to avoid the disclosures that the involvement of a senior officer would necessitate[11]. Instead one of Fastow's subordinates, Michael Kopper, was chosen to play this role.

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The price payable by Chewco to CalPERS was $383 million and therefore the external investor in Chewco needed to provide equity of 3% of $383 million or $11.5 million. Initially Kopper planned to have full control of Chewco, but there was apparently some worry that if Chewco were completely controlled by Kopper, it could be regarded as being controlled by Enron since Kopper was an Enron employee. It was necessary to bring in somebody else with at least partial control over Chewco. Kopper therefore brought in his domestic partner[12], William Dodson as an investor willing to invest $10,000. Kopper himself was willing to invest $115,000 of his own money, and an outside investor had to be found for the remaining $11.4 million.

Enron approached Barclays Bank to provide this $11.4 million in a complex structure which had a whole pyramid of companies and partnerships:

- Chewco itself was formed as a limited partnership. In a limited partnership, there is a general partner who has unlimited liability for the debts of the partnerships and there are one or more limited partners whose liability is limited. The general partner typically manages the partnership while the limited partner provides capital.

- Kopper became the general partner of Chewco through a company formed to shield Kopper from the unlimited liability of a general partner. Kopper owned the company SONR #1 LLC that was the general partner of Chewco. Via this company, Kopper invested $115,000.

- The limited partner of Chewco was a pyramid of companies controlled by Dodson into which Barclays injected $11.4 million. This pyramid was formed as follows. Dodson formed a company, SONR #2 LLC, that contributed $10,000 to Little River Funding LLC. Little River received $331,000 from Barclays Bank and invested the combined amount of $341,000 into Big River Funding LLC. Big River in turn received $11.1 million from Barclays Bank and invested the combined amount of $11.4 million in Chewco to become its limited partner. In two stages, therefore Dodson's controlling investment of $10,000 was scaled up more than a thousand times into a $11.4 million stake in Chewco.

- Chewco now had $11.5 million of equity ($0.1 million from Kopper and $11.4 million from Dodson's Big River) against which it borrowed $240 million from Barclays Bank and $132 million from JEDI itself. It thus had the $383 million to pay to CalPERS to take over its stake in JEDI. The borrowing from Barclays Bank was guaranteed by Enron and was not problematic for the purpose of SPE accounting[13] as it was part of the 97% debt that Chewco could have without falling afoul of FAS 140 and EITF 90-15.

The real problem was the $11.4 million that Barclays provided to Big River and Little River. To comply with the accounting standards, this had to be equity at risk to first dollar of loss. Barclays however was willing to lend but not to take equity. In an attempt

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to bridge the gap, the transaction was described as equity notes. The term "notes" allowed Barclays to classify it as loans in its books while the term "equity" allowed Chewco to classify it as equity[14]. Such semantic games were apparently common practice in SPE transactions in the United States at that time. Continuing this semantic game, the notes did not talk about interest; they talked about yield because that term could cover both interest and dividends. The semantics were the easy part[15] but the hard part was the requirement of first dollar of loss.

Again Enron resorted to an elaborate fudge to paper over this problem. Big River and Little River established cash "reserve accounts" as a form of security for repayment of the $11.4 million provided by Barclays. To maintain the "equity" appearance of the transaction it was provided that the reserve accounts would be funded only with the last 3% of any cash distributions from JEDI to Chewco, and that Barclays could not utilize those funds if it would bring Chewco's "equity" below 3%.

Based upon this structure, Enron's auditors came to the conclusion that Barclays' contribution to Big River and Little River could be regarded as equity at risk for the purpose of the 3% equity requirement. This meant that Chewco did not have to be consolidated into Enron. Moreover since Chewco was an outside investor holding more than 3% of the equity of JEDI, it was not necessary to consolidate JEDI either. A total of $711 million of debt of Chewco and JEDI was thus kept out of Enron's balance sheet[16]. All the accounting and legal legerdemain of this transaction was a small price to pay for this singular achievement.

Unfortunately, however, all this sleight of hand could not get around the fundamental problem that Barclays was unwilling to bear the first dollar of loss. Before they disbursed the $11.4 million to Big River and Little River, they demanded that the reserve accounts set up by these two entities be funded in cash to the extent of $6.6 million ($6.4 million for the Big River Reserve Account and $0.2 million for the Little River Reserve Account) These reserve accounts maintained at Barclays Bank constituted cash collateral for the equity notes". Since this portion of the "equity notes" was not at risk, it was evident that the Chewco structure no longer met the requirement of 3% outside equity at risk.

Four years after the Chewco transaction was completed, Enron finally admitted that the non consolidation of Chewco and JEDI was an error and restated its financial reports from 1997 onward. This restatement was one of the proximate causes for the collapse of Enron in November 2001.

It is not clear who knew about the change in the transaction structure (the cash collateral in the reserve accounts) back in 1997. The accounting staff at Enron as well as the external auditors naturally claimed that they were not aware of this development. The auditors stated[17]: "In 1997, we performed audit procedures on the Chewco transaction. The information provided to our auditors showed that approximately $11.4 million in Chewco had come from a large international financial institution unrelated to Enron. That equity met the 3 percent residual equity test. However, we recently learned that Enron

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had arranged a separate agreement with that institution under which cash collateral was provided for half of the residual equity. … Very significantly, at the time of our 1997 procedures, the company did not reveal that it had this agreement with the financial institution. … It is not clear why the relevant information was not provided to us"

The critical question is the nature, seriousness and depth of "audit procedures on the Chewco transaction" that Anderson claimed to have performed in 1997, and whether these procedures did detect or should have detected[18] the cash funding of the reserve accounts. In this connection, the audit partner who audited this transaction stated[19]: "I also requested that I be provided documents relating to Chewco's formation and structure. Mr. Glisan told me that Enron did not have these documents and could not obtain them because Chewco was a third party with its own legal counsel and ownership independent of Enron. I did not view this as unusual. Quite frequently an auditor does not receive documents from a third party who is represented as being independent".

2.1.4 Enron's SPEs: The LJM Swap Sub

In mid 1999, Enron's Chief Financial Officer, Andrew Fastow proposed that he be allowed to set up an SPE to hedge Enron's substantial investment in a internet company called Rhythm NetConnections Inc. Under the proposal, Fastow would be the manager (general partner) of the SPE and would seek investment by outside investors. As narrated in 2.1.3 above, Enron had rejected a similar proposal by Fastow a year and a half earlier in connection with the Chewco transaction. But this time Fastow claimed that his presence as the manager of the SPE was necessary to attract outside investors, and the Board approved the proposal. Accordingly, LJM Cayman LP was formed with Fastow as the general partner (through a limited liability intermediary company to shield him from unlimited liability). Two investment vehicles affiliated to two leading international banks, Credit Suisse First Boston (CSFB) and NatWest became the limited partners. This SPE came to be known in Enron as LJM1 because months later Enron allowed Fastow to form a similar SPE with a similar name that came to be known as LJM2. The two LJM partnerships entered into more than 20 distinct transactions with Enron and several of them raise questions of accounting propriety, but in this paper, we will discuss only one of them – the Rhythms transactions alluded to above.

The Rhythms transaction involved two ideas. First, Enron's large investment in Rhythms had appreciated hugely in value and Enron was keen to lock in this gain. Because the Rhythms investment was classified as part of Enron's merchant portfolio it was accounted for under mark-to-market accounting. In other words at every balance sheet, the Rhythms stock would have to be shown at its then prevailing market price and any increase or decrease in the stock price would appear as a profit or loss in Enron's income statement. Enron wished to avoid having to report any losses if the stock declined in value. However, the terms of the original investment prohibited Enron from selling the stock till the end of 1999. Rhythms had gone public in April 1999 at a price 11 times what Enron had paid for it a year earlier. Within a month the stock price tripled again and

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a modest investment of $10 million was worth more than $300 million. Enron wanted to hedge its exposure to Rhythms and lock in its profits at this price.

The second consideration was that Enron had entered into a forward transaction to buy its own stock from an investment bank. This transaction had been entered into to hedge the dilution that would arise when Enron issued new stock under its employee stock option programmes. Since the Enron stock had appreciated sharply, this forward contract had made large gains, but accounting standards prevented Enron from recognizing any gains from transactions in its own stock. Enron wanted to unlock the value in these forward contracts and use that to support the hedging of Rhythms.

The structure that was used was that LJM1 and Fastow formed another SPE called LJM Swap Sub L.P. with LJM1 as the limited partner and Fastow as the general partner (via an intermediary limited liability company). The purpose of the new SPE was presumably to shield LJM1 from the liabilities arising out of the proposed hedging transactions. To capitalise Swap Sub, Enron restructured the forward contracts and obtained 3.4 million of its own shares. These were sold to LJM1 in return for (a) a note from LJM1 for $64 million and (b) a put option from Swap Sub on 5.4 million Rhythm shares at a strike price of $56. (The put options granted Enron the right, but not the obligation, to sell 5.4 million Rhythm shares to Swap Sub at a price of $56). According to an independent valuation (by PricewaterhouseCoopers) the Enron shares sold to LJM1 were worth $168 million and the Rhythm puts were worth $104 million so that the puts together with the $64 million note constituted a fair consideration for the Enron shares.

The catch here is that the 3.4 million Enron shares had a market value of $276 million. The accounting value of $168 million represented a 39% to the market price and was justified on the ground that Enron had placed a contractual restriction on most of the shares that precluded their sale or transfer for four years. The restriction also precluded LJM1 and Swap Sub from hedging the Enron stock for one year. The restriction did not, however, preclude LJM1 from pledging the shares as security for a loan.

It is true that restricted shares are often valued at substantial discounts to market price. One empirical study by Silber[20] of restricted stock issues from 1984 to 1989 found that the median discount for restricted stock was 33.75%. This was in line with similar studies of restricted stock issues in the 1960 and 1970s. On the basis of this kind of evidence, accountants routinely grant fairness opinions for valuations that include a discount of this order. However, the median discount in Silber's study predominantly reflects the steep discounts that obtain for large blocks of shares in relatively small firms. The illiquidity discount tends to be smaller (a) for large firms (b) for profitable firms, and (c) for blocks of restricted shares that are small in relation to the total number of shares outstanding. Enron was one of the largest companies in the United States, it was profitable (at that time), and the 3.4 million shares sold to Swap Sub were a miniscule fraction of its total equity. All this suggests that the discount should have been much lower. Silber estimated a regression equation relating the restricted shares discount to size, profitability and other characteristics. If we use this equation[21], we find that the restricted share discount for the

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LJM1 transaction should be negligible (zero). The 39% discount used in the fairness opinion appears grossly unjustified.

From a theoretical point of view also, the restricted shares discount is justified from the point of view of the issuer (Enron) on the ground that the sale restrictions prevent a large overhang of selling pressure in the market that could depress the market price or destabilize incumbent management. The shares involved in the Swap Sub transaction accounted for less than ½ % of its issued capital and was too small to make a significant difference. It is this fact that is reflected in the zero discount proposed by the Silber equation which is dominated by the term involving the size of the restricted block as a percentage of the total equity.

In the case of the Swap Sub transaction, the principal purpose of the sale restrictions appears to have been the fact that the 39% discount provides a significant credit capacity to the SPEs concerned. If the Rhythms stock were to decline and the put options were to lose money, the losses could be absorbed by the 39% cushion (unless the Enron stock also fell at the same time). Thus it is possible to argue that the entire restricted share structure and the associated valuation were fraudulent in intent, fraudulent in execution and fraudulent in effect.

To complete the transaction structure, there was also a transaction between LJM1 and Swap Sub. LJM1 capitalized Swap Sub with 1.6 million restricted shares of Enron and $3.75 million in cash. The Swap Sub Balance Sheet would appear as follows after this transaction:

Enron shares valued at market price of $81 per share		**Enron shares valued at restricted valuation of $49.5 per share**	
Assets ($ million)		*Assets ($ million)*	
Enron shares	130	Enron shares	79
Cash	4	Cash	4
Total assets	134	Total assets	83
Liabilities and Equity ($ million)		*Liabilities and Equity ($ million)*	
Rhythm Puts	104	Rhythm Puts	104
Equity*	30	Equity*	(21)
*Equity as % of total assets = 22%		*Equity as % of total assets = -25%	

If we momentarily forget the accounting fiction of the restricted value and think of Swap Sub's balance sheet in economic terms using the unrestricted market price, the left hand side of the table shows that Swap Sub has a positive equity of 22%. In this case, Swap Sub comfortably met the 3% requirement of FAS 140. But the correct accounting value for the actual transaction structure requires that the balance sheet be drawn up using the restricted value of the shares. The right hand side of the table shows that in this case

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Swap Sub has negative equity and does not meet the 3% outside equity requirement of FAS 140 at all.

It would appear that those structuring the transaction and those auditing it did lose sight of their own fiction of the restricted value of the shares and were deluded into believing that the requirement of FAS 140 were met[22]. The auditors testified[23] that: "In evaluating the 3 percent residual equity level required to qualify for non-consolidation, there were some complex issues concerning the valuation of various assets and liabilities. When we reviewed this transaction again in October 2001, we determined that our team's initial judgment that the 3 percent test was met was in error". Presumably, the "complex issues concerning the valuation" refers to the confusion between restricted value and market value. The very fact that such an error could arise in the minds of so many trained accountants lends further support to the proposition advanced in this paper that the whole idea of a restricted shares discount for the Swap Sub transaction was pure fiction.

2.2 Enron's Profit Manipulation by Abusing Mark to Market Accounting

Enron's energy trading business involved selling long term energy contracts to customers and hedging them with a variety of transactions in the energy and derivative markets. Under traditional accounting methods, the profit or loss on this transaction would flow into the income statements over several years as the obligations under the long term contracts are fulfilled.

For a long time, however, an alternative method known as mark to market accounting (or fair value accounting) has been used in the financial industry as a more accurate way of measuring the true state of affairs of the company. For example, suppose that a bank invested $100 million in a 5 year bond a year ago at an yield of 7%. Suppose further that during the last year, the yield on comparable bonds has gone up to 9% and the average interest rate on the bank's short term deposits has risen to 7.5%. Under the traditional method of accounting, the bank's financial statements would reflect the loss caused during that year by earning only 7% on $100 million of investments while paying 7.5% interest to the depositors. It would not reflect the loss that the bank would continue to make year after year in future as it earns less than its cost of funds on this investment. Under mark to market accounting, however, the bank would record the $100 million investment in the bond at the price at which the bonds could be sold today, say $93 million, and record an immediate loss of $7 million. This loss would include the present value of the losses that the bank would make in future years on that investment. Needless to say, this would work in reverse as well – if the value of an asset has increased, mark to market accounting would recognize the increased value and the associated profit.

Finance theory has long favoured fair value accounting as the preferred way of accounting particularly for liquid assets for which market prices are readily available. Over the last 10-15 years, the accounting standard setters have also moved towards this idea. Accounting standards in the United States began to require fair value accounting by all companies in respect of certain financial instruments. FAS 115 requires fair value

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accounting in the balance sheet for equity securities that have readily determinable fair values as well as for all debt securities unless the debt securities are to be held to maturity. As far as the income statement is concerned fair value accounting (that is, treating unrealized gains and losses as income) applies only to the equity and debt securities that are bought and held primarily for the purpose of selling them in the near term. In other cases, the unrealized gains and losses do not form part of earnings but are shown in the balance sheet as a separate component of shareholder equity. Similarly, FAS 133 ("Accounting for Derivative Instruments and Hedging Activities") requires fair value accounting for derivative contracts. In 2000, a Joint Working Group consisting of the International Accounting Standards Committee (the predecessor of the International Accounting Standards Board, IASB), the FASB of the US and standard setters from around the world issued a report[24] recommending the use of fair value accounting for all financial instruments. Fair value accounting was recommended for the income statement as well for all financial instruments. The report also recommended that the same treatment be used for "contracts to buy or sell a non-financial item that can be settled net by a financial instrument, except for contracts that were entered into and continue to be for the purpose of delivery of a non-financial item in accordance with the enterprise's normal purchase or sale requirements".

As may be seen, all these accounting standards deal only with financial instruments. However, in 1991, when few firms outside the financial industry used mark to market accounting, Enron requested permission from the SEC to use this method of accounting for its natural gas trading activity in North America[25]. Enron was proposing fair value accounting not only for the balance sheet, but also for the income statement. More importantly, it was proposing it not for a business that bought and sold energy contracts on an exchange but for a business where Enron was entering into long term contracts with customers. Under this proposal, Enron would book the present value of all future profits from a gas contract at the time the contract was signed, in contrast to traditional accounting methods that would have required that the company spread out the recognition of revenue over the life of the contract. This raised the issue not only of fair value accounting, but also of revenue recognition. Accounting standards pertaining to revenue recognition for long term contracts normally require profits to be recognized either when the contract is completed or on a percentage completion method (ARB 45 in the US and IAS 11 internationally).

After a long exchange of correspondence spread over several months, the SEC issued a no objection letter to Enron in 1992. The SEC's approval was explicitly conditioned on the company's representations that it would value such contracts objectively. The SEC approval was for the application of mark to market accounting to begin in the first quarter of fiscal year 1992. Enron went further than this: "By letter dated February 11, 1992, Enron replied that ''upon further review,'' it had decided that the ''most appropriate period for adoption of mark-to-market accounting'' was the beginning of 1991—a year earlier than the SEC had approved—and represented that the impact on 1991 earnings was not material. Apparently, the SEC did not respond further to this correspondence and

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Enron went ahead and reported EGS's 1991 financial information using the mark-to-market method."

By the late 1990s, application of mark to market accounting became quite widespread in the energy industry and in 1998 the accounting standard setter permitted the application of this method for all energy contracts[26].

While short term energy contracts that are traded in the New York Mercantile Exchange or other exchanges have readily observable market prices, that is not true of long term energy contracts for which Enron was using mark to market accounting. Enron's annual report contained a cryptic statement that ''[t]he market prices used to value these transactions reflect management's best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments.'' There is some evidence that Enron used mark to market accounting to inflate its profits. The Senate Committee staff report[27] stated: "The evidence suggests that Enron, at a minimum, overestimated and very possibly manipulated the values of the energy contracts it marked to market." The report also added that the effect of such manipulation would have been quite significant: "For the year 2000, Enron's unrealized trading gains—that is, the profits it expected to earn in future years—constituted over half the company's $1.41 billion originally reported pre-tax profit."

At the end of the day, however, the problem of mark to market accounting at Enron appears to be more related to the implementation of the method than to its conceptual validity. The Enron debacle also shows that there is as much scope for manipulating historical cost accounting as for manipulating fair value accounting. It is interesting that in April 2002, when Enron attempted an assessment of the true value of its assets[28], it indicated that the assets accounted for under historical cost methods would need to be written down by $14 billion. It indicated that while the substantial majority of this amount would be attributable to the bankruptcy itself, a material portion would relate to correction of accounting errors or irregularities. On the other hand, the adjustment on the mark to market assets was $8-10 billion and arose primarily from the bankruptcy itself.

2.3 Enron's use of prepay contracts to disguise loans

A prepay is a contract in which the buyer pays in advance for a service or product to be delivered at a future date. In the seller's balance sheet, the prepay is clearly a liability, but it is classified as a trading liability rather than as debt. In the cash flow statement, the money received from the prepay is shown as cash flow from operations rather than as cash flow from financing activities. Both of these differences are important considerations from an outside investor or lender's point of view. The debt-equity ratio is used as a key measure of credit worthiness and this ratio can be improved by treating a liability as a trading liability and not as debt. The cash flow from operations is a key metric used by analysts to evaluate the value of equity shares and treating a debt as a prepay improves this metric. Moreover the ratio of operating cash flows to interest is a

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ratio used to assess credit worthiness and this ratio is also improved by treating a debt as a prepay.

Enron resorted to prepays in a big way to conceal its debt. It has been estimated that about $4 billion of debt was wrongly classified as prepays. The result was to reduce debt by nearly 30%, increase cash flow from operations by nearly 90%, reduce the debt-equity ratio from 96% to 69%, and increase the funds flow interest coverage ratio from 2.37 to 4.07. Had the prepays been treated as debt, Enron might have been in danger of losing its investment grade rating that was so important for its business.

The mechanics by which loans were disguised as prepays was quite complex, but the underlying idea is quite simple. Suppose in 2000, Chase Manhattan Bank[29] agreed to a prepay contract to buy gas from Enron in 2010, while simultaneously in a reverse non-prepay transaction, Chase agreed to sell gas to Enron in 2010 with the payment to be made in 2010, Chase has effectively given a loan to Enron. The gas that Enron has to deliver to Chase in 2010 under the first contract and the gas that Chase has to deliver to Enron in 2010 under the second contract will cancel out. All that is left is that Chase will have given Enron a loan in 2002 (the price of the prepay contract) and Enron will return the amount to Chase (with interest) in 2010 as the price of the gas under the second contract. Naturally, the prepay price will be lower than the normal price under the second (non prepay) contract to reflect the implicit interest costs.

Enron could not have done something so simple as this, because any accountant would insist on classifying this transaction as a loan and not as a prepay. What Chase did was to establish an offshore SPE called Mohonia in Jersey Channel Islands and interpose this SPE between Enron and itself so that the prepay transaction and the opposing transaction appeared to be two different transactions with two different counterparties. The typical transaction structure was as follows[30]:

1. Mahonia sold a prepay forward contract for natural gas to Chase. Mahonia received money upfront from Chase and had an obligation to deliver gas in the future. The determination of the prepay price is discussed later.

2. Enron sold an identical prepay forward contract to Mahonia. The net result of these two transactions was that Enron had sold a prepay to Chase and received money upfront with an obligation to deliver gas in future.

3. Enron and Chase entered into a financially settled commodity swap. In this swap, Enron agrees to pay a fixed price to Chase while Chase agrees to pay Enron the market price of gas. Both payments are made for a fixed notional quantity of natural gas at a fixed time in future. No gas actually changes hands and only the price difference is settled in cash. That is why the transaction is called cash settled or financially settled. For example, suppose that the fixed price agreed to is $2.75 per unit (million BTUs), and the swap is for 100 million units in 2005. Then in 2005, Enron would have to pay Chase $2.75 x 100 million = $275 million while

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Chase would have to pay Enron 100 million times the then prevailing market price of gas. Suppose the market price turns out to be $3, then Chase would pay Enron $3 x 100 million or $300 million on the floating leg while receiving $275 million from Enron on the fixed leg. If on the other hand, the market price turns out to be $2 per unit, Chase would pay $200 million on the floating leg while receiving $275 million on the fixed leg. The swap entered into here would be for the same maturity and the same notional quantity of gas as in steps 1 and 2. The determination of the fixed price per unit is discussed later.

At inception, Mahonia receives the prepay price from Chase (step 1) which passes it on to Enron (step 2). This completes the disbursement of the loan from Chase to Enron.

To see how the loan gets repaid, let us look at what happens on the maturity date. Two things happen:

- Enron buys gas from the market at the current market price (not part of steps 1, 2, 3 above), delivers gas to Mahonia (Step 1 above) which delivers it to Chase (Step 2 above). Chase sells the gas in the market (not part of steps 1, 2, 3 above), pays the sale proceeds as the floating price of the commodity swap (floating leg of step 3 above). The net result of all this circular flow of gas and money is precisely zero. Nobody is left with either gas or money as a result of all this. In some cases, this step was even more simplified. Instead of Chase selling the gas in the market as stated above, it sold the gas back to Enron. In these cases, no gas actually changed hands, there were just a set of book entries showing all these transactions.

- The important part was the fixed leg of step 3 under which Enron would make a fixed payment to Chase. This constitutes the repayment of the loan with interest.

Now it is clear how the prepay price (step 1 and 2) as well as the fixed price in the commodity swap (step 3) would have been set. These must be set such that the fixed payment equals the principal plus the interest on the loan. Therefore, the fixed price leg of the swap must equal the prepay price plus interest. Where the normal (non-prepay) forward contract is fairly liquid, the fixed price leg of the swap would presumably be set equal to this and the prepay price would be calculated to provide the desired interest rate. Suppose for example, the fixed price leg is set at $2.75, the maturity is one year and the interest rate is 4%. Then the prepay price must be set at 2.75/1.04 = 2.6442. If 100 million units are transacted at this price, then at inception, Enron receives a loan of $264.42 million. A year later Enron repays $275 million ($264.42 million principal plus $10.58 million of interest at 4% for one year on this principal).

Most of Enron's prepay financing arrangements were with JP Morgan Chase and Citigroup though Barclays, Credit Suisse First Boston, FleetBoston, Royal Bank of Scotland, and Toronto Dominion participated in some transactions. The accounting

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implication of transactions of this kind between three parties (Enron – Bank – SPV) are well described in Roach's testimony[31]:

> "In order for transactions like the ones used by Enron and the banks to be legitimately booked as a trading liability and not debt, four elements had to be present:
>
> – The three parties had to be independent.
>
> – The trades among the three parties could not be linked.
>
> – The trades had to contain price risk.
>
> – There had to be a legitimate business reason for the trades.
>
> The Enron type prepays we examined failed on all accounts:
>
> – Two of the three parties in the Enron trades were related, that is the banks and their offshore special purpose entities which the banks established and controlled.
>
> – The trades among the parties were linked, that is contracts associated with the trades were designed so that a default in one trade affected the other trades.
>
> – There was no price risk. Except for fees and interest payments, the final impact of the trades was a wash.
>
> – Neither the banks nor the banks' special purpose entities had a legitimate business reason for purchasing the commodities used in the trades."

Responding to allegations that the prepaid forward transactions were disguised loans, Chase stated[32] in its testimony that: "The prepaid forwards were undoubtedly financing, as all contracts are that involve prepayment features, but every financing is not a loan. These transactions had different features, benefits and risks than loans." Of course, this assertion misses the point that it is not the prepaid forward that is a loan, but the totality of circular transactions including the prepaid forward and the swap. Regarding Mahonia, Chase stated that "Mahonia is beneficially owned by a charitable trust. Neither Chase nor Enron has any ownership interest in Mahonia. No employee or officer of Chase or Enron served as an officer or director or held shares in Mahonia. The directors and officers of Mahonia make the ultimate determination as to whether or not to enter into a transaction. Those directors and officers are neither appointed, nor controlled, by Chase or Enron. The use of entities like Mahonia is standard activity in structured finance."

Chase did not mention in this statement that the charitable trust that owns Mahonia was set up by a Jersey law firm, Mourant, hired by Chase specifically to establish a trust to own special purpose vehicles that would be "controlled by Chase but, for accounting and

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other requirements...[not be] wholly owned by Chase"[33]. Roach's testimony[34] also pointed out that "In reality, Mahonia could not have functioned as an independent trading party because it had only £10,000 of capitalization, no employees and Mourant attorneys who served as the Directors. … Mahonia agreed to let Chase operate as its agent. The agency agreement allowed Chase to review transaction documents on behalf of Mahonia, and even more broadly, to 'perform such other functions as are reasonably' necessary."

The prepays gave rise to another controversy because the banks in some of these structures tried to eliminate even the credit risk so that even if Enron went bankrupt, the banks would get their money back. Initially, Chase required Enron to obtain a Performance Letters of Credit (PLC) from other banks. The bank issuing the PLC guaranteed the performance by Enron of its obligation to deliver gas to Mahonia. Subsequently, the PLCs were replaced by surety bonds issued by several insurance companies. However, when Enron filed for bankruptcy, these insurance companies refused to pay up on the surety bonds. They claimed[35] that the trading transactions for which they provided the cover were sham transactions that "were not intended to be fulfilled," and that Mahonia was a "mechanism to obtain surety bonds to secure loans to be made to Enron in the guise" of trades. JP Morgan retorted that the insurers' claims were without merit, noting that the surety contracts say the insurance liability is "absolute and unconditional." Subsequently, the dispute was settled out of court with JP Morgan accepting approximately 60% of its claims in full settlement of the dispute[36].

2.4 WorldCom's outright falsification of accounts

After the bewildering complexity of Enron's SPEs and prepays, Worldcom's fraud is simplicity itself. During the 1990s, WorldCom became a global telecommunication giant by acquiring companies such as MCI and building a large telecommunications network. In addition, WorldCom entered into long-term, fixed-rate line leases to connect its network with the networks of incumbent local exchange carriers.

Faced with the telecom downturn and intense pressures on earnings, WorldCom undertook a series of measures to inflate earnings[37]. The largest and simplest of these related to line costs. WorldCom simply recharacterized its sizeable line costs as "Prepaid Capacity" and transferred them from the Company's income statements to its balance sheets. The result was that over $3.8 billion of line costs that should have been shown as expense were capitalized as assets. WorldCom's income was overstated by the same amount.

There were no SPEs and no complex accounting tricks. There was simply a journal entry passed under the directions of the Chief Financial Officer, Scott Sullivan, that reclassified expenses as assets without any supporting documentation whatsoever. When this was finally discovered by the internal audit department, Sullivan offered an equally brazen explanation[38] which is worth quoting at length:

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> "… the Company also entered into various network leases to complement the service offerings for data, Internet and local service. The lease commitments were entered into to obtain access to large amounts of capacity under the theory that revenue would follow and fully absorb these costs and to expedite 'uptime to market'. We believe that this provided an advantage over our competitors and created the leader in Internet backbone at OC 192-c[39]. The commitments were entered into with the knowledge that we would incur an expense prematurely and the revenues would be earned subsequent to that date. The Company was willing to absorb this cost prior to recognizing the revenue stream because it believed that the future revenues would be matched up with these costs. These commitments were entered into as the result of customers for which services would be rendered and the lease commitments were entered into to expedite the customer provisioning and revenue stream in accordance with SAB 101 and as further supplemented by FASB 91, direct and indirect costs associated with obtaining a customer may be deferred and amortized over the revenue stream associated with that contract. The Company also factored in these costs in the development of pricing and all costs were expected to be recovered through future revenue streams.
>
> Subsequent to the asset being put into service, the Company continued to incur costs associated with network lease commitments as noted above. The portion of these commitments that were not being utilized was deferred until the related benefit (i.e. revenues) was generated.
>
> At the time of the cost deferral, management had determined that future economic benefit would be derived from these contractual commitments as the revenues from these service offerings reached projected levels. At that time, management fully believed that the projected revenue increases would more than offset the future lease commitments and deferred costs under the agreements. Therefore, the cost deferrals for the unutilized portion of the contract was considered to be an appropriate inventory of this capacity and would ultimately be fully amortized prior to the termination of the contractual commitment.
>
> The classification of these costs as an asset does not contradict the definition of an asset in FASB Concept Statement No. 6. 'Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events' (FASB CON No. 6, par. 25). 'An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash endows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.' (FASB CON No. 6, par. 26)."

Sullivan even had an explanation for why there was no detailed documentation for the capitalization of $3.8 billion of costs:

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> "The preparation of the Company's financial statements requires the Company to make estimates and assumptions that affect the reported amount of assets and liabilities as well as the reported amounts of expenses, including line costs. Significant management judgements and estimates must be made and used in connection with establishing these amounts.
>
> Because of the volume and size of our network, the Company was not able to obtain a circuit by circuit analysis of the network for the cost deferral. Instead, estimates were made, based on information available and recorded at the end of each quarter."

WorldCom's previous auditors, Andersen, and current auditors, KPMG both rejected Sullivan's explanation as being totally inconsistent with generally accepted accounting principles. In fact, Sullivan's statement is best seen as an admission that he had no meaningful defence to offer for his action.

2.5 Adelphia's outright falsification of its debt

In a series of disclosures[40] between March 2002 and June 2002, Adelphia Communications Corporation announced that it had concealed $2.6 billion of its indebtedness. At the time, Adelphia was the sixth largest cable television operator in the United States. The Rigas family that owned a controlling stake in Adelphia also owned several other companies ("Rigas entities") that were also in the cable telivision business. The Rigas entities were managed by Adelphia. Moreover, Adelphia subsidiaries and the Rigas entities borrowed money under a co-borrowing agreement with that made all parties jointly and severally liable for the borrowing regardless of who had drawn down the money. This meant that the debt had to be shown as a debt of the Adelphia subsidiaries (and therefore as part of Adelphia's consolidated debt) and not as a contingent liability. The following footnote in Adelphia's December 31, 2000 balance sheet would have led everybody to believe that this liability was included in the consolidated debt:

> "Certain subsidiaries of Adelphia are co-borrowers with Managed Entities[41] under credit facilities for borrowings of up to $3,751,250[,000]. Each of the co-borrowers is liable for all borrowings under the credit agreements, and may borrow up to the entire amount of the available credit under the facility. The lenders have no recourse against Adelphia other than against Adelphia's interest in such subsidiaries."

In fact, however, this amount was not included in Adelphia's consolidated debt. The footnote was thus calculated to conceal this debt completely. At least, if the note had disclosed a contingent liability, readers would have known that that this debt was in addition to the debt on the balance sheet. Of course, even that would have been inaccurate from an accounting point of view as the co-borrowing needed to be disclosed as debt and not as a contingent liability. The SEC stated[42]: "The omission of these liabilities was a deliberate scheme to under-report Adelphia's overall debt, portray

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Adelphia as de-leveraging, and conceal Adelphia's inability to comply with debt ratios in loan covenants."

In March 2002, while presenting the results for the last quarter of 2001, Adelphia for the first time disclosed the existence of $2.3 billion of hidden debt treating it as a contingent liability[43]:

> "Certain subsidiaries of the Company are co-borrowers with certain companies owned by the Rigas Family and managed by the Company ('Managed Entities') for borrowing amounts of up to $5,630,000. Each of the co-borrowers is liable for all borrowings under the credit facilities and may borrow up to the full amount of the facilities. Amounts borrowed under these facilities by the Company's subsidiaries are included as debt on the Company's consolidated balance sheet. Amounts borrowed by Managed Entities under the facilities are not included on the Company's consolidated balance sheet. The Company expects the Managed Entities to repay their borrowings in the ordinary course. The Company does not expect that it will need to repay the amounts borrowed by the Managed Entities. As of December 31, 2001, co-borrowing credit facilities balances, net of amounts otherwise reflected as debt on the Company's consolidated balance sheet, totaled approximately $2,284,000[,000]."

Subsequent disclosure made it very clear that the amount of $2.3 billion was not just a contingent liability but was very much a part of Adelphia's debt. It turned out that there was not in fact any clear demarcation between the draw downs by Adelphia and the Rigas Entities. The apportionment of the co-borrowing between them was an arbitrary reclassification carried out every quarter while preparing the financial statements. The SEC stated[44]: "Adelphia management allocated and reallocated co-borrowing liabilities among Adelphia's consolidated subsidiaries and unconsolidated Rigas Entities at will and through a single, quarterly cash management reconciliation of the inter-company receivables and payables outstanding at quarter end between or among Adelphia's subsidiaries and Rigas Entities" In fact, Adelphia operated a Cash Management System (CMS) into which Adelphia, its subsidiaries and the Rigas Entities deposited their cash receipts (generated from operations or obtained from borrowings) and from which they withdrew cash for expenses, capital expenditure and debt repayment. This resulted in the commingling of funds between Adelphia and the Rigas Entities.

Adelphia's fraud was not restricted to concealment of debt. "Between mid-1999 and the last quarter of 2001, Adelphia misrepresented its performance in three areas that are important in the metrics financial analysts use to evaluate cable companies: (a) the number of its basic cable subscribers, (b) the percentage of its cable plant 'rebuild,' or upgrade, and (c) its earnings, including its net income and quarterly EBITDA" [45]. Most of this was accomplished by outright falsification or by fictitious transactions with the Rigas Entities through the CMS.

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The transactions between Adelphia and the Rigas Entities were also used to enrich the Rigas family by $300 million as discussed in 3.3 below.

2.6 Revenue recognition problems at Xerox, AOL, Qwest and others

Revenue recognition is the most important area of accounting fraud in the United States. During 1997 to 2002, it accounted for 38% of all accounting restatements and was the single largest reason for restatement in each year[46].

Revenue recognition issues have arisen in a number of major companies in the last year or so:

- Xerox restated[47] its income for the years from 1997 to 2002 partly to reflect incorrect accounting practices relating to the timing and allocation of revenue from bundled leases. Xerox sells most of its products and services under bundled contracts that contain multiple components – equipment, service, and financing components – for which the customer pays a single monthly-negotiated price as well as a variable service component for page volumes in excess of stated minimums. The SEC claimed that Xerox's revenue-allocation methodology for these contracts did not comply with the accounting standards and forced Xerox to change its methodology. Under the original methodology, Xerox estimated the fair value of the financing component (using a discounted cash flow method based on the company's cost of equity and debt) and of the service component (by using an estimate of service gross margins) and attributed the balance to equipment. In the new methodology, the fair value of the service component and the fair value of the equipment (using cash sale prices) are deducted from the total lease payment to arrive at the financing component as a balancing figure and the implicit financing rate is determined. Interestingly, the company's previous auditor, KPMG regards the original accounting as correct and regards the new accounting adopted by the company and its new auditors, PricewaterhouseCoopers under pressure from the SEC as incorrect. KPMG stated[48] that:

  > "KPMG remains firm in its conviction that the financial statements reported on by us in May 2001, including Xerox's financial statements for 2000 and the restated financial statements for 1997-1999, were fairly presented in accordance with generally accepted accounting principles.
  >
  > KPMG, Xerox and PricewaterhouseCoopers had it right the first time, when the company and three separate teams from PwC all agreed with us that Xerox's lease accounting methodology was GAAP compliant. By contrast, today's news reports lead us to believe that the restated financial statements defy economic reality. They apparently give Xerox the benefit of recognizing revenues in 2002 and in future years that it had already recognized in prior years.

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… We cannot believe such an opportunistic restatement can well serve the interests of the investing public or to help reestablish confidence in the capital markets."

It is believed that the US SEC will file a civil action against KPMG in relation to the Xerox audit[49].

- AOL Time Warner Inc. admitted[50] in October 2002 that it had improperly inflated revenue by $190 million and profitability (EBITDA[51]) by $97 million by improperly accounting for some online ad sales and other deals between July 2000 and June 2002. While AOL Time Warner did not identify the transactions involved, it is likely that these were the ones that the *Washington Post* had highlighted in two articles[52] in July 2002. The *Post* had alleged that America Online (AOL) resorted to questionable accounting practices in an attempt to shore up advertising revenue at a time when it was in the process of acquiring Time Warner in a stock swap deal. From late 2000 onwards, stock markets were extremely worried about the sustainability of advertising revenue for internet companies. A weakness in advertising revenues could conceivably have led to a sharp fall in the AOL stock price that could have endangered the merger with Time Warner. The *Washington Post* alleged: "AOL converted legal disputes into ad deals. It negotiated a shift in revenue from one division to another, bolstering its online business. It sold ads on behalf of online auction giant eBay Inc., booking the sale of eBay's ads as AOL's own revenue. AOL bartered ads for computer equipment in a deal with Sun Microsystems Inc. AOL counted stock rights as ad and commerce revenue in a deal with a Las Vegas firm called PurchasePro.com Inc". AOL's accounting is under investigation by the SEC and by the Justice Department. While the restatements are small relative to AOL's total revenues and profits, it could have had a disproportionate impact on the share price at a critical point of time when it was clinching the merger deal with Time Warner.

- On September 22, 2002, Qwest Communications International Inc. announced a restatement of its 2000 and 2001 results in which it reversed $950 million of revenues relating to capacity swaps. Many telecom companies bought network capacity from other companies while also selling surplus capacity that they had. Much of this did not involve an outright sale of assets but was an "indefeasible right of usage" or IRU. In principle, such exchanges allowed each company to create a network at lower cost and run it at higher efficiency. The difficulty came in the accounting when many companies recognized the IRU it sold as revenue while recording the IRU it bought as capital expenditure. What was worse was that many of the IRU transactions were swaps between the same two companies – for example, Qwest sold an IRU to Global Crossing while buying an IRU for a similar amount from Global Crossing. Moreover, it has been alleged that many of these swaps were sham transactions that had no business purpose at all and were

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designed only to boost revenues[53]. In most of these swaps, however, the parties were careful to exchange cheques so that both sides of the swap could be recorded as separate transactions for which payment was made or received in cash. In such cases, it was still possible under US accounting standards to record the sell side as revenue and the buy side as a capital expenditure provided "1) the network capacity received in the exchange will not be sold in the same line of business as the network capacity given up in the exchange, 2) the network capacity received in the exchange is a productive asset that is dissimilar to the network capacity given up, and 3) the fair values of the assets exchanged are determinable within reasonable limits."[54] In many of these cases, it is likely that these requirements were not met. Even if the conditions were met, one wonders whether it would still not have made far more sense to treat the swap as an exchange of assets that did not involve any element of revenue. In August 2002, the SEC sent a memo[55] to the US accounting professional body, AICPA, stating that IRU swaps should be accounted for in compliance with the accounting standard (APB Opinion 29) on exchange of assets and required that if necessary past financial statements must be restated accordingly. One accounting expert commented on this memo that "The SEC stated the obvious when it pointed out that APB Opinion 29 is the applicable guiding literature. … Accounting for telecom swaps was and remains very easy. The profession needs to quit playing games and quit aiding and abetting top managers in their corruption of accounting. If we do our jobs, then we won't have quite so many Global Crossings and Qwests who make a mockery of our accounting and our auditing."[56] He went on to suggest that the SEC should assume that accountants can read the relevant accounting literature and should simply enforce the rules instead of sending such memos.

2.7 Transactions in own stock

It is a fundamental principle of accounting that a company cannot make a profit out of a transaction in its own stock. If a company sells a $10 share for $30, it does not make a profit of $20. The entire $30 is capital – a part of shareholders' equity. The reverse is also true that a company cannot make a loss out of transactions in its own stock. It can buy stock at $50 per share when the market price is $40 per share without having to report a loss. If it has entered into derivative transactions on its own stock, it is not required to mark this to market. However, there have been a number of situations where one wonders whether this rule has not helped companies hide losses and manipulate their accounts.

- The most striking is the case of EDS which sold put options on its own stock when the stock was soaring to hedge the dilution that would arise from its employee stock options. In 2002, with the stock price falling, EDS lost an estimated $225 million to close out these put options. During the nine months ended September 30, 2002, EDS had purchased 5.4 million shares of EDS common stock million at a weighted-average exercise price of over $60 per

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share[57]. In September 2002 EDS stock traded at around $20 per share and dropped sharply after these losses were discovered.

- Household International bought back its own shares at an average cost of $53.88 a share under certain forward contracts even while it was issuing new equity at $21.72 a share[58]. The loss is estimated at $600 million, but none of that flows through into the income statement because these are transactions in its own stock.

- Enron had several transactions in its own stock as discussed elsewhere in this paper. Some of these did abuse the accounting rules regarding such transactions.

2.8 Cookie jar reserves at WorldCom

The line-cost capitalization fraud at WorldCom has been described earlier in this paper. But before indulging in such outright fraud, WorldCom is alleged to have tried some other accounting tricks relating to manipulation of reserves. The term "cookie jar reserves" is used for the technique of managing earnings by manipulating reserve accounts to pump up income in lean times while storing excess profits during good times in "cookie jars" so that they may be drawn down on when current performance lagged. The bankruptcy court examiner found evidence that such activity took place at WorldCom:

> "WorldCom manipulated its reported financial performance by drawing down excess or other reserves into earnings. At around the time that the reserves were being drawn down, WorldCom agreed to combine with Sprint Communications, Inc. ("Sprint") in October 1999. This combination would have allowed the Company not only to replenish its reserves, but also to increase them dramatically. When the government ultimately refused to approve the Sprint merger in July 2000, and signalled that it would not be sanctioning other large mergers, WorldCom did not have adequate excess reserves to draw down as a vehicle to increase earnings going forward. Shortly after this time, the Company took the brazen and radical step of converting substantial portions of its line cost expenses into capital items."[59]

3 Looting the Company

There were two aspects to much of the fraud that went on at Enron and other companies. One was the company fooling its investors and lenders by presenting false financial information. The other was the company management cheating the company itself by self dealing and by availing of unauthorized compensation.

The two are possibly related. The evidence does suggest that in the case of Enron and other companies, the Board and the auditors were quite willing to let management engage in aggressive and creative accounting. Even where these did not violate the accounting standards, these transactions would have amounted to fooling the investors and lenders. It

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does appear that the Board and the auditors were willing to countenance this to the extent to which it was thought that by doing so the company's growth and profitability might be enhanced. However, the opaque structures that they allowed to be set up in this process allowed the management to defraud the companies. It is conceivable that the same boards and auditors that condoned aggressive and misleading accounting might not have wished to be a party to a fraud on the company itself.

In the following two sections we look at some of the ways in which chief executives and other senior managers defrauded their companies.

3.1 Related party transactions and self dealing at Enron

It is known that Enron employees involved with the Chewco, LJM and other partnerships described in 2.1.3and 2.1.4 above made a lot of money for themselves at the cost of the company. The Powers Report[60] stated:

> "Enron employees involved in the partnerships were enriched, in the aggregate, by tens of millions of dollars they should never have received – Fastow by at least $30 million, Kopper by at least $10 million, two others by $1 million each, and still two more by amounts we believe were at least in the hundreds of thousands of dollars. We have seen no evidence that any of these employees, except Fastow, obtained the permission required by Enron's Code of Conduct of Business Affairs to own interests in the partnerships. Moreover, the extent of Fastow's ownership and financial windfall was inconsistent with his representations to Enron's Board of Directors."

Many of the huge windfall gains arose when the transactions with the SPEs were unwound after they had served their purpose. When the Chewco transaction was unwound, Kopper and Dodson earned about $10 million on an investment of $125,000 and this represented an internal rate of return of 360%. In addition, at Fastow's insistence, Enron made a $2.6 million tax indemnity payment claimed by Kopper though Enron's in-house lawyers and external lawyers stated categorically that it was not obligated to make such a payment. When the Rhythms transaction with LJM1 Swap Sub was unwound, Enron took back the restricted shares that it had sold to LJM1 at the inception of the hedge. The original transaction had valued the restricted Enron shares at a steep discount to the market price. But when it took them back, it valued them at the unrestricted price. The Power Report estimates that this meant a gain of $70 million to LJM1. "[T]he terms of the transaction were extraordinarily generous to LJM1 and its investors. These investors walked away with tens of millions of dollars in value that, in an arm's-length context, Enron would never have given away." There is evidence that much of the gain went to Fastow and other employees of Enron. Similarly, it appears that many of the transactions between Enron and the various other SPEs were done at terms disadvantageous to Enron to benefit the Enron employees who participated in these SPEs.

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3.2 Self-dealing and looting at Tyco

The SEC's complaint[61] against the top Tyco management was blunt and harsh as befitted the case:

> "This is a looting case. It involves egregious, self-serving and clandestine misconduct by the three most senior executives at Tyco International Ltd. ('Tyco'). From at least 1996 until June of 2002, L. Dennis Kozlowski ('Kozlowski') (then Tyco's Chief Executive Officer) and Mark H. Swartz ('Swartz') (then Tyco's Chief Financial Officer) took hundreds of millions of dollars in secret, unauthorized and improper low interest or interest free loans and compensation from Tyco. Kozlowski and Swartz concealed these transactions from Tyco's shareholders. Kozlowski and Swartz later pocketed tens of millions of dollars by causing Tyco to forgive repayment of many of their improper loans. They also concealed these transactions from Tyco's shareholders. Moreover, Kozlowski and Swartz engaged in numerous highly profitable related party transactions with Tyco and awarded themselves lavish perquisites - without disclosing either the transactions or the perquisites to Tyco shareholders. ... During his tenure as Chief Corporate Counsel at Tyco, Mark A. Belnick ('Belnick') also defrauded Tyco shareholders of millions of dollars through egregious self-dealing transactions."

Tyco had a Key Employee Loan Program (KELP) that provided low interest loans to employees to pay federal income tax on pay taxes due as a result of vesting of ownership of Tyco shares granted under the employee restricted stock ownership plan. It is alleged that Kozlowski took $270 million of loans under KELP of which only $29 million was for the purpose (tax payment) permitted under KELP. Similarly out of $85 million of KELP loans taken by Swartz, only $13 million was for the permissible purpose. Kozlowski and Swartz took a further $46 million and $32 million respectively under a relocation loan program, and a major part of this loan was also for purposes not permitted under this program. Kozlowski and Swartz also oversaw and authorized a loan forgiveness of $88 million to themselves in September 2000 and a further $24 million in December 2000.

3.3 Self-dealing and fraud at Adelphia

The background of the Adelphia CMS and of the transactions between Adelphia and the Rigas family has been provided in 2.5 above. Many of those transactions were used to conceal debt or to overstate Adelphia's operating performance. However, some of those transactions also served to fraudulently enrich the Rigas family by over $300 million at the expense of the company.

- The largest of these was the payment of Rigas family margin loans by the Adelphia CMS: "Certain Rigas Persons and Entities have entered into margin loan agreements with various investment banks and other financial institutions and pledged equity and debt securities issued by the Company to secure such

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loans. Although, the total amount of these loans is unknown, since January 1, 2001, certain Rigas Persons and Entities have made $241,167,006 of payments in connection with margin calls. Of that amount, $177,789,669 has been paid in 2002, with approximately $174,638,151 having been paid since March 27, 2002. Funds for these margin call payments by Rigas Persons and Entities came from the Adelphia CMS. The use of the Adelphia CMS to fund margin calls on behalf of Rigas Persons and Entities was not presented to or approved by the Board of Directors or the independent directors of the Board of Directors.”[62]

- The Rigas Entities bought $59 million of Adelphia securities “using funds … obtained from the Adelphia CMS and for which it never reimbursed or otherwise compensated Adelphia”[63]

- The Rigas family also used Adelphia “… to pay for vacation properties and New York City apartments used personally by the Rigas Family, develop a golf course on land mostly owned by the Rigas Family …”[64]

In May 2002, the Rigas family entered into an agreement[65] with Adelphi under which the family relinquished all its seats on the Adelphia board and gave up all its officer positions in the company. The family transferred its cable operations (the assets of theRigas entities) to the company. The family also transferred to company the Adelphia debt held by it and pledged to the company its shares in Adelphia.

4 Securities Market Frauds

4.1 Insider Trading at ImClone[66]

ImClone Systems Incorporated was in the business of developing biologic medicines. Its lead product development was Erbitux, a biological treatment for irinotecan-refractory colorectal cancer.

At the end of December 2001, ImClone expected the United States Food and Drug Administration (the “FDA”) to decide whether its licensing application for Erbitux would be accepted for filing and review. In view of this, on December 21, 2001, ImClone put into effect a companywide blackout in trading in ImClone stock by its employees.

On December 26, 2001, ImClone’s Chief Executive Officer, Dr Samuel Waksal[67] learned that FDA was expected to reject ImClone’s licence application on December 28, 2001. It was evident that when this information became public, ImClone’s shares would drop sharply in value. This was particularly disastrous for Waksal since he had more than approximately $75 million in indebtedness, over $50 million of which was margin debt secured by his shares of ImClone stock. The lenders were very likely to sell the pledged ImClone stock to recover the margin debt and Waksal’s net worth would be sharply reduced.

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Waksal passed on the news about the FDA rejection to his friends and family members who sold a total of over 175,000 shares valued at $10.75 million. Since ImClone shares fell by 16% when the FDA rejection became public, these sales were highly profitable. In addition, Waksal attempted to sell nearly 80,000 of his own shares worth $4.9 million, but the broker refused to sell them without clearance from ImClone's General Counsel.

In addition to the insider trading charges, Waksal was also charged with bank fraud and other charges. For his borrowings, he had pledged the same warrant to two lenders without informing either that the asset was already charged to the other. What is worse, Waksal then exercised the warrant making it worthless to the lenders without informing them.

Waksal has pleaded guilty to the charges of insider trading and bank fraud, but not to the charge that he tipped his friends and family members[68].

The ImClone controversy has also affected a prominent public figure, Ms. Martha Stewart, chief executive officer of Martha Stewart Living Omnimedia. There have been allegations that when she sold nearly 4,000 shares of ImClone one day before the FDA rejection became public, she was acting on the basis of a tip received from her broker that Waksal and his family were selling their shares[69]. Stewart has asserted that she was acting on the basis of a prior understanding with her broker to sell the shares if they fell below $60 a share. The House Energy and Commerce Committee has written[70] to the US Attorney General to investigate whether the above explanation given by Stewart to the Committee was false.

4.2 Undisclosed Insider Stock Sales (Enron)

In May 1999, the Compensation Committee of the Enron board agreed to let its Chairman Kenneth Lay to repay company loans with stock. At this time, Lay had a $4 million credit line with Enron that was subsequently raised to $7.5 million. A credit line allows the borrower to drawn down the line again after repaying the earlier draw down. This was precisely what Lay proceeded to do. As a US Senate report[71] described it, "Mr. Lay began using what one Board member called an 'ATM approach' toward that credit line, repeatedly drawing down the entire amount available and then repaying the loan with Enron stock. Records show that Mr. Lay at first drew down the line of credit once per month, then every 2 weeks, and then, on some occasions, several days in a row. In the 1-year period from October 2000 to October 2001, Mr. Lay used the credit line to obtain over $77 million in cash from the company and repaid the loans exclusively with Enron stock. … [B]y characterizing the stock transfers as loan payments rather than stock sales, Mr. Lay bypassed requirements for reporting insider stock sales on a quarterly basis and instead delayed reporting the transactions to the SEC and investing public until the end of the calendar year in which they took place."

The legal position in respect of such loans and stock sales has changed since then. Under the Sarbanes Oxley Act, companies are now prohibited (with some exceptions) from

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making personal loans to directors or executive officers. Moreover, insiders are now required to file a transaction report within two business days of any transaction in the company's stock.

4.3 IPO Abuses

At the height of the technology stock boom from late 1998 to early 2000, many technology companies that made an initial public offering found their share prices rise sharply on the first day of listing. The best known example is that of VA Linux which ended its first day of trading in December 1999 at nearly eight times the IPO price netting a 698% gain for those who got shares in the IPO. Of course, VA Linux was a record of sorts, but during this period there were spectacular gains to those lucky enough to get an allocation of shares in most technology stock IPOs. This placed a lot of power in the hands of investment banks that managed these IPOs. The allegation is that the investment banks unfairly allotted pre-IPO shares in return for a variety of kickbacks.

Another allegation is that of spinning – the investment banks allocated IPO shares to high-tech executives as a quid pro quo for getting their companies' financing business. New York Attorney General Eliot Spitzer filed a lawsuit[72] alleging that Salomon Smith Barney (SSB) distributed large numbers of IPO shares to corporate executives who were in a position to influence investment banking decisions of their companies:

> "For example, from September 1998 to February 2002, more than 21 IPO offerings were made to Worldcom executives, including former CEO Bernard Ebbers, who individually made more than $11 million on the deals. During approximately the same period, SSB obtained 23 investment banking contracts with Worldcom, generating $107 million in fees.
>
> From March 1996 through June 2001, 57 IPO offerings were made to executives of Qwest Communications, including the company's former chairman, Philip Anschutz, who made $5 million in profits on the deals; and former CEO Joseph Nacchio, who received 42 IPO allocations and made more than $1 million in profits. SSB earned $37 million in underwriting and investment banking fees from Qwest during that same period.
>
> SSB provided 37 IPO offerings to the founder and chairman of Metromedia Fiber Networks, Stephen Garofalo, who made more than $1.5 million on the deals during the period from November 1997 until October 2000. SSB made more than $47 million in investment banking fees during that same period.
>
> SSB provided 32 IPO offerings to Clark McLeod, former CEO of McLeodUSA, from September 1997 to June 2000. McLeod personally made more than $9 million on the deals. SSB received some 16 investment banking deals during the period and received fees approximately $49 million."

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Allegations of spinning have been made against many other investment banks as well[73]. The technology business magazine, Red Herring ran a seven part investigative series[74] "IPO Antics" that described in detail the various different kinds of abuses in IPO allocations and showed how virtually all investment banks participated in this process.

In this paper, however, we illustrate the problem of IPO abuses with the example of Credit Suisse First Boston that paid a $100 million fine to settle the SEC's allegations against it. It has been alleged that SEC targeted CSFB "because CSFB lacks the political power of such rivals as Goldman Sachs and Morgan Stanley Dean Witter, which are traditionally seen as more politically connected"[75] But it is also true that since CSFB managed the largest number of deals during the boom, it was a natural target. In any case, to avoid any appearance of bias, this paper uses the example of another investment bank (Merrill Lynch) to illustrate the conflict-of-interest problems in research reports (see 4.5.1 below) and the example of a third securities firm (Salomon Smith Barney) to illustrate conflicts of interest in employee stock option administration (see 4.4.2 below)[76].

4.3.1 IPO Abuses at CSFB

The SEC's charge[77] against CSFB was that "From at least April 1999 through June 2000, CSFB employees allocated shares of IPOs to over 100 customers who were willing to funnel between 33 and 65 percent of their profits to CSFB. The profits were channeled to CSFB in the form of excessive brokerage commissions generated by the customers in unrelated securities trades that the customers generally effected solely to satisfy CSFB's demands for a share of the IPO profits."

The pattern appears to be that over 70% of any issue was allocated to large institutions against whom the investment banks like CSFB had little bargaining power. These institutions managing hundreds of billions of dollars of assets were the best customers of the investment banks and received their allocations as a matter of course. The problem was with the smaller institutions and high net worth individuals. The allegation is that CSFB demanded that these customers funnel a portion of their profits to CSFB as the price for getting IPO allocations. In the specific instances cited in the SEC complaint, about 5-10% of the allocation appears to have been made to customers making such payments (typically 25-35% of their profits) to CSFB. These customers funnelled profits to CSFB by paying "excessive commissions on off-setting trades in large capitalization, highly liquid, exchange-listed securities otherwise unrelated to the IPOs." A customer might pay a commission of say $1 per share on a trade of say 100,000 shares of say Coca Cola when the going rate for such trades was only $0.06 as a quid pro quo for an IPO allocation. This was effectively a payment of $94,000 to CSFB. Of course, the customer might not have actually wanted to buy 100,000 shares of Coca Cola at all, and so might simultaneously sell 100,000 shares of Coca Cola through another broker at the same price. The SEC complaint alleges that senior executives at CSFB either personally engaged in such practices or knew of and encouraged such practices by their subordinates.

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CSFB settled[78] with the SEC by paying a $100 million[79] fine and agreeing to make certain changes in its IPO allocation practices. Specifically, CSFB agreed to establish an IPO Allocation Review Committee to implement criteria for IPO allocations and to prohibit "(1) making a wrongful arrangement or a wrongful quid pro quo of any kind with customers in exchange for IPO allocations; and (2) sharing profits or losses with a customer who receives an IPO allocation or allocations, except as may be permitted by NASD Conduct Rule 2330, NYSE Rule 352 or rules of other Self Regulatory Organizations."

The IPO allocation practices that have come to light raise three issues

1. Why were the IPOs of this period so highly underpriced? Why did the issuers of capital not seek a higher price for their shares?

2. Why did the issuers of capital not seek a greater say in the allocation process?

3. Were the kickbacks producing a more level playing field between big institutions and the smaller ones that would otherwise be excluded from IPO allocations?

The first question (of IPOs) has been widely researched in the IPO literature. The under-pricing phenomenon has been observed in many different countries in many different time periods, though it has rarely been as spectacular as in the technology boom of 1999 in the United States[80]. A variety of explanations based on asymmetric information have been proffered for this.

The second question is more baffling and there are no clear answers yet. One possibility is that the investment banks were seen as performing a very valuable service in selling the shares to the public and that therefore issuers were willing to let the banks have this benefit. If so, it raises issues of lack of competition in investment banking.

The third question is the most problematic of all. Like Sherlock Holmes drawing attention to the dog that did not bark[81], we should also focus attention on the large institutions that had easy access to IPOs without giving any kickbacks at all. We need to ask whether the power of the big institutions stems from inadequate competition in the asset management and brokerage industries and if so whether this is the hidden and true flaw in the IPO allocation process.

All in all, the IPO problems are very different from the other malpractices surveyed in this paper in that it is very difficult to state categorically that the true problems are the ones that the regulators have sought to focus on.

4.4 Defrauding employee investors – stock options and 401(k) (Enron, Worldcom)

In modern capitalism, employees are also significant investors both collectively through pension funds and individually through employee stock options and through individual

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tax sheltered retirement plans referred to as 401(k) in the United States. The corporate scandals in the United States have exposed failures to protect the interests of these employees as investors. This paper discusses two examples – the 401(k) plan of Enron and the employee stock options of WorldCom.

4.4.1 Enron's 401(k) plan administration

United States law allows employees to accumulate a tax sheltered stock portfolio under what is called a 401(k) plan. In the typical participant-directed plan, employees make contributions to their 401(k) accounts and control where their contribution is invested. Employers often make matching contributions (usually some percentage of the employee contribution). When they do so, employers can make this contribution in their own stocks and can also require the employee to hold this stock for a long waiting period before switching the matching contribution into other stocks. Enron made a matching contribution of 50% in its own stock and allowed employees to switch out of it only at the age of 50. In addition, employees voluntarily held Enron stock in their part of the portfolio also.

At the end of 2000, 62% of Enron's 401(k) plan assets were invested in Enron common stock; eighty-nine percent of this represented stock purchased by employees and the rest was attributable to company matching contributions The high holding on employer stock (62%) was by no means unique to Enron. At General Electric and Coca Cola, the corresponding numbers were above 75%, while at Pfizer it was above 85% and at Proctor and Gamble it was nearly 95%. The 401(k) plan assets of one in five companies were at least 50% invested in the company's own stock.[82] However, the high holding of employer stock meant that the demise of Enron also destroyed the lifetime savings of many employees.

While this was a calamity, it did not result from any action that was illegal or irregular except

- The overstatement of profits and understatement of debt in the Enron financial statements certainly induced many employees to hold stock by painting a rosy picture of the company's performance and prospects.
- While employees lost their lifetime savings, some insiders were selling stock surreptitiously and protecting their own investment (see 4.2 above).
- While selling stocks on the sly, Enron's top management was encouraging employers to buy the stock stating the prospects of the company were very good.

There was another aspect of the Enron 401(k) that was very problematic. During a crucial period between the middle of October and the middle of November when Enron was spiralling downwards, employees were prevented from moving their investments out of Enron stock into other assets. This happened because Enron was changing the plan

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administrator and during the changeover period all changes in investment options were blocked. The exact number of days for which this blackout lasted is disputed. According to the outgoing administrator[83], the blackout period began on October 29, 2001 while according to the incoming administrator[84], the blackout period began on October 26, 2001 and ended on November 13, 2002. Apart from this small discrepancy, employees have alleged that the blackout period began much earlier and was longer. Some of the confusion might also be because even according to the plan administrators, the blackout periods for loans and withdrawals began on October 19, 2001 while the blackout for investment option changes began only on October 26/29, 2001. The exact dates are very crucial because the Enron stock fell from $26.05 on October 19, 2001 to $15.40 on October 26, 2001, $13.81 on October 29, 2001 and further to $9.98 on November 13, 2001. Therefore, if the dates claimed by the plan administrators are correct, the fall in the stock price during the blackout was only about 28% while if the blackout began ten days earlier, the fall is over 60%.

The related issue is whether given the magnitude of problems facing Enron in the second half of October 2001, the planned schedule of blackouts and change of administration should not have been altered. The incoming plan administrator has testified that discussions were held on October 25, 2001 on delaying the changeover process as well as shortening the blackout period. A further discussion was held on November 1, 2001 on whether it would be feasible to halt the process in place and have the old administrators simply reassume their duties until a later date. This option was apparently abandoned as infeasible.

4.4.2 WorldCom's stock options administration

Salomon Smith Barney (SSB), a unit of Citigroup was the exclusive options administrator for WorldCom employee stock options. In that capacity, it is alleged that the Atlanta unit of SSB gave wrong advice to option holders. Specifically, it is alleged[85] that most option holders were advised to exercise the options and hold the resulting shares.

The optimal option exercise strategy involves complex questions of taxation, option value and liquidity and concentration risks. But two commonly used strategies are easy to explain and justify. It is a well known result in option pricing theory that options should not normally be exercised prematurely because the true value of an option is always greater than the intrinsic value obtained by exercising it[86]. One common strategy is therefore to hold on to the option until its expiry date. This strategy leads to illiquidity and to concentration risks when an employee has a lot of money tied up in options. Illiquidity arises because employee options are not transferable and the employee can use the option money only by exercising that option and selling the stock. The concentration risk arises because all the option money is exposed to risk of fluctuations in the price of a single stock. In order to diversify the portfolio across a basket of stocks, the employee again has to exercise the option, sell the stock and deploy the proceeds in other stocks or

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other investment. These considerations lead to the second strategy – exercise (the option) and sell (the stock).

It is evident that a strategy of exercising the option and holding on to the stock is the worst of both worlds. It suffers from the liquidity and concentration problems of keeping the options unexercised while also exposing the employee to the loss of option value as in the exercise and sell strategy. In fact, it is worse than either of the strategies in that it leaves the employee out of pocket for the exercise price of the option that has to be paid to the employer. If the employee borrows for this purpose, he ends up with a levered position in the stock which aggravates the concentration risk. Except in special tax advantageous situations, therefore, the exercise and hold strategy is not usually a sensible one.

The principal allegation[87] against SSB appears to be that it routinely advised WorldCom employees to "exercise and hold" without any reference to the specific situation of these clients. In so doing, it is alleged to have achieved two purposes:

- SSB earned substantial income by lending margin loans to the WorldCom employees to follow the exercise and hold strategy.
- WorldCom benefited from receiving the exercise price from these employees and it also benefited from avoiding the selling pressure that might have arisen if many employees had chosen to exercise and sell.

The advice to the employees not to sell the shares was based to a significant extent on the research reports of SSB's star analyst Jack Grubman which were allegedly vitiated by the kinds of conflicts of interest described in 4.5 below.

4.5 False research reports issued by investment banks

All the major securities firm in the United States have large research departments that provide research reports on most major companies to their institutional and retail clients. This research is known as "sell-side" research as it is done by firms that are trying to sell these securities to their clients. Some of the large investment institutions like mutual funds and pension funds also do their own research ("buy-side" research), but they also rely to a great extent on the sell-side research at least as a starting point for their own research.

The collapse of Enron and other companies have highlighted three major problems[88] with sell-side research:

- A conflict of interest within the investment banks that causes analysts to put out false research reports to help win investment banking business for their employers. It is these false reports that have led to investigations and fines as discussed in 4.5.1 below using the example of Merrill Lynch[89,90].

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- Sell-side analysts make far too few sell recommendations and rate almost all companies that they cover as buy or neutral. In the Merrill Lynch example discussed in 4.5.1 below, though the company had a five point scale, "Buy-Accumulate-Neutral-Reduce-Sell", no "Reduce" and "Sell" ratings were actually issued by the Internet Group[91]. If a company is too bad, the analysts simply drop coverage of the stock rather than rate it as sell. This practice does not fool the institutional clients who understand the coded language of each of the investment banks. For example, institutions might well have understood neutral as a euphemism for sell and accumulate as a euphemism for neutral. Moreover, institutions could also talk to the analyst for a frank opinion shorn of all the guarded language of the published reports. However, it might have fooled retail clients who might quite legitimately have expected words to have their natural meaning.

- Sell side research is not sufficiently in-depth. Particularly, in the case of complex companies like Enron, few analysts actually understood the company and its business. Rather than simply admit ignorance and drop coverage of the company, the analysts took the company on faith and put out optimistic research reports. An analyst whom Enron castigated for his unfriendly ratings testified[92] that "[Enron] became a nearly impossible company to model. There were a tremendous number of moving parts. Analysts increasingly had to rely on company guidance to make the numbers work. This turned out to be very dangerous." Another analyst testified[93] "… the analysts to some degree were more victims rather than culprits in the Enron situation. … One reason that analysts may have been more willing than normal to accept company guidance for Enron was that it was becoming increasingly difficult to understand how Enron was achieving its revenue growth and profitability. … Often the way out for analysts when faced with difficult to analyze situations like Enron is to drop coverage. Why take the risk when there are plenty of companies that are transparent enough to do meaningful analysis with confidence? The problem with dropping Enron was that it had become the giant in the industry. If you were an analyst covering that industry, you essentially had to cover Enron."

The paper turns to an examination of the Merrill Lynch case to illustrate the conflict of interest problem.

4.5.1 Conflicts of interest at Merrill Lynch

While the US SEC regulates the securities markets at the federal level, many states have their own securities regulation. In New York, Article 23-A of the General Business Law, commonly referred to as the Martin Act, regulates securities issuance and trading in the state of New York. The Martin Act prohibits any fraud, misrepresentation, deception, concealment, promise or representation that is beyond reasonable expectation while engaged in the issuance, distribution, investment advice, sale or purchase of securities

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within and from the State of New York. Unlike the federal securities laws, no purchase or sale of stock is required, nor are intent, reliance, or damages required elements of a violation. This Act provided the authority to New York Attorney General Mr. Eliot Spitzer to commence an investigation into the analyst reports in June 2001. Traditionally, this kind of matter would have been left to the US SEC to investigate. Spitzer's action invited much criticism on the ground that action by state regulators on what is a national problem would lead to the balkanization of rulemaking and oversight in the US securities markets. Spitzer in turn has defended his action vigorously and has accused the US SEC of inaction[94]:

> "The Merrill investigation and settlement was not a state excursion into rulemaking. My office became aware of possible fraud by Merrill; we investigated it; we exposed Merrill's practices to public view; we commenced a proceeding; and we reached a settlement with Merrill which provided for both a monetary penalty and substantive relief. As Attorney General of New York, I have a legal duty to enforce the Martin Act -- a law that predates the federal securities acts--and that has been integral to protecting investors for over eighty years. Unlike rulemaking, which is the province of the SEC and the securities SROs, the settlement we reached with Merrill was a resolution of an enforcement proceeding against a firm. It imposed no rule on the securities industry as a whole. Indeed, it imposed no change on any firm other than the firm investigated, Merrill Lynch. …
>
> Critics of state action overlook the absence of federal action that made the Merrill investigation and reforms necessary. The analyst conflicts of interest we investigated had been widely reported in the press for years. But until we published the Merrill Lynch e-mails virtually nothing had been done about it - there were no meaningful new SEC regulations to address the problem, no legislation to correct abuses, and no serious enforcement actions against those who defrauded the public. During the period of this federal enforcement vacuum, untold millions of individual investors lost vast sums of money."

Spitzer's investigations focused on the Internet Group at Merrill Lynch. As already stated Merrill Lynch had a five point scale, "Buy-Accumulate-Neutral-Reduce-Sell", but no "Reduce" and "Sell" ratings were actually issued by the Internet Group. Spitzer found[95] that the analysts' internal emails were often totally at variance with the published reports. While contemplating a "Neutral" rating for a particular stock, the analysts were internally saying amongst themselves that the stock was "going a lot lower," that the company was "crap," or a "dog". Similarly while contemplating an "Accumulate" rating for another stock, the analysts were saying that there was "[no] reason to buy more of" the stock and its business was "falling apart," "[n]o reason to own" the stock, or that the group expected the stock to be "flat" over the next six months without "any real catalysts [for change]". Analysts internally disparaged some "Accumulate" rated stocks as a "piece of shit," and "such a piece of crap." There was even a case of the head of the internet group

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research team describing as "a piece of junk" an internet stock which carried the highest "Buy" rating and was included in Merrill's "Favourite 15" stocks across all sectors.

The most flagrant abuses that Spitzer found were where the analysts wrote false reports to get investment banking mandates. There were instances where the investment banking demanded a higher rating for a stock and an analyst wrote in an email that "the whole idea that we are independent from banking is a big lie – without banking this would be [rated Neutral]." There was another case where the research group downgraded all companies in the mobile internet sector except one with which there was an investment banking relationship. A senior analyst argued that this was "the one choice we cannot do … we are not in the business of writing press releases." Blodget finally threatened to rate stocks honestly no matter what the investment banking consequences: "we are going to just start calling the stocks (stocks, not companies) … like we see them, no matter what the ancillary business consequences are." In another instance, when an institutional investor e-mailed Blodget about the rating of GoTo.com asking, "What's so interesting about GOTO except banking fees????" Blodget responded, "nothin."

In May 2002, Merrill settled with Spitzer by paying a $100 million fine[96] and agreeing to some changes in its research practices:

- Disclosure on each research report of investment banking relationships with that company
- Disclosure on each research report of the distribution of ratings by category (in other words, the percent of stocks rated as buy, accumulate, neutral and so on)
- Elimination of any link between analyst compensation and investment banking performance
- Research Recommendations Committee to monitor objectivity and integrity of research reports
- Disclosure of termination of coverage

As part of the settlement, Merrill also issued an apology:

> "[We] publicly apologize to our clients, shareholders and employees for the inappropriate communications brought to light by the New York State Attorney General's investigation. … We sincerely regret that there were instances in which certain of our Internet sector research analysts expressed views which at certain points may have appeared inconsistent with Merrill Lynch's published recommendations. ... [S]uch communications, some of which violated internal policies, failed to meet the high standards that are our tradition and will not be tolerated. ... In addition, we are taking steps to reinforce the fire walls that separate our Research Department from Investment Banking. ... Through the adoption of new

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> policies, intensified oversight and strengthened enforcement of existing one, we pledge to provide investors with research that sets a new industry standard for independence and objectivity."

One does not have to be a lawyer to recognize that Merrill was saying that the analyst views were inconsistent with the published research and not the other way around. Merrill was saying that the analysts were wrong to describe the high rated stocks as "junk" or "crap"; it was not saying that they were wrong to award high ratings to stocks which they thought were "junk" or "crap." It is also clear that in future, there will be no such juicy emails for any future investigators to go after: "such communications ... will not be tolerated."

4.5.2 Settlement with other investment banks

On December 20, 2002, the SEC, the New York Attorney General and other regulatory agencies arrived at a settlement[97] in principle with ten large investment banks regarding the research abuses. Full details of the settlement are not known yet. The SEC stated[98]: "When a final agreement is reached among the parties, and the last details hammered out, the commitments among the parties will be articulated in formal, public documents. Those documents will describe the misconduct uncovered in our investigations. The documents also will articulate clearly the relief to be provided by the firms."

The investment banks agreed to make total payments of $1.4 billion including $900 million of fines, $450 million of support for independent research and $85 million for investor education. The terms of the agreement include:

- Firms will be required to sever the links between research and investment banking, including analyst compensation for equity research, and the practice of analysts accompanying investment banking personnel on pitches and road shows.
- Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions.
- For a five-year period, each of the brokerage firms will be required to contract with no less than three independent research firms that will provide research to the brokerage firm's customers.
- Each firm will make publicly available its ratings and price target forecasts.

5 Crises at non US Companies

This paper has confined itself so far to the developments in the United States not because corporate fraud is less rampant or less severe in other countries, but because there is a lot

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more authentic information on what happened in the United States. The Economist rightly pointed out[99]: "Europe's corporate culture is serving shareholders and owners with no more distinction than its short-termist American counterpart. Nor is the continent free of accounting scandals. Indeed, it appears simply to be behind America in bringing them to light."

In this section, an attempt is made to throw some light on similar problems in other countries. Four European companies – Lernout and Hauspie, Vivendi, ABB and Kirch Media – and one Indian company – Tata Finance – present very different sets of governance issues. Not enough is known about these companies (except Lernout and Hauspie which had a US listing), but a discussion of corporate scandals would not be complete without some discussion, however sketchy, of these companies.

5.1 Lernout and Hauspie (L&H)

Lernout and Hauspie (L&H) was a Belgian company engaged in the development of natural language software. The dream was to make computers understand human speech and talk back in a natural language. It was listed in the United States on the NASDAQ after an IPO in 1995, but until its acquisition of two US companies in 2000, it was treated as a foreign private issuer and did not have to file detailed reports with the SEC.

At the height of the technology boom, L&H was regarded as a world leader in natural language software and had a market capitalization of nearly $10 billion. But in the second half of 2000, L&H was engulfed in an accounting scandal and filed for bankruptcy.

As the SEC's complaint[100] against L&H stated: "The eventual result of this fraudulent conduct was the destruction of L&H as an operating company and a financial loss, borne by investors in the U.S., Belgium and elsewhere, of at least $8 billion in market capitalization." There were three main charges against L&H:

1. "From September 1999 to June 2000, L&H reported approximately $175 million in sales revenue from its Korean operations ("L&H Korea"), the majority of which was fraudulent. The purported dramatic growth in sales from its Korean subsidiary accompanied the inflation of the price of L&H stock. The majority of this revenue was fraudulent because L&H Korea: (1) entered into oral and written side agreements with customers freeing them from any definite payment obligation; (2) disguised the uncollectibility of the receivables resulting from some of these fraudulent sales by factoring the receivables to Korean banks, subject to side agreements protecting the banks from any risk of non-collection; and (3) secretly arranged to fund the pay-down of receivables resulting from other bogus sales."

2. "Between 1996 and 1999, L&H improperly recorded over $60 million in revenue from transactions with two Belgian entities – Dictation Consortium N.V. ('Dictation') and Brussels Translation Group N.V. ('BTG') – formed for the

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purpose of engaging in transactions with L&H. Transactions between L&H and these two companies were arranged to allow L&H to fraudulently claim revenue from its own research and development activities, which otherwise would not have resulted in reported revenue unless and until the projects resulted in marketed products."

3. In 1998 and 1999, L&H created "new customers, dubbed 'Language Development Companies' (or 'LDCs'), [which] enabled L&H to claim revenue of $102 million in license fees and $8.5 million in prepaid royalties from the LDCs in 1998 and 1999 … In actuality, the LDCs were little more than shell companies created, like Dictation and BTG, as a means for L&H to improperly fabricate revenues."

The first charge is fairly clear. A brief description[101] of Dictation would give some flavour of the other charges. When L&H found that the large research expenditure that it needed to make would be too big a burden on its profits, it set up Dictation Consortium in 1996 ostensibly with outside investors. Dictation gave a contract to L&H to develop software and paid for the development expenses. These payments became revenues for L&H. When the development was complete in 1998, L&H acquired Dictation for $40 million using an option built into the original contract. Since Dictation had no tangible assets, this price had to be amortized over 7 years, but that was much better than writing it off in 1996 and 1997. However, it appears that Dictation was owned by companies allegedly controlled by L&H itself. If so, Dictation would be a creature of L&H itself and the revenues earned from Dictation would be a sham. This is the allegation in the SEC complaint.

The story of how the fraud at L&H was uncovered is an interesting story with important regulatory implications and is discussed in 7.2.2 below.

5.2 Vivendi

In the 1990s, Jean-Marie Messier transformed a French water utility, Vivendi, into a global media giant through a series of acquisitions. The acquisition of Seagram brought with it ownership of Universal, the large US film and music business. But this spree of acquisitions also brought with it $18 billion of debt that made the company highly vulnerable during the downturn in 2001 and 2002.

In mid-2002, Messier was ousted amidst an acute liquidity crisis that pushed Vivendi to the verge of bankruptcy. As the company itself admitted[102] after the crisis had passed:

> "In a very unfavorable economic climate, marked by the Enron and Worldcom scandals, the downgrading of Vivendi Universal's status by the rating agencies and the banks' sudden loss of confidence in the company's future, brought the financial crisis to a height in early July. The cash crunch came when the company had an untenable level of debt given the available cash flow (35 billion euros at June 30,

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2002, of which 19 billion euros for Media and Communication), with repayment terms that were too tight and could not be rescheduled."

The Company's explanation[103] of the causes of crisis points to a number of imprudent financial policies:

"The principal reasons for this crisis were as follows:

- a series of excessive, rapidly undertaken investments without appropriate financing (6 billion in 18 months);
- a significant loss of cash (€4.5 billion) through the acquisition of treasury shares that were subsequently absorbed into shareholder equity, and losses on puts on Vivendi Universal shares in the amount of €840 million;
- the cancellation of the €2 billion debt issue at the end of the first quarter 2002 ;
- the payment of a dividend of €1 billion at the end of May 2002. (An additional €300mm of withholding tax should be paid within 6 months);
- a debt payment schedule and a debt level that could not be supported by cash flow;
- at the request of the shareholders of Cegetel, a withdrawal of advances made by Cegetel to the parent company, thus abruptly depleting the treasury of €720 mm;
- negative publicity about the integrity of Vivendi Universal's financial statements in the highly unfavorable context of the Enron and Worldcom matters;
- downgrades of Vivendi Universal by the rating agencies, resulting in an immediate cessation in the Group's access to commercial paper – its habitual and most important source of financing;
- a crisis of confidence among the Group's creditors about its future, which peaked at the beginning of July 2002."

Vivendi has been under investigation from several different agencies about its accounting and financial disclosure. These agencies include the French securities regulator, Commission des Opérations de Bourse (COB), the Paris public prosecutor, the US SEC and the US Justice department. The precise nature of the possible charges against Messier and Vivendi are not known.

One issue is certainly that the liquidity position of Vivendi was not fully disclosed to the public until Messier's resignation. The company itself admitted[104] the "complexity" of its financial disclosure:

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> "The PwC assignment consisted of delivering some information to the new general management about some specific aspects, but it was not an audit of Vivendi Universal's accounts. To date, this assignment has not revealed any malfunction of a nature to bring the sincerity of the written financial information provided by Vivendi Universal into question. On the contrary, it has revealed the complexity of that information and has led to the identification of ways and means of improving and coordinating the procedures used by the various business units and the holding company, in particular in terms of cash, Vivendi Universal commitments, and basic accounting structures and processes. The Board noted senior management's decision to take full account of these recommendations and adopt the measures necessary for implementing them as quickly as possible."

Two accounting issues have been discussed in public:

1. The leading French newspaper Le Monde raised some concerns about the accounting treatment of a transaction for the disposal of Vivendi's shares in BSkyB. Responding to this report, the company defended its accounting and stated[105] that under US accounting standards, the transaction was treated as a sale, while under French accounting standards, it was treated as a borrowing secured by the BSkyB shares.

2. Vivendi owned 44% of Cegetel which in turn owns 90% of the profitable French mobile operator SFR. Though it owns only 35% of SFR, Vivendi has been including Cegetal (and therefore SFR) in its consolidated accounts on the ground that it has board and management control over Cegetel. This is not a problem as far as net income is concerned as the share of outside shareholders in the subsidiaries (referred to as "minority interest") is automatically deducted in arriving at that figure. It can however become a problem while using other figures from the income statement prior to the subtraction of minority interest. Vivendi, its lenders and the rating agencies all focused on a measure of profitability known as ebitda (earnings before interest, taxes, depreciation and amortization) as well as on the ratio of debt to ebitda. The *Economist* pointed out in an article[106] about a month before the crisis that by including the full profits of SFR, Vivendi was showing a debt to ebitda ratio of 3.8, while the true ratio (after adjusting for minority interest) was 5.1. It went on to say that "Only near-bankrupt companies show ratios as large as 5." Interestingly, in recent analyses[107] of its liquidity and cash flow position, Vivendi has been including only companies in which it holds more than 50%. It may also be noted that later in 2002, Vivendi took full control over Cegetel after a battle with Vodafone.

5.3 ABB

Another European company to come back from the brink of collapse is the engineering giant ABB. Its financial woes relate mainly to high debt, poor operating performance and above all an unresolved asbestos liability related to its American unit. These, however,

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are not the reasons for its inclusion in this paper. ABB features here for the revelations about the huge pension payments made to its former chief executives, Percy Barnevik and Goran Lindahl without proper approval of the board[108]. It turned out that ABB had no proper remuneration committee of the board and that essentially Barnevik and his successor has given themselves SFr 233 million ($136 million) of retirement benefits without keeping the board fully informed. The situation arose because the pension was set at 50% of Barnevik's last base salary plus an average of his performance based bonuses. This effectively meant that there was no upper limit on his pension. Since Barnevik's average bonus was over five times his last base salary, the amount involved was quite large. ABB demanded the money back and after initial wrangling, Barnevik returned 60% of his retirement benefit while Lindahl agreed to a 55% cut in his pensions. The irony of it was that Barnevik, the architect of the Swedish-Swiss merger that created ABB had previously been regarded as a managerial hero in Europe and a "self-proclaimed champion of corporate governance[109]".

5.4 KirchMedia

KirchMedia, which filed for bankruptcy in April 2002, is very different from the other companies discussed in this paper in that it did not involve the capital markets at all. As one newspaper[110] put it: "Leo Kirch opted to keep his business largely private. He was able to do so by a form of capitalism that remains very different from the Anglo-Saxon model. Based in London or New York, Leo Kirch would have long ago been forced to go to the market for his funding. Instead, he was able to charm one banker after another into accompanying him on his adventurous way."

Because of the private nature of the group, very little is known about its financial position, not even about the scale of its debts. For example, the group's pay-TV business, Premiere was previously thought to be paying its way[111]. Instead, the insolvency specialist, Wolfgang van Betteray, hired by the banks to run the company under the German equivalent of Chapter 11 bankruptcy stated[112] that KirchMedia had absorbed €0.8 billion purchasing films for Premiere at excessive prices from American studios. There were also press reports that Kirch's debt was far higher than originally assumed.

The biggest lender to the Kirch Group was the Bayerische Landesbank controlled by the state of Bavaria. Kirch had been a close ally of the ruling party in that state. Thus the taxpayer pays for the insolvencies of favoured industrialists in a system where the capital market plays a less prominent role.

5.5 Tata Finance

Tata Finance Limited is a non banking finance company belonging to one of India's oldest and largest business groups. In April 2001, while a rights issue of convertible preference shares was in progress some allegations were made that Tata Finance had incurred significant losses on account of stock market investments made by its subsidiary, Niskalp[113]. While the company described most of the allegations as baseless,

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incorrect and misleading, the securities regulator, SEBI, required Tata Finance to make additional disclosures in connection with the rights issue. Investors were also allowed to withdraw subscriptions that they had made to the rights issue prior to the additional disclosure. Since the rights issue was substantially undersubscribed, the promoters stepped in to pick up the unsubscribed portion.

Within a month, however, the board came to know that the financial position of the company was indeed extremely unsatisfactory and sacked the chief executive DS Pendse. The board hired an audit firm, AF Fergusson to investigate the finances of the company. Fergusson's preliminary report stated that:

1. There was substantial diversion of funds of over Rs.5.26 billion from the Company to its subsidiaries and associate companies without the knowledge and authorization of the Board and in violation of the Reserve Bank of India regulations.

2. Certain back-dated transactions based on forged ante-dated documents were undertaken to show a fictitious profit of Rs. 0.26 billion in the accounts of its subsidiary, Niskalp.

3. Certain circular transactions were entered into merely as a device to cover up the capital adequacy problems faced by the Company at every reporting quarter end.

4. Violations of the prudential norms prescribed by the Reserve Bank of India had taken place.

5. Possible violations of the provisions of the Companies Act with regard to the use of two associate companies to finance the purchase of the Company's own shares.

6. Significant deployment of the funds of the Company's subsidiaries and affiliates for funding stock market operations and excessive dealing in select scrips. The Stock Market operations of the subsidiary and associate companies of the Company were totally disproportionate to their paid-up capital.

7. Allegations of insider trading in Tata Finance Limited shares by some Directors of the Company.

The company made a provision of Rs 2.7 billion for its exposure to Niskalp and reported a loss of Rs 3.7 billion that wiped out over 70% of its net worth. It also filed criminal complaints against its former chief executive, Pendse and other officers. Pendse however denied any wrongdoing and claimed that the Board was fully aware of what happened during his tenure.

The issue became more controversial when Ferguson presented their final report. Tata Finance stated[114]:

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> "The Company received a Report dated April 24, 2002 from A F Ferguson & Co., (AFF), Chartered Accountants on the special investigative assignment given by the Company. The Report was placed before the Board of the Company when the Board expressed its reservations with respect to the objectivity and fairness of the report and authorized the Chairman to address a suitable letter to AFF. In response to the letter sent by the Company, AFF conveyed its decision to withdraw the Report and to assign a new and independent team to re-examine and review all the data and information already collected."

Mr. YM Kale, the audit partner, who had written the withdrawn report resigned or was sacked and immediately there were allegations about what prompted the withdrawal of the report and the resignation. A press report[115] quoted passages allegedly from the withdrawn report that was likely to embarrass the Tata group. Another press report[116] stated:

> "According to sources, Kale was under tremendous pressure from the Tatas and Ferguson to soften some of the observations made in the report. He was forced to resign as he refused to make any modification to the report, the sources said.
>
> The report compiled by Mr Kale had made highly critical observations about the functioning of TFL and commented about poor corporate governance practices in TFL during the period. It also unearthed several questionable inter-group transactions by several Tata group companies."

Yet another press report[117] described the episode as "India's meagre contribution to the chain of scandals that has rocked the global accounting industry" and after pointing out that Ferguson does the audits of several Tata group companies bringing in business worth about Rs 100 million went on to ask: "If in the case of Andersen it was huge amounts of consulting fees that suppressed the auditor in them, was it large exposure to the client that made Ferguson withdraw its report?".

Ferguson denied that it was under pressure from the Tatas and asserted that they had sacked Kale because it had lost faith in him[118]. That only prompted the press to publish[119] extracts from a note written to Kale by the Managing Partner of Ferguson commending his work on Tata Finance and stating: "I cannot remember during my 30 years of professional work any such single large assignment of this significance — importance both in terms of the category of work and the client."

The Tata Finance issues are being investigated by the Institute of Chartered Accountants of India[120], the Securities and Exchange Board of India, the Department of Company Affairs and the Mumbai Police. The information collected by these agencies has not however been made public and there is a dearth of authentic information about the matter.

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6 Governance and Supervisory Failure and Regulatory Response

6.1 Management

In many of the cases where charges have been made against the chief executive and senior officers of the company, these persons have exercised their constitutional rights against self-incrimination and declined to testify about their actions. One exception is ImClone chief executive Waksal who pleaded guilty as described in 4.1 above. The more interesting case is that of former Enron chief executive, Skilling who testified before the Senate and denied any wrong doing.

Skilling stated[121]:

> "First, contrary to the refrain in the press, while I was at Enron, I was not aware of any inappropriate financing arrangements, designed to conceal liabilities, or overstate earnings. The off-balance sheet entities or SPE's that have gotten so much attention are commonplace in corporate America; and if properly established, they can effectively shift risk from a company's shareholders to others who have a different risk/reward preference. As a result, the financial statements issued by Enron, as far as I knew, accurately reflected the financial condition of the company.
>
> Second, it is my belief that Enron's failure was due to a classic "run on the bank:" a liquidity crisis spurred by a lack of confidence in the company. At the time of Enron's collapse, the company was solvent and highly profitable – but, apparently, not liquid enough. That is my view of the principal cause of its failure." (emphasis in original)

One difficulty in establishing wrongdoing by Skilling is that he did not sign some of the crucial papers. Apparently, he did not himself lie[122] to the Board, but let others do it. The Powers Report[123] stated:

> "Skilling appears to have been almost entirely uninvolved in overseeing the LJM transactions, even though in October 2000 the Finance Committee was told by Fastow – apparently in Skilling's presence – that Skilling had undertaken substantial duties. Fastow told the Committee that there could be no transactions with the LJM entities without Skilling's approval, and that Skilling was reviewing Fastow's compensation. Skilling described himself to us as having little or no role with respect to the individual LJM transactions, and said he had no detailed understanding of the Raptor transactions (apart from their general purpose). His signature is absent from many LJM Deal Approval Sheets, even though the Finance Committee was told that his approval was required. Skilling said he would sign off on transactions if Causey and Buy had signed off, suggesting he made no independent assessment of the transactions' fairness. This was not sufficient in light of the representations to the Board."

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In his oral testimony, Skilling stated that when the Finance Committee meeting referred to above took place the lights had gone out and people were walking in and out of the room and that he did not recall hearing Fastow tell the Committee that Skilling would review the transactions. He also claimed that he was not personally involved in everything:

> "Enron Corporation was an enormous corporation. Could I have known everything going on everywhere in the company? I had to rely on the best people. We hired the best people. We had excellent, excellent outside accountants and law firms that worked with us to ensure …"
>
> "But in terms of the assertion by *The New York Times* that I was a control freak, I think probably a more accurate description would be that I was a controls freak. We had a company that was an enormous organization that was far flung across the globe. We had to put in place the ability for our managers across the world to make decisions on a timely basis. To do that, we put in force what I believe was a very effective control structure for the company."

It is up to the courts to determine what Skilling knew or did not know and what he did or did not know. However, a situation where the chief executive completely disclaims responsibility for a fraud as serious and extensive as Enron is certainly unacceptable.

In response to the Enron and other corporate failures, the US has passed the Sarbanes-Oxley Act requiring chief executive officers and chief financial officers to certify in the quarterly and annual financial reports that:

> "(1) the signing officer has reviewed the report;
>
> (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
>
> (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
>
> (4) the signing officers--
>
> > (A) are responsible for establishing and maintaining internal controls;
> >
> > (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such

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officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)--

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses."

6.2 Board of Directors and its Audit Committee

Before blaming the board of directors for what happened at Enron and other corporate failures, it is necessary to keep in mind the practical limitations on the ability of the Board to supervise a large company. The Chairman of the Audit Committee of Enron's Board stated[124] in defence of the Enron Board:

- "We do not work full time in this job. … We do not manage the Company. We do not do the auditing. We are not detectives."
- "Directors are … entitled to rely on the honesty and integrity of their subordinates and advisers until something occurs to put them on suspicion that something is wrong."
- "… a Board of Directors can fulfil its duty to act with due care either through one of its Committees or through the use of outside Consultants."
- "We put in place multiple controls involving of numerous parties, because we are aware that one check may not be sufficient. We could not have predicted that all the controls would fail."

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While recognizing the merit in these assertions, it must still be said that the Enron board failed in some key respects as pointed out by a US Senate Subcommittee Report[125]:

- "The Enron Board of Directors knowingly allowed Enron to engage in high risk accounting practices."
- "Despite clear conflicts of interest, the Enron Board of Directors approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The Board exercised inadequate oversight of LJM transaction and compensation controls and failed to protect Enron shareholders from unfair dealing."
- "The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse."
- "The Enron Board of Directors approved excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by Board Chairman and Chief Executive Officer Kenneth Lay of a company-financed, multi-million dollar, personal credit line."
- "The independence of the Enron Board of Directors was compromised by financial ties between the company and certain Board members. The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor."

Given the size and complexity of Enron, it is certainly possible to challenge the Senate Report's claim that executive compensation at Enron was excessive. But all the other conclusions listed above are quite correct.

As an aside, it must also be noted that at least two directors had invested well over $1 million each in Enron stock[126] and had a strong financial incentive to ensure that the company does not collapse. This did not prevent them from going along with Enron management on many issues where they should have resisted.

The Sarbanes Oxley Act has certain provisions for strengthening the independence and competence of audit committee members, but it is doubtful that it would do anything to rectify the deficiencies observed in the case of Enron.

For example, it more or less mandates[127] an audit committee to include a financial expert. However, its definition of a financial expert as one who has experience of the preparation

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or auditing of financial statements is fundamentally flawed. The two classes of people, chief financial officers and auditors that it regards as financial experts have not exactly distinguished themselves in the Enron case or in other corporate failures. The definition excludes the important category of users of financial statements who could bring a diametrically different perspective to the preparation of financial statements. It is quite likely that a fund manager would more clearly see the significance and desirability of a disclosure than a CFO or an auditor who has spent a lifetime in avoiding or minimizing such disclosures. However, even so distinguished an investor as Warren Buffet does not qualify as a financial expert under this definition. The definition also excludes academics who might bring a fresh and independent perspective, though it must be admitted that in the Enron case, the Chairman of the Audit Committee was a distinguished and well respected academic[128]. Thankfully, the US SEC has while framing rules to implement the provisions of the Sarbanes Oxley Act expanded the definition to include "experience in preparing, auditing, analyzing or evaluating financial statements."

6.3 Auditors

In June 2002, Enron's auditor, Arthur Andersen, was found guilty of obstruction of justice[129]. As a result of this conviction Andersen had to cease its accounting practice in the United States[130]. Andersen has virtually become defunct with its US partners and employees joining rival firms and its non-US affiliates being taken over by these rivals. As a result any possible regulatory action or private litigation against Arthur Andersen on the ground of negligence and fraud in relation to its audit would be pointless.

A senate committee staff report[131] states the case against Andersen in relation to the Enron audit quite clearly:

> "Andersen was aware of how problematic these transactions were and warned the Board of Directors that they represented 'high-risk accounting.' Among themselves, Andersen partners involved on the Enron engagement were even more frank. In its yearly client risk analysis on Enron, Andersen expressed concern about some of Enron's business as 'form over substance transactions'; in an e-mail describing the content of one annual client retention meeting regarding Enron on February 6, 2001, Andersen acknowledged 'Enron's dependence on transaction execution to meet financial objectives,' and how 'aggressive' Enron was in its accounting.
>
> One of the major concerns about Andersen as the auditor of Enron has been that it did not exhibit sufficient independence and objectivity in discharging its responsibilities. In 2000, Andersen earned $52 million in fees from Enron. Less than half of that amount, $25 million, was for audit work; $27 million related to consulting services. As discussed above, it is difficult to comprehend how such large consulting fees could not have created a serious conflict of interest for Andersen. But regardless of the cause, the result is clear: Enron's auditor failed to discharge its role of verifying the accuracy of Enron's books."

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It would be noted that this charge against Andersen does not depend on how much Andersen knew or did not know about the information that was allegedly concealed from it in respect of the Chewco transaction (see 2.1.3 above) and other such transactions. It is a statement about how well Andersen performed its duties in the overall context of the Enron audit engagement. In this light, the conclusions of the staff report are quite correct.

Under Section 10A of the Securities Exchange Act of 1934 (as amended by the Private Securities Litigation Reform Act of 1995, an audit must include:

- procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

- procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

- an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

It is difficult to escape the conclusion that Andersen did not discharge this duty.

Andersen's conduct also exemplifies a situation where auditors whose principal responsibility is towards the shareholders of the company see the company management as their principal client. It is the management that plays a key role in appointing[132] the auditor and in giving the firm any non audit business.

6.4 Rating Agencies

The rating agencies never gave a high rating to Enron. The rating of BBB was seven levels before the top rating of AAA and was just three levels above junk. However an investment grade rating was extremely important for Enron as already discussed[133]. Even as the Enron accounting restatements took place, the rating agencies maintained an investment grade rating while lowering the rating by one or two notches. However, the investment grade rating was based solely on a proposed merger with Dynegy that would have provided a large capital injection. When that merger collapsed, Enron was downgraded to junk – the new S&P rating of B- was 6 notches below investment grade. Subsequently, it was further downgraded to default.

The Senate Committee Staff in their report[134] criticised the rating agencies for several deficiencies:

- "the analysts who worked on Enron appear to have been less than thorough in their review of Enron's filings, even though they said that they rely primarily on public filings for information in determining credit ratings." The report states that

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the rating agencies did not bother to understand the opaque disclosure about SPEs and missed the warning signals that they contained.

- Even after *The Wall Street Journal* carried a story on LJM, the rating agencies "never received—or appear really to have pressed for—a clear explanation from Enron officials"

- When the rating agencies were informed in early October 2002 about an accounting adjustment that Enron was going to make, "it does not appear that they made any effort to obtain a cogent explanation for why the reduction was taking place or how such a significant accounting error could have occurred."

- On November 19, 2002, Enron disclosed that its rating downgrade (within the investment grade category) had triggered an immediate repayment of a $690 million obligation. The rating agencies did not know about the existence of such a trigger clause. "Enron officials told S&P that current Enron management had not even known about the $690 million obligation; it was a surprise to them when the trustee for the affected entity had exercised the trigger. S&P not only failed to ask if there were other ''surprises'' regarding credit triggers or other obligations, but the S&P analysts appear to have also been unconcerned about the fact that Enron management itself appeared to lack knowledge about a major company commitment."

- In its segment reports, Enron subsumed its trading business under its Wholesale Division which included other businesses. In response to some reports about the declining profitability of the trading business, the rating agencies sought information about the profitability of the trading business. "When the credit rating agencies asked for this information — information which Moody's Chief Credit Officer Pamela Stumpp told Committee staff was 'fundamental' to a credit analysis — Enron, according to the credit analysts, told them that it did not have that kind of detail. Enron's response appears to be either not credible or a sign of a company in trouble. A company must know how each of its businesses is performing in order to monitor it. Nevertheless … the credit rating agencies acknowledge that they did not push for the information. According to what the credit analysts told Committee staff, they simply accepted Enron's refusal."

The rating agencies' defence of course is that they were duped by the company. As a rating analyst told[135] the US Senate: "Senator, this was not a ratings problem. This was a fraud problem." Or as another rating analyst put it[136]: "But the reason was because the company misled."

Any criticism about the rating agencies must keep in mind that the agencies gave Enron a rating that reflected a high level of risk. In their public documents, the rating agencies define the BBB/Baa ratings as follows:

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> "Bonds and preferred stock which are rated Baa are considered as medium grade obligations (i.e., they are neither highly protected nor poorly secured). Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well." (Moodys)

> "An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation." (S&P)

The rating agency, S&P has also testified[137] that "… the 'BBB' level rating we had assigned was not only well below how Enron was often treated when it borrowed money from the market, but consistently lower than the ratings of other companies its size."

It must also be remembered however that the difference between investment grade and speculative grade is very large and even a couple of notches would have made a huge difference to Enron lenders and counterparties. It is therefore difficult to escape the conclusion that the rating agencies were somewhat complacent in their rating of Enron.

6.5 Accounting Standard Setter (FASB)

After the collapse of Enron, the Financial Accounting Standards Board (FASB) has come in for criticism of its accounting standards. Some academics have questioned[138] the standard setting process itself:

> "… accounting standard setting process appears structured in such a fashion as to produce the occasional accounting debacle. Industry and financial groups, and their auditors, sponsor a private sector agency, the Financial Accounting Standards Board (FASB), to offer accounting pronouncements and guidance from which the very same corporations and their auditors will either benefit or suffer. In other words, it is a process that, at best, seems fraught with moral hazard problems and, at worse, results in accounting opinions that appear to pander to the worst aspects of corporate America. These problems are only exacerbated when auditors who lobby the rule-making process in behalf of their corporate clients are then asked to implement the rules. In an environment like this, should we have expected anything less than the occasional Enron/Andersen misadventure?"

The US SEC however defended[139] this system where the SEC has the authority to set accounting standards but leaves the task to the private sector standard setter:

> "The cooperative effort between the public and private sectors has given the United States the best financial reporting system in the world, and the Commission is intent on making it even better."

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Another strand of criticism is that the US accounting standards are based on detailed rules instead of broad principles. As one accounting professor put[140] it:

> "there were two paths that could have been taken. The path not taken would be the path based on axioms, principles the way we did it in geometry in high school, the 12 Euclidian axioms. Here's what you can derive from it. Accounting could have said here's what an asset is. … Here's what an revenue is. … and derive the fundamental accounting principles from those. Instead, we didn't do it that way. We said we've got these myriad accounting problems, let's write rules to deal with specific problems. … We are getting evermore specific rules to deal with evermore specific transactions. And it leads managements to say there are these rule books out there. … Let me see where there's a transaction that's not covered in the rule book. And I'll invent one. I'll make one up. … As fast as we can write rules, they can get around it. … the rules don't come fast enough to deal with the transactions. I think it would be a mistake to ever think we could get there. … Now the SEC has had a hand in this. The SEC says we've got this big rule book. If you want to do something, you show me where it says you can and now accountants are afraid to do a transaction without going to the SEC, without getting preclearance for some transaction. We're bogged down in rule books."

The Sarbanes-Oxley Act goes some way towards addressing these criticisms:

- It formalises the role of the FASB and provides it an independent source of funding through fees levied on public companies.
- It also mandates that the SEC conduct a study on the adoption of a principles based accounting system in place of the rules based system that exists currently. The FASB has announced its plans to work towards a principles based accounting system[141].

Another issue that has been raised is that of detailed real time disclosure in addition to the quarterly accounting statements. The point is that with today's technology, it is possible to provide real time information on a web site. It is also possible to provide detailed information which the interested user can aggregate and analyse in any manner that may be considered desirable. Accounting statements were designed in an era when this was not possible and therefore a particular method of aggregation and analysis was chosen which could be used by all companies. These constraints do not exist today and there have been a number of proposals for real time disclosure[142].

This paper now turns to two specific accounting issues that have attracted a lot of attention in the light of the Enron experience.

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6.5.1 Special purpose entities (SPEs)

The main criticism that can be levelled against the accounting standard setter in the context of Enron is that it allowed accounting on the basis of "Form over Substance". The FASB has grappled with the issue of SPEs since 1989 when the SEC observer first raised all the relevant issues in the FASB's interpretive body, the Emerging Issues Task Force (EITF)[143]:

> "The SEC Observer announced that the SEC staff is becoming increasingly concerned about certain receivables, leasing, and other transactions involving special-purpose entities (SPEs). Certain characteristics of those transactions raise questions about whether SPEs should be consolidated (notwithstanding the lack of majority ownership) and whether transfers of assets to the SPE should be recognized as sales. Generally, the SEC staff believes that for nonconsolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE (including residuals). Conversely the SEC staff believes that nonconsolidation and sales recognition are not appropriate by the sponsor or transferor when the majority owner of the SPE makes only a nominal capital investment, the activities of the SPE are virtually all on the sponsor's or transferor's behalf, and the substantive risks and rewards of the assets or the debt of the SPE rest directly or indirectly with the sponsor or transferor.
>
> Also, the SEC staff has objected to a proposal in which the accounting for a transaction would change only because an SPE was placed between the two parties to the transaction. The SEC staff believes that insertion of a nominally capitalized SPE does not change the accounting for the transaction."

Over the last thirteen years, the FASB has made several pronouncements on this issue including FAS 140 and the various EITF Issues that have been discussed at length earlier in this paper (see 2.1.2 above)[144]. Naturally, if the FASB did not get it right after thirteen years of deliberations, it does raise questions about the standard setting process.

The requirement regarding 3% external capital for unconsolidated SPEs that emerged out of all the pronouncements of the FASB has been severely criticised after the collapse of Enron[145]. One analyst stated[146]: "A 97-3 debt-equity capital structure will not pass any laugh test in today's equity markets." An accounting professor stated[147] in a more restrained tone: "The current rules which includes the infamous 3 percent rule for consolidation needs to be abandoned in favor of rules that emphasize economic control, rather than specific numbers that can be easily violated. Economic control should be assumed, unless management can prove otherwise."

In June 2002, presumably in response to widespread criticism of the 3% rule, the FASB issued an exposure draft[148] of a proposed interpretation that would impose a requirement

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that "the equity investment is sufficient to permit the SPE to conduct its activities without additional financial support."

6.5.2 Mark to Market Accounting

The FASB's decision to permit mark to market accounting for energy contracts also came up for severe criticism after Enron. One accounting professor argued[149]:

> "While there are strong conceptual reasons to support MTM accounting, the Enron crisis points to at least some need to revisit and revise the current accounting rules for reporting transactions and assets that rely on MTM values. In particular, MTM rules should be modified to require that all gains calculated using MTM method for assets and contracts that do not have a ready market value should be reported only in ``Other Comprehensive Income'' in the balance sheet, rather than the income statement, until the company can meet some high ``confidence level'' about the realization of revenue for cash flows that are projected into future years. Normal revenue recognition rules do require that revenue should be recognized after service is performed, and moreover that revenue should be ``realized or realizable'', meaning that cash flow collection should be likely. In the absence of satisfying this condition, revenue rules (such as those explained in SEC Staff Accounting Bulletin 101) normally compel a company to wait until service is performed and cash collection probabilities are higher. Extending this logic to MTM accounting would protect the investing public from unverifiable and unauditable claims of gains being reported in the income statement."

An analyst castigated[150] it even more sharply:

> "The actual or potential abuse of longer-term deal valuations via M-t-M has all but destroyed the credibility behind this system. No one on Wall Street seriously believes in 'paper earnings' any more after the Enron experience."

While evaluating the role of mark to market accounting in the context of Enron, we must however remember that:

- 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.

Even after the collapse of Enron, the FASB strenuously defended the use of mark to market accounting and stated[151] that:

> "MTM accounting is especially important in providing relevant and transparent information about energy trading contracts and many derivative instruments because

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> the alternative often would be not to account for the contracts at all during the period they are outstanding. Because energy trading contracts and many derivative instruments often are entered into at no net upfront cost (because they create rights and obligations that are initially equal but opposite), those contracts escape accounting recognition in a cost-based accounting model until the contracts are transferred or closed."

The SEC also defended the use of this method while conceding that there are difficulties in energy contracts[152]:

> "I don't know that there's any evidence to indicate that mark-to-market accounting has led to misleading information to investors. The broker-dealers in this country have used mark-to-market accounting to account for their activities for many, many years. They have sophisticated financial instruments that aren't quoted on exchanges that need to be accounted for at market value. And so estimates need to be made of value in order to accomplish the mark-to-market process. Energy trading contracts can be and are very, very complicated and they sometimes go on for periods of time as I understand it that go beyond the period of time where there are quotes, either for purposes of forward contracts, or broker-dealer type contracts, and therefore they require that a model be developed that takes into account recency of other transactions and mechanics such as that, leading to an estimate of fair value. That really is the difficult part of it. It's fairly easy to mark-to-market a financial instrument that is traded on the New York Stock Exchange. Even I can calculate that. But the calculation of the market value of a thirty year contract to supply electricity requires a great deal of specialized expertise."

However, several months later, at the special October 25, 2002 meeting[153], the FASB's interpretative body, EITF decided to rescind EITF Issue No. 98-10. Mark-to-market accounting was precluded for all energy trading contracts not within the scope of FASB Statement No. 133 ("Accounting for Derivative Instruments and Hedging Activities"). The standard setter does therefore seem to have changed its mind.

6.6 Stock Market Regulator (SEC)

The US SEC comes in for criticism in three areas:

- Failure to review the filings of Enron from 1997 to 2001 particularly in the context of its known concern about SPEs.
- Ineffective action against audit firms
- Failure to act against false research reports and illegal IPO practices during the boom

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- Granting permission to Enron to use mark to market accounting for energy contracts

The first three issues are discussed further below. The last issue of market to market accounting has been discussed at length in 6.5.2 above. The SEC has also been criticised for having granted Enron certain exemptions under the Public Utility Holding Company Act (PUHCA) but this does not appear to be a serious charge[154].

6.6.1 Failure to review filings

The nature of the review of company filings by the SEC is described[155] as follows:

> "The review of a company's periodic filings, however, is not intended to serve as a second audit of the financial statements or otherwise validate the numbers set forth …The primary goal is to ensure that required disclosures are set forth in the report and that the disclosures themselves are facially accurate and comprehensible … Nonetheless, when … review … does reveal a troubling item or some indicia of fraud … staff may refer it … for further investigation."

It is generally accepted[156] that a serious review of Enron's annual report for 2000 and possibly even for 1999 would have thrown up enough disturbing signals that might have prompted a further investigation. The question therefore arises as to why the SEC did not review the filings of the 7th largest corporation in the United States particularly one that was known to be using derivatives and other complex structures quite extensively. The SEC's then Chief Accountant stated:

> "Well, I think the Commission staff, in its review of filings, uses what is referred to as a 'selective' process for picking which filings will be reviewed, with the goal of reviewing each company's filings no less frequently than once every 3 years. As I understand it, when Enron's turn came up for review earlier in 2001, which was prior to my return to the Commission, Congressman, it was decided to wait to conduct that review in 2002 because of the fact that our new accounting rules went into place in early 2001 concerning derivative financial instruments. It was known that Enron engaged in a lot of derivative financial instruments, and it was felt—and it was a very principal decision—that it would be more productive to review Enron in 2002 when the financial statements for the first time then would reflect these new accounting requirements." [157]

It is true that the relevant department of the SEC has only 330 people to review the filings of 11,000 companies; that in the year 2001 only 16% of the filings were reviewed; and that 53% of companies did not have their filings reviewed for the last three years. Yet as the SEC Chief Accountant admitted[158]:

> "We have the resources to review the financial statements of the Fortune 500 companies. That project is beginning, and while that necessarily takes away from

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> other activities, we believe that it is an appropriate deployment of our resources to review those financial statements."

It must also be emphasized that the SEC had for long been concerned about the abuses of SPEs. As early as 1989, it had expressed its serious concerns on this issue (see 6.5.1 above). In November 1999, the SEC's then chief accountant took a tough stand[159] on the kinds of abuses that Enron was guilty of:

> "While we know that legitimate SPE transactions exist, we have also become aware of SPE transactions that have not complied with all of the relevant accounting requirements specified in EITF Topic D-14 and Issues 90-15 and 96-21. We have seen what appear to be contrived, structured transactions that defy transparency, and we are prepared to challenge registrants in instances where they have not complied with the appropriate accounting and reporting guidance. For example, there is specific and very clear guidance in Issue 90-15 that discusses the minimum substantive amount of real equity needed by an SPE. SPEs that do not comply with these rules, such as when they use subordinated debt rather than equity, or do not have the minimum amount of equity as discussed in the staff's announcement in Issue 90-15, will be required to be consolidated. In an effort to improve the guidance in this area, we have asked the FASB to address the consolidation of SPEs in its consolidation project. ***In the interim, those who do not comply with existing rules may be feeling like a long-tailed cat in a room full of rocking chairs***." (emphasis added)

Unfortunately, Enron, the "long-tailed cat" with the longest tail of them all found that there were no "rocking chairs" in the room. The regulators who should have been in those rocking chairs were busy doing other things. The charge against the SEC is not that it did not follow its own normal procedures in relation to Enron.

The charge is that its normal procedures represented an inappropriate and unacceptable set of priorities of how the SEC should use its limited resources. For example, the SEC reviewed all IPO filings while reviewing annual reports only on a selective basis. As far back as 1996, an advisory committee[160] appointed by the SEC had pointed out the need to give greater emphasis on periodic reporting requirements rather than the transactional filings: "a regulatory structure that focuses on [offering] transactions is neither efficient nor does it necessarily serve the public interest well, especially in light of the relative size – 35 times larger – of the equity trading markets (approximately $5.5 trillion dollars in 1995) as compared to the primary markets (approximately only $155 billion in 1995)."

The resources of any regulator are always limited and it is necessary to direct those resources to the areas of maximum impact. On the other hand, however, the SEC like all bureaucratic agencies the world over has tended to turn its resources to areas of greatest visibility and glamour rather than maximum impact. This is illustrated by the contrast between SEC's actions against Enron and against a 15 year old kid described in 8.1.5 below.

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6.6.2 Ineffective supervision of audit firms

Prior to the Sarbanes-Oxley Act of 2002, the audit profession was self-regulated. The SECPS (SEC Practice Section) of the AICPA (American Institute of Certified Public Accountants) was a self regulatory body whose primary self-regulatory mechanism was a system of peer reviews in which accounting firms reviewed each other's performance. The SECPS, in turn, was subject to oversight by the independent private sector body, Public Oversight Board (POB) set up by the AICPA and consisting of five members "drawn from among prominent individuals of integrity and reputation, including, but not limited to, former public officials, lawyers, bankers, non-practicing certified public accountants, securities industry executives, educators, economists and business executives."[161]

This system of self-regulation suffered a severe blow to its credibility when the peer review of Andersen completed after the collapse of Enron found "that its system of accounting and auditing quality has been deemed to provide reasonable assurance of compliance with professional standards, following the most extensive peer review in the firm's history."[162] Critics also pointed out that "since this process was put in place in 1978, there has <u>never</u> been a qualified report issued by one Big Five accounting firm against another at the end of any peer review."[163] (emphasis in original)

The POB's Chairman himself was severely critical of the self-regulatory system[164]:

> "First, the funding of the POB is subject to control by the firms through the SECPS. In the past - as noted above - the SECPS has cut off that funding in an effort to restrict POB activities. In addition, the AICPA and SECPS insisted on a cap on POB funding when the new charter was created.
>
> Second, the disciplinary system is not timely or effective. Disciplinary proceedings are deferred while litigation or regulatory proceedings are in process. This results in years of delay and sanctions have not been meaningful. The Professional Ethics Division of the AICPA, which handles disciplinary matters against individuals, does not have adequate public representation on its Board. Investigations by the Quality Control Inquiry Committee of the SECPS, which handles allegations of improprieties against member firms related to audits of SEC clients, do not normally include access to firm work papers and firm personnel involved in the engagements under investigation. The disciplinary system cannot issue subpoenas or compel testimony - it must rely on the cooperation of the individual being investigated - and cannot talk to the plaintiff or the client company involved. Furthermore, there is no privilege or confidentiality protection for investigations or disciplinary proceedings, and disciplinary actions are often not made public.
>
> Another problem is that monitoring of firms' accounting and auditing practices by the peer review process has come to be viewed as ineffective, and has been described as 'clubby' and 'back-scratching'. The peer review team does not examine the work

> of audits that are under investigation or in litigation, and public peer review reports are not informative.”

To make matters worse, the SEC itself has avoided taking action against accounting firms though it has the authority to do so. In a speech[165] in December 2002, the enforcement director of the US SEC stated that the SEC “rather seldom has sought to charge accounting *firms* for their role in financial reporting frauds. Instead, when improper accounting or auditing has contributed to such a failure, the Commission typically has viewed the misconduct as a failure by an *individual* auditor rather than by the firm. … Indeed, you can count on your fingers the number of times that the Commission has sued a Big Four or Big Five or Big Six or Big Eight accounting firm in the last quarter century for an audit failure caused by one or more of its partners.” He went on to say that the lack of action against audit firms “is a product of prosecutorial discretion, not legal inability. It is an exercise of discretion that has resulted in a presumption that the misconduct of individual audit partners normally will not be laid at the feet of the firm as a whole.”

Making it clear that he was stating only his views and not the views of the SEC or its staff, the enforcement director then proceeded to argue that the SEC must in fact target the firm itself:

> “A decision by the Commission to systematically exercise its prosecutorial discretion in *favor* of charging accounting firms for the failures of individual audit partners would create powerful incentives. Accounting firms would be prompted to strengthen their internal controls, bulk up their systems of supervision, and reinvigorate their training programs. Such an approach also would encourage firms to embrace broad principles of remediation, including disciplining or terminating wrongdoers, and after instances of misconduct, reviewing and revising firm procedures to prevent recurrence of the problem. They also would be likely to cooperate more readily with Commission investigations. Finally, if firms expected to be held accountable for the actions of their audit partners, the deterrent effect of Commission enforcement actions involving auditors would be enhanced. Investors would benefit from the improvements within firms and from greater efficiency in the Commission's investigative process.”

Viewed as an implicit criticism of what the SEC has been doing so far, this is quite devastating. Coupled with the lack of competition in the accounting profession (discussed in 7.4.1 below), the ineffective self-regulatory system for audit firms discussed above and the undue influence of accounting firms in the standard setting process (described in 6.5 above), we have a picture of a cosy protected oligopoly that fits the standard description of regulatory capture.

In response to the failure of the auditors in Enron and other corporate failures, the Sarbanes Oxley Act has made major regulatory changes relating to audit.

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1. To strengthen the oversight of the auditors, the Sarbanes Oxley Act has created a new Public Company Accounting Oversight Board (PCAOB) as a non governmental non profit organization to: (a) register accounting firms that audit public companies; (b) establish or adopt auditing standards; (c) inspect accounting firms; and (d) conduct investigations and disciplinary proceedings against accounting firms. The PCAOB consists of five full time members appointed by the SEC "from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures." Two and only two of the members shall be or shall have been certified public accountants.

2. To strengthen auditor independence, the Sarbanes-Oxley Act:

    - prohibits auditors from performing non audit services to an audit client. Some tax services and other such services may be performed with the prior approval of the audit committee.

    - requires the lead partner to be rotated every five years

    - requires the auditor to disclose to the audit committee any management letter or other major written communication as well as the discussions that it has had with management on accounting treatment and accounting policies

    - prohibits an auditor from auditing a company whose chief executive, controller, chief financial officer or chief accounting officer was during the preceding one year period an employee of the audit firm and participated in the audit of that company

    - requires the Comptroller General of the US to conduct a study on requiring mandatory rotation of the audit firm itself

6.6.3 Failure to act against IPO abuses and false research reports

While the accounting frauds at Enron, WorldCom and others were not known until they collapsed, the IPO abuses (see 4.3 above) happened under the public glare and it is difficult to believe that the SEC was unaware of what was going on. Indeed it has been alleged[166] that the SEC even began an investigation and then abandoned it:

> "In 1998, the commission began an investigation into spinning – the allocation of IPO shares, under the 'friends and family' category, to high-tech executives as an incentive to bring their financing business to the underwriting bank. The investigation ended almost as soon as it started, however. Wall Street firms

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> successfully lobbied the federal regulators that they could police their own ranks and put an end to spinning by basing allocation solely on the level of commission business."

A former chief economist at the SEC has been quoted[167] as saying in this context that "the SEC is captured by its regulatees" and that the commission does not act until "there's a great public outcry."

Similarly, it is difficult to believe that the SEC was unaware that the research reports put out by investment banks were tainted by severe conflicts of interest (see 4.5 above). Indeed, when the SEC threatened to take action against a 15 year old kid for price manipulation (see 8.1.5 below), he is reported to have responded that he was only doing on a small scale what the big investment banks were doing all the time. It strains credulity to imagine that what was obvious to a 15 year old was not evident to the SEC.

6.7 Legislature (US Congress)

In the aftermath of Enron, the US Congress itself has been criticised for its role in thwarting some of the sensible moves by the accounting standard setter, FASB. One accounting professor testified[168]:

> "The accounting standard setting process has become too political, which slows progress to improved standards. Standard setting profits from the political nature of its activity. However, of late, the standard setting has become too political. Emboldened by their success in opposing the FASB's proposal to expense stock option compensation, opponents of FASB's proposals have found that complaints to Congress have been quite successful in impeding FASB's progress, with congressional hearings becoming commonplace before a final standard can be passed. These hearings often produce arguments suggesting that the proposed standard will materially alter business, as we know it, significantly affecting the competitiveness of U.S. companies. However, I have seen no evidence of the significant deleterious effects claimed by businesses after the proposal has passed. Yet the delay for lobbying activities significantly slows FASB's progress, hindering its ability to develop timely standards that may serve to reduce accounting abuses, such as those found at Enron."

Another criticism of the Congress relates to the Private Securities Litigation Reform Act of 1995. A hedge fund manager testified[169] about this Act that:

> "While no fan of the plaintiffs bar, I also must point out that the so called 'Safe Harbor' Act of 1995 has probably harmed more investors than any other piece of recent legislation. That statute, in my opinion, has emboldened dishonest managements to lie with impunity, by relieving them of concern that those to whom they lie will have legal recourse. The statute also seems to have shielded underwriters and accountants from the consequences of lax performance of their

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'watchdog' duties. Surely, some tightening of this legislation must be possible, while retaining the worthy objective of preventing obviously frivolous lawsuits."

The implications of this Act are discussed further in 7.3 below.

6.8 Regulatory Response in India

There has been some thinking in India on adopting salient features of the Sarbanes-Oxley Act and other US regulatory changes in India. A high level committee appointed to review the corporate governance issues in India has submitted a report[170] recommending many measures similar to that of the Sarbanes-Oxley Act:

1. Strengthened auditor independence
2. Prohibition on provision of non audit services to an audit client
3. Compulsory rotation of the audit partner and 50% of the engagement team every five years
4. Enhanced disclosure of contingent liabilities
5. CEO and CFO certification of annual accounts
6. Establishment of an independent Quality Review Board to conduct audit quality reviews (This is closer to the erstwhile Public Oversight Board than to the Public Company Accounting Oversight Board set up under the Sarbanes-Oxley Act in the US.)
7. Strengthened role of independent directors
8. Establishment of a Corporate Serious Fraud Office on the lines of the Serious Fraud Office in the United Kingdom

The Institute of Chartered Accountants of India has taken some steps to strengthen its auditing standards to address the problem of frauds. It has issued an exposure draft[171] stating that "When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error." The Institute has also revised[172] its auditing standard on risk assessment requiring the auditor to "assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level."

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7 Failure of Market Discipline

Having dissected at length the massive regulatory failure represented by Enron and other corporate frauds, the paper now turns to the failure of market discipline that is equally evident. The issue addressed here is not the “infectious greed” that Alan Greenspan blamed[173] for the failures that have taken place:

> “Why did corporate governance checks and balances that served us reasonably well in the past break down? … An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed.”

If greed alone could destroy so much, then free market capitalism would be a very fragile institution indeed for greed is intrinsic to human nature. From the days of Adam Smith, those who have placed their faith in free markets have done so in full knowledge of the greed that permeates human society.

Instead this paper argues that the breakdown of market discipline is attributable to state interventions in the free market that fatally weakened its ability to correct itself. Essentially, the argument is that:

- corporate governance was compromised by weakening the market for corporate control
- capital market discipline was weakened by regulatory restrictions on short sales
- the contract enforcement mechanism that is critical for free market capitalism was weakened by restricting private securities litigation
- the private sector watchdogs failed because they operated as cosy oligopolies that had no incentive to succeed

This paper now addresses each of these issues in turn.

7.1 Regulatory shutdown of the hostile take over market

In the 1980s, corporate governance in the United States was transformed by the emergence of a market for corporate control that has been well documented by Michael Jensen[174]:

> “The takeover boom of the 1980s brought the subject of corporate governance to the front pages of the newspapers, as a revolution was mounted against the power complexes at corporate headquarters. The mergers, acquisitions, LBOs, and other leveraged restructurings of the 1980s constituted an assault on entrenched authority that was long overdue. Control of the corporation was transformed from a means of perpetuating established arrangements into a marketplace where the highest bidder

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> made certain that the owners' interests would prevail. In many cases, the result was a convergence of interest between management and owners."

However, politicians, regulators and the popular media had a different view of the phenomenon which is best captured by the title of a best selling book of the time: *Barbarians at the Gate*[175]. Towards the end of 1989, the hostile takeover market was virtually shut down as Michael Jensen explains:

> "political forces produced a major reregulation of our financial markets. … With the eclipse of the new-issue market for junk bonds, the application of HLT rules to commercial bank lending, and new restrictions on insurance companies, funding for large highly leveraged transactions all but disappeared. And, even if financing had been available, court decisions (including those authorizing the use of poison pills and defensive employee stock ownership plans) and state antitakeover and control shareholder amendments greatly increased the difficulty of making a successful hostile offer."

What the Enron and other corporate failures have shown is that the shutdown of the hostile takeover market is a great mistake. While the raiders of the 1980s might well have been barbarians, the real barbarians were inside the gate[176]. What the regulators achieved by stopping hostile takeovers was to entrench the barbarians inside the gate. It is perhaps not a coincidence that the 1990s witnessed the rise of the "Imperial CEO" the worst manifestation of which was seen at Adelphia and Tyco.

There is perhaps only one major case of accounting concerns triggering a takeover battle in the United States during the last couple of years. *The New York Times* carried a report[177] in April 2001 containing serious allegations about accounting practices at Computer Associates. Less than two months later, a proxy fight was launched by a Texan billionaire to wrest control over the company. While the proxy fight failed to oust existing management, it did succeed in forcing significant governance and accounting changes. One newspaper[178] described the failure of the takeover attempt as an illustration of the proxy fight paradox: "The more managements mend their ways, the less likely the dissidents are to win the contest". To this extent, the Computer Associates episode could be regarded as a partial vindication of the role that hostile takeovers could play in keeping managements honest.

7.2 Regulatory restrictions on short sales

This paper has been a long litany of failures by various parties (management, board, auditors, rating agencies, analysts, regulators and others) to provide warnings about Enron and other similar failures. There is however one category of people who come out in flying colours in all these scandals – the short seller. In almost all the cases, the short-seller was the only person warning of problems. In many cases, it is the short seller who alerts the media, and it is the media that alerts the SEC. Most importantly, the short-seller puts his money where his mouth is[179].

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Unfortunately, however, short selling has been frowned upon in regulatory circles around the world. Governments tend to have a vested interest in keeping their stock markets at high levels and short sale restrictions are one way to do that. The United States introduced the uptick rule that allows a stock to be shorted only on a uptick (when it has moved up), not on a downtick (after it has moved down). This was introduced in the 1930s in the mistaken idea that the great crash was induced by a great wave of short selling. During the great stock market boom of the late 1990s, nobody thought of introducing a reverse rule allowing stocks to be bought only on a downtick though this would have logically consistent with the uptick rule for short selling!

In the following sections, this paper presents three examples of how short selling is beneficial in curbing dishonest managements.

7.2.1 Short selling in Enron

It is now accepted[180] that Bethany McLean of Fortune magazine was the first journalist to highlight hard questions about Enron's balance sheet with her piece "Is Enron Overpriced?"[181] in March 2001. After Enron went bust, she explained[182] who had given her the key lead about Enron: "it's not hard to find the person who first said that the emperor had no clothes. In early 2001, Jim Chanos, who runs Kynikos Associates, a highly regarded firm that specializes in short-selling, said publicly what now seems obvious".

In his testimony[183] to Congress, Chanos explained how he had seen the red flags in Enron's SEC filings, and started short-selling Enron as early as November 2000, raising the position substantially in February 2001. The red flags that he saw were: a low rate of return on invested capital, mark-to-market accounting, insider stock sales and the related party transactions.

The short-seller borrows stock that he does not own and sells it in the expectation that he can buy it back at a lower price to return the borrowed stock. Clearly, the short-seller makes a profit if the stock falls. The typical mode of operation is to discover stock with hidden problems, short the stock, publicize the problems and hope that the stock falls as other recognize the problems. The short-seller devotes considerable resources to alerting the media and the regulators to the problems because that is how he makes money. That is what Chanos tried to do in the case of Enron unsuccessfully for several months.

Chanos stated in his testimony:

> "I can't think of one major financial fraud in the United States in the last ten years that was uncovered by a major brokerage house analyst or an outside accounting firm. Almost every such fraud ultimately was unmasked by short sellers and/or financial journalists. …

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> Finally, I want to remind you that, despite two hundred years of 'bad press' on Wall Street, it was those 'unAmerican, unpatriotic' short sellers that did so much to uncover the disaster at Enron and at other infamous financial disasters during the past decade (Sunbeam, Boston Chicken, etc.). While short sellers probably will never be popular on Wall Street, they often are the ones wearing the white hats when it comes to looking for and identifying the bad guys!"

7.2.2 Short selling in Lernout and Hauspie (L&H)

The battle against L&H (whose accounting scandals were discussed in 5.1 above) was waged from the beginning by the hedge fund Rocker Partners and its partner Marc Cohodes. Cohodes' bearish views on L&H were aired by the high profile financial news service TheStreet.com, particularly its columnist Herb Greenberg. Immediately after L&H made its quarterly filing with the SEC, Greenberg put out a column arguing that L&H's sales had fallen in every country except Korea where there had been spectacular growth.[184]

> "The breakdown shows that while Lernout's revenues may have been booming … sales were tumbling in every country but one. Where, then, did the big gain come from? None other than Korea. (Korea? Yes, Korea! The same Korea where tech sales, in general, are slowing!) Lernout's sales in Korea went from virtually zero ($97,000) a year ago to $58.9 million in the first quarter. That's almost triple the sales, during the same period, from either the U.S. or Europe. That's also more than half of Lernout's total sales in the quarter!"

It was implied that the revenues in Korea were fictitious. The Wall Street Journal followed up on this with an investigation[185] that claimed that many of L&H's alleged customers in Korea had not bought products from L&H. While L&H hotly denied this accusation, soon L&H came under SEC investigation and within months L&H was bankrupt[186].

Interestingly Microsoft had a 5.2% stake in L&H and Intel was another large investor[187]. It is interesting that a lowly short seller could spot what these giant corporations could not.

7.2.3 Research Analysts serving Short Sellers

This paper has discussed the conflicts of interest that lead to false research reports. At the same time, there are some small research boutiques that do produce research which is valuable. In a survey[188] of such boutiques, the Investment Dealers Digest covered a research boutique that is the favourite of the short sellers:

> "The Center for Financial Research & Analysis Inc., for example, has fashioned itself as a forensic accountant and alerts its clients when financial statements appear to be manipulated to disguise operating troubles. … Its 14 researchers

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> comb through publicly filed financial statements in search of signs-like soaring accounts receivable or suspicious earnings boosts-that a company's core business may be running aground. … Of the dozen largest accounting scandals in the past eight years, the Center for Financial Research & Analysis … issued cautionary notes on least eight”

This is yet another example of the role that short sellers play in keeping companies honest.

7.3 Restrictions on class action lawsuits

The Private Securities Litigation Reform Act of 1995 made sweeping changes in class action law suits in the United States in the area of securities law:

- The court appoints as the lead plaintiff not the person who first filed the suit, but “the member or members of the purported plaintiff class that the court determines to be most capable of adequately representing the interests of class members”
- The lead counsel is appointed by the lead plaintiff
- Procedural delays were introduced by the requirement to stay all discovery during the pendency of a motion to dismiss the suit
- Imposed restrictions on attorney’s fees
- Required the plaintiff to provide complete information while filing the suit “if an allegation … is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed”
- Reaffirmed that those who aid and abet a fraud can be proceeded against by the SEC but not by private litigants[189]
- Introduced the concept of proportionate liability of defendants based on the percentage of total fault

What the Enron and other episodes show is that the regulator cannot be relied upon to protect investors and it is therefore necessary to depend more on private litigation to do this. There is a need to review some of the measures introduced by the Private Securities Litigation Reform Act.

7.4 Regulation induced monopolies and oligopolies

As discussed earlier in this report, and as pointed out in the Senate Committee Staff report the various private sector watchdogs – auditors, rating agencies and analysts – also failed to alert the public to the problems at Enron. One reason why these agencies failed

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is that the market structure had become a cosy oligopoly and therefore they did not face significant competitive market pressure to perform their jobs well. Unfortunately, much of this happened because of regulatory action and inaction. It is easy to see that regulators that seek to enhance their own power particularly the power of "moral suasion" would prefer oligopolies. First of all an oligopoly requires to be regulated and therefore the creation of an oligopoly makes the regulators own job secure. Second and more important, a regulated oligopoly creates huge rents and this gives powers to the regulator who can withhold those rents through various subtle actions. It is this power that is manifested in the form of "moral suasion." Moral suasion is not derived from law and not therefore subject to legal checks and balances. It is therefore power without accountability and hence most beloved to all regulators. For the same reason, moral suasion must be correctly described as immoral suasion because it is inimical to the interest of the public. The rents on which its success depends comes at the cost of the public. The following sections of the paper present some examples of regulatorily induced monopolies and oligopolies.

7.4.1 Accounting

It was not so long ago that the Big Four[190] accounting firm were the Big Eight. Many of us can even recall the times when there were twenty accounting firms that could be considered for the audit of the largest corporations in the world. Over the years, the number of such accounting firms has shrunk through mergers and through a process of marginalization of smaller firms.

Part of the reason was the complexity of the accounting standards and SEC regulations. The accounting pronouncements on a single not so important area of accounting could run into hundreds of pages. Large firms had a competitive advantage in keeping abreast of all of this particularly because they played a big role in the formulation of these rules in the first place.

The SEC did not always exercise its powers in a transparent manner and encouraged the accounting firms to consult with it on complex issues. Numerous no action letters were also issued which were often in violation of accounting standards as in the case of the use of mark-to-market accounting by Enron (see 2.2 above). Large firms certainly gain an inside edge in this process.

It is possible to argue that the requirement in the Sarbanes Oxley Act (and in the Naresh Chandra Committee report in India) to mandate rotation of the lead partner (rather than a rotation of the audit firm itself) would favour large firms. Large firms are more likely to have several senior partners with expertise in the same industry so that rotation can be done easily.

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7.4.2 Investment Banking

Superficially, it would appear that investment banking was highly competitive since the major banks went to great lengths to win clients. As evidence for such competition one could even cite all the false reports that they wrote to win investment banking mandates and the IPO allocations that they gave to the chief executives of their clients for the same purpose.

However, it is well known that intense non price competition is fully consistent with a collusive price fixing oligopoly[191]. It is possible to argue that the apparent competition in the investment banking industry (equity underwriting) was entirely of the non price variety and that there was practically no price competition. Price competition in investment banking has two aspects – first is the commission that the bank charges for its services and second is the price that it promises to fetch for the shares that it underwrites. Competition was arguably quite weak in both areas. If that were so, it would follow that where it really mattered, investment banking was a cosy oligopoly.

Partial evidence for the lack of competition is that during the last twenty years or so investment banking (especially the underwriting of equities) has become highly concentrated in a few bulge bracket firms. Attempts by highly capitalized European banks to break into this bulge bracket have been largely unsuccessful.

Once again, the complexity of the regulatory framework is at least partly to blame for the emergence of the oligopoly. During the last twenty years or so, the regulatory framework for securities issuance in the United States has become increasingly obsolete. As one influential comment[192] on this framework put it:

> "Over 60 years after the enactment of the Securities Act, the statute's premises have been rendered essentially irrelevant by changed market realities. The explosion of information technology, the volatility of securities prices, the dominant role of institutions and the globalization of the markets have forced the SEC to take administrative action to rationalize the public offering process. Notable SEC achievements to this end include the integrated disclosure system, shelf registration and the creation of safe harbors for institutional resales, offshore offerings and research activities. Without the SEC's achievements to date, U.S. corporations (with the possible exception of those engaged in initial public offerings) would long since have found the Securities Act an unacceptable anachronistic impediment to their ability to raise capital."

In dealing with this fundamental issue, the US SEC has attempted to ameliorate the problem with carefully crafted exemptions and relaxations that have arguably tended to favour large firms. The proposals[193] that the US SEC has made over the last decade to make fundamental changes in the regulatory framework have not been implemented.

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In this context it is disturbing that the settlement between the regulators and the banks threaten to exacerbate the oligopolistic structure of the industry. As the Economist noted[194]:

> "Big banks can always afford to pay fines, higher regulatory costs or contributions to third-party research; smaller ones cannot. Investment banking is already overly dominated by established 'bulge-bracket' firms, so much so that many companies complain of an underwriting cartel for new share issues. Indeed, this dominance may lie at the heart of the malfeasance that Mr Spitzer and his sort have uncovered. It would be a sad irony if supposed reforms ended up strengthening, not weakening, the bulge bracket's grip."

7.4.3 Credit Rating

Credit rating is an area where it would appear that the regulations in the US exist only to create cosy monopolies. The US SEC uses credit ratings in several of its rules, but does not meaningfully regulate them. The rating agencies (technically known as NRSROs, Nationally Recognized Statistical Rating Organizations) are registered under the Investment Advisors Act, but as the Senate Committee staff report[195] points out:

> "The legal application of the Investment Advisers Act to the credit rating agencies, however, is in doubt. As part of the designation, the agencies agreed to voluntarily register, but they insist that they are not covered by the Act and that any information they provide the SEC is given strictly on a voluntary basis, not pursuant to the requirements of the Act. The Act, in defining investment advisers, contains an exception for publishers, and the credit rating agencies would argue that they fit under that exception. To the extent that they are correct—and the case law on this point is very favorable to them—none of the requirements of the Investment Advisers Act would apply to them. In any event, the SEC has never taken enforcement action against the rating agencies based on their ratings, whether under the Investment Advisers Act or otherwise."

Thus the regulatory structure has given benefits to the rating agencies without casting any regulatory burden on them. As one academic testified[196]:

> "One of the sad consequences of this onslaught of regulation is that they have had the cumulative effect of removing both market forces and market incentives from the work performed by NRSROs. The NRSROs incentives in today's regulatory environment are to reduce costs as much as possible, knowing that regulation guarantees a fixed, stable demand for their services."

More importantly, the regulations have been anti-competitive in nature. The US SEC has stated[197] in testimony to Congress that:

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> "To assess whether a rating agency may be considered an NRSRO for purposes of the Commission's rules, the Commission staff consider a number of criteria. The single most important criterion is that the rating agency is nationally recognized, which means the rating organization is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. Thus the designation is intended largely to reflect the view of the marketplace as to the credibility of the ratings, rather than represent a "seal of approval" of a federal regulatory agency. …
>
> A number of observers, including the U.S. Department of Justice, have criticized the national recognition requirement as creating a barrier to entry for new credit rating agencies.[198] Generally, this argument is based on the premise that users of securities ratings have a regulatory incentive to use ratings issued by NRSROs, rather than non-NRSROs, and that this makes it quite difficult for non-NRSROs to achieve the national recognition necessary for Commission designation as an NRSRO." (footnote in original)

8 Investigative Process – US Experience

The US experience regarding the investigative process in Enron and other corporate frauds is that:

1. The regulators failed to detect the fraud.
2. After the fraud came to light, the trials have been speedy, effective and fair

The paper turns to a discussion of both these aspects of the US experience.

8.1 Failure to detect fraud

It is evident from all that has been said in this paper so far that the regulators failed to detect the fraud until it was too late. Moreover, in almost all cases, the regulators cannot claim credit for detecting the fraud either. In seeing what lessons can be drawn from this experience, we must keep in mind some of the important characteristics of the US regulator.

8.1.1 US SEC's experience, skill and budget are envy of world

The US SEC itself claimed in testimony[199] to Congress that:

> "I think that it is safe to say that there is no other country in the world that has anything that approaches the SEC in terms of its oversight of the markets, oversight of the preparer, the registrants and the auditors. It just doesn't exist."

Most impartial observers would agree with this assessment.

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8.1.2 Lewitt was one of the best SEC Chairmen

The Chairman of the US SEC during the period when the frauds took place was Arthur Lewitt who was widely seen as highly aggressive in protecting the investors' interests. He did not for example hesitate to take on the big accounting firms on the issue of separating consulting and research in the face of strong political opposition. It is possible to argue that Lewitt was the best Chairman that the SEC has had in the last half a century[200]. Perhaps, the last SEC Chairman of comparable or greater calibre was William Douglas[201].

This is important because it makes it difficult to attribute the failure of the US SEC to the incompetence of the Chairman or his unwillingness to offend vested interests.

8.1.3 SEC was focussed on accounting issues

Similarly, it is not possible to argue that the SEC failed to detect the accounting frauds because it did not pay much attention to accounting issues. Throughout the period, the US SEC was in fact strongly focused on accounting. The SEC Chairman and Chief Accountant made a number of high profile pronouncements on accounting issues. The Chief Accountant's speech about SPEs and long tailed cats has already been referred to[202].

8.1.4 Yet failed to detect frauds

Despite having the human and financial resources, despite having an aggressive Chairman and despite being focused on accounting issues, the SEC failed to detect the fraud at Enron and other companies. The failures of the SEC have been discussed at length in 6.6 above and there is no need to repeat all this. But it is useful to examine why the SEC could have missed things that were so obvious to a short seller or to the press. This has to do with the incentives or lack of it.

8.1.5 Perverse incentive (contrast between Lebed and Enron)

A good example of the perverse incentives that a regulator has is provided by a relatively trivial investigation to which the SEC devoted large resources with the personal involvement of the Chairman himself.

In September 2000, the US SEC settled[203] a stock manipulation case against a 15 year old kid, Jonathan Lebed. Lebed was the first minor to face proceedings for stock market fraud. Lebed had made $800,000 by trading stocks on the internet after talking them up in internet chat rooms. The SEC forced him to return $285,000 of these profits to settle the case, but that still left him with half a million dollars of profits. Many people believe as the New York Times wrote[204] "the S.E.C. let Jonathan Lebed walk away with 500 grand in his pocket because it feared that if it didn't, it would wind up in court and it would lose."

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It is obvious to any person who studies the facts of the case that the charges against Lebed were no different from the charges of false research that have been made against all the investment banking firms (see 4.5 above). Yet while the US SEC made no attempt to move against these research reports, it devoted substantial top management time to prosecuting a 15 year old kid and publicising it. The *New York Times* reported:

> "The Philadelphia office had brought the case, and so when the producer from '60 Minutes' called to say he wanted to do a big segment about the world's first teenage stock market manipulator, he called the Philadelphia office. 'Normally we call the top and get bumped down to some flack,' says Trevor Nelson, the '60 Minutes' producer in question. 'This time I left a message at the S.E.C's Philadelphia office, and Arthur Levitt's office called me right back.' Levitt, being the S.E.C. chairman, flew right up from Washington to be on the show."

The episode shows how utterly misplaced are the priorities of a regulator. The harm that Lebed did to the market could not have been even a miniscule fraction of the harm caused by the big banks or the harm caused by Enron. Yet the SEC had the time to go after Lebed, but no time to read the filings of the SEC or to go after the big investment banks.

The point is not that the SEC was doing something with evil motives. The point is to emphasize the kinds of incentives that regulators have. They will always spend time on things that have a lot of publicity and glamour value or are politically useful rather than spend time and energy doing the dull boring things that are really important to keep the markets fair and clean. The internet was glamorous; there was a lot of publicity mileage to be got by going after a minor and sending the message that the SEC will spare nobody, and there were no vested interests to be overcome. So the SEC found the time and resources to do it though the benefit to the investing public was probably negligible.

8.2 Speedy, effective and fair trial after detection

Though the regulators failed to detect the frauds for several years as they were being committed, the investigations have moved fairly quickly after the frauds came to light. The accounting firm, Arthur Andersen has virtually ceased to exist as a result of legal charges brought against it in relation to the Enron case. The big investment banks have paid fines of $1.4 billion to settle charges relating to false research reports. Trials are in progress against many people involved in the frauds.

That is not to say that there are no complaints about the process. Questions are being asked as to why action against some Enron executives has been slow in coming. There is also a perception that some investment banks and their chairmen have got away rather lightly. Yet the overall assessment must be that of reasonably speedy, effective and fair trials particularly in contrast to other jurisdictions.

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8.2.1 Contrast with other jurisdictions (e.g., India and France)

A good contrast to the US experience is provided by the example of the noted billionaire George Soros being fined $2.26 million by a French court in December 2002 for an insider trading alleged to have been committed in 1988. It is strange that the conviction came 14 years after the incident. And it is even stranger that the penalty was only a fine too small to make a material difference to the fortunes of one of the richest men in the world. Lastly, questions have been raised[205] about the fairness of the trial in view of the fact that several French businessmen implicated in the case were let off and only an American citizen was convicted.

Another contrast is provided by the Indian experience with the securities scam of 1992. A Special Court was set up by statute to ensure faster trials of the scam cases. A decade after the scam came to light, 66 out of the 72 cases arising out of this scam have yet to be adjudicated[206]. Out of the 6 cases disposed of by the courts, 3 resulted in conviction and 3 in acquittal.

8.3 Open and Transparent Processes

Another important aspect of the US experience is that subsequent to the discovery of the frauds, the investigative processes have been open and transparent. All the Congressional hearings are conducted in public and the transcripts of the hearings have been printed and made available on the internet. In many cases, video recordings are also available on the internet. Thus we have the benefit not only of the reports that have been published by Congressional committees but also of a great deal of the evidence that the Committees have gathered in the process of their investigations. Also, the hearing transcripts are available long before the committee finalizes its reports. This paper itself has cited the testimony at these hearings far more often than the Committee reports themselves. It was quite evident while writing this paper that hearing transcripts are far more valuable, incisive and insightful than the reports of the Committees that conducted these hearings.

By contrast, in India, the Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters Relating Thereto conducted its hearings behind closed doors and did not publish transcripts of its hearings[207]. The JPC records that it received six investigation reports from the Securities and Exchange Board of India. These have also not been published.

9 Lessons to be learnt

At the end of a long paper, it is useful to summarize the lessons to be learnt from all this. These lessons have been brought out in detail in the body of the paper. So it is scarcely necessary to provide lengthy justification for these conclusions.

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9.1 Strengthen market discipline because regulators are poor at detecting fraud

The Enron and related scandals demonstrate a massive regulatory failure. More importantly, they demonstrate regulatory failures that do not admit of any easy fixes. Instead one must proceed on the basis that such state failure are inevitable and try to strengthen the processes of market discipline. The market failures that took place are fixable and should be fixed. The action that needs to be taken are listed below:

9.1.1 Encourage hostile take overs

The foundation of sound corporate governance is a well functioning market for corporate control. Hostile takeovers are the market's primary mechanism for discipline delinquent managements and no regulatory restrictions should be placed on them. The US decision to shut down this market during 1989-90 was a costly mistake as discussed in detail in 7.1 above.

In India, there have been only a handful of hostile takeover bids in the last several years and most of these hostile bids have been defeated. That this should be so in a period of rising investor dissatisfaction with the governance and performance of the Indian corporate sector is both surprising and distressing. More than the deficiencies in the take over code itself, it is the major weaknesses in the financial sector that have led to this unsatisfactory state of affairs. In particular, the limited availability of leveraged financing in India, the regulatory bias against innovative financial instruments, and the general climate of political hostility to corporate raiders are to blame.

Regulators worldwide should eliminate this bias against hostile takeovers and recognize them as an essential part of a healthy market for corporate control.

9.1.2 Allow free short selling

The short sellers are the only category of people to have come out of these scandals with an enhanced reputation. Short sale restrictions are an open invitation to company managements to manipulate the prices of their stocks. These restrictions must go in order to have a genuinely free market and prevent recurrence of such frauds as discussed in 7.2 above.

In India, there are severe restrictions on short selling and these restrictions are the single most important culprit for the frequency and severity of episodes of stock market manipulation that have taken place in this country during the last decade[208]. All institutions (including banks, financial institutions, mutual funds and foreign institutional investors) are prohibited from short selling in the Indian capital market. This restriction has been in place for a long time, but the restriction has become more serious with the progressive institutionalisation of the capital market in the 1990s. Over a period of time, therefore, an increasingly large and important segment of the market has been precluded from short selling. Moreover, at various critical junctures (most recently in March 2001),

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the regulators have moved to impose a total ban on short selling by all investors. Above all, the absence of a working mechanism of securities lending inhibits short selling.

Regulators worldwide should eliminate all impediments to short selling and allow all categories of investors to short securities without restriction. Countries which do not have an effective and viable mechanism of securities lending, must create these mechanisms quickly.

9.1.3 Permit class action lawsuits

Where the regulators are negligent, the victims must be encouraged to defend their own interests vigorously. The single biggest strength of the US capital market is not the SEC but the class action law suit. Countries like India which do not have a class action mechanism must create them and countries like the US which do have them should strengthen them as discussed in 7.3 above. Violation of any company law or securities law requirement should give the investor the right to sue the company and its management. This would empower the investor to protect his own interests. It is far more important to empower the investor than to empower the regulator.

9.1.4 Promote competition in the securities industry

When regulations induce monopolies and oligopolies, the result is to weaken market discipline. It is imperative to have a competitive market structure in accounting, investment banking and credit rating so that these private sector watchdogs have the market incentives to do their job well. The oligopolies that afflicted key private sector watchdogs in the US have been documented in 7.4 above. The US needs radical reforms to make these industries competitive.

Other countries also have anti-competitive regulations of very different kinds. In India, the Institute of Chartered Accountants of India imposes a Code of Ethics that amounts to cartelization of the accounting industry. Clause (6) of the code prohibits an auditor soliciting clients or professional work by circular, advertisement, personal communication or interview or by any other means. Clause (7) of the code prohibits an auditor advertising his professional attainments. These restrictions are highly pernicious. In the United States, the audit firm, PricewaterhouseCoopers, has released full-page newspaper advertisements stating[209] its willingness "to ask the tough questions and tackle the tough issues," and declaring that "In any case where we cannot resolve concerns about the quality of the information we are receiving or about the integrity of the management teams with whom we are working, we will resign." In India, an audit firm would not be able to communicate such a stand to investors because of the ban on advertising. Since auditors are in practice appointed by company managements to serve shareholders, the ability of the auditor to advertise directly to shareholders is absolutely critical.

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These problems are not restricted to accounting. In the case of investment banking, the Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992, Schedule III, Code of Conduct for Merchant Bankers provides that "A merchant banker shall not make any statement or become privy to any act, practice or unfair competition, which is likely to be harmful to the interests of other merchant bankers or is likely to place such other merchant bankers in a disadvantageous position in relation to the merchant banker, while competing for or executing any assignment." This provision is clearly anti-competitive and serves no legitimate purpose. It is a different matter that in India, the emergence of a bulge bracket of investment banking firms has been more muted than in the United States. The fact is that India has had a prolonged drought of primary market equity issuance and the competitive dynamics of the industry are yet to play themselves out fully.

In the case of credit rating, India unlike the United States has a transparent regulatory regime that avoids the implicit barriers to entry described in 7.4.3 above. Under these regulations, any company with a net worth of Rs 1 billion can establish a rating agency. Banks, financial institutions and foreign rating agencies can set up rating agencies in India even if they do not meet this net worth requirement.

Regulators worldwide should identify the anti competitive effects of their regulations and redress them as rapidly as possible. Regulators should recognize that while they have a mandate to protect the investors, they have no mandate to protect their regulatees. Regulations that try to ensure that competition is "nice" and "gentlemanly" should be discarded.

9.2 World must learn from US to prosecute and punish wrong doers swiftly after they are caught

The US has shown that it can prosecute and punish wrong doers far more speedily than most other jurisdictions. It has also shown that it is possible to have reasonably fair and effective trial processes as discussed in 8.2 above. These are lessons that the rest of the world including India need to learn quickly.

9.3 Changes Required in Regulation and Supervision

The major thrust of this paper has been that the massive regulatory failure that took place in the context of Enron and other corporate frauds is inherent in the regulatory process. Regulations, however elaborate, and regulators, however powerful, cannot prevent frauds from taking place. In this sense, therefore, the process of strengthening market discipline (9.1 above) and the deterrence of fraud through speedy trials (9.2 above) are far more important than the reforms that are outlined in this section. Yet, the frauds that have come to light in the last couple of years have revealed several serious deficiencies in the regulatory system and it is necessary to fix them.

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9.3.1 Review of Accounting Filings

The US system of review of accounting filings by the SEC did not work in the case of Enron and other frauds. The US would benefit from a drastic change in the method of selecting companies for review of their filings by giving investors greater information and control in the process. This paper would propose that:

1. The US SEC should disclose on a real time basis which filings it has reviewed and the action if any that it has taken on the basis of that review. The high level of secrecy that the SEC currently maintains about these matters is totally dysfunctional[210] and goes against its basic mandate for investor protection.

2. Any investor should be able to force the SEC to review any specific filing by paying a fee to the SEC of say $15,000. Publicly available information about the SEC budget, staffing patterns and workload indicates that the proposed fee of $15,000 would cover the cost of the review[211].

Some people may object to the very idea that the regulator could cede control of the review process even partially to the investors. But this is an entirely healthy thing to happen. The SEC proudly calls itself "the investors' advocate" and if it takes this description seriously, there is nothing wrong in the regulator taking his brief from the investor.

Many other countries like India do not have a system of review at all. In India, annual accounts are filed with the Registrar of Companies under the Department of Company Affairs in the Government of India. But there is no system of reviewing accounting reports even on a selective or sample basis. The Naresh Chandra Committee has also not made any recommendations in this area.

India could also adopt a system similar to that proposed above for the SEC. Given the lower employee compensation levels in India, it is likely that a review fee of approximately Rs 100,000 should cover the costs of reviewing a filing in India[212]. Since India does not currently have a system of regular review of filings, it would be a good idea to begin with reviews only on demand (that is on payment). Depending on the experience with this system, it may be possible to extend this to include a component of suo motu review as well. Initially, it may be possible to have the review completely outsourced to accounting or legal firms in which case it may be necessary to increase the fee to cover the profit margin of these firms as well.

The reader might wonder whether anybody would actually pay even a modest fee of $15,000 or Rs 100,000 to get the regulator to review a filing when the results of the review would be publicly released and would not be the privileged information of those who pay for it. The answer is that a short seller or a corporate raider would benefit from the price fall that follows an adverse review, and would be willing to pay for a review when there is prima facie reason to believe that a review would lead to regulatory action.

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Thus the success of this measure is dependent on there being free short selling and a vibrant market for corporate control. The proposal would therefore be a process of facilitating market discipline and not a substitute for it.

9.3.2 Oversight of Audit Firms

In the United States, the Sarbanes Oxley Act has for the first time introduced a (potentially) credible and independent body to oversee the audit industry. It remains to be seen whether this body will live up to its promise and whether it would make a worthwhile contribution to the deterrence and detection of accounting fraud. There is however merit in this idea and other countries including India need to move in this direction. It is disappointing to note that the Naresh Chandra committee in India has recommended a review mechanism that is similar to the widely discredited Public Oversight Board that existed in the United States prior to the Sarbanes Oxley Act.

9.3.3 Vast improvement in accounting standards

Accounting standards today are unnecessarily complex, ad hoc and lacking in conceptual foundations. These deficiencies need to be rectified. Accounting standards must be based on sound theoretical foundations and not on pragmatic considerations. It is necessary to put the 'principles' back into 'Generally Accepted Accounting Principles' or GAAP. Such principle based standards would be closer to the International Accounting Standards than to the US standards.

Yet even the International Accounting Standards are not completely free from the complexities and ad hocism of the US standards. A good illustration of this phenomenon is provided by the International Accounting Standard, IAS 39, *Financial Instruments: Recognition and Measurement,* which establishes principles for recognising, measuring, and disclosing information about financial assets and financial liabilities. The standard is so complex[213] that it is accompanied by an implementation guidance[214] running into over 150 pages. The Standard is full of ad hoc exemptions that make the standard long, complex and difficult to understand. To give one example, the standard excludes financial guarantee contracts that provide for payments to be made if the debtor fails to make payment when due. This was an exception tailored to exclude letters of credit and other similar instruments. However, many credit derivatives, such as certain credit default swaps would also be excluded under this clause. The credit derivatives market is growing rapidly and is estimated to have a notional amount outstanding of $2 trillion as at the end of 2002[215]. The ad hocism of the standard is even more apparent when it is realized that not all credit derivatives are excluded from the standard. A credit derivative is within the scope of IAS 39 if it makes a payment based on a ratings downgrade or a change in credit spread or the debtor's default on debt payable to a third party. Scores of similar examples can be given of how attempts to placate some vested interest or the other leads to several layers of irrational exceptions and exceptions to the exceptions that make the standard an exercise in sophistry.

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The International Accounting Standard Board and several national standard setters have been working on a much simpler standard that treats all financial assets and liabilities in the same way. This effort[216] produced a 50 page draft standard and a 70 page application supplement that would be a vast improvement over existing standards but progress in this direction has been extremely slow. Moreover this draft too has several exemptions (for example, insurance contracts) and some highly ad hoc provisions relating to securitization that detract from a true principles-based-approach.

There should be a concerted effort at the international level to rationalize and simplify the accounting standards, eliminate exemptions for vested interests and put the accounting standards on a sound theoretical basis derived from first principles.

9.3.4 Real time disclosures of underlying data

In this day and age when business moves at the speed of thought, it is necessary to move towards faster and more detailed disclosure of information. It is necessary to disclose a great deal of the underlying data on which the accounting statements are based in order to provide investors with meaningful information.

Historically, the frequency of corporate disclosure was constrained by the cost of disseminating information. A paper based reporting system becomes prohibitively expensive beyond an annual or quarterly frequency. However, with the emergence of electronic dissemination through the internet, dissemination cost has ceased to be a barrier to more frequent disclosure. In many sectors, companies do voluntarily reveal data on a weekly or even daily basis. For example, the world's largest retailer, Wal Mart[217] puts out a release every Monday on its web site giving a summary of the sales pattern during the preceding week including an indication of geographic sales patterns as well as product category wise trends. This is supplemented with more quantitative data every month. In the entertainment industry, daily revenue data is publicly available. When a new film is released, investors are able to track box office collections on a daily basis and this information is reflected in the stock price of the film studio. For example, when Walt Disney released its animation film *Treasure Planet* just before the Thanksgiving weekend, the box office data allowed the financial press to report on Monday that the film had flopped; the next day, the company issued a profit warning; and by the middle of the week, analysts were debating the future of traditional film animation[218]. These voluntary disclosures show that high frequency disclosure is possible cost effectively with current technology. The time has come to mandate these disclosures for a much wider range of industries and companies. Over the next decade or so, daily disclosure of revenue and operational data and monthly reporting of profits should become the norm for all publicly traded companies.

Historically, the size of the annual or quarterly accounting report has been limited by the cost of dissemination and retrieval. Electronic dissemination eliminated the dissemination cost, but until recently the retrieval cost was still prohibitive. An investor who received a 5,000 page annual report (in paper or electronic form) would have enormous difficulty in

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wading through the whole report and finding what was useful. However, new technologies are solving this problem as well. Of particular importance in this context is the emergence of XBRL[219] (eXtensible Business Reporting Language), an electronic language that allows financial data to be presented in a form that a computer can understand and interpret. XBRL allows a computer to "read" large amounts of financial data and extract only the information that is desired by a particular user. What this means is that a company can today publish a 10,000 page annual report[220] in XBRL without worrying about how investors will digest this information overload. Given this huge XBRL annual report, one investor might ask his computer to extract a twenty page summary similar to a conventional annual report. Another user might ask his computer to extract the full details of all the SPEs with which the company is involved. Evidently, Enron would have found it very difficult to hide its SPEs if it has been required to make such detailed disclosures. Similarly, Enron would have found it difficult to abuse mark to market accounting if had been required to publish an XBRL annual report that contained full details of the pricing methodology including the forward prices and implied volatilities that were used.

Several large companies including Microsoft[221] are already publishing their annual reports in XBRL. What is proposed in this paper is that instead of merely converting the existing annual report into XBRL, regulators should take the opportunity provided by the new technology to mandate a massive increase in disclosure requirements (perhaps a hundred or even a thousand times what is required today). The technology allows this to be done without great cost to the company[222] and without creating an information overload for the vast majority of investors who may want only a brief summary of the financial position of the company.

This vast majority would want assurance that the brief summary that they extract from the raw report is honest. The best assurance of this is provided by the small minority of investors and analysts who do pore over the minute details of the full report looking for contradictions, errors and warning signals. The question is what gives them the incentives to do this. That brings us back to market discipline. It is the short seller, the corporate raider or the class action lawyer who would find it worthwhile to spend time and money doing this because he stands to profit from the information that he uncovers through this process. Private sector watchdogs like credit rating agencies would also use put in this effort if they faced enough competitive pressure to do so. In other words, strengthened market discipline (discussed in 9.1 above) is critical and the regulatory interventions discussed above can only facilitate the process of market discipline.

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[1] 2000 Annual Report, Enron Corporation

[2] Skilling became President and Chief Operating Officer (COO) on January 1, 1997 (Enron Corporation Press Release, December 10, 1996) and Chief Executive Officer (CEO) on February 12, 2001 (Enron Corporation Press Release, December 13, 2000).

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[3] 1999 Annual Report, Enron Corporation

[4] For a vivid description of the struggle between Rebecca Mark and Jeffrey Skilling see "Enron's dirty linen", *Newsweek,* March 11, 2002. For a more matter of fact analysis of their respective strategies see "The Amazing Disintegrating Firm", *Economist,* December 8, 2001.

[5] Rebecca Mark quit Enron in August 2000 (Enron Corporation Press Release, August 25, 2000), after being sidelined by Skilling's ascendancy.

[6] Enron stated in its 2000 Annual Report: "Enron's continued investment grade status is critical to the success of its wholesale businesses as well as its ability to maintain adequate liquidity. Enron's management believes it will be able to maintain its credit rating."

[7] The example of Mahonia in 2.3 below shows how easy it is to get an outsider to make a small gift that serves as the equity investment in an SPE.

[8] The FASB's Emerging Issues Task Force (EITF) discussed the accounting for leases in which an SPE is the lessor in EITF Issue No. 90-15, "Impact of Non Substantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions". The EITF decided that the lessee must consolidate the SPE lessor inter alia if "The owner of record of the SPE has not made an initial substantive residual equity investment that is at risk during the entire term of the lease." In interpreting this decision, the US Securities and Exchange Commission (SEC) staff provided further guidance stating that "The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC Staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed." The SEC's acting chief accountant communicated the SEC staff views to the EITF Chairman and the EITF took this letter on record.

[9] See 6.5.1 below for a discussion of this criticism and the standard setter's response.

[10] Unless otherwise stated, all the facts relating to Enron in this section are based on the Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation, (William C. Powers, Jr., Chairman), February 2002. This report is known as the Powers Report.

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[11] Two years later, Enron allowed Fastow himself to set up the LJM partnerships discussed in the next section.

[12] Traditionally, employers have given certain medical and other benefits to the spouses of their employees. In recent years, employers in the United States have allowed employees to designate a person other than a legally married spouse as the "domestic partner" to whom these benefits are then extended. Typically, a "domestic partner" is a same-sex or opposite-sex partner with whom the employee shares his/her life in a committed relationship.

[13] There is however the question of disclosure. Normally, guarantees and commitments should be disclosed. What happened in the Enron case is not clear. While the annual report did disclose some guarantees in respect of non consolidated affiliates, it does not appear to cover all the guarantees and commitments made by Enron in respect of its various SPEs. An accounting expert testified to the US Congress that he could not explain why these disclosures were not there: "… we do have an accounting standard that requires that guarantees of the indebtedness of others be disclosed, even if the possibility of a loss resulting from that is remote. I have struggled to understand why there was—and I have not found it—but why there was no disclosure of those guarantees, why there was no disclosure of those commitments. Using my own reasoning, I can start to develop pathways for why it may have been believed that the disclosure standard I just referred to didn't apply in that circumstance, but it gets rather speculative. And so I just—I haven't seen enough facts in the public record for me to dispositively say, here is why they did what they did or didn't do what they did." (Oral Testimony of Prof. William W. Holder before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, May 1, 2002, page 70)

[14] The FASB's Emerging Issues Task Force (EITF) decided in the context of leasing transactions where the lessor is an SPE that "An initial substantive residual equity investment must represent an equity interest in legal form, must be subordinate to all debt interests, and must represent the residual equity interest throughout the term of the lease." (EITF Issue No. 96-21 "Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities")

[15] In testimony before the US Congress, the auditors stated that "Based on documents we did not have in 1997 but that were made available to us in early November 2001, we now know that the $11.4 million — 'equity interest' provided by Barclays was, in fact, in the form of yield certificates the bank purchased from two intermediary entities, Big River Funding LLC and Little River Funding LLC. If these facts had been known to us in 1997, a key issue would have been the terms of the certificates. Depending on the terms, Enron could have been required to treat the capital as debt rather than equity, disqualifying the SPE from non-consolidation." (Prepared Testimony of Joseph F. Berardino, Managing

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Partner – Chief Executive Officer, Andersen, before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, February 5, 2002).

[16] Form 8K filed by Enron on November 8, 2001 with the United States Securities and Exchange Commission.

[17] Prepared Testimony of Joseph F. Berardino, Managing Partner – Chief Executive Officer, Andersen, before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, December 12, 2001.

[18] See 6.3 below for a discussion of the responsibilities of the auditor under US law.

[19] Prepared Testimony of Mr. Thomas H. Bauer, Partner, Andersen LLP, before the Subcommittee on Oversight and Investigation, Committee on Energy and Commerce, U.S. House of Representatives, February 7, 2002

[20] Silber, W. L. (1991), "Discounts on restricted stock: The impact of illiquidity on stock prices", Financial Analysts Journal, 47, 60-64.

[21] Silber's regression equation is:

$$\ln(100\text{-Percent_Discount}) = 4.33 + 0.036 \ln(\text{revenues}) - 0.142 \ln(\text{percent_stake}) + 0.174\ \text{earnings_dummy} + 0.332\ \text{customer_dummy}$$

The earnings dummy equals 1 if earnings are positive and the customer dummy is 1 if the buyer of the restricted shares is a customer of the company.

In our case revenues=$40 billion, percent_stake = 100*3.4/705, earnings_dummy=1 and customer_dummy = 0. According to the equation, the percent_discount is negative, and so must be taken as zero or negligible.

[22] It may be noted that it was not sufficient for LJM1 to meet the 3% outside equity requirement. This requirement had to be met at the level of Swap Sub also. It may be recalled that LJM1 was a limited partner of Swap Sub and had no liability for the Rhythm puts beyond the capital that it had contributed to Swap Sub. The FASB's Emerging Issues Task Force (EITF) had specifically dealt with multi-tier SPE structures in the context of leasing transactions and decided that "… the conditions set forth in Issue 90-15 are to be applied at the lowest level at which the parties to a transaction create an isolated entity, whether by contract or otherwise." (EITF Issue No. 96-21)

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[23] Prepared Testimony of Joseph F. Berardino, Managing Partner – Chief Executive Officer, Andersen, before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, December 12, 2001.

[24] Joint Working Group of Standard Setters, *Recommendations on Accounting for Financial Instruments and Similar Items,* December 2000. The Joint Working Group consists of nominees of accounting standard setters or other professional organizations in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the United Kingdom, and the United States, as well as the International Accounting Standards Committee (now known as the International Accounting Standards Board).

[25] *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs,* Report Prepared by the Staff of the Committee on Governmental Affairs, United States Senate, October 7, 2002. The facts regarding SEC's consent to Enron's mark to market accounting in this and the following paragraphs are from this report.

[26] The FASB' interpretative body, the EITF sanctioned this in EITF Issue No 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities".

[27] See footnote 25 above.

[28] Form 8K filed by Enron with the US SEC on April 22, 2002 containing the operating statement filed with the bankruptcy court.

[29] Currently known as JP Morgan Chase

[30] This description is based on the Prepared Testimony of Mr. Robert Roach, Chief Investigator, Permanent Subcommittee On Investigations, Committee On Governmental Affairs, United States Senate, July 23, 2002

[31] See footnote 30

[32] Statement of JP Morgan Chase & Co. Submitted to Permanent Subcommittee On Investigations, Committee On Governmental Affairs, United States Senate, July 23, 2002

[33] Roach's testimony cited earlier. Mourant put a very ingenuous spin on this when its senior partner testified in court that "Chase may well have requested but the decision to make the gift [that set up the trust] is for Mourant alone. We could not be required in any shape or form to make that gift" ("Focus on offshore vehicle in $1bn Enron case", *Financial Times*, December 6, 2002).

[34] See footnote 30

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[35] "Hit for J.P. Morgan could be huge: Enron-linked energy-trade venture could cost bank $1 billion" by Jathon Sapsford and Anita Raghavan, *The Wall Street Journal,* January 25, 2002

[36] "JP Morgan settles with insurers over Enron", *Financial Times,* January 2, 2003.

[37] Unless otherwise stated, the facts relating to WorldCom in this section are from the First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, In re WorldCom, Inc., et al, Submitted to United States Bankruptcy Court, Southern District Of New York, November 4, 2002

[38] Memorandum Prepared By WorldCom CFO Scott Sullivan during June 21-24, 2002 Outlining His Position on the Transfers of WorldCom Line Costs to Capital Accounts, Exhibit 4 of Revised Statement filed by WorldCom with the United States SEC on July 8, 2002 pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934.

[39] OC-192c refers to a backbone with a very high transmission speed (10 gigabits per second).

[40] Press release dated March 27, 2002 announcing results for last quarter of 2001; Form 8Ks filed with the US SEC on May 24, 2002 and June 9, 2002. See also Complaint filed by the US Securities and Exchange Commission against Adelphia Communications Corporation and others, United States District Court, Southern District of New York, July 24, 2002

[41] "Managed Entitites" was the term used by Adelphia (while under Rigas management) for what this paper (following the SEC) refers to as the "Rigas entities"

[42] SEC Complaint, cited in footnote 40

[43] Adelphia pres release March 27, 2002.

[44] SEC Complaint, cited in footnote 40

[45] SEC Complaint, cited in footnote 40

[46] United States General Accounting Office, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges,* Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, October 2002

[47] Xerox Corp, Form 10-K filed with the US SEC on June 28, 2002.

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[48] KPMG Statement dated June 28, 2002.

[49] "KPMG Expects S.E.C. Move Over Audits Done for Xerox", *New York Times,* January 23, 2003.

[50] AOL Time Warner, Inc. Form 8K filed with the US SEC on October 23, 2002.

[51] EBITDA, earnings before interest, taxes, depreciation and amortization is a widely used measure of profitability.

[52] "Unconventional Transactions Boosted Sales: Amid Big Merger, Company Resisted Dot-Com Collapse", *Washington Post,* July 18, 2002 and "Creative Transactions Earned Team Rewards" , *Washington Post,* July 19, 2002.

[53] Prepared testimony of Mr. Roy Olofson, Former Vice President of Finance, Global Crossing Ltd. before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, US House of Representatives, September 24, 2002

[54] Prepared testimony of Mr. John M. Morrissey, Deputy Chief Accountant, U.S. Securities and Exchange Commission, before the Subcommittee on Oversight and Investigations, Committee on Financial Services, US House of Representatives, March 21, 2002. Mr. Morrissey added that "Capacity swap transactions likely include complex terms that would require a diligent analysis and professional judgment to determine the proper accounting treatment."

[55] US SEC staff memo to the SEC Regulations Committee of the American Institute of Certified Public Accountants, http://www.aicpa.org/members/div/secps/iru_cap_swap.htm, August 2002

[56] Ketz, J. E., "Telecom Swaps: The SEC Finally Arrives at the Scene of the Crime", http://www.smartpros.com/x35354.xml, October 2002.

[57] Electronic Data Systems Corporation, Form 10-Q filed with the US SEC for the quarter ended September 30, 2002

[58] "Did bad accounting encourage this fiasco?", *New York Times,* November 8, 2002.

[59] First Interim Report Of Dick Thornburgh, Bankruptcy Court Examiner, In re WorldCom, Inc., et al, Submitted to United States Bankruptcy Court, Southern District Of New York, November 4, 2002

[60] Cited in footnote 10 above

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[61] US SEC's complaint against L. Dennis Kozlowski, Mark H. Swartz and Mark A. Belnick, United States District Court, Southern District of New York, September 12, 2002

[62] Form 8K filed by Adelphia Communications Corporation with the US SEC on May 24, 2002.

[63] SEC Complaint, see footnote 40

[64] SEC Complaint, see footnote 40

[65] Form 8K filed by Adelphia Communications Corporation with the US SEC on May 24, 2002.

[66] Unless otherwise stated, the facts in this section are from the complaint filed by the US Government in United States of America v. Samuel Waksal before the United States Magistrate Judge, District of New York, June 12, 2002 and the Indictment in the same case on August 7, 2002.

[67] Waksal had a doctorate in immunobiology.

[68] "ImClone's Waksal Pleads Guilty To 6 Charges", *The Washington Post,* October 16, 2002

[69] See United States of America v. Douglas Faneuil, Misdemeanour Information filed by the US Attorney before the United States District Court, Southern District of New York.

[70] Letter dated September 10, 2002 from the Committee on Energy and Commerce, US House of Representatives to the US Attorney General.

[71] *The Role of the Board of Directors in Enron's Collapse*, Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, July 8, 2002. Unless otherwise stated, all the facts in this section are from this report.

[72] "State Suit Seeks Repayment of IPO and Stock Option Profits of Corporate Executives: Spitzer Charges Hot IPO Offerings and Inflated Stock Ratings Were Used to Secure Investment Banking Business", Press Release, Office of New York State Attorney General Eliot Spitzer, September 30, 2002

[73] "Goldman Sachs Cited For IPO Favoritism: Panel Releases Details of Grants to Clients", *Washington Post,* October 3, 2002; "Analyst's '99 E-Mail Details IPO Rewards: Credit Suisse Says She Got It Wrong", *Washington Post,* September 7, 2002

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[74] This Web exclusive series http://www.redherring.com/ipo/2001/0502/310019231.html appeared in seven parts at RedHerring.com from May 2, 2001 to May 10, 2001.

[75] See "Why CSFB and not the others?," Part Five of RedHerring.com's "IPO Antics" Series, May 8, 2001, http://www.redherring.com/ipo/2001/0508/680019268.html This article also quoted Columbia University School of Law professor John C. Coffee as saying: "It does make more sense for SEC … to go after CSFB, because it's not the kind of institution that has the power of a Goldman, Morgan, or Merrill Lynch in Washington, D.C.". But it also pointed out that "During the high-tech IPO boom of 1999 and 2000, CSFB was literally the Big One, leading 79 technology IPOs in 1999 and 60 technology IPOs in 2000, nearly double the number of deals of any other bank."

[76] The US SEC has not been in the forefront of the investigations regarding these allegations.

[77] Complaint filed by the US Securities and Exchange Commission against Credit Suisse First Boston Corporation in the United States District Court, District Of Columbia, January 22, 2002.

[78] US Securities and Exchange Commission v Credit Suisse First Boston Corporation, "Final Judgment of Permanent Injunction and Other Relief against Credit Suisse First Boston Corporation", United States District Court, District Of Columbia

[79] Actually, $70 million of this was described as a disgorgement of money improperly obtained by CSFB. However, this amount was to be paid to the US Treasury and not either to the CSFB customers or to the issuer companies. As such, it is perhaps best described as a fine.

[80] R. G. Ibbotson and J. R. Ritter, "Initial Public Offerings', Chapter 30 of Robert Jarrow (ed), *Handbooks in Operations Research and Management Science, Volume 9, Finance*, 1999 is a good survey paper that reviews empirical studies from 27 countries and also discusses several competing explanations for the phenomenon.

[81] See "Adventure I: Silver Blaze" in *Memoirs of Sherlock Holmes* by Arthur Conan Doyle

[82] The data in this paragraph come from the Prepared Testimony of Professor Susan J. Stabile before Committee on Governmental Affairs, U.S. Senate, February 5, 2002 and from "A poor retirement" by Andrew Hill and Elizabeth Wine, *Financial Times*, December 11, 2001

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[83] Prepared Testimony of Mr. Joseph P. Szathmary, Associate, Northern Trust Retirement Consulting, LLC, before the Committee on Governmental Affairs, United States Senate, February 5, 2002

[84] Prepared Testimony of Catheryn Graham on Behalf of Hewitt Associates before the Committee on Governmental Affairs, United States Senate, February 5, 2002

[85] Most of the proceedings against SSB have been arbitration proceedings under the auspices of the self regulatory organization of securities firm – the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). As such, full details of the charges are not publicly known. The principal source of information about the precise nature of the allegations is perhaps a Special Study (http://www.publicinvestorsattorney.com/SpecialStudy.PDF) published by an attorney of some of the WorldCom employees. See also Gretchen Morgenson, "Salomon Faces Complaints over Options at WorldCom", *New York Times*, April 24, 2001.

[86] More precisely, a call option on a non dividend paying stock should never be exercised before maturity provided the option itself is tradable. The fair value of an option is equal to the intrinsic value plus the time value of the option. In the case of exchange traded options, one can always sell the option (and realize its fair value) rather than exercise it (and realize its intrinsic value).

[87] See footnote 85 above.

[88] This list of problems is drawn from "After Enron - agenda for reform 2002: Unofficial watchdogs need sharper eyesight", *Financial Times*, February 14 2002

[89] Affidavit in Support of Application for an Order under the Martin Act, Attorney General of the State of New York v. Merrill Lynch & Co., Inc., and others, in the Supreme Court of the State of New York, County of New York, April 2002

[90] Agreement between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc., dated May 21, 2002

[91] New York Attorney General' affidavit cited in footnote 89 above

[92] Prepared testimony of Mr. John Olson, Senior Vice President and Director of Research, Sanders Morris Harris before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, US House of Representatives, February 7, 2002

[93] Prepared testimony of Mr. Charles L. Hill, Director of Research, Thomson Financial / First Call before the joint session of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises and the Subcommittee on Oversight and

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Investigations, Committee on Energy and Commerce, US House of Representatives, 12 October 2001

[94] Prepared Testimony of New York State Attorney General Eliot Spitzer before the Subcommittee on Consumer Affairs, Foreign Commerce and Tourism, Committee on Commerce, Science and Technology, United States Senate, June 26, 2002

[95] The facts in this and the following paragraphs are based on Spitzer's affidavit cited in footnote 89 above.

[96] This was described as a payment made in civil settlement of the claims of New York and of the other 49 states. Roughly half the amount went to New York and the other half to the remaining states.

[97] "SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement To Reform Investment Practices: $1.4 Billion Global Settlement Includes Penalties and Funds for Investors", Press Release 2002-179, U.S. Securities & Exchange Commission, December 20, 2002

[98] Statement at the Announcement of Agreement in Principle on Research Analyst Issues by Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities & Exchange Commission, December 20, 2002

[99] "European companies: Not so different after all", *The Economist*, July 11, 2002

[100] Complaint for Injunctive Relief filed by Securities and Exchange Commission against Lernout & Hauspie Speech Products N.V., United States District Court For the District of Columbia, October 2002

[101] This description is based on "How High-Tech Dream Shattered in Scandal at Lernout & Hauspie", *The Wall Street Journal,* December 7, 2000

[102] Press Release dated September 25, 2002 included in Form 6K filed by Vivendi with the US SEC on the same date.

[103] Press Conference: Slides and Notes Presentation, part of Form 6K filed by Vivendi with the US SEC on September 25, 2002.

[104] Press release cited in footnote 102 above

[105] Form 6K filed by Vivendi Universal with the US SEC on July 2, 2002.

[106] "Vivendi Universal: Messier's Mess", *Economist,* June 6, 2002

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[107] Press Conference: Slides and Notes Presentation cited in footnote 103 above.

[108] ABB Limited, Press Release dated February 13, 2002 "ABB Board of Directors reassesses benefits of former CEOs" and Press Release dated March 10, 2002, "ABB reaches settlement agreements with former CEOs on benefits".

[109] "ABB: Barnevik's bounty", *The Economist,* February 28, 2002

[110] "Sporting spirit that led to collapse" by John Hooper, *The Guardian,* April 9, 2002

[111] "Kirch: The beginning of the end", *The Economist*, April 11, 2002

[112] Statement by Wolfgang van Betteray at the Press Conference on the Insolvency of KirchMedia held in Munich on 8 April 2002

[113] Unless otherwise stated, all the facts in this section are from the Annual Report of Tata Finance Limited for the year 2000-2001.

[114] Tata Finance Limited, Annual Report 2001-2002, Directors' Report dated August 8, 2002

[115] "Ferguson pulls up Tatas, says Tata Fin deals stink", *Economic Times,* August 7, 2002

[116] "Kale quits, Tatas deny pressure on auditor", *Economic Times,* August 8, 2002

[117] "When the client gets bigger than profession" *Economic Times,* August 9, 2002

[118] "Ferguson denies Tatas forced it to rescind report" , *Economic Times,* August 9, 2002

[119] "AFF heaped praise on Kale, then sacked him", *Economic Times,* September 19, 2002

[120] "ICAI seeks more info from AFF on Kale", *Economic Times,* September 21, 2002

[121] Prepared Testimony of Mr. Jeffrey K. Skilling, Former President and CEO of Enron before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, US House of Representatives, February 7, 2002

[122]The Chairman of the Finance Committee of Enron' Board was forced to admit "I don't believe that Mr. Skilling ever lied to us. No, sir.", Oral Testimony of Mr. Herbert S. Winokur, Jr., Chairman of the Finance Committee, Board of Directors, Enron Corporation before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, US House of Representatives, February 7, 2002

[123] Cited in footnote 10 above

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[124] Prepared Testimony of Mr. Robert Jaedicke, Chairman of Audit and Compliance Committee, Enron Board of Directors before Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, US House of Representatives, February 7, 2002

[125] US Senate Report cited in footnote 71 above.

[126] Oral testimony of Mr. Herbert Winokur and Mr. John Duncan. The $1 million refers to the cost of the shares when these directors acquired the shares. The market value of the shares prior to the collapse of Enron would have been much higher.

[127] Actually, it requires the company that does not have a financial expert in its audit committee to disclose this fact and explain the reason. This would more or less compel all firms to include a financial expert in the audit committee.

[128] "Professor Who Led Audit Panel Failed to Spot Smoke and Mirrors", *New York Times,* February 7, 2002

[129] The government's main charge was that after Enron informed Andersen of an SEC investigation into its accounting, "Andersen partners … launched … a wholesale destruction of documents. … dozens of large trunks filled with Enron documents were … shredded", Indictment, United States of America v. Arthur Andersen LLP, United States District Court, Southern District Of Texas. In a press conference after the trial, several members of the jury stated that the document shredding charge did not sway them as much as an internal email in which an Andersen staff lawyer requested a change in an internal memo to reduce the chance of her being called as a witness. See for example, "Decision by jurors hinged on memo", *Houston Chronicle,* June 19, 2002.

[130] "SEC Statement Regarding Andersen Case Conviction", US SEC Press Release dated June 15, 2002.

[131] Cited in footnote 25 above

[132] In the US, shareholder approval may not even be required for auditor appointment: "I believe it is generally a matter of State law as to whether the shareholders are required to elect the auditors, or are required to ratify the appointment of the auditors by the board of directors.", Oral Testimony of Mr. Robert K. Herdman, then SEC Chief Accountant, before the Subcommittee on Commerce, Trade, and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives, February 14, 2002. But even where shareholder approval is required, management may still play a decisive role.

[133] See footnote 6 above.

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[134] Cited in footnote 25 above

[135] Oral Testimony of Mr. Ronald M. Barone, Managing Director, Corporate and Government Ratings Group, Standard & Poor's before the Committee on Governmental Affairs, United States Senate, March 20, 2002

[136] Oral Testimony of Mr. John C. Diaz, Managing Director, Moody's Investors Service before the Committee on Governmental Affairs, United States Senate, March 20, 2002

[137] Prepared Testimony of Mr. Ronald M. Barone, Managing Director, Corporate and Government Ratings Group, Standard & Poor's before the Committee on Governmental Affairs, United States Senate, March 20, 2002

[138] Prepared Testimony of Prof. Robert E. Verrecchia, The Wharton School, University of Pennsylvania before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, May 14, 2002

[139] Prepared testimony of Mr. Robert K. Herdman, then SEC Chief Accountant before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, May 14, 2002

[140] Prepared Statement of Roman L. Weil, Graduate School of Business, University of Chicago before Committee on Energy and Commerce, US House of Representatives, February 6, 2002

[141] "Proposal for a Principles-Based Approach to U.S. Standard Setting", Financial Accounting Standards Board, October 21, 2002. See also "FASB and IASB Agree to Work Together toward Convergence of Global Accounting Standards", News Release, Financial Accounting Standards Board, October 29, 2002

[142] Andy Kessler, "Show Me the Books", *Wall Street Journal,* July 18, 2002, Peter Krass, "The Never-Ending Audit: Can software prevent future Enrons?", *CFO Magazine*, November 06, 2002 and Spencer Reiss, "The Transparent Corporation: Winning back investors' trust is easy. Just show them everything", *Wired,* Issue 10.11, November 2002

[143] "Transactions Involving Special-purpose Entities", EITF Topic No. D-14

[144] During 1997 to 2001, the FASB worked on a Consolidation Policy and Procedures Project that would have required consolidation on the basis of a control criterion. After issuing an exposure draft in 1999 and a modification in 2000, the FASB decided not to issue a standard in early 2001.

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[145] In fairness though, the 3% rule originated in the SEC and not in the FASB: see footnote 8 above.

[146] Prepared testimony of Mr. John Olson cited in footnote 92 above

[147] Oral testimony of Prof. Bala G. Dharan, Rice University before Committee on Energy and Commerce, US House of Representatives, February 6, 2002

[148] "Exposure Draft: Proposed Interpretation Consolidation of Certain Special-Purpose Entities; An interpretation of ARB No. 51", Financial Accounting Standards Board, June 28, 2002

[149] Prepared testimony of Prof. Bala G. Dharan, Rice University before Committee on Energy and Commerce, US House of Representatives, February 6, 2002

[150] Prepared testimony of Mr. John Olson cited in footnote 92 above

[151] Prepared Testimony of Mr. Edmund L. Jenkins, Chairman, Financial Accounting Standards Board, before the Subcommittee on Commerce, Trade, and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives, February 14, 2002

[152] Oral Testimony of Mr. Robert K. Herdman, then SEC Chief Accountant, before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, December 12, 2001.

[153] EITF Issue No. 02-03 "Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities"

[154] About the two exemptions that the SEC did grant, the Senate Committee Staff report cited in footnote 25 stated about the first application: "Although it is possible to disagree with the SEC staff's reasoning, it does not appear to Committee staff that the conclusion they reached was insupportable.", and about the second application: "the Commission's approach, first set forth in 1937, is well-established and the Commission's response to Enron's application was consistent with this precedent.". About the third application on which the SEC did not take any action, the report states: "the lack of coordination between the SEC and FERC permitted Enron to take full advantage of the gaps and overlaps in the agencies' jurisdiction"

[155] Senate Committee Staff report cited in footnote 25

[156] Senate Committee Staff report cited in footnote 25 also expresses this view. This is also evident from a reading of the complex and obscure footnotes in these annual reports.

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[157] Oral Testimony of Mr. Robert K. Herdman, then SEC Chief Accountant, before the Subcommittee on Commerce, Trade, and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives, February 14, 2002

[158] Oral Testimony cited in footnote 157 above.

[159] "Quality—Tomorrow and Today", Remarks by Lynn E. Turner, Chief Accountant, U.S. Securities and Exchange Commission at the AICPA National Conference on Banks and Savings Institutions, November 9, 1999

[160] *Report of the Advisory Committee on the Capital Formation and Regulatory Processes,* US Securities and Exchange Commission, July 1996

[161] Public Oversight Board, Charter, February 9, 2001

[162] Arthur Andersen press release "Andersen Announces Results of Audit Quality Peer Review", January 2, 2002, quoted in "Fact Sheet: How Lax Regulation and Inadequate Oversight Contributed to the Enron Collapse", Minority Staff, Committee on Government Reform, U.S. House of Representatives, February 7, 2002 (revised March 1, 2002). The review did not include the Enron audit but did include the Houston office that conducted the Enron audit.

[163] Letter dated November 16, 2001 from Mr. John D. Dingell, Ranking Member, Committee on Energy and Commerce, US House of Representatives to Mr. Charles A. Bowsher, Chairman, Public Oversight Board

[164] Prepared Testimony of Mr. Charles A. Bowsher, Chairman, Public Oversight Board, before the Banking Committee, US Senate, March 19, 2002

[165] "Remarks before the American Institute of Certified Public Accountants", by Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, December 12, 2002

[166] "Where was the SEC?", part six of the "IPO Antics" series by RedHerring.com (http://www.redherring.com/ipo/2001/0509/830019283.html)

[167] Susan Woodward, former chief economist at the SEC quoted in RedHerring.com article cited in footnote 166 above

[168] Prepared Testimony of Prof. Thomas J. Linsmeier, before the Subcommittee on Commerce, Trade, and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives, February 14, 2002

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[169] Oral Testimony of James S. Chanos, President, Kynikos Associates, Ltd. before Committee on Energy and Commerce, US House of Representatives, February 6, 2002

[170] Report of the Committee on Corporate Audit and Governance (Naresh Chandra Committee), Ministry of Finance and Company Affairs, Government of India, December 2002

[171] Exposure Draft, Statement on Standard Auditing Practices1 (SAP) 4 (Revised), "Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", Institute of Chartered Accountants of India, October 28, 2002.

[172] Statement on Standard Auditing Practices (SAP) 6 (Revised) "Risk Assessments and Internal Control", Institute of Chartered Accountants of India, May 29, 2002

[173] Testimony of Mr. Alan Greenspan, Chairman, Federal Reserve Board, "Federal Reserve Board's semi-annual monetary policy report to the Congress", before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 16, 2002

[174] Michael C. Jensen, "US Corporate Governance: Lessons from the 1980's" Negotiation, Organizations and Markets Research Papers Paper No. 00-02, Harvard Business School. This paper is available in the Social Science Research Network Electronic Paper Collection:: http://papers.ssrn.com/paper.taf?abstract_id=146150, has been reprinted in Peter L. Bernstein, *The Portable MBA in Investment*, John Wiley and Sons, Inc., 1995 and has been published in abridged version in Michael C. Jensen, *A Theory of the Firm: Governance, Residual Claims and Organizational Forms* (Harvard University Press, December 2000)

[175] Bryan Burrough and John Helyar, *Barbarians at the Gate,* New York, Harper & Row, 1990

[176] Michael Jensen (cited in footnote 174 above) attributes this remark to Joseph Grundfest, 1990, "Just Vote No or Just Don't Vote", Stanford Law School. See also Grundfest, Joseph A., 1993, "Just vote no: Minimalist strategies for dealing with barbarians inside the gate", *Stanford Law Review* 45, 857-937 as also Grundfest, Joseph A., 1990, "Subordination of American capital", *Journal of Financial Economics,* 27, 89-114

[177] "A Software Company Runs Out of Tricks: The Past May Haunt Computer Associates", *The New York Times,* April 29, 2001

[178] "CA's 'victory' in proxy war not so clear", *The Chicago Tribune,* August 31, 2001

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[179] The cynic would argue that the short seller puts his mouth where his money is. But even if that be so, he provides a valuable counterweight to other analysts who are usually long on stocks.

[180] "Early Scrutiny: 10 Months Ago, Questions on Enron Came and Went With Little Notice", *New York Times,* January 28, 2002

[181] Bethany McLean, "Is Enron Overpriced?" Fortune, March 5, 2001

[182] Bethany McLean, "Why Enron Went Bust", Fortune, December 9, 2001

[183] Cited in footnote 169 above

[184] Herb Greenberg, "*Extra* Lernahooligan Alert: A Revealing Look at Lernout's Financials", posted on *TheStreet.com* and on *RealMoney.com*, May 7, 2000.

[185] "Tech Firm's Korean Growth Raised Eyebrows", *Wall Street Journal,* August 8, 2000

[186] For a comprehensive description of the entire L&H story, see "How High-Tech Dream Shattered in Scandal at Lernout & Hauspie", *Wall Street Journal,* December 7, 2000

[187] Form S3 filed by Lernout and Hauspie with the US SEC on June 30, 2000

[188] Carolyn Sargent and Paul Sweeney, "The Economics of Independence", *Investment Dealers Digest,* November 18, 2002

[189] This interpretation of the Securities and Exchange Act was first established by the Supreme Court of the United States in *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A,* 511 U.S. 164 (1993). The 1995 Act not only did not amend the Securities and Exchange Act to change this interpretation, it in fact reinforced the bar on private litigation for aiding and abetting violations. However, in the Enron case, the United States District Court for the Southern District of Texas, Houston Division, has ruled in a class action law suit (The Regents of the University of California, et al v. Kenneth L. Lay et al., Civil Action No. H-01-3624, Memorandum and Order re Secondary Actors Motion to Dismiss) that secondary actors could be asked to stand trial on the ground not that they aided and abetted the fraud but that they were participants in the fraud themselves.

[190] The big five became the big four (sometimes called the Fat Four) after the collapse of Andersen. They are KPMG, Deloitte & Touche, Ernst & Young, and PriceewaterhouseCoopers (PwC)

[191] See for example, "Non-Price Competition" in John Eatwell (ed), *New Palgrave: a dictionary of economics,* London, Macmillan Press, 1994

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[192] Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association, Comment Letter to the US SEC on "Securities Act Concepts and Their Effects on Capital Formation - Release No. 33-7314 (File No. S7-19-96)" December 11, 1996

[193] The Report of the Advisory Committee on the Capital Formation and Regulatory Processes, US Securities and Exchange Commission, July 24, 1996 recommended a radical overhaul of the regulation of securities offerings. A highly watered down version of this emerged in what the SEC itself called the "Aircraft Carrier" proposal: "The Regulation of Securities Offerings", Proposed Rulemaking, File No. S7-30-98, Securities and Exchange Commission, November 13, 1998. Even these proposals have not been implemented.

[194] "Investment banking: Redesign flaws", *The Economist,* November 14 2002

[195] Cited in footnote 25 above

[196] Testimony of Jonathan R. Macey, J. DuPratt White Professor of Law, Cornell Law School, before the Committee on Governmental Affairs, United States Senate, March 20, 2002

[197] Prepared Testimony of Isaac C. Hunt, Jr., Commissioner, U.S. Securities and Exchange Commission before the Committee on Governmental Affairs, United States Senate, March 20, 2002

[198] See, e.g., Comments of the United States Department of Justice in the Matter of: File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (March 6, 1998). *(footnote in original)*

[199] Oral Testimony of Mr. Robert K. Herdman, then SEC Chief Accountant, before the Subcommittee on Commerce, Trade, and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives, February 14, 2002

[200] This is clearly a personal opinion. For those who want to judge for themselves, the most influential history of the US SEC is: Joel Seligman, *Transformation of Wall Street; A History of the Securities and Exchange Commission and Modern Corporate Finance,* Boston, Houghton Mifflin, 1982

[201] William O. Douglas was Chairman of the US SEC from March 1938 till his elevation to the US Supreme Court in April 1939.

[202] See footnote 159 above

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[203] The facts in this section are from the "Cease-and-Desist Order" filed against Jonathan Lebed by the US SEC and from Michael Lewis "Jonathan Lebed: Stock Manipulator, SEC Nemesis – and 15", *New York Times,* February 25, 2001.

[204] See article cited in footnote 203 above

[205] See for example, "George Soros convicted of insider trading", *Financial Times,* December 20 2002

[206] Report of the Joint Parliamentary Committee on Stock Market Scam and Matters Relating Thereto, December 2002

[207] The minutes of the Committee as well as the evidence collected by the Committee were not printed, but five copies of these were placed in the Parliament Library.

[208] This point is argued at length in J. R.Varma, *Indian Financial Sector after a Decade of Reforms,* ViewPoint 3, Centre for Civil Society, New Delhi, 2002.

[209] "Pricewaterhouse Taking a Stand, and a Big Risk", *New York Times,* January 1, 2003

[210] To give one example, in April 2002, a research company, SEC Insight sought and obtained information from the US SEC under the Freedom of Information Act about investigations against IBM. The SEC's letter stated that it "conducted a preliminary investigation of IBM commencing on February 15, 2002". SEC Insight failed to get a clarification from the SEC as to whether the use of the past tense – 'conducted' – implied that the matter was closed. Nor was IBM able to give a clarification because it had not even been informed about the inquiry. SEC Insight put out a newsletter stating that the absence of a termination date in the SEC letter implied that the investigation was ongoing and unresolved. In response to this report, IBM stock fell to a 52 week low. It was only after close of trading that the SEC clarified that that the investigation had been closed without action shortly after it was opened. For more information see "SEC Dispels Shadow on IBM", *New York Times,* April 12, 2002.

[211] According to the data presented in the Senate staff committee report cited in footnote 25, the 330 staff in the SEC's corporate finance division reviewed a total of 3025 annual reports and IPO filings implying that a review requires 0.11 person years to complete. The SEC's budget for fiscal 2001 of $427 million for a staff strength of 3265 (according to the SEC annual report for 2001, Appendix Table 17) implies a person-year cost of $130,000 including not only the salary but also all overheads. Thus $15,000 would cover the costs of 0.11 person year required to complete a review.

[212] The Securities and Exchange Board of India (SEBI) does not publish its budget, but its annual report (2001-02) does disclose its staff strength (215 officers excluding lower

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level staff) and its fee income (Rs 980 million). If one assumes that SEBI's budget is the same percentage of fee income as for the SEC (20.5%), one arrives at an annual cost per officer (salaries plus overheads) of Rs 0.95 million. Alternatively, one could look at the Reserve Bank of India (RBI) which does publish its accounts in its annual report (2001-02). Its total establishment costs of Rs 13 billion for 20,666 employees (excluding peons and other Class IV employees) represents a per employee cost of Rs 0.63 million. Since RBI has a large number of clerical employees it is prudent to increase this cost by 50% to arrive at a per person year cost of Rs 0.95 million. In either case, the cost of reviewing a filing would amount to approximately Rs 100,000 assuming the same level of employee productivity as in the US SEC (0.11 person year per filing reviewed).

[213] It must be mentioned that the corresponding US Accounting Standard (FAS 133) is, if anything, even more complex. In fact, there is a web site (FAS133.com) devoted exclusively to unraveling the mysteries of this standard.

[214] IAS 39 Implementation Guidance: Questions and Answers as of 1 July 2001, Approved for Issuance by the IAS 39 Implementation Guidance Committee, International Accounting Standards Board, July 2001

[215] Pass the parcel: Grumbles in the booming market for credit derivatives, *The Economist,* January 18, 2003

[216] Joint Working Group of Standard Setters, Recommendations on Accounting for Financial Instruments and Similar Items, December 2000

[217] http://www.walmartstores.com/

[218] "Disney Studios Deliver a Turkey for the Holiday", *Wall Street Journal,* December 2, 2002; "Film Flop Prompts Disney Restatement", *Financial Times,* December 4, 2002; "Box-Office Letdown for Disney Raises Worry about Animation", *The New York Times*, December 5, 2002

[219] The complete XBRL specification and a wide variety of resources about XBRL are available at the official web site www.xbrl.org. XBRL is a royalty free open standard that is being developed by a consortium of over 170 organizations that includes the US accounting professional body (AICPA), the big four accounting firms, many of the largest computer hardware and software firms in the world. XBRL is based upon XML (eXtensible Markup Language) which is becoming the lingua franca of the web.

[220] Only a fairly large company might actually need this big a report. On the other hand, for a company as large and complex as Enron, 10,000 pages might be an underestimate of what is needed for investors to understand the company.

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[221] http://www.microsoft.com/msft/xbrlinfo.htm

[222] Most of the information required for this would come straight out of the company's computerized information systems and could potentially be produced automatically without major manual intervention.