

The International Capital Markets in the Post “Enron” Era

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To understand the impact of Enron, WorldCom and Global Crossing in the international capital markets, it is necessary to begin with some retrospective. Over the past two years the NASDAQ market declined from over 5000 to under 1300, representing a decrease in market capitalization of well over \$3 trillion (although the index has recently recovered somewhat). In the calendar year 2001 alone, more than 200 publicly traded corporations in the United States have defaulted on more than \$100 billion in bonds. Although the losses for Enron are estimated to be as much as \$80 billion and Global Crossing as much as \$20 to \$60 billion¹⁾, in the final analysis, it is quite likely that the “hard” losses will be significantly smaller²⁾. Add to the politically explosive mix in late July, 2002, was the bankruptcy filing of WorldCom, another telecommunications company, with assets reported to exceed \$100 billion, the largest bankruptcy filing ever, surpassing Enron. Each of these companies can be considered more part of political crises than economic crises. In the case of Enron, might be noted that the “half-life” has been about 60 days, while with Global Crossing the half-life has been about 30 days. The concept of the “half-life” of an event, analogous to the measures of decay-rates of nuclear radioactivity, relates to the amount of time that the event is a significant focal point in the eyes of the Congress and the mass media of the United States. In the case of Enron, both the Congress and the mass media have extracted from the bankruptcies about as much attention as is available. Global Crossing has virtually disappeared from the front pages of the newspapers and from regular television reports. As a political event, on a logarithmic scale of 1 to 10, least to most damaging, the Enron crisis

¹⁾ The Chapter 11 filing for Enron in the United States Bankruptcy Court, Southern District of New York of the “List of Creditors Holding the 20 Largest Unsecured Claims” lists a total of less than \$8 billion, with Chase first at \$1.9 billion, Citibank second at \$1.75 billion, and Bank of New York listed third, but with a total of about \$2.5 billion in a series of ten loans. The unsecured creditors are residual claimants, behind secured creditors, but ahead of shareholders. Secured creditors, of course, look for recovery to the assets against which their credit is secured (which, in some cases, may be no more than the stock of the company, a rather ill-advised anchor, with a circuitous result).

²⁾ The estimate of total assets reported by Enron, in its bankruptcy filing, is reported to be \$50 billion. On 23 April 2002, Enron stated that it would write-off about \$14 billion, due in part to its bankruptcy filing, but, in substantial part to valuations of assets “that may have been overstated due to possible accounting errors or irregularities”. See: “Enron Expects Asset Write-off of \$14 billion” The Washington Post 23 April 2002. P. E1.

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rates a 5.0 (Nixon's "Watergate" rating a 9.95), while, as an economic event, on an analogous scale, Enron rates a 4.5 (with the September 11th events rated at 8.5). WorldCom, although still a relatively new crisis, appears to have a "half-life" equivalent to Enron, or perhaps a bit longer, perhaps as much as 80 days.

Nevertheless, the crises faced by these three and other companies has served as a foundation for an important national debate on corporate practice.

The focus of this article will be on developments in the international capital markets, combining mathematics, economics and law, all of which, taken together, have revolutionized the capital markets over the past thirty years. Specifically, the refinement of the concept of an almost limitless divisibility of economic interests, both as to present and future values, resulting in infinitesimal economic interests, coupled with precise legal descriptions of such economic interests in order that the interest can be "securitized", that is, carved into economic interests that can be represented by legal descriptions, attached to "risk-bearing paper" (securities) and sold to investors on the world's capital markets³⁾.

One of the most salient factors in the failure of Enron, Global Crossing and WorldCom is that key executives in all three companies were rather inexperienced. This may sound strange, that an executive of a multibillion dollar corporation can be termed "inexperienced," but it must be recalled that most of the leading executives of corporations in United States today are, in age, in their early forties to mid-fifties, which means that when the United States last had a significant recession, in the period from 1978 to 1981⁴⁾, these executives were in entry-level positions with re-

³⁾ Among the instruments which have become popular are "derivatives", instruments which derive their value directly and/or indirectly from underlying assets in which there may or may not be an "ownership" interest (underlying assets may include bonds, notes, letters of credit, loans, composite asset pools, etc.). By one estimate, the world market for derivatives is estimated to be \$40 trillion or more. The most common derivatives in the United States, constituting about 68% of the total, are Credit Default Swaps (CDF), Total Rate of Return Swaps (TRORS) and Collateralized Debt Obligations. In the CDF, a buyer of protection against credit default, desiring to "layoff" the risk, pays a risk-based premium to the entity agreeing to acquire the responsibility for the risk of credit default. In the Total Rate of Return Swap, the buyer acquires both the return of the income stream and the changes in the value of the underlying asset. The seller in this case is effectively "renting" the economic interest to the buyer, for which the seller is paid an agreed upon fee. CDO's are hybrids which may include components comprised of CDF and TRORS. The present value of credit derivatives may be exceedingly difficult to determine, due to the complexity of their composition and the indirect link to the underlying asset values.

Other estimates of the derivative market indicate a total of \$120 trillion, with about two-thirds in interest rate swaps, one-sixth in foreign exchange derivatives, twenty percent exchange traded derivatives, with the balance in other types of instruments. Generally, except for the insurance industry, derivatives relatively equally protect buyer and seller. In the insurance industry, sellers seek protection through derivative instruments three times more frequently than buyers. See: "New Dangers." *The Economist*. 16 May 2002 (Available at the [Economist.com](http://www.economist.com)).

⁴⁾ The 1991 recession was largely limited to the Savings & Loan industry, arising out of the 1986 tax act which significantly reduced the advantages of investing in real estate and created a phase-out of those advantages over a period of five years. Savings & Loans (S&Ls) are financial institutions established with the purpose of promoting home ownership, but in

spect to the responsibility of management of corporate affairs. As a result, most of these executives have not had the responsibility of managing a corporation through a period of real economic adversity. None had a “trial by fire” in terms of managing corporate crises. Moreover, most of these executives did not have the experience to anticipate the impact that the actions of the Federal Reserve in 2000–2001 would have on the U.S. economy. This is equally true of the boards of directors of most of these corporations.

Most managers that had gone through the significant downturns of the 1973 to 1975 and the 1978–1981 recessions had the good sense to understand that the upswing of the economy would eventually come to an end and that executive management would have been well-advised to manage operations conservatively to enable the corporation to endure the downturn. As the U.S. economy had experienced an almost constant expansion from 1981 through the end of 1999, many of the less-experienced executives had little reason to believe that the good times would end.

Moreover, almost constantly throughout this period, with a brief exception of the 1990–1991 recession, asset values inflated rapidly. Corporate managers, in many cases, had no experience which would have led them to believe other than that the continuation of the increase in asset values would simply inflate the balance sheet to profitability. Eventually, however, economic reality re-emerged.

Notwithstanding the collapse of the NASDAQ and the Enron, Global Crossing and WorldCom bankruptcies, the strength of the United States economy is remarkable. Unlike the command economies of the world, the U.S. economy consists of an intricate web of interrelationships among myriad firms. Were one to do a combined Leontieff input-output/ Critical path analysis of the U.S. economy, an understanding of why events like “9–11” and the Enron, Global Crossing and WorldCom bankruptcies are rather well absorbed would emerge. In a sense, it is similar to the systemic balance of the human organism with perhaps even fewer critical supply linkages.

In general, risk-based equities in market economies have outperformed debt instruments over the past century. A recent study at London Business School notes that equities provide premiums over debt averaging 4.5% on world markets over the past century, with German equities leading the sixteen countries studied with an “equity premium” exceeding six percent. There are instances, however, such as the bankruptcies of Enron, Global Crossing and WorldCom, when “exception proves the rule:” bond holders in these three bankruptcies may receive pennies on the dollar, while the shareholders will receive nothing⁵⁾. “Financial markets have a way of killing off the easy bets...each time a financial pattern emerges – that small companies’

the mid-1980s were allowed to engage in a wide variety of real estate related transactions. As it turned out, the “phase-out” period was imprudently designed, triggering a collapse of certain types of real estate investment, which in turn precipitated the collapse of many Savings and Loans which had a variety of loans in such real estate. The “bail-out” of the Savings & Loan industry was accomplished by the creation of the Resolution Trust Corporation (RTC), which liquidated more than a half-trillion dollars of assets of the failed S&Ls over a period of about four years.

⁵⁾ See “Great Expectations.” *The Economist*. 8 February 2002. P. 72. The article discusses the results of a study commissioned by ABN Amro undertaken by Professors Elroy Dimson and Paul Marsh, and Research Director Michael Staunton of the London Business School. The study covers the markets of 16 countries over 100 years.

shares outperform those of large ones, that shares outperform in January, and so forth - investors exploit the pattern, thus undermining (ergo, market returns oscillate towards an equilibrium)⁶.

Enron Specifics

From its founding in the mid-1980s, Enron grew to be the seventh largest corporation in United States, measured by market-capitalization." Its activities were centered on energy - related activities and trading and it positioned itself to take advantage of deregulation in the electric power industry. One of the bases of power industry deregulation was the separation of the ownership of infrastructure, e.g., the power and transmission lines, from the energy generation (production) side of the business. Enron and many other companies aggressively sought to have the federal and state governments enact legislation driving deregulation of the industry. The companies underwriting the lobbying effort were then in a position to benefit from the deregulation of the industry. Inherently, this effort was bound to be confronted by technical problems as the infrastructure was never designed to operate as interchangeable components. Even today, after a decade of deregulation, the transmission infrastructure in the electrical energy industry is poorly designed to handle the needs of a deregulated system. Moreover, the capital cost of revamping the infrastructure to be able to efficiently accommodate a deregulated power industry is prohibitive.

In the mid - to latter 1990s, the utility industries developed, parallel to their transmission structure, an infrastructure of electronic technology. A significant component of this infrastructure was fiber-optic cable. Enron saw its investment in fiber-optic cable to be the basis for a profitable nationwide high-speed broadband communications network.

The company saw opportunity in the expansion of the "high-tech" market in the 1990s to transform itself from a energy trading company to an information network management company. The company certainly did not contemplate the NASDAQ "high-tech" bubble which burst in the year 2000.

As Enron grew from its creation in the 1980s, as with many companies, it used large amounts of debt. As will be explained in greater detail below, prudently managed debt can be a blessing to a company, while badly managed debt can be its undoing.

As a way of moving the debt off its balance sheet, Enron used "SPEs." SPEs are "special-purpose entities." To reduce the burden of this debt, the company established "Special Purpose Entities" (SPEs). An example is the creation of a legal entity at the behest of Enron, to which a "pool" of Enron's debt would be transferred, treating the transfer as a sale on Enron's books. The new entity obtained cash for transaction through an offering of its shares. Typically, Enron contributed only a small amount of cash to the entity, and remained liable on the debt which it had transferred as the underlying asset of the newly established SPE⁷). More detail on SPEs will be provided below, but at this point, we will just note that the entities

⁶) See "Great Expectations." *The Economist*. 8 February 2002. P. 73.

⁷) See: "Firms Repeatedly Dodged Efforts To Rein In Off-the-Books Deal." by Glenn R. Simpson. *The Wall Street Journal OnLine*. 10 April 2002.

were used to move the debt off of Enron's balance sheet without significantly diminishing the company's liability for the debt⁸⁾.

As a rather simple example, consider a company that has equity of \$10 million and debt of \$100 million. This company has a debt-equity ratio of 10 to 1. The markets would generally consider such a company to be rather highly "leveraged" and, as a result, an unattractive investment. If a company were to set up an SPE and move \$60 million of the debt from its balance sheet to that of the SPE, it would thereby improve its debt-equity ratio to 4 to 1, making it a more attractive investment and enhancing its share-price. The problem is that the company cannot just restructure its debt without approval of its creditors. Otherwise, the company would be in violation of the covenants (terms and conditions) of its credit agreements. In order to do so, therefore, the company may be required to retain residual liability for the indebtedness as well as provide additional security, which Enron, in some cases, did through providing its own stock as additional security⁹⁾.

In mid-2001, Enron was faced with the collapse of two primary determinants of market confidence: the volatility of pricing in the energy industry and the bursting of the NASDAQ bubble (even though Enron was NYSE-listed). As is often the case when markets are collapsing, sources of debt and equity capital retrench and even the most apparently creditworthy companies have difficulty meeting their needs for capital.

⁸⁾ One problem with SPEs is that the entity need have only 3% of "outside" equity investment, a highly leveraged structure. The sponsoring corporation can contribute 97% in the form of debt and/or loan guarantees and yet not have to report ownership for accounting purposes. This 3%-97% relationship is proposed to be replaced with a 10%-90% rule. However, such a rule may still expose the company to substantial liability for an "off-balance sheet" item. See: Amy Feldman, "Off Balance." Money April 2002. P. 46-47. Other "Off-Balance Sheet" transactions are described: 1) Operating Leases (contrasted with Capital Leases, by which the lessee ultimately owns the underlying property) in which the lessee pays a predetermined charge over the term of the lease, but never takes ownership, never having to report the capitalized present value of the obligation. 2) Synthetic Leases, in which a lessee "rents" an office building or warehouse but never has the obligations of ownership. The full extent of the obligation never appears on the company's balance sheet. In the synthetic lease, the lessee may acquire, by contract, certain "ownership-like" rights, such as the right to depreciate the structure and/or to deduct the interest expense of debt encumbering the property. 3) Securitizations, by which "packages" of receivables or other assets are marketed publically or to institutional investors, enabling the seller to replenish its cash position. However, in many such transactions, the seller may retain contingent liability not disclosed in its public filings.

⁹⁾ "Off-balance sheet" financing is common in the power industry. The Wall Street Journal reports that the Enron partnerships "took a turn from the straightforward and mundane to the deceptive and possibly illegal..." "To do outside partnerships, some basic accounting guidelines have to be followed. The company has to relinquish control of any assets put into the partnership. It can't have side deals that oblige it to repurchase or redeem the assets during the partnerships' lives, typically five to 10 years. Since 1996, a partnership also has had to attract outside equity equal to at least 3% of its total capital in order to be considered separate from the sponsoring company. Enron's partnerships appear to have met these standards for many years, but eventually Enron started to look at a "higher-octane" partnership (more leverage, ergo more risk). (See: "Minutes from a 1997 Meeting Reveal Enron Brass Were in Partnership Loop," John R. Eshmillier and Rebecca Smith, The Wall Street Journal Online, 1 February 2002.

It is important to understand that corporate strategy in the United States for publicly traded companies is driven both by tax law and securities law. Each of these legislative regimes requires planning which is sometimes contradictory. Consider the situation with respect to debt. From the point of view of the corporation, debt is often considered to be desirable in the sense that it does not require the corporation to give up voting control, since debt holders have no voting rights, and since the interest on debt, for tax purposes, is deductible to the corporation, reducing taxable income, ergo taxes paid by the corporation. Equity investment, on the other hand, generally requires that the corporation yield voting rights to the shareholders which ultimately dilutes the control of management. In addition, the payment of dividends to shareholders is not deductible to the corporation nor is it excludible as income for a shareholder-recipient. For this reason, with the interest on debt being deductible, reducing taxable income, and with dividend payments being nondeductible, corporations often consider it desirable to “load-up” on debt.

Moreover, with dividends taxed at rate of almost 40% and capital gains (“profits” realized on the sale of appreciated stock shares) taxed at rate of 20%, “shareholders prefer that companies use earnings to lift the price of their shares rather than pay taxes on dividends,” according to Jeremy Siegel, Professor of Finance at the Wharton School, University of Pennsylvania¹⁰). From the point of view of corporate securities law, debt is a mixed-blessing. The positive aspect of debt is that it permits the corporation to grow using other people’s money (the “OPM” principle) without diluting the control of management. On the other hand, when a corporation’s debt-equity ratio becomes too high, investors begin to consider the company too highly leveraged and seek a yield premium to invest in the company stock which, in turn, results in lower share prices. This is exactly the situation which became a concern to Enron senior management in the late 1990s and which resulted in the decision to resort to SPEs.

Another controversial issue for Enron was its use of stock-options. Prior to its bankruptcy, Enron had about 24,000 workers, half of which participated in the company’s 401(k) plan. Employees could contribute up to 15% of pretax salary, subject to the IRS limit of \$10,500 (for 2001). Employees fully controlled the investment of this portion of their retirement program. The total investment in the 401(k) plan was about \$1 billion, with \$500 to \$600 million invested in Enron stock. The company itself contributed up to six percent of base pay but that contribution was in the form of a “matched stock” contribution which employees were required to hold until the age of fifty.

As with most plans, from time to time when the company changed record-keepers, Enron had a “lockdown” which required that transactions in stock to be barred from sale for a period of 30 to 60 days. This enables the requisite record-keeping with respect to the transaction to be properly reconciled. This “transaction suspension period” occurs when a company changes recordkeepers so that the accounts of the old recordkeeper can be fully registered and reconciled with the new record-keeper¹¹). Enron employees were notified in advance of the forthcoming lock-

¹⁰) See: “The Dividend Deficit.” by Jeremy J. Siegel. The Wall Street Journal OnLine. 13 February 2002.

¹¹) The Wall Street Journal notes that the loss to Enron employees was more a result of the company’s flawed accounting than of any flaws in the structure of the law establishing

down and had the opportunity to sell shares at a higher price well in advance of the lockdown and subsequent collapse of share prices. Many Enron workers may have had excess concentrations of Enron share holdings, but the company did make available over 20 different types of accounts including mutual funds and a brokerage account.

Enron has also been criticized for its use of stock options¹²⁾ as a method of compensation for senior executive management¹³⁾. The overwhelming majority of publicly traded corporations use stock options as a method of compensation for executive management. There is a continuing public debate concerning the argument that the use of options is a cause of corporate executives focusing too much on increasing shareholder value rather than on long term corporate growth, essentially creating a gambling operation in which executives seek to maximize personal gain, sacrificing prudent corporate management¹⁴⁾. In the case of Enron, there is certainly an issue as to whether certain members of its senior management team exercised their options based upon knowledge of "inside-information" about the financial condition of the company not available to the public at large (effectively engaging in "insider-trading, barred by securities regulations). If these individuals sold their stock simply because the price was high and they decided to take advantage of the opportunity there would be no violation of law. However, if the individuals sold their

401(k) plans. It notes that credit-rating agencies, stock analysts, federal regulatory overseers, auditors and possibly even much of the company's senior management suffered from the same lack of information. See: "Taking Stock of Enron," The Wall Street Journal OnLine, 24 January 2002.

¹²⁾ An option is a contractual agreement by which the company offers an employee, often a management executive, the opportunity to buy, at some future date, the company's stock at a fixed price (called the "exercise" price), normally a price established at the time the option agreement is written. If the performance of the company results in an increase in the value of the stock above the exercise price, the holder of the option will exercise the option and purchase the stock. If the company's performance is poor and the price of its stock declines, the option becomes worthless. The gain realized on the exercise of the option is taxable as ordinary income, just as any compensation would be. Incentive-based compensation such as options can be structured very flexibly.

¹³⁾ For a number of years, there has been an ongoing debate with respect to a proposal that companies be required to deduct as an expense the cost of stock options received by executives as compensation. The problem is as to how value the options at the time when granted, since stock prices gyrate rather significantly. This issue parallels the entire "market-to-market" debate which has been argued in banking and accounting circles for years. An indication of the changing climate with respect to this issue is that the Council of Institutional Investors(CIIO), whose members are responsible for \$2 trillion in assets, voted to support "expensing" by voice-vote on 25 March 2002, after having long resisted the idea. See: Martha McNeil Hamilton, "Option Reform Gains Backing," The Washington Post. 26 March 2002. P. E1. Of course, the proposal would still need to go through the legislative and rule-making procedures to become effective. Given the "full-plate" of the Congress in this election year and the opposition it will face from the accounting profession and industry, it is not clear that it will become law in this legislative session.

¹⁴⁾ It is noted that, over the past decade, the percentage of shares outstanding in publicly trade companies has risen from 5% of outstanding shares to 15%. See: Martha McNeil Hamilton, "Option Reform Gains Backing," The Washington Post. 26 March 2002. P. E1.

stock based upon "insider information" not available to the trading public, they may be guilty of insider-trading. The Securities and Exchange Commission has a more than adequate legal basis for handling "insider-trading"¹⁵).

The collapse of Enron also caused "collateral" economic damage to many firms throughout the world. A typical example is that of the banking entity JP Morgan Chase. JP Morgan Chase loaned more than a billion dollars to Enron, against which it obtained surety bonds from six insurance companies to guarantee repayment of the debt. Using "forward-sale" contracts, subsidiaries of Morgan Chase paid large amounts up-front to Enron subsidiaries, by which the Enron subs were obligated to make future deliveries to the Morgan subs of oil & gas. Five days after the Enron bankruptcy, Morgan Chase asked the insurers to pay upon the guaranties. The insurance companies refused to pay, alleging fraud. The insurance companies alleged that the contracts were for the delivery of oil & gas, but that the Morgan Chase subsidiaries had no intention of taking delivery of the commodities. The companies allege that the transactions were really loans from the Morgan Chase subs to the Enron subs and that the surety contracts were not designed to insure loans. Although the insurance companies' position seems tenuous, since holders of a wide variety of future contracts hold those instruments without the intention of taking delivery, the companies have gained time¹⁶).

¹⁵) The Enron affair has triggered an effort on Capitol Hill sponsored by Senator Carl Levin (D., Mich.) to renew an earlier effort to enact legislation controlling more fully the use of stock options. The bill introduced is entitled "Ending the Double Standard for Stock Options Act." An effort in 1994 to enact similar legislation failed in the Senate by a 88-9 vote. Writing in the Wall Street Journal, T. J. Rodgers, President and CEO of Cypress Semiconductor notes "Riding the coattails of corporate malfeasance (referring to Enron) into any regulatory bill is apparently *de rigueur* in Washington these days." Rodgers adds that none of the five senatorial sponsors for the bill "has ever been a CEO or CFO." See: "Options aren't Optional in Silicon Valley." T.J. Rodgers, The Wall Street Journal OnLine, 4 March 2002.

Among proposals currently being considered for revising the treatment of options are: a) a footnote entry in SEC filings estimating the cost to the company of options (Senator Lieberman); b) immediate expensing of options (reducing earnings at the time the options are issued by an estimated market-value of the issued stock) (Senator McCain) and c) "expensing" the cost of options when actually exercised. (Secretary of the Treasury Paul O'Neil). Senator Lieberman's proposal would have no direct impact on a company's "financials." Senator McCain's proposal relies on a speculative valuation of the issued stock. Secretary O'Neil's proposal would, at least, use a market-based value, but the payment received by a company from an option is not, by nature, an item of revenue. For example, if the company had sold the shares on the market, the proceeds would be added to capital. Therefore, it is questionable whether treating the item as an expense (immediately reducing earnings) is appropriate. Perhaps the better treatment would be as a "negatively amortized" expense. This approach would require filing of amended tax returns. Practically, treatment as a positively amortized expense at the time the option is exercised would be more practical. See: "Rethinking Options," Business Week, 1 April 2002. P. 35.

SEC Chairman Harvey Pitt suggests that "(Corporate) Boards should consider requiring executives to show to show long-term growth before they can exercise their options". Such a proposal might best be implemented through amendment of the Internal Revenue Code to permit structured incentives. See: "Pitt Calls for Stricter Control of Options." The Wall Street Journal. Friday, 5 April 2002. P. A4.

¹⁶) See "Trying Not To Pay." By Roger Furman. U.S. Banker. March 2002. P. 34.

Global Crossing Specifics

Global Crossing was able to convince many investors that it had a good idea, but it certainly had an insufficient understanding of economic reality in the marketplace. The company raced through the late 1990s laying cable worldwide, including transoceanic networks, with the thought that it would be “Microsoft” of the cable market, commanding a market-share so dominant that no other company would challenge it. About one hundred and thirty years earlier, when the first transatlantic communications cable were laid, a similar theory arose and similarly floundered¹⁷⁾. In late 1999, despite intense lobbying by Global Crossing, the Federal Communications Commission updated the Submarine Cable Landing License Act, resulting in a subsequent 2,000% increase in trans – Atlantic and trans – Pacific cable capacity. While Global Crossing once controlled 50% of the traffic from the United States to Europe, it now only controls 15% and that percentage is declining¹⁸⁾. Towards the end, before its bankruptcy filing, Global entered into “capacity-swaps” – essentially cashless transactions which were reported as revenue, with the corresponding associated costs amortized over twenty-five years.

In the final analysis, Global Crossing reported over \$12 billion in debt in its bankruptcy filing, but also wasted tens of billions of dollars investing in over-priced asset acquisitions (the purchase of a company and/or a company’s assets) in its later years.

WorldCom Specifics

In the 1990s, with the acquisition of MCI, WorldCom became the second largest long distance telecommunications company in the United States, substantially behind AT&T, but a factor in the market, none-the-less. In 1999, the company’s market capitalization was \$115 billion and listed the NASDAQ and AOLTime Warner among its clients. WorldCom also owns UUNet, one of the most advanced networks for handling internet traffic, a valuable asset which might, in bankruptcy, be sold to various network operators.

On June 25th, after a change in auditing firms led to the revelation of \$7.1 billion¹⁹⁾ in accounting irregularities, the company found itself spiraling towards bankruptcy, although its interim CEO John W. Sidgmore indicated that the company’s cash position was adequate²⁰⁾.

¹⁷⁾ See “Winnick’s Voyage To the Bottom of the Sea” by Andy Kessler. The Wall Street Journal OnLine. 21 March 2002.

¹⁸⁾ See “Winnick’s Voyage To the Bottom of the Sea” by Andy Kessler. The Wall Street Journal OnLine. 21 March 2002.

¹⁹⁾ Originally, prior to its bankruptcy filing, the company reported a restatement of earnings of \$3.8 billion. On 8 August 2002, the company reported that another adjustment would be made pertaining to the first quarter of 2002 for an estimated \$ 3.3 billion in improperly booked revenues. The majority of adjustment is to restate reserves improperly accounted for as operating income. See: Reuters. Jeremy Pelofsky. “WorldCom Finds \$3.3 Billion in Errors.” 8 August 2002.

²⁰⁾ See: “WorldCom’s Sorry Legacy.” Charles Haddad and Dean Foust. Business Week. 8 July 2002. P. 38–40.

The accounting issue arose when WorldCom treated "line costs," immediate expenses paid other telecom providers for the right to network access, as capital items, the cost of which was allocated over a period of years, rather than deducted currently, as accounting practice requires. The adjustment in its financial statements substantially lowered its EBITDA (earning before interest, taxes, depreciation and amortization), upon which investors rely as an accurate indicators of a company's financial health²¹).

WorldCom might have assured itself of the same capacity using IRU (Indefeasible Right of Use) contracts, common in the industry, which provide for access to capacity for up to twenty years. The advantage is that IRU contract can be depreciated over its twenty year useful life²²).

In addition to the adjustments noted above, WorldCom announced that it may take a one-time write-off of \$50.6 billion for certain intangible items and goodwill, thus joining JDS Uniphase and AOL Time Warner, Inc., both of which also had recent write-offs exceeding \$50 billion²³).

The Options Issue

The renowned Professor William J. Baumol of New York University and Burton G. Malkiel of Princeton University note that "The first purpose of employee stock options is to provide a non-cash substitute for part of the wage compensation the firm must provide to attract and retain employees. A new, entrepreneurial firm may not be able to provide the cash compensation needed to attract outstanding workers...stock options must be recognized as only a redistribution of benefits between initial stockholders and the new, prospective management stockholders...(not resulting) in any reduction in the overall size of the firm's earnings ...(only affecting) the way in which that pie (the earnings "pie") is sliced and divided up ... different from ... a rise in wages (or other true expenses) that results in a net reduction in the firm's cash (ergo, the cash available for the payment of dividends)"²⁴). A contrary position is asserted by former Enron CEO Jeffery Skilling, testifying on Capitol Hill that "...Essentially...(a company issues)...stock options to reduce compensation expense, and therefore increase profitability"²⁵). However, it is quite likely that the amounts of cash compensation which would be offered by companies would be far less than the compensation realized by key employees as the result of stock options. For example, Skilling received \$62.5 million in 2000 from exercising incentive options. It is

²¹) "How to Hide \$3.8 Billion in Expenses." Peter Elstrom. Business Week. 8 July 2002., P. 41.

²²) See: "Back to IRU Reality." Elizabeth Starr Miller. America's Network. 15 July 2002, pp. 16-17. Also, see, on page 6, "Of Sound Mind and Body." By Joan Engebretson, Editor.

²³) See: Reuters. Jeremy Pelofsky. "WorldCom Finds \$3.3 Billion in Errors." 8 August 2002.

²⁴) See Malkiel, Burton G. and Baumol, William J. "Stock Options Keep the Economy Afloat." The Wall Street Journal. Thursday, 4 April 2002. P. A18 (parentheticals added).

²⁵) See: "Stock Options Come Under Fire in the Wake of Enron's Collapse." by Gregg Hitt and Jacob M. Schlesinger. The Wall Street Journal. Tuesday, 26 March 2002. P. A1. In April 1993, the FASB voted to require options to be expensed. Intense industry lobbying, supported by the Clinton administration and a non-binding resolution sponsored by Senator Joe Lieberman and passed by an 88-9 vote. Senator Lieberman later sponsored legislation which would have put the FASB out of business, although it never was enacted.

quite unlikely that Enron's compensation committee on the Board would have authorized a cash incentive payment of that amount.

Aside from the issue of deductibility of options, noted above, which, if mandated, might reduce a company's cash position and, consequently, its shareprice, there remains the question of whether the value of options should be considered taxable compensation when issued. Although, for the time being, no income tax is imposed on options until exercised, the United States Internal Revenue Service, for more than two years, has asserted that the standard "payroll" taxes (Social Security withholding, Medicare and unemployment premiums) should be levied against the value of options. However, interest groups have so far managed to "convince" IRS that its position is not tenable. Consider the situation in which an option share is "artificially" evaluated at \$100 (all evaluations of options are necessarily speculative, since valuation is predicated on knowing the future fortunes of the company in question). If the payroll levy is exacted at a rate of 25%, the holder of the option would be required to pay \$25. However, if the company floundered and the stock fell below the exercise price, the option would be worthless. Would the government then rebate the tax, with interest? Not likely.

An Ad Hoc special interest group, the "Coalition to Stop Higher Payroll Taxes" has motivated its members to send to Congress and the Department of the Treasury (which oversees the IRS) more than 20,000 letters and e-mails in opposition to the proposals to tax stock options²⁶⁾.

The Sarbanes-Oxley bill passed by the Congress and signed by the President just prior to the August 2002 summer recess did not include a provision requiring stock-option compensation to be deducted as a compensation expense, although many companies, generally more mature companies with relatively well-defined, but modest, growth prospects, including Coca Cola, General Motors and the Washington Post, have announced that the practice of deducting the cost of options will be implemented, while other companies, many in the "high-tech" market, such as Intel, for which the growth prospects are less certain, have chosen not to deduct the cost of options offered as compensation. Senate Majority Leader Tom Daschle stated that the Senate will take up the issue upon its return from the August recess, but, as an "orphan" issue in a pre-election period, it is quite uncertain whether this requirement will be enacted²⁷⁾.

Accounting Issues

At this point, it may be of value to consider key aspects of accounting. Over the past decade, there has been increasing attention to the "buzz-word" "transpa-

²⁶⁾ See: "Stock-Option Taxes Face Opposition" The Washington Post, 14 May 2002. P. E1.

²⁷⁾ Robert C. Merton, Professor of Finance from Harvard Business School and a Nobel prize laureate for his work in options, together with Professor Robert Kaplan (Harvard Business School) and Professor Zvi Brodie (Boston University School of Management) argue that "Even when a company's options are not trade directly in a market (as they often are), their approximate price can be inferred from the prices of other securities that are traded in the markets...In this respect, options are no different from any other class of financial assets such as stocks, bonds, mortgages and widely-traded derivative securities. See: "Options Should be Reflected in the Bottom Line." Zvi Brodie, Robert S. Kaplan and Robert C. Merton, The Wall Street Journal OnLine. August 2002.

rency” in the context of the accounting industry. More transparency is supposed to be better, less transparency worse. The problem with transparency is that, while investors have a right to material information with respect to corporate operations before investing, the corporation also has a right to protect its proprietary interest against other corporations that would seek to gain an advantage from detailed knowledge about a corporation’s financial and/or technical plans. For example, Coca-Cola has long protected in its interest in the formula for producing the Coca-Cola syrup, and, indeed, the formula is neither copyrighted nor patented (which would require relinquishing rights to the formula after statutory periods).

It is well recognized that a company has the right to protect such proprietary information. With respect to financial information, were the corporation required to report detailed aspects of its financial structure, other companies might well be able to determine the corporation’s long-term growth strategy and take steps which would place the corporation at a competitive disadvantage.

In a related topic, the SEC has recently implemented its rule “Regulation Fair Disclosure” (Reg FD) which requires disclosure on a limited basis of “material,” non-public information by publicly traded companies to analysts and institutional investors and simultaneously to the market as a whole. The idea of Reg FD is that the general public should have access to important corporate information at the same time as heretofore privileged corporate “insiders.” At the time regulation FD was being considered, under former SEC Chairman Arthur Levitt, the professional investment community was strongly opposed to the regulation. Since the implementation of regulation FD (Reg FD), the corporate community has been generally supportive although professional investment firms still only grudgingly accept the regulation. One observation with respect to Regulation FD is that it does not increase the transparency or provide more information to the marketplace, rather, it just changes the timing of the information provided to the general public, ensuring that the general public receives the information at the same time as the professional investment community²⁸).

The accounting industry has a number of devices available which can affect the operating statements and balance sheets for corporations. The basic idea is to turn “income into capital” and “capital into income” whenever it is beneficial (and, arguably, in good-faith, legal) with respect to a particular corporate strategy (tax planning or with respect to SEC reporting) and it is arguably reasonably consistent with the law (or, as some might term it, not arguably reasonably inconsistent with the law – and lawyers will assure you there is a difference). For example, it may be of advantage to a corporation to record revenue before is actually received or defer receipt of revenue. Thus, if a corporation has a contract which calls for payments over several years, under appropriate circumstances, it may choose to record all of the revenue payable in the current year. Another method concerns the valuation of assets. As an example, energy companies such as Enron may enter into a contract for the delivery of gas for a period 10 years into the future. This contract certainly has a present value, but it is a present value very difficult to determine since it depends on a commodity with a commodity price that is very volatile from year to year. This problem of valuation becomes even more complicated when a company

²⁸) See “Fair, Foul or Full Disclosure” by Eric Krell, *Business & Finance Mag*, February 2002.

engages in a large number of mergers and/or acquisitions in a given year and the contracts of the merged or acquired entities have to be evaluated²⁹).

Moving transactions “off the books” is another tool of creative accounting. For instance, if a corporation obtains a loan, it is required to report that loan as an obligation. However, suppose the corporation finds another entity to serve as the primary obligor and/or guarantor on the loan, with the corporation itself retaining only residual liability, the question then becomes should the corporation be required to report the loan as its obligation? If the primary obligor/guarantor on the loan is sufficiently strong so that the transferor corporation only has a 1 in 1000 probability of exposure on the obligation of the loan, should it then be required to report an obligation of \$1000 on \$1 million loan or should take the approach that its obligation to pay is so remote that it is not required to report the loan at all? These are just some of the issues that accountants wrestle with constantly³⁰.

The Public Debate:

If it has had no other effect, the Enron affair has certainly stimulated wide-ranging discussion in the public arena about corporate governance and disclosure. While no entirely new ideas have been interjected into the realm of public commentary, it may be worthwhile to explore the most important propositions and assess the likelihood of legislative and/or regulatory action with respect to those ideas. President Bush has suggested that those committing fraud be barred from serving as officers and/or directors of publicly traded companies. In 1994, Victor Posner, a corporate “take-over” magnate, was convicted of concealing a fraudulent take-over scheme and barred by the judge in the case from serving as an executive or on the board of any public company³¹.

However, it is important to understand that, generally, the law does not provide for the criminal prosecution. The reason is that criminal conduct requires specific criminal intent. Corporate entities can only reflect the intent of the individuals empowered to conduct corporate operations. It is quite likely that the conduct of

²⁹) Howard Schilit, formerly a Professor of Accounting at American University, Washington, D.C. and recognized as an expert in detecting accounting fraud, notes seven items which may be employed by companies in an effort to produce overstated, favorable results: 1) reporting revenue before it is received; 2) reporting revenue that is never earned (Bausch & Lomb); 3) Mis-stating as income “special” items (one-time items that would not be characteristic of the company’s on-going operations (Boston Market, interest payments on loans to franchisees, 1996); 4) shifting expenses properly allocable to one period either forward or backward to other periods to produce favorable results (AOL shifted \$370 million allocable to 1994–96 to later years); 5) shifting expenses properly allocable to future periods to the present period (in 2001, JDS Uniphase wrote-off \$45 billion in expenses properly allocable to later periods to improve their prospects in the later years); 6) shifting items to off-balance sheet entities (the Special Purpose Entities (SPEs) used by Enron); Shifting revenue properly allocable to the current period into later periods (“smoothing” earnings) (W. R. Grace reported growth from 1991 to 95 by shifting earnings determined by the SEC to be properly allocable to 1991–92). See: “Seven Deadly Accounting Sins,” Money, April 2002. P. 60.

³⁰) See: “Creative Accounting: Four Areas to Buff Up A Company’s Picture” by Ken Brown. The Wall Street Journal OnLine, 21 February 2002.

³¹) See: The Economist, March 9th to 15th, 2002, P. 83. This would be possible, of course, only for corporate personnel actually convicted of fraud in a judicial process.

Enron and its counsel, Arthur Anderson, will lead to criminal indictments of individuals from each of those companies³²⁾.

The Issue of Materiality

An item of account, either in the operating statement or the balance sheet (or even “off-balance sheet” items) need not be disclosed on a company’s financial statement unless and until it is “material.” The question then becomes: “What constitutes a “material” item?” The Financial Accounting Standards Board (FASB) determined in 1998 that something is material when “the judgement of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement”. The accounting profession generally considers that an item is material if its impact is 5 to 10 percent or larger, but the question becomes “5 to 10 percent of what?” Should the base against which the test is applied be 5 to 10 percent of current revenue, or assets, or profits? Moreover, should the test of materiality be applied against future revenue or assets or profits, or perhaps even the “deltas” of these items, since an investment is normally made in anticipation of the future value of these items? Writing in the Wall Street Journal, Andy Kessler, a former hedge-fund manager notes that, as a \$100 billion company, using a 10 percent threshold, for Enron anything less than \$10 billion would not have been considered material³³⁾. Perhaps a multi-pronged test is required in which a certain percentage is applied to revenues and/or changes in revenues, another percentage is applied to assets and/or changes in assets and a third percentage is applied to profits and/or changes in profits. Investors would then have a number of indices upon which to base their investment decisions.

The Issue of Special Purpose Entities

Companies have been able to employ Special Purpose Entities (SPEs) to move debt off the companies’ balance sheets because the legal requirements concerning consolidation of obligations permits companies to “keep SPEs off their books if independent third parties have at least a 3% (ownership) stake (in the SPE)”³⁴⁾. The proposal is that consolidation on the balance sheet of the sponsoring company will be required if the SPE has less than 10% equity owned by independent third parties. Moreover, the test for independence of the third party investor is to be strength-

³²⁾ See: “Corporations Aren’t Criminals.” by John S. Baker Jr., The Wall Street Journal OnLine. 22 April 2002. “...First, the complexity of modern corporations is said to justify criminal liability due to the difficulty of proving the responsibility of a particular individual. Second, it is argued, corporations ought not to benefit from the criminal acts of their agents... Justice (The U.S. Department of Justice) seems to be operating on the premise that widespread wrongdoing by individuals in a company justifies a criminal indictment of the company itself...(however) under common law, a corporation could not be guilty of a crime because it could not possess *mens rea*, a guilty mind.”

³³⁾ “Listing in a Material World” by Andy Kessler. The Wall Street Journal OnLine. 25 February 2002.

³⁴⁾ See “FASB Speeds Plans to Toughen Rules Governing Special-Purpose Affiliates.” By Jonathan Weil and Carol S. Remond. The Wall Street Journal OnLine. 28 February 2002.

ened to ensure that such third parties actually bear the risk of loss on the investment in a SPE. Financial Accounting Standards Board Chairman Edmund Jenkins indicated that the new rules could become effective by August 2002, following a 60 to 90 – day comment period after the proposed revisions are issued. However, over the past 20 years, the FASB has addressed the issue of consolidation but has always withdrawn proposed standards to toughen the rules when confronted by industry opposition. It will be interesting to observe if the collapse of Enron and Global Crossing are sufficient to motivate real reform in this election year³⁵).

The Issue of Corporate Governance

The Association for Investment Management and Research (AIMR) has suggested a wide range of reforms that should be implemented by the FASB and the SEC. Most salient among these suggestions are:

1) Corporate management must insure that their companies provide financial reports to the benefit rather than the detriment of investors. Financial reports should be written in plain English which can easily be understood by the average investor.

2) Boards of directors must appoint audit committees that are “accounting-literate,” that is, sufficiently knowledgeable of accounting rules to ask management and auditors the right questions and judged the veracity of their answers. Moreover, boards of directors must take responsibility for the financial reports issued by the companies they oversee.

3) Auditors must regain their lost independence and fully disclose in the client’s annual report any and all non-audit (consulting, tax services, etc.) services they provide to the company.

4) The Financial Accounting Standards Board must implement new rules which adequately treat in the following items: a) employee stock options and other equity compensation; b) provision of accurate guidance on the value of financial assets, liabilities and derivatives; c) corporate operating performance; and d) proper reporting of the risks and responsibilities of off-balance sheet assets and liabilities.

5) The SEC must a) enforce aggressively and consistently all financial reporting rules; and b) restore recently eliminated supplemental SEC disclosure rules with respect to items such as the detailed schedule for fixed assets and bad debt reserves.

6) The investment industry must a) demand quality financial reports in order to have a reasonable and adequate basis for the recommendation of investment analysts; b) aggressively seek information not contained in a company’s primary financial statements; and c) play a much stronger role in supporting improved financial reporting and accounting³⁶).

³⁵) See “FASB Speeds Plans to Toughen Rules Governing Special-Purpose Affiliates.” By Jonathan Weil and Carol S. Remond. *The Wall Street Journal OnLine*. 28 February 2002.

³⁶) SEC Chairman Harvey Pitt is recommending the companies be required to file faster; in the case of quarterly reports, 30 days after the close of the quarter rather than the current 45 days, and, for annual reports, 60 days after the close of the firm’s year rather than the current 90 days. See: “Pitt Calls for Stricter Control of Options.” *The Wall Street Journal*. Friday, 5 April 2002. P. A4.

7) Congress must a) allow the FASB to establish accounting standards without undue political interference and b) ensure that the SEC has sufficient funds to carry out its enforcement obligations³⁷⁾.

The Issue of Reform of the Credit – Rating Agencies

In Congressional hearings, the SEC charged that credit ratings agencies should have alerted the market to Enron's deteriorating financial condition. Senator Fred Thompson (R – Tenn.) noted that the agencies had the right to undertake an assertive, affirmative due-diligence to ascertain the true financial condition of the company but did not do so and, rather, relied on "deceptive" and "fraudulent" information (so characterized by Ronald Barone, Managing Director of S&P). Senator Thompson remarked "It seems there isn't much value-added by either analysts or credit raters." The larger credit rating agencies, Standard & Poor's Rating Group (S&P) and Moody's Investors Service Inc. are registered with the SEC and receive a "stamp of approval" which conveys to the market the notion that the capital markets can rely on the agencies' representations with respect to rated debt instruments³⁸⁾.

General Issues in the Accounting Industry

The respected publication Business Week issued a special report the week of 28 January 2002 which set forth some ideas for reform of the accounting industry. Among these ideas are the following³⁹⁾:

1) Ensure that self-regulation is effective. At the moment, the American Institute of Certified Public Accountants (AICPA) has a Public Oversight Board which is to ensure representation of the public interest in auditing oversight. This board however has no authority to investigate, no subpoena power, and no power to punish infractions and receives its funding from the CPA industry. This board has another offshoot which is the Quality Control Inquiry Committee (QCIC) which investigates approximately 50 cases of audit failure raised by issues in lawsuits filed against accounting firms. This committee, too, has no subpoena power and works entirely from public documents. No big five accounting firm has ever failed a review by this committee.

2) Accounting firms should be barred from providing consulting services to their audit clients. As is noted in the table appended, non-audit services have become the primary source of revenue to the "Big-Five" accounting firms. Too often, the non-audit services lead to conflicts of interest which prejudice the ability of the accounting firms to carry out their audit function⁴⁰⁾.

³⁷⁾ "How to Fix a Damaged Financial Reporting System: Place Investor Needs Above Corporate Interests" by Thomas A. Bowman, President & CEO, Association for Investment Management and Research. These ideas were published widely in the Washington Post, The New York Times, the Wall Street Journal and other media sources.

³⁸⁾ See "SEC Mulls Curbs on Credit Agencies Amid its Probe of the Enron Collapse." by Michael Schroeder. The Wall Street Journal OnLine. 21 March 2002.

³⁹⁾ "Accounting in Crisis." Business Week, 28 January 2002. P. 44-48.

⁴⁰⁾ "The Real Scandal" The Economist. January 19-25th, 2002. The Economist argues under present International Accounting Standards (IAS) and/or British Standards, Enron would

3) Mandate the rotation of auditors. An accounting firm should only be able to audit the books of a particular client for a fixed period of time, e.g., three to five years. At the end of this term, a new audit firm would be required to be brought in. Such a practice would certainly entail substantial additional costs to the audit clients, but it would insure investors that the information upon which they were relying for their investment decisions is accurate. Clearly, a new audit firm taking over would have to spend several months in a detailed review of the work of the departing auditor.

4) Auditing firms ought to be required from time to time to engage in substantial forensic accounting of client accounts. Just as world-class athletes are required to submit to drug tests from time to time to ensure they are clean, corporations ought to be required from time to time to submit to extraordinary forensic review of their accounts to ensure that reported information is accurate and fairly reflects the financial condition of the company. These audits would be analogous to IRS "super-audits" but would be broader in scope and not specifically focused on tax avoidance issues.

5) Place restrictions on the "revolving-door" of auditors moving to their client-companies. Just as there are restrictions on politicians and members of their staffs moving from the government into the private sector, there should be limitations on the ability of individuals from audit firms to move into the employ of their audit clients and, similarly, staff members from audit clients moving to the employ of the accounting firms.

6) Ensure that a board of director's auditing committee is truly capable of providing independent judgment with respect to the Company's financial reports⁴¹⁾.

The Securities and Exchange Commission in 1999 "recommended that audit committees be made up solely of independent directors, each of whom should be financially literate, with at least one having accounting or financial management expertise." The Investor Responsibility Research Center, in a recent survey, reported that, of the 1,200 companies surveyed, 30% reported audit committees are not independent, 27% reported their compensation committees are not independent and 53% reported nominating committees are not independent. Moreover, the concept of "independence" employed in the practice of corporate governance is questionable⁴²⁾.

not have been able to overstate its profits to the degree it did. Further, the editorial article argues that the U.S. may want to reconsider its use of GAAP and seriously consider adopting (presumably in part or full) International Accounting Standards. Perhaps British accountants are less creative than American accountants (or more guided by legal principles)?

⁴¹⁾ In 1999, the New York Stock Exchange, the American Stock exchange and the NASDAQ implemented rules by which member firms were required to disclose whether directors are independent. These exchanges also began requiring that members of the audit committees have adequate expertise in financial matters to be able to make a meaning inquiry into the financials presented them. The NYSE uses a definition of "independence" of a director which requires separation from the employ of the company for at least three years. TIAA - CREF, one of the largest institutional investors, supporting efforts at reform of corporate governance, has endorsed proposals that a company's board audit, compensation and nominating committees should be comprised only of independent directors. See: "Pitt Calls for Stricter Control of Options." The Wall Street Journal Friday, 5 April 2002. P. A4.

⁴²⁾ See: "Turn up the Heat on Board "Cronyism"", Mr. Grasso." Business Week, 22 April 2002., P. 36.

7) Reform the accounting rules. Professor Uwe Reinhardt of Princeton University notes that “a more productive approach for Congress would be to help convert the Financial Accounting Standards Board (FASB) into a genuinely independent, permanently endowed research-and rule-making body, akin in power and stature to the Federal Reserve, and accountable only to the SEC. Its activities should be absolutely beyond the direct influence of corporate executives for whom the FASB makes rules (although corporations should, of course, be allowed to present their perspectives to FASB). More important, FASB should be absolutely beyond the direct influence of any member of Congress. Finally, Congress should mandate the SEC to list on its web-site all communications on corporate governance between individual members of Congress and the SEC”⁴³).

The Practical Lessons – Evaluating Prospective Direct and/or Portfolio Investment⁴⁴

1) An investor should seek to determine whether the business in which it is contemplating investment has a defined business model and whether that model has well-defined parameters. Are its parameters too broad or too narrow? Is the company's recent experience one of operating within the parameters it has established in prior business plans? If the business plans to broaden itself, does it have the experience to incorporate new lines of operation? Does the business have any “whistle blowers” that indicate that not all is well with in the corporation? If the answers to any of the foregoing questions are equivocal, the investor should do a serious due-diligence before investing.

2) Does the company issue straightforward financial reports which provide clear guidance to the investor as to the details of its operations in the current year and/or in past years, adequate explanation of any changes in its balance sheet and reasonable bases for any projections for future growth? Are there indicia that the firm is employing “aggressive” accounting techniques? In the case of Enron, an “early warning” indicator should have been noted by analysts in the five years preceding its bankruptcy as the company's reported earnings consistently exceeded its cash-flow.

3) Beware of the “earnings-expectations” strategies followed by many companies: the company establishes a “target earnings expectations” level which it is confident it can surpass in order to inflate the investor expectations when it reports results that do, in fact, surpass previously estimated earnings. Rappaport notes that 78 percent of companies typically match or beat the earnings targets they have established.

4) Carefully evaluate the competitive status of an industry in order to anticipate price wars for the underlying products of competitive companies in the industry which may lead to lower gross profit margins and an a subsequent erosion of

⁴³) “Can't Executives be As Honorable as Our Soldiers?” By Uwe Reinhardt, Professor of Political Economy, Princeton University. The Wall Street Journal OnLine. 12 March 2002.

⁴⁴) The points noted in this section are extracted from an article entitled “To Avoid Trouble, Look at these Red Flags” by Alfred Rappaport, Leonard Spacek Professor Emeritus, J.L. Kellogg Graduate School of Management, Northwestern University. The Wall Street Journal OnLine, 25 February 2002.

value in a given company's stock. As a new industry becomes mature, the gross margin on a company's products declines, eroding the company's profit margins, consequentially leading to an erosion in the value of the company's shares.

5) Decade after decade, companies become overconfident in their ability to manage businesses of all types and engage in mergers and acquisitions which often proved disastrous. As this is being written, Hewlett-Packard is engaged in an aggressive battle to take over Compaq Computer. In the year 2000, AOL, with a highly inflated stock price resulting from the high-tech boom of the last half of the 1990s, took over Time Warner, precipitating a significant erosion in the market capitalization of the combined company. Although GE is thought by some analysts to be an exception to the rule, its decade of acquisitions may yet prove to be an overwhelming management task.

6) Carefully evaluate a company's share "buyback" program. From time to time, a company's executive management may conclude that the company's strong cash position, coupled with a perception that its shares are undervalued by the market, argue for a decision to buyback the company shares. Often, however, the company will use its own shares for the buyback program. Rappaport notes "Most companies disclose the size of the synergies they expect (from a share buyback program). Compare the value of the expected synergies with the premium."

7) Very carefully evaluate the executive compensation programs which a company has established. In view of the collapse of the NASDAQ and the retrenchment of the NYSE (specifically, the DJIA), the popularity of stock options has declined and companies have either had to lower the share-price of stock options or increase the amount of cash compensation in order to attract and/or retain executive management. As a part of the analysis of executive compensation, consideration should also be given to the takeover defenses which are in place.

8) Evaluate the extent to which market capitalization is derived from the value of "intangible" assets. Fifty years ago, tangible assets constituted more than 75% of the market capitalization of non-financial business in the United States. The balance of the market capitalization was comprised of the value of intangibles (patents, copyrights, goodwill, etc.). By mid-2000, the value of tangible assets declined to about 55%, with intangible assets constituting 45%. For the NASDAQ "high-tech" bubble firms, intellectual property comprised, in some cases, 80% to 90% of the market capitalization. As noted by Federal Reserve Board Chairman Alan Greenspan, "...a firm is inherently fragile if its value-added emanates from conceptual (intellectual property [note added]) as distinct from physical assets...trust and reputation can vanish overnight. A factory cannot"⁴⁵).

Lessons from the "Go-Go" Nineties

If there is a single most important lesson from the "Go-Go" '90s, it is that even the more than seventy years of capital markets regulatory development in the United States is not sufficient proscriptively to eliminate the financial shenanigans of companies aided by scheming, clever managers and/or business planners. For the Russian market, with less than a decade experience in regulating capital markets,

⁴⁵) See "Mind over Matter – Why Many Highfliers Built on Big Ideas Are Such Fast Fallers." The Wall Street Journal, Thursday, 4 April 2002. P. A1.

patience is required. In time, it will become an efficient, well-regulated market for domestic and foreign investment and transactions. It should not be expected that the first efforts in Russian regulation of complex markets will be without significant failure, given that more than seventy years of regulation in the United States has been marred, periodically, with major regulatory failures.

It is also clear that “unbridled optimism” or “irrational exuberance,” as Federal Reserve Chairman Alan Greenspan termed it (“over-blown expectations”) must absolutely be restrained by common sense, without exception. At a recent investment forum in New York, a Russian investment banker, touting the Russian market, and noting the consistent growth in the Russian market over the last three years since the 1998 market collapse, reflected that he expected the market to continue growing at least to the end of the year before President Putin’s second term ends. This is an expression of optimism that certainly should give an investor reason to be concerned. First, it presumes that President Putin will be well enough received by the Russian people to be elected to a second term and, second, that the Russian market will continue to grow without any substantial correction for least another five years. While first presumption may be moderately risky, the second presumption is certainly very risky. Markets inevitably become oversubscribed and/or overbuilt and are subjected to corrections. Moreover, as United States has witnessed with the Sept. 11th events, unforeseen intervening political and economic phenomena always hold the potential for altering the investment climate.

This is not to suggest that one should be pessimistic about the Russian market. Barring the occurrence of unforeseen political and/or economic events of a substantial magnitude, there’s no reason why the Russian market should not experience decades of stable long-term above average growth. It should be expected however that the growth will be cyclical, marked by upswings for periods of several years with shorter, but sharp, cyclical downturns.

Postlude

This article has been written over the course of the first two quarters of 2002 and part of the third. It was suggested above that the Enron matter would have a “half-life” of about 60 days, with Global Crossing at about thirty days. Both have dropped of the “political horizon” and are now rarely mentioned in press reports. However, as noted above, in late July 2002, the bankruptcy of WorldCom occurred. Occurring just before the August congressional recess, and about three months before the congressional mid-term election, this filing provided the critical-mass to spur lawmakers to pass comprehensive legislation on the accounting industry and corporate governance, signed into law by President Bush. The Washington Post columnist Robert Samuelson, in a remarkably well-written article entitled “Reform Hysteria,” quotes humorist Mark Twain: ‘Nothing so needs reforming as other people’s habits’⁴⁶⁾. Samuelson notes “We live in an era of moral exhibitionism. Every reform moment is an opportunity for public figures – politicians, TV commentators, columnists – to strut their self-righteousness. These crusades become orgies of rhetorical self-promotion”⁴⁷⁾. Samuelson’s comments, occurring before the WorldCom

⁴⁶⁾ The Washington Post OnLine. Robert Samuelson. “Reform Hysteria.” 17 July 2002. P. A23.

⁴⁷⁾ Ibid.

filing, perfectly captured the mood of Congress. The WorldCom filing provided the impetus to action.

Arthur Anderson has faced a multi-week trial in Houston, Texas. The jury had been deliberating for almost a week without reaching a verdict, a clear indication that the government's case against the company and its key employees had not been conclusive⁴⁸). On 12 June 2002, the jury announced that it could not reach a decision, a legal status which is termed a "hung jury," which may indicate that a "mistrial" might have to be declared by judge Melinda Harmon, in charge of conducting the trial. If a mistrial were to be declared, the government would have to have faced the choice of an expensive retrial of the matter or being embarrassed by dropping its legal claims. The judge, in instructing the jury to continue its deliberations, further instructed the jury that "...the 12 jurors...did not have to be in agreement as to which Anderson employee had acted with criminal intent to obstruct justice," conflicting with her earlier instruction that "the jury must, in order to convict, conclude that a single employee committed all the necessary elements to complete the crime"⁴⁹). Wanda McKay, one of the twelve jurors, quoted in the New York Times, states "They forced us to come back with a guilty verdict"⁵⁰). It is quite likely that the verdict will be appealed, so the issue is not yet finally settled. However, the damage to Anderson is practically irreversible.

It was noted above that the prospects of new legislation covering the issues arising out of the Enron and Global Crossing cases were very uncertain in this election year. This would be true in any election year, but the exigencies imposed by the 9-11 events would have made it much more unlikely that any significant legislation would be passed by the Congress, particularly since President Bush challenged the Congress to enact legislation creating a new "Department of Homeland Security" before the end of the current session⁵¹). Practically, the current session has about

⁴⁸) See: "Andersen Jury Deadlocked in Obstruction Trial" by C. Bryson Hull. Reported on Yahoo, Reuters. 12 June 2002. 7:12 PM ET. "After almost a week of deliberations, a federal jury on Wednesday said it was unable to reach a unanimous verdict on whether the accounting firm Andersen was guilty of criminal obstruction of justice in an investigation of its client, Enron Corp.

The 12-member jury, which heard nearly five weeks of testimony before U.S. District Judge Melinda Harmon, sent the judge a note that said simply: "We are unable to reach a unanimous decision".

The key issue before the jury is whether Andersen, which is based in Chicago, criminally intended to obstruct justice when it destroyed Enron audit records last fall while the U.S. Securities and Exchange Commission (news - web sites) was investigating Enron's off-balance-sheet transactions and accounting practices".

Even without a verdict, Andersen still faces a mountain of lawsuits and possible civil punishment from the SEC".

The judge can (and has) instruct (ed.) the jury to continue trying to reach a verdict, and it will continue to do unless it decides to report to the judge that it is "hopelessly deadlocked", in which case a mistrial will be declared.

⁴⁹) See: The Wall Street Journal OnLine. John S. Baker, Jr. "An Injustice in Houston." 18 June 2002. Parentheticals and emphasis added.

⁵⁰) Ibid, requoted.

⁵¹) Cresting a new Department is roughly equivalent to the creation of a new ministry in a parliamentary/ministerial system of government. President Bush is seeking to form the new cabinet by taking functions from several existing departments in the government, a difficult

four “working” weeks remaining before the November election, as intervening, there is a July 4th holiday recess and an August/Labor Day recess, with full-time campaigning beginning not later than the first week of October.

Concerning the three primary areas of legislative interest noted above, accounting issues, executive compensation and corporate governance, the WorldCom bankruptcy proved the crucial factor in precipitating congressional and presidential action. Moreover, by the next Congress, the memory of current events will have faded, and the focus of politicians will soon be on the 2004 Presidential election⁵²⁾.

The new law will not apply to the problems of Enron, Global Crossing, WorldCom or any other corporate failures which involve corporate conduct which occurred prior to its passage. It is prospective.

The principal elements of the law cover accounting regulations, criminal penalties for certain conduct, corporate governance and extended protection for investors.

The law requires the formation of a five-member oversight board which will replace the Financial Accounting Standards Board (FASB) and which will be under the oversight of the Securities and Exchange Commission. Only two members of the Board may be drawn from the accounting industry. Board members are to serve fulltime, with terms limited to five years. Auditing firms are barred from providing nine types of consulting service to audit-clients. Perhaps, the most important change is the requirement that firms covered by the law are required to rotate reviewing partners on client-company assignments every five years, although this provision stopped far short of the proposal noted above (see: p. 29, subparagraph 3) that would have required the rotation of auditing firms every three to five years⁵³⁾.

Substantial new criminal penalties have been added. The maximum prison term for securities fraud has been increased to twenty years. Penalties for mail or wire fraud in connection with securities transactions have been increased to twenty year, while corporate CEOs or CFOs (Chief Financial Officers) making false statements to the SEC or failing to certify financial reports face fines up to \$5 million and/or imprisonment for terms up to 20 years⁵⁴⁾.

In the matter of corporate governance, CEOs and/or CFO's will forfeit profits and/or bonuses if earnings are restated due to securities fraud. Executives can not receive loans that are not available to “outsiders,” except that this provision will not apply to the banking industry, for which the Federal Reserve already regulates insider loans through its Reg. O, which bans loans on preferential terms and requires a bank's board to approve loans exceeding certain limits. Corporate officers also cannot use the federal bankruptcy law to escape liability arising from judgements of fraud in connection with their corporate responsibilities⁵⁵⁾. The audit committees of

task, given the vested interests of the bureaucracy (and the real political constituencies of each agency in the bureaucracy) in the *status quo*. The new agency would be roughly equivalent to a “ministry of the interior” in ministerial systems of government.

⁵²⁾ For an excellent analysis of the current status of proposed legislation see: “What Cleanup?” By Amy Borus, Mike McNamee, Paula Dwyer, Marcia Vickers and David Henry, Business Week. 17 June 2002. P. 26–29.

⁵³⁾ See: “Overhaul of Corporate Oversight Has Far Reaching Consequences.” Shailagh Murray and Michael Schroeder. The Wall Street Journal OnLine. 26 July 2002.

⁵⁴⁾ Ibid.

⁵⁵⁾ Ibid.

corporate boards will be required to be independent and will have affirmative responsibility to hire and manage the company's auditor.

Shareholder protections have been enhanced by increasing the statute of limitations on actions arising out of securities fraud from three years, at present, to five years under the new law, or two years from the time the fraud is discovered. Moreover, as "whistle-blowers" have more ability to prove retaliation by employers and enhanced ability to sue for such retaliation, there is an incentive for companies not to engage in fraudulent securities and/or accounting practices⁵⁶).

The impact of the new law is not clear. It will take time to develop regulations necessary to implement its provisions, in some cases, the implementing regulations may not be available for years. Nevertheless, the mood of the Congress is clear and that mood has been clearly conveyed to the corporate community; the influence of the corporate and accounting industry lobbies in Congress is certainly diminished, at least temporarily.

A clarion as to whether the Congress has sated the electorate's desire for regulation will be noted in its return for the pre-election session in September 2002. With the Congressional election looming the first week in November, if it is able to enact law requiring that options be expensed, the issue will be clear. If not, it will be understood that the Sarbanes - Oxley legislation has proved sufficient political "cover" to satisfy public concerns about the capital markets. It is quite possible and, perhaps, not surprising, that the new legislation will turn-out to be another "Lawyers & Accountants Relief Act." Given the importance of understanding accounting principles and auditing, companies covered by the act may increasingly consider hiring CEOs that are certified public accountants. This would be a departure from historical precedent, by which companies prefer to have a "hands-on" manager with experience in the company's business in the CEO position. Moreover, the executive staff of covered companies will increasingly turn to outside counsel for "comfort" letters and legal opinions to be sure corporate practice is consistent with the law. Accounting and auditing firms will likely also increasingly seek opinion of counsel, given the serious, career and/or business termination consequences of being wrong.

⁵⁶) See: "Overhaul of Corporate Oversight Has Far Reaching Consequences." Shailagh Murray and Michael Schroeder. The Wall Street Journal OnLine. 26 July 2002.

APPENDIX I

STATUS OF THE U.S. ACCOUNTING INDUSTRY – Part I

	Firm Name	\$ millions	% chng/yr	Mix of Services Provided, %				SEC Audit Accounts
				acct/audit	tax plnng	managemnt cnslt	other	
1.	Pricewaterhouse-Coopers	8,058	3.2	35	20	31	14	3,025
2.	Deloitte & Touche	6,130	+5.0	33	21	35	11	2,877
3.	Ernst & Young	4,485	+7.9	58	39	0	3	2,923
4.	Anderson	4,300	+19.4	43	31	26	0	2,311
5.	KPMG	3,171	+10.3	62	38	0	0	1,786
6.	BDO Seidman	420	1.9	37	47	16	0	325
7.	Grant Thornton	380	+16.6	53	31	16	0	380
8.	McGladrey & Pullen	167	+31.5	94	6	0	0	98

Notes:

- 1) Source: Public Accounting Report, reported in the Wall Street Journal.
- 2) "Other" includes outsourced services contracted for and provided by firm.
- 3) The figures are for Fiscal Year 2001 U.S. Income. In the case of Anderson, foreign income about doubles annual revenue.

APPENDIX II

STATUS OF THE U.S. ACCOUNTING INDUSTRY – Part II

	Firm Name	Revenue per partner in \$ millions	Global Revenue in \$ millions	Global Staff	
				Partners	Total
1.	Pricewaterhouse-Coopers	2.15	19,831	9,219	154,879
2.	KPMG	1.91	12,400	6,500	103,350
3.	Ernst & Young	1.71	9,900	5,777	83,767
4.	Anderson	1.94	9,300	4,806	84,586
5.	Deloitte & Touche	1.82	11,700	6,442	95,342
6.	BDO Seidman	1.01	2,200	2,175	22,403
7.	Grant Thornton	0.74	1,680	2,270	21,792
8.	McGladrey & Pullen	0.79	1,632	2,065	17,966

Notes:

Source: Public Accounting Report, reported in the Wall Street Journal. "Can Anderson. Partners Keep Their Firm Alive?", The Wall Street Journal, Friday, 29 March 2002. P. C1.

APPENDIX III

THE "MARKET" PUNISHES BAD MANAGEMENT

COMPANY	LEGAL/AUDITING ISSUE	LOSS IN VALUE 14/01/00 – 19/06/02	AUDITING FIRM
GLOBAL CROSSING	IMPROPERLY BOOKED REVENUE FROM SALES	- 99.87%	ANDERSON
ENRON	OFF-BALANCE-SHEET TRANSACTIONS	- 99.80%	ANDERSON
ADELPHIA	IMPROPER INSIDER TRANSACTIONS (LOANS & GUARANTEES)	- 99.75%	DELOITTE & TOUCHE
MICROSTRATEGY	IMPROPER REPORTING OF REVENUE (SALES CONTRACTS)	- 99.07%	PRICEWATERHOUSECOOPERS
WORLDCOM	IMPROPER CLASSIFICATION OF EXPENSES	- 96.60%	ANDERSON
LUCENT TECHNOLOGIES	\$679 MIL REV ADJUSTMENT FOR 2000, SEC INVESTIGATING	- 93.39%	PRICEWATERHOUSECOOPERS
KMART	IMPROPER ACCOUNTING PRACTICES	- 91.02%	PRICEWATERHOUSECOOPERS
QWEST	IMPROPER ACCOUNTING FOR SWAPS & EQUIP SALES	- 88.35%	ANDERSON
XEROX	INCORPORATING FUTURE REVENUE ON CURRENT STATEMENTS	- 67.53%	KPMG
DYNEGY	IMPROPER ACCOUNTING FOR TAX PURPOSES, INFLATED REVENUE	- 64.97%	ANDERSON

NOTES:

1) SOURCE – THE WALL STREET JOURNAL ONLINE, 19 JUNE 2002.

2) The losses cover the period from 14 January 2000, the day the Dow-Jones Industrial Average (DJIA) was at its all-time high, until 19 June 2002. WorldCom had not yet filed for bankruptcy.