# The International Capital Markets in the Post "Enron" Era

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**To understand the impact of Enron and Global Crossing in the international capital markets, it is necessary to begin with some perspective. Over the past two years the NASDAQ market declined from over 5000 to under 1500 representing a decrease in market capitalization of over $3 trillion ( although it has recently recovered several hundred points). In the year 2001 alone more than 200 publicly traded on 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 billion,[1] in the final analysis is quite likely that the "hard" losses will be significantly less.**

**Both 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**

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[1] The Chapter 11 filing 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.

**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 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 scale of 1 to 10, least to most damaging, the Enron crisis 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 ).**

**Nevertheless, these two companies have 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 the legal description 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 markets.[2]**

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[2] 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.). The world market for derivatives is estimated to be $40 trillion or more. The most

**One of the most salient factors in the failure of both Enron and Global Crossing is that key executives in both 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 1981,[3] these executives were in entry-level positions with respect to corporate responsibility. 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.**

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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 "lay-off" 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. CDOs 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.

[3] 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) were financial institutions established with the purpose of promoting home ownership, but in 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 periods of about four years.

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 must hedge operations in such a way 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 - 91 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.

## Enron Specifics

From it's 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 because 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 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 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.” More detail on SPEs will be provided below, but at this point, we will just note that the entities were used to move the debt off of Enron’s balance sheet without significantly diminishing the company’s liability for the debt.

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 security.[4]**

**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 thought 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.**

**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 is deductible to 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**

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[4] "Off-balance sheet" financing is common in the power industry. The Wall Street Journal reports 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. (See: "Minutes from a 1997 Meeting Reveal Enron Brass Were in Partnership Loop," John R. Eshmiller and Rebecca Smith, The Wall Street Journal OnLine, 1 February 2002.

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.

From the point of view of 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 50.**

**As with most plans, from time to time when the company changed recordkeepers, 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 recordkeeping 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 recordkeeper.[5] Enron employees were notified in advance of the forthcoming lockdown 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 options as a method of compensation for senior executive management. The overwhelming majority of publicly traded corporations use stock options as a method of compensation for executive management. In the case of Enron, there is certainly an issue as to**

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[5] 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 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.

**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 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."[6]**

**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" "transparency" 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 the corporation. For example, Coca-Cola has long protected in its interest in the formula for producing the Coca-Cola syrup.**

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[6] 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 rigeur* in Washington these days." Rodgers adds that none of the five senatorial sponsors fo 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.

**It is well recognize 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 corporations 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 the disclosure on a limited basis of "material," nonpublic 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 insiders. At the time regulation FD was being considered, under former SEC Chairman Arthur Levitt, the professional investment community was strongly opposed to to the regulation. Since the implementation of regulation 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 community.**[7]

[7] See "Fair, Foul or Full Disclosure" by Eric Krell, BusinessFinanceMag, February 2002.

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 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 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 evaluated.

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 constantly.**[8]

**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.**

**Issue #1: 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**

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[8] See: "Creative Accounting: Four Areas to Buff Up A Company's Picture" by Ken Brown. The Wall Street Journal OnLine, 21 February 2002.

**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 judgment of a reasonable person relying or 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 material.[9] 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 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.**

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[9] "Listing in a Material World" by Andy Kessler. The Wall Street Journal OnLine. 25 February 2002.

**Issue #2: 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 this 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) properly report 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 accounting.**

**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 obligations.[10]**

**Issue # 3: 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 following:[11]**

**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**

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[10] "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.

[11] "Accounting in Crisis." Business Week, 28 January 2002. pp. 44 - 48.

**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 proximately 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 function.**[12]

**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.**

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

**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 reports. 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."**[13]

[13] "Accounting in Crisis." Business Week. 28 January 2002. P. 48

**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."[14]**

**Issue # 4: Evaluating Prospective Direct and/or Portfolio Investment[15]**

**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**

[14] "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.

[15] The points noted below 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.

have any “whistleblowers” 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 the companies in the industry which may lead

to lower gross profit margins and an a subsequent erosion of 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 leading to a decline 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 that 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, it's 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 had to either 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.**

**Lesson from the "Go-Go" Nineties**

**If there is a single most important lesson from the "Go-Go" '90s, it is that unbridled optimism must absolutely be bridled - without exception. At an investment forum in New York recently, touting the Russian market, a Russian investment banker, 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.**

# APPENDIX

## STATUS OF THE U.S. ACCOUNTING INDUSTRY

| | Firm Name | $ millions | %ch ng/yr | MIX OF SERVICES PROVIDED | | | | SEC Audit Accounts |
|---|---|---|---|---|---|---|---|---|
| | | | | acct/ audit | tax plnng | manage-mnt cnslt | other | |
| 1 | PricewaterhouseCoopers | $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.**

**Note -**
**Karl William Viehe has been the U.S. Vice Chairman of the Russian - American Securities Law working group ( nee: SASLAW, Soviet - American Securities Law Working Group), Chaired by Mr. Richard Bernard, Executive Vice-president of the New York Stock Exchange. Mr. Viehe has been an Adjunct Professor of International Law at the George Washington University, Washington D.C., and Adjunct Professor of International Business at the American University, Washington, D.C. and a member of the faculty at the International Law Institute, Washington D.C. Mr. Viehe has twice been Co-chairman of the U.S. Department of Commerce annual conference on "Current Issues in International Trade" and three times co-chairman of the United States Internal Revenue Service's annual conference on "Current Issues in International Taxation."**

**In 1991-1994, Mr. Viehe served as legal consultant to Conoco Oil company with respect to its $460 million investment in the Russian "Polar-Lights" oil project in northern Russia.**

**In 1996-1997, Mr. Viehe served as General Counsel for PromstroiBank of Russia with respect to its successful bid to become the first Russian bank to be accredited to open a representative office in United States.**

**In 1997-1998, Mr Viehe created the first "financial-instrument" guarantee to be issued by the World Bank's Multilateral Investment Guarantee Agency (MIGA) in the amount of $100 million and successfully developed a strategy to obtain said guarantee an for an international investment fund.**