Enron fallout is spreading

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The collapse of Enron appears, at least so far, to have caused relatively little disturbance in energy markets where it primarily traded. One reason for this less-than-expected outcome may be that Enron's practice of listing the full value of the trades it arranged as sales, rather than just the income it secured, vastly inflated its size. But when it comes to the financial markets more generally, the shock waves from the Enron collapse are having a major impact and widening in their scope.

Last Tuesday, for example, Wall Street's Dow Jones index fell by almost 160 points, or 1.6 percent, while the Nasdaq index dropped by more than 3 percent on fears that the accounting methods developed by Enron to boost profits and hide debts were very widespread.

Indeed it appears that the rot starts right at the top. IBM, regarded as the bluest of the blue chip stocks, recorded one of the biggest slides. Its shares went down by more than 3 percent following concerns that its complex accounting methods could cause problems. According to one analyst, they "represent a can of worms that hasn't been opened yet."

Telecommunications companies are another area of concern. Fears over their future in the aftermath of the Enron debacle were heightened last month when Global Crossing filed for bankruptcy protection, in the biggest collapse to emerge from the telecom industry.

Just as Enron inflated its results, there are fears that telecom companies engaged in similar practices. As an article published in the *Financial Times* of February 12 put it, their reports of booming profits in the 1990s may have had a "hollow ring."

"Many telecoms companies," it noted, "traded with each other, exchanging capacity on each others' networks, and treated their trades as revenues. But some of those deals may have been 'hollow swaps', artificial deals concocted merely to create the illusion of activity, according to a growing chorus of industry analysts."

One of those to come under investigation for such practices is Qwest Communications, which has received a subpoena from the US Securities and Exchange Commission for documents relating to its dealings with Global Crossing. The investigation was triggered by claims by a former Global Crossing accounting executive that swap transactions were artificial and aimed at inflating the company's stated revenue.

Concerns over accounting practices have significant financial consequences. One of these is to shut companies coming under suspicion out of commercial financial markets. Qwest Communications has been forced to turn to the banks for $4 billion in funding after investors would not back it with short-term credit. There are predictions that other well-known firms will be excluded from the commercial paper market, one of the chief sources of corporate funding.

JP Morgan Chase has already warned the US telecom firm, Sprint, is "overextended" in the commercial paper market and that "there is a reasonable chance that Sprint will have to look elsewhere for financing." The forecasts are that Sprint will need up to $2 billion to meet its funding needs this year.

One measure of the nervousness is the contraction in the size of the market. Figures from the Federal Reserve show that the amount of non-financial commercial paper has fallen to $209 billion, down 40 percent from its peak in November 2000.

But the problems extend far beyond the companies whose accounting practices have been called into question. According to the former head of the US Federal Reserve, Paul Volcker: "Accounting and auditing in this country is in a state of crisis."

An article in the *New York Times* of February 12 reported that in 1998 a survey of 160 financial officers at public companies found that two thirds of them had been asked by their executives to misrepresent their

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companies' results. Twelve percent admitted they had done so.

"Last year," it continued, "a study by Financial International, a trade group for corporate executives found that public companies had revised their financial results 464 times between 1998 and 2000, nearly as many restatements as in the 20 previous years combined, and the problem probably worsened last year.

"Some of the world's best-known companies, including IBM and AOL Time Warner, are on the list of companies that allegedly use aggressive accounting practices to lift their earnings."

The level of concern generated in financial circles by the Enron debacle and its implications for the financial system as a whole can be gauged by the tone of a series of articles published in the *Financial Times* this week.

An editorial covering the four-part series began as follows: "Individual greed on a spectacular scale. A shocking willingness to overlook questionable practices by institutions claiming to uphold the highest standards. A shameful determination to cover up evidence. Politicians eager to accept money from a company subsequently shown to be a sham. These are the hallmarks of the Enron scandal."

The editorial warned that the accounting practices that accompanied the high-technology bubble, the hiding of debts off balance sheets and rogue trading "have shaken public confidence in big business and the way it is conducted."

Enron's collapse had to mark a watershed. Just as the collapse of banks and utility companies in the 1930s led to regulatory reform, so Enron's demise "should set in train a similar process" not only in the US but also on a world scale.

However, the *FT* counselled against the introduction of more detailed rules and regulations.

"Detailed prescriptions suffer from a fatal flaw. By spelling out in excruciating detail what auditors, directors, bank managers and other responsible parties must do, they create the possibility of observing merely the letter of the law. As long as you have complied with the manual—or persuaded some luckless auditor that you have done so—your real actions and purposes can be as reckless or flagrant as you like. Since no set of regulations, not matter how detailed, can outmanoeuvre a really determined manipulator, the rules provide, in effect, a road map for abuse."

Rather than the detailed prescriptions of the US Generally Accepted Accounting Principles it called for the development of standards devised by the International Accounting Standards Board that call for an emphasis on substance rather than form. But, like everything else in the business world, accounting standards and rules are a matter of fierce competition and the IASB approach "has been treated with mild suspicion in the US."

But in the view of the editorial, new measures will have to be set in place, along with "a new determination on the part of all participants to act in accordance with their letter."

While this would not stop fraud, it would restore public trust in routine transactions and "stop the poisonous erosion of confidence in everyday activities and financial reports that has been so marked a feature of the past weeks."

The conclusion of the editorial revealed some of the fears in ruling circles about the political implications of the Enron disaster. Describing trustworthy business standards as "among the most important social capital the developed world possesses," it warned that the weaknesses revealed by Enron, "if left unremedied, could ultimately imperil a precious collective achievement."

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