THE LEGAL IMPLICATIONS of OFF BALANCE SHEET FINANCING:
A COMPARATIVE ANALYSIS OF UK and US POSITIONS

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Abstract

Off balance sheet financing (OBF) is either not visible or only partially visible in financial reporting for a number of reasons. It has attracted controversy in the light of its employment in a number of major corporate scandals. Previous investigations dominated by short works and consultancy papers have focused mainly on the financial aspects of OBF. This academic cross-country research on the use of OBF in the UK and US capital markets was undertaken to extend the published analyses to include a legal perspective by studying its legal implications for directors, financial advisers, auditors and financial regulators. The study’s legal focus prompted relying primarily on the doctrinal approach, which was in turn completed by the use of a modified case study in order to help address the how and why issues of the research phenomenon.

The study found that OBF instruments are double-edge financial instruments with good and bad consequences. When corporations used OBF for liquidity enhancement or to realise financial savings, they result in positive outcomes. In contrast, when used for aggressive window-dressing or in the manipulation of financial reporting for fraudulent ends, OBF mechanisms generated serious legal liabilities for directors, auditors, and financial advisers in terms of compensation suits or even criminal sanctions. Financial regulators were nonetheless found to be less likely to face legal consequences as a result of current judicial attitudes on the tort of public misfeasance. However, the extensive applications of OBF in conjunction with other forms of creative accounting have resulted in various regulatory responses. On a comparative note, litigation and enforcement actions were found to be relatively more extensive in the US because of the higher incidence of large corporate frauds and the work of regulatory champions especially in New York using deferred prosecution agreements.
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US Cross-Case Analysis:
Dedication

This work is dedicated to my parents and friends.
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**Introduction**

This cross-national investigation is undertaken to examine the legal consequences arising from off-balance sheet financing (OBF) in the corporate world. OBF like other forms of creative accounting emerged in the 1960’s when some corporations saw the need to window-dress their financial statements. These needs range from the need to facilitate access to cheaper funding sources, preparation for takeovers, share value enhancement, board and management remuneration justifications, and the more seedy aim of financial fraud.

Previous works looked at the subject mainly from the financial perspective, with primary focus on its beneficial or negative effects. This comparative country case study seeks to gather further insights on the motives behind its employment and how these might give rise to various legal implications to the users, financial advisers, and financial gatekeepers (comprising internal audit committees, external auditors, and financial regulators) in the UK and US capital markets. Further details of the purpose and aims of this investigation, together with the research approach and study methodology employed are provided in chapter one.

As the use of OBF instruments are linked to corporate financial reporting, chapter two of this study will examine and compare the usefulness and challenges posed by them to preparers and users in both jurisdictions. The analysis will also cover the statutory obligations behind its preparation and disclosure and the roles played by accounting and financial regulators to ensure the quality of financial reporting.

The varied nature of OBF instruments and how these are reported in financial statements will be addressed in chapter three. This chapter will compare and contrast
its applications in both the defined capital markets and will also analyse how its
manner of use may impact upon the quality and reliability of corporate financial
reporting.

Like other forms of borrowing, OBF may pose serious financial and legal risks to the
preparers, their advisers and financial gatekeepers; depending on the motives behind
its employment and the manner of its disclosure. These will be explored and discussed
further in chapter four of this investigation.

Deeper insights into the motives behind the use of OBF will be accessed from three
pairs of corporate case studies from each jurisdiction. One pair from each will cover
those using OBF for viable financial benefits; a second will cover those with financial
window-dressing aims, and; the third on those with dishonourable or fraudulent
objectives. Details of these intra and cross-case analysis will be provided in chapter
five.

The study will end through chapter six with conclusions on how and why the use of
OBF may pose legal implications to OBF preparers, financial advisers, and financial
gatekeepers in varying manner in the UK and the US capital markets. It will also
discuss the wider implications to the global capital markets and suggest relevant areas
for further research.
CHAPTER ONE

Research Approach, Scope and Limitations

Introduction

This chapter will introduce the aims for the undertaking of this study. This will be followed by a discussion on the research context. The significance of the thesis as well as its contribution to knowledge is addressed thereafter. Key insights and prior research and theories are then critically examined for the purpose of identifying the research gap and the pertinent research question. The research approach and methodology employed are then discussed as the closing part of this chapter.

The Research Aims

Prior works on OBF comprising mainly book chapters and consultancy papers were undertaken from a financial perspective. This academic investigation will extend from this to incorporate the legal perspective. In particular, it will examine its legal implications to financial information preparers, connected advisors and various financial gatekeepers in the UK and US capital markets. This comparative cross-country case investigation is envisaged to generate wider global implications to market participants across the world as the two jurisdictions taken together lead and dominate the global capital markets in terms of width, depth, and innovations.

An off-balance sheet transaction is commonly defined as, ‘The funding or refinancing of a company’s operations in such a way, that under legal requirements and existing accounting conventions, some or all of the finance, may not be shown on its balance
It thus allows businesses to engage in such transactions without disclosure or only as footnotes in their financial statements.

OBF is the product of creative accounting techniques. Viewed from a more positive perspective, OBF represents a financial innovation of high practical value to corporations seeking to raise funds under less stringent conditions. It is entrepreneurial and growth-oriented. Some of its more commonly used instruments include consignment stock financing, sale and repurchase agreements, debt factoring, securitisation, leasing and loan transfers.[2]

OBF by securitisation is by far the more complex of the lot. These include debt underwriting, derivatives, contingent banking and bank assets securitisation. They are widely and popularly used because of their enormous flexibilities when compared to the more traditional sources of funding and also because suppliers do make huge profits out of them. However, in view of their immense complexity, the underlying risks behind their usage are not often fully grasped. This poses great challenges to corporations in terms of risk management whenever these are used with inadequate understanding or precautions.

The mixture of motives in the use of OBF generates controversies. Investors who are apparently hurt by them have condemned its use in the aftermath of high profile cases like Enron, WorldCom and Parmalat; and indeed in much earlier cases like BCCI.

Maxwell, and Barings. Regulators and watchdogs tasked to look after shareholders’ welfare and creditors’ rights are now paying more and closer attention to OBF, particularly in the wake of the 2004 BCCI liquidator’s suit against the Bank of England. The abusive use of OBF together with the wilful distortions of on balance sheet items and other forms of management culpabilities have generated huge financial catastrophes.\(^3\) Nonetheless, much of the financial community still holds to the belief that OBF is extremely useful to corporations when properly used.\(^4\) Hence, OBF when used for financial leveraging is a double-edge sword depending on the manner and reasons for application as well as business and market conditions.\(^5\)

The debate over the pros and cons of OBF for corporate funding purposes continues despite attempts by the accounting and financial regulators to streamline disclosure requirements for OBF instruments. The major difficulties faced by the accounting and regulatory bodies lie in the way accounting standards are formulated both within countries and between countries. Within countries, whilst standards exist for the way in which OBF instruments should be reported, professional judgements still need to be exercised. Attempts to internationalise and harmonise accounting standards have also encountered difficulties, especially for financial derivatives.


This investigation argues that OBF when used under particular circumstances would generate not only serious financial consequences when not properly managed but also serious legal implications to corporate directors, auditors, financial advisors and financial regulators. A proper understanding of such legal implications would motivate a more careful use of such otherwise innovative and beneficial financial instruments. Creditors would also find the research insights useful, as the use of OBF could impose risks upon their borrowers’ debt servicing capacities. As for investors, further knowledge of this would provide them with better directions for their investment strategies.

Whilst the UK and US share many common law traditions, there are various divergences. For instance, after the Enron debacle, the US imposed tighter regulations and rules over the use of specific OBF instruments. In contrast, the UK still hung on largely to its voluntary disclosure regime reinforced by a specific reporting standard. This thesis will adopt a comparative approach in order to compare and contrast the legal implications of OBF between these two jurisdictions.\[6\]

The Research Context

In the late 1980’s, in response to the growing doubts on the quality of corporate financial statements in the UK, members of the financial community jointly produced the 1992 Cadbury Committee Report.\[7\] This report acknowledged the possibility of different accounting treatments being applied on basically similar facts, with the consequence that different financial positions could be reported, with each apparently

\[6\] Prior analysis tends to look at OBF from the more restricted national perspective.

complying with accounting standards to exhibit ‘a true and fair view’. OBF was cited, as one of the contributing factor towards the manipulation of financial data.

In response, the Committee recommended a ‘Code of Best Practice’ for all UK listed companies in the UK. This was reinforced by a ‘comply or explain’ procedure whereby directors would have to confirm their compliance to this Code or to explain their deviations. This version of voluntary disclosure system did contribute to some improvements, but was severely tested in the BCCI case. The bank collapsed primarily because of its significant involvement in criminal activities and enormous exposure to the Ghokal Shipping group. It employed OBF instruments to hide illicit activities and the huge losses in the latter.[8]

Financial corporate governance received further attention in the aftermath of the fall of Barings and appeared in the form of a Combined Code, which was given currency by the UK Stock Exchange as part of its continuous reporting obligations. The updated 2003 Combined Code paid particular attention to risk management, internal controls, institutional shareholders’ involvement, and auditor independence.[9]

These obligations were taken to a new level in 2005 when the government enacted a new regulation requiring companies listed on the Main Board of the London Stock Exchange to prepare an Operation and Financial Report (OFR) as a key component in their Annual Reports. Of concern to these listed corporations was the inclusion of a new criminal offence of ‘recklessly approving an OFR’ with potential unlimited

In the meantime even well before this, significant numbers of FTSE 100 corporations had already incorporated OFRs in their 2003 Annual Reports because of of its earlier voluntary adoption as a best reporting practice. In making such voluntary disclosures, the Boards of these listed corporations showed confidence of the quality of their financial reporting. Then again such exemplary financial corporate governance behaviour seems to flow mainly from corporations in strong financial positions with minimum or no exposures to OBF.

However, it can be argued that the combined effects of the Combined Code, the less aggressive financial behaviour of UK listed corporations, and greater transparency of executive incentives like stock options grants probably contributed to the reduced incidence of financial scandals in the UK when compared to the US.[11] This is not to imply that UK financial reporting is free from the ills of OBF. It is indeed often the subterranean nature of OBF which makes it so difficult to reach such conclusions. UK’s experience of the Barings Bank failure and some other subsequent cases illustrated this point only too well.[12]

In the face of the huge calamities inflicted on the US economy in terms of large job losses, equity evaporations from important pensions funds, and irrecoverable losses to investors and creditors arising from the collapse of Enron, WorldCom, and others; the Securities Exchange Commission (SEC) had to respond in a tough and fast manner in

[12] supra note 8; Other high profile cases include Farepak and the MG Rover Group; Palepu, K. G., ‘Information and the Regulation of Markets’ in Geoffrey, O., Tom, K. & Jeremy, G. (eds.), ‘Corporate Governance in the US and Europe: Where Are We Now?’, Palgrave Macmillan Ltd.: Basingstoke, 2006, Chapter 15. The researcher here argued that the auditors could help improve the quality of financial information by critically challenging the information content in public accounts.
order to secure investor confidence. Fuller or more transparent disclosures are now demanded for OBF reporting. Corporations in the US had to spend millions to cope and comply with the now stricter disclosures requirements demanded by the Sarbanes-Oxley Act 2002 (SOA). The increasing numbers of financial restatements filed in by corporations in the US over the last two years also gave some reasons for concern that all is not over yet where OBF controversies are concerned. A case in point is that of Computer Associates where its previous CEO was found guilty of tampering with the company’s account.

The study of OBF is shaped by developments in the theory and practice of financial corporate governance, and in particular financial disclosures theories. In respect of corporate governance, it seems to be the result of fusion between law and economics (taken to include finance and accounting). There is now a growing body of literature examining the relationship between legal origin, investor protection, risk analysis and corporate finance. La Porta and his colleagues arguably are the main driving force behind this approach. They demonstrated empirically the links between the legal framework and financing patterns and eventually corporate performance and

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economic growth. Their research also indicated significant differences between countries at different levels of development.[16]

Financial information is used within corporations and by external parties. Internally, management uses financial information for decision-making and planning purposes. Externally, investors, creditors, and professional analysts used it for their various respective agenda. For management the supply of such information could either imply additional compliance costs and revelations of corporate secrets to competitors; or opportunities to communicate with various stakeholders to secure support for their positions or their financial agenda[17] OBF by its nature appears to go against the information needs of shareholders and other stakeholders who require enhance transparency for informed decision-making.

The Confederation of British Industries (CBI) and others have long argued against increasing regulations being introduced for compliance by the business community in terms of spiralling costs and bureaucratic red tapes. For instance, new reporting rules of the 2005 International Accounting Standards (IAS) have led to massive reporting compliance cost burdens.[18] The tension increased further with announcements that the regulators would be watching closely some identified business sectors under economic stress to prevent the occurrence of systemic risks.[19] Economic risks management in particular became a subject of close regulatory scrutiny after various

[19] The Financial Times, ‘City Regulator Plans to Get Tough with Accounts in Five Industries’, December 21, 2004. These were the automotive, pharmaceutical, retail, transport, and utilities sectors
regional economic crises and the ‘2000 Dotcom’ bubble.\textsuperscript{[20]} The Enron and WorldCom dramas in 2002/3 sharpened the necessity for systemic corporate financial risks assessment.

Financial disclosure theory and practice, corporate law theory and practice and risk theory and analysis therefore form the bedrock for the study of OBF. There are now increasing arguments for corporations and financial regulators to broaden their perception of risks. Rather than reacting to bad risk events, as is commonly the case, financial regulators now encourage capital market participants to define and anticipate upside risks. These include hazard risks, financial risks, operating risks, organisational risks and strategic risks. Regulated businesses and financial institutions are now required to put in place appropriate risks mitigation measures to protect corporate assets and shareholder interests.\textsuperscript{[21]} This study by putting focus on the examination of financial and legal risks posed by the use of OBF will contribute further useful insights for more effective financial risk management.

\textit{Significance of the Study}

Research on OBF before the Enron debacle both in the UK and USA has been confined mainly to its use as a financial innovative instrument for enhanced liquidity at favourable cost or as deceptive instruments to perpetuate various corporate frauds. Often its examination is also conducted as peripheral studies within the wider field of creative accounting practice.\textsuperscript{[22]} After the Enron disaster, the research thrusts in the

\textsuperscript{[22]} McBarnet, D. & Whelan, C.,’ Creative Accounting and the Cross-Eyed Javelin Thrower’, John Wiley & Sons Ltd.: West Sussex, 1999, 3-13
UK and even more so in the US began to pay greater attention to OBF and in particular to the aggressive use of ‘Special Purpose Vehicles’ (SPVs) as funding vehicles. The main studies tend to dwell on their financial effects and the apportionment of blameworthiness between market participants.\[23\] To gain a greater understanding of the hazards of OBF, however, not only must this phenomenon be examined from this perspective but also on the reasons for their occurrence and the legal implications of these to directors, professional consultants, auditors, and financial regulators.

For financial democracy and market discipline to function effectively, explicit disclosures of the financial health of corporations are not options but necessary obligations of corporations. Where such information is not timely or faulty, punishing consequences may follow. In as far as OBF is concerned, much controversies and debates surround the manner it can be presented or in some situations not presented.\[24\]

Though there are certain guidelines and procedures for OBF presentations in financial statements, these are not ironclad. Such rules are characterised by flexibilities and options. For as long as they appear to adhere to general accepted accounting principles (GAAP) or the applicable standards, they are deemed to comply with the ‘true and fair view’ criterion, and through that comply with the requirements of the


1989 Company’s Act.[25] Despite this, under certain circumstances it can be misleading or in extreme cases read as calculated with the intention to deceive. The separation between a borderline legal indiscretion and acceptable legal discretion can be paper-thin. It is dangerously easy to fall out from one to the other. Further knowledge and analysis of OBF reporting practices and their legal implications will be of use not only to accounts preparers but also those who need to monitor or regulate their applications.

The function of the balance sheet has evolved from that of ensuring the proper matching or balancing of the assets and liabilities of the business to that of an instrument for the ascertainment of value. This transformation came about on the back of the mergers and acquisitions frenzies in the 1980’s and thereafter. These developments in the capital markets especially in the UK and US saw the essential need to use the balance sheet to derive valuations for the worth of businesses.[26] Such widespread practices take place despite its inherent limitations. Foremost, it provides information, which is mainly historical and do not show explicitly contingency transactions which might adversely affect the financial health of a corporation nor does it provide assessments of changes in the business environment. It also ignores pertinent non-financial matters, which may have subsequent financial consequences, such as corporate reputation damage or the loss of creative corporate talents in service industries.

[25] Sections 226-7 CA 1985
Balance sheet valuations are crucial not only in terms of merger activities but also for ascertaining of board remuneration or for the making of investment decisions by caretakers of pension funds. It is also the main tool for those who earn their livelihood as independent advisors or consultants or as rating agencies. All of them use balance sheet analysis to evaluate corporations in terms of their intrinsic worth. It is within this context that some OBF instruments can create controversies, by being kept out as normal on-balance sheet items.

Past and recent financial scandals have shown how easy credit and speculative mania can contribute to ‘irrational exuberance’ in the capital markets. This refers to extreme buoyant market conditions where asset prices are driven unusually high without support of viable economic justifications and are therefore at high risks of imminent collapse. Often this is associated with fraud and criminal conduct by corporate executives. Three independent reports covering over a decade in the UK, US, and Italy concluded that these could not have occurred without the willing or naive participation of financial intermediaries; all of whom encountered conflicts between their motivation to generate income from their corporate borrowers and those placing investment funds in their care.

Ground evidence appear to show that these conflicts were resolved in perpetuation of their own agenda despite the presence of regulatory, managerial, and market-discipline guidelines set to safeguard investors’ interests.[27]

[27] Smith R. C. & Walter, I., ‘Governing the Modern Corporation: Capital Markets, Corporate Control and Economic Performance’, OUP: Oxford, 2006, Chapter 10. The authors identified 2 type of conflicts of interest; type 1 pertaining to those arising between a firm’s own economic interests and those of its clientele, and type 2 which develops between clients and inducing the firm to work for one with adverse interest to the other. (Prince Jefri v KPMG [1999] 2 AC 222 is a good example of this category of case, where the House of Lords ruled against its continued perpetuation)
Indeed, it is market and information imperfections even in highly developed financial system such as those of the UK and US which provide the basis for the perpetuation of these conflicts of interest. OBF and other forms of negative creative accounting contributed to the rise of such flawed financial information flow.

To present ‘true and fair view’ accounts, corporations are required to comply with prevailing accounting standards.[28] This was made clear in an audit negligence suit in 1985.[29] FRS 5 and FRS 8 were formulated to deal with the problems posed by OBF. The former requires corporations to report on the commercial realities of transactions, and the latter on disclosures of dealings between connected parties.[30]

The UK Law Society, however, did not support this position as it maintains that it is more appropriate to look at the legal effects of transactions, because interpretations on the basis of economic effects may lead to subjective variations. The disagreement has persisted over the last two decades and is still awaiting resolution. FRS 8 requires corporations to be more transparent on related party transactions. There are some ambiguities over this standard. This was amply demonstrated in the BCCI debacle where the meaning and implications of FRS 8 were severely tested.[31]

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[28] supra note 25
[29] Lloyd Cheyham & Co. Ltd. v Littlejohn & Co [1987] BCLC 303
[30] IAS 17 Leases, IASC revised 1997. This was the first formal imposition of the substance over form principle of accounting. As the IASB has not issued a standard on accounting for this, guidance on this can be derived from the Framework for the Preparation and Presentation of Financial Statements; Holgate, P. ‘Accounting Principles for Lawyers’, Cambridge University Press: Cambridge, 2006, Chapter 5.
insights addressing this kind of problem will be helpful for corporations and regulators.

Accounting practices in the 19th and 20th centuries were significantly subjected to British influence. However, the increased activities of multinationals and emergence of economic blocs, together with environmental and cultural differences shaped the development of accounting systems in different economies. These variations provided the basis for the grouping of accounting behaviour across economies. This resulted in the distinction between countries on the basis of strong or weak equity market classification. Using this basis of accounting classification, the UK and US are placed in the strong equity category. This implied the orientation of accounting towards the safeguard of investors’ interests through enhanced reporting transparency.

Some have also argued that various societal values like short and long term financial orientations have also contributed to the differences in accounting management practices. Accounting values like secrecy, transparency and flexibility were also said to be influential in the development of accounting practices. Indeed, a major controversy in advanced economies concerns the clash between self-regulation by the professional community or more state intervention through public regulations. As an example, in the UK the concept of ‘a true and fair value’ relies heavily on the

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[33] ibid
[38] supra note 34, 12-13
judgement of the accountants whereas in much of continental Europe and the US greater reliance is placed on prescriptive rules.

Societal values reinforced by accounting values therefore drive the nature of particular accounting systems.\[39\] Based on this approach, the Anglo-American accounting system is argued to be of high transparency and optimism. In contrast, the European continental system and that of Japan are less transparent and more conservative. Indeed, the huge successes of the Anglo-American economies have also led to the transplantation of much of their financial reporting practices across the world.

The capital market exerts a dominating influence on accounting regulation in the US. The Securities and Exchange Commission (SEC), however, enforces the securities laws and formulates and enforces the accounting standards as well. The SEC’s standards-setting function has, nonetheless been delegated to the Financial Accounting Standards Board (FASB), but it retains the right to intervene. Listed corporations in the US have to adhere to the standards set by the FASB. Where the capital market is concerned, the US is reputed to have the most comprehensive system of accounting regulations in the world.\[40\] Yet, for some reasons it was unable to prevent the occurrence of the massive financial scandals in the 2001/02 where OBF manipulations played major roles.

Like the US, accounting regulations in the UK are geared mainly towards the information needs of investors. Unlike the US, however; the UK’s accounting

\[39\] ibid
community and its stock exchange get relatively more involved in the regulatory process. After a spate of financial scandals, the UK Financial Reporting Council (FRC) set up the Accounting Standards Board (ASB) to parallel that of the FASB in the US. Its quiet agenda was to discourage state intervention by instituting a code of best practice reporting through a self-regulatory process. To underline the importance of its accounting standards, the ASB indicated at a very early stage that departure from their accounting standards will only be accommodated for the purpose of reflecting the true and fair view principle.\[41\]

Hence, whilst both accounting settings share many common traditions, the US model appears to have a much tighter and detailed set of regulatory regime. Yet, the financial scandals perpetuated largely through the use of OBF are far more extensive and larger in scale in the US. This study will gather insights for better appreciation of this occurrence.

The UK and USA capital markets taken together are highly significant in terms of size and global reach.\[42\] In as far as financial governance and financial innovations are concerned; they are exemplary leaders to the rest of the world. This comparative UK and US study will generate useful practical insights on OBF practices and reporting obligations in these two respective economies. It will also seek further insights on why their different regulatory approach for OBF has and may continue to lead to varying degrees of legal implications for directors and financial gatekeepers.

\[41\] ASB ‘Accounting Standards’, June 1993, paragraph 18
Prior Research and Theoretical Background

Four studies on OBF have been undertaken in the US. One dealt primarily with the issue of value generated by OBF to shareholders. The work suggests that the use of OBF contributed to the enhancement of shareholders’ value. It also provided an analysis of the underlying process involved. Its omissions of information and analysis on the financial risks and distortion effects of OBF have, however, deprived a more balanced view of the financial impact of this financial instrument. [43]

The impact of operating leases as an OBF instrument on debt ratings was examined in another study. The research findings suggest that whilst moving debt off-balance sheet may be useful in maintaining higher debt ratings, this does not appear to fool the market because the yields on new bond issues showed that the market evaluates off-balance obligations despite their limited disclosures. This analysis could have been enriched by the assessment of the impact under varying market conditions and the controversial conflicting roles of financial intermediaries. [44]

The more extensive US third study examined whether OBF scandals were a product of profound systemic failure or mere isolated incidents of corporate fraud. The investigation concluded that it was probably the former. The work emerging so close after the Enron debacle understandably took a pessimistic position. Corporate frauds perpetuated through OBF were significant and probably extensive but they were still not serious enough to suggest a profound systemic failure of the US financial economy. The investigation drew attention on how businesses expand and bury financial risks posed by the use of OBF instruments and why very little was done to

contain or deter their abusive applications. Stemming from a largely financial perspective, legal analysis of the consequential effects of OBF was restricted to some peripheral comments on regulatory enforcement deficiencies. The study argued that further state intervention to curb the ills of corporate excesses and professional conflicts of interest within the capital market was not really needed as existing securities laws were adequate for such purposes provided these were seriously enforced.\[^{[45]}\] This was shown to be the case in various subsequent high-profile corporate fraud cases involving the use of OBF.

A fourth piece of research centred on Enron as a single case study. It addressed in great details on how the corporation, its board and managers used OBF and other creative accounting techniques to glorify the corporation’s performance through a mixture of misleading, deceptive and pure dishonest acts. More importantly, the work demonstrated how the corporation and its directors were able to perpetuate corporate frauds with varying support from financial intermediaries and financial gatekeepers. These range from active collaborations to blind eye postures.

This study also implied that careful analysis of the company’s financial statements by financial intermediaries and financial regulators and some minimum corporate enquiries would have uncovered various serious financial weaknesses despite the shrewd application of the creative accounting charade. While the claim by this and others may have some merits, these are weakened by the general failure of the market to detect the underlying corporate deception before the revelations made by inside corporate whistle-blowers. In fact, the catalysts for eventual scrutiny by the SEC in

many high profile cases were initiated only after the contributions made by these whistleblowers and findings of particular academic research.\[46\]

This piece of research, however, illustrated the massive fraudulent activities mounted through special purpose vehicles (SPVs). This was a serious charge as SPVs were also innovatively used in many forms of securitisation to unlock low cost liquidity in the larger financial and capital markets. Nonetheless, prior to this argument little attention was paid to the bad side of SPVs. As the problems at Enron were unfolding, the World Bank conducted a special global study on the use of SPVs across economies. The investigation found evidence of their links to money laundering and other illicit activities.\[47\] The US Enron case study could have been further enriched by investigating more closely the financial and legal reasons for the continuing applications of SPVs despite concern looks from financial regulators.

Thus US studies pre-Enron dealt mainly with the rationalisation of the use of particular OBF instruments like leasing and how they helped to enhance share values. Studies after the outbreak of the Enron scandal gave some attention to various other OBF instruments but still tend to focus on SPVs due to their extensive use in Enron and some other cases which followed and for the most part are also predominantly finance-based works.

In the UK, the use of SPVs to promote the use of OBF was examined critically in a legal reform proposal paper. This policy paper in fact challenged the rationale and

\[46\] Jensen, B., ’Bob Jensen’s Thread Frauds at Anderson, Enron and WorldCom’, available at http://www.trinity.edu/rjensen/FraudEnron.htm, 11/10/2004; The SEC’s 2006 investigations of options backdating in corporate America for instance were also prompted by another academic research finding.

legality of the activities of SPV’s especially in overseas financial services havens with
tainted reputations. It urged the Law Commission to prevent the abusive use of such
entities through legal reforms.\textsuperscript{[48]} It is submitted that the approach taken by this
review paper was weakened by the lack of more convincing arguments and evidence;
and the failure to incorporate other financial instruments associated with OBF. It
missed the opportunity to press home a more convincing case by its restrictive view of
OBF.

The use of creative accounting techniques (including OBF) to generate misleading
financial statement was addressed in two separate studies. The initial study focused in
details on both ‘on and off-balance sheet’ tools. This investigation concluded that
such manipulative techniques were allowed to flourish by regulators despite various
limitations and dangers these posed to investors and lenders.\textsuperscript{[49]} As OBF accounted
for only one component of a plethora of creative accounting techniques, it was only
given a cursory treatment by this study.

Building perhaps from the earlier study, the second UK investigation looks beyond
the techniques of creative accounting to include the response by enforcement agencies
and the judiciary. This study indicated the general reluctance of enforcement agencies
to intervene with the practice of creative accounting. It also concluded that subsequent
corrective actions made produced only very limited results, and that the accounting
industry itself is still developing new weapons to contain and deter the
manipulative use of creative accounting.\textsuperscript{[50]} This study only made sparing discussions
of OBF in passing as it used creative accounting as its main unit of analysis.

\textsuperscript{[49]} Smith, supra note 3
\textsuperscript{[50]} supra note 22
A much more detailed investigation on OBF in the UK was carried out in a quantitative-based study. This focused on the diffusion aspects of OBF. It explored extensively the innovative features of financial instruments associated with OBF over the last two over decades. It examined the demand and supply equation of OBF products. It showed how the demand for financial innovation created various risks transferring products and more importantly why financial services institution issue OBF assets. The risks involved and the penalties paid by those who used it without proper understanding were also given some attention in the study. The main contribution of this work is the provision of key insights on the competitive and strategic interactions across firms in the context of innovation adoption and diffusion and in relating these to financial services.

It showed clearly how the industry transformed from relationship banking (associated with lower risk and lower earnings) to transactional banking (associated with higher risks and higher earnings). This largely quantitative-based study is particularly effective for the demonstration of high risks associated with the latter banking approach, but it is less effective in dealing with the legal analysis of corporate fraud and associated criminal activities related to cases like Barings and BCCI.\[51\]

OBF risk transfer features were also analysed in a risk awareness manual. This work dwelt essentially on the key concepts and process of financial risks management against the background of UK financial corporate governance practices. Control of risk, containment of risk and risk management especially in banks within the context of the Basel Accord were also raised in the study. Some discussions on the duties of

directors against the background of UK company law were also addressed. It did not, however, connect adequately directors’ general role in financial risks management. It could have achieved more with further discussions and analysis of OBF financial reporting obligations imposed by accounting standards and how this may contribute to better risks management and evaluation.\[52\]

OBF practices and the challenges they posed to financial reporting in terms of the transparency criterion were discussed extensively in a consultancy paper. This work together with others sharing the same sentiments may have significantly contributed to the reconstituted reporting standard for OBF, namely Financial Reporting Standard 5 (FRS 5). FRS 5 requires the reporting of OBF to reflect on the commercial realities or substance of transactions.\[53\] This was said to have contributed to the lesser perpetuation of corporate frauds through the use of OBF in the UK in comparison to that of the US where more prescriptive reporting rules governed their applications.

Risk management was examined against financial regulatory frameworks in the UK, US, Japan and other developing economies in another work. This was approached from a regulator’s perspective, and understandably focused its analysis on how regulators approach and manage risks pertaining to innovative financial products like OBF.\[54\] The economic, political and legal analysis of money-laundering perpetuated through the use of secret trusts and SPEs in various international financial services centres was undertaken through a robust academic study. The analysis could have been enriched by some reflections on the role of creative accounting techniques to

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money laundering activities.\textsuperscript{[55]} The risks of liability for financial regulators in high profile corporate and banking failures were legally analysed in an extensive study.

In particular, it drew out the charge of public misfeasance against financial regulators over the scandalous collapse of BCCI and Barings through ineffective monitoring of improper applications of creative accounting and particular OBF instruments.\textsuperscript{[56]} However, its evaluations concentrate more on the limits to financial regulation, with the OBF factor mentioned only in passing. Financial manipulation in the UK and US capital markets was legally analysed in another academic study.\textsuperscript{[57]} The study focused mainly on the comparative strengths and weaknesses of the criminal justice process in both jurisdictions and though superseded by new legislations some useful insights could be drawn on the securities laws governing the capital markets in both jurisdictions.

In view of the country’s earlier encounter with OBF-type scandals in the late 1970s and the introduction of FRS 5, UK studies tend to cover OBF instruments in the context of various financial reporting weaknesses flowing from connected and opaque transactions. Owing to this, UK post-Enron studies did not change much as most Enron-type issues like connected parties’ transactions and so on were already covered earlier. Instead, more interests were centred on how creative accounting may have contributed to global money-laundering activities.


The survey and analysis of prior main works in the US and the UK on OBF applications therefore showed a clear focus on creative accounting analysis. The peripheral works merely scrutinised OBF in passing as a form of creative accounting. Enron case studies focused on the causes for its failure and ascertainment of blameworthiness between connected market participants. Studies on enforcement by financial regulators in the capital market focused on market abuse practices in general and consequently omit to highlight on OBF manipulations in particular. This literature review shows the need for a much more comprehensive integrated academic study on OBF; meaning the need to extend from the financial focus to the more important legal implications arising from its manner of employment.

*The Research Question*

This thesis argues that the debate concerning off-balance sheet financing should not be restricted to accounting issues, but should rightfully cover the relatively more important legal implications for directors, financial consultants, auditors, and financial regulators. Prior research demonstrates that there is also as yet a comprehensive academic investigation looking at the implications of OBF from an integrated financial-legal perspective. The ‘bits and pieces’ approach of prior works or their leanings towards other research agenda showed the gap for an academic framework to deal specifically with the motivations behind OBF applications and reporting practices and how and why under particular circumstances these may generate varying legal implications for various market participants.

This study will therefore develop from the hitherto largely financial perspective to incorporate the legal analysis of OBF. The central research question for this study is accordingly framed as follows:
‘Why and how will the use of OBF generate legal implications for corporate directors, financial advisors, auditors, and financial regulators?’

This investigation, and in particular the data-gathering process will be guided by the following sub-questions:

1. Why do corporations borrow and do they bother to pay enough attention to the financial and legal risks involved?
2. Why do they choose OBF over the more traditional forms of borrowings?
3. What are the common problems posed by OBF in financial reporting, and how financial regulators addressed these?
4. Under what circumstances will the use of OBF pose financial and legal risks to accounting preparers and financial gatekeepers?

Research Approach

As the focus of this investigation is on legal issues, it will primarily draw on the use of the doctrinal or black letter approach traditionally employed in legal research. Some elements of empirical research will be adopted nonetheless to enhance the information gathering and analytical process. The doctrinal approach argues that, ‘…there is a distinctly legal mode of reasoning that determines ‘correct’ rules, facts and results in particular cases, i.e. law is presented as a closed logical system. On this view, the answer to all legal queries are contained in books—legal reasoning is simply a matter of looking up the rules of law (in statutes and case-books) and applying them to the facts of the problem…and by this process arrive at the ‘right’ result.’[^58]. It therefore uses reason, logic and argument. It is an internal approach taking the perspective of an insider in the system; and draws its sources mainly from statutes and

decided cases and supplemented by lawyers’ reflective literature. This study, however, needs to consider the effects of law on corporate and management actions including the political acceptability of public policy implemented through legal instruments.\textsuperscript{[59]}

Traditional scholarship as dictated by the doctrinal approach has over the years been enriched by the empirical study of the practice of law which drew on the disciplines of sociology, philosophy, psychology, finance, and economics. Accordingly, legal research is now said to be influenced by socio-legal studies, critical legal studies, and the law-and-economics movement. The law and economics approach has been observed to be the dominant methodology in US legal scholarship and is increasingly witnessed in the UK in competition law, labour law, company law, and financial services regulations.\textsuperscript{[60]} Though this study does not use the pure version of the empirical approach, it nonetheless draws heavily on the evidence provided by empiricists as to how law works and how it affects corporate decisions.\textsuperscript{[61]}

On the basis of the above, the archive method commonly used in legal and major accounting studies will be adopted here.\textsuperscript{[62]} The survey method is not considered appropriate for studies pertaining to sensitive reporting issues like those connected with OBF. This is because most of the professionals involved in this activity have a high consciousness of the possible legal implications of their opinions in view of

recent outcomes of current cases pertaining to the use or rather the misuse of such products.\[63\] The increasing willingness of the FSA to enforce various rules surrounding the abusive application of various financial products is beginning to be felt in the financial community. This has made OBF users and suppliers more sensitive about the dissemination of information even for research purposes other than those commissioned by the FSA.

The archive method goes beyond describing the events in the past. It helps to illuminate the present. It is of particular relevance to studies on accounting and finance. In the process, data is being interrogated and the assumptions behind them evaluated. Issues and themes of importance to the study in question could then be uncovered through the technique of hermeneutic interpretation. Hermeneutics puts particular focus on the historical and social context surrounding a phenomenon when interpreting text. Increasingly hermeneutics has been used in legal research where the reasons behind judgements and interpretations of statutes are being sought.\[64\] In this regard, content may not be the most critical feature of a document. Rather, the dynamics involved in the interactions between a document’s production, consumption, and content represent a more important focus.\[65\] Documents analysis in this work will thus be driven by this guidance.

Archival records are, however, subject to some limitations as these are compiled through a selective process and often weakened further by weaknesses associated with the recall process. To mitigate this problem, this work will wherever possible make

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\[63\] Supra note 22. The researchers encountered such problems in their work; In January 2005, the Bank of England announced that it would track grapevine in the City in order to gather data relevant to the issue of systemic risk. Market participants as a result are sensitive over interviews on matters like OBF
\[65\] supra note 62 (b), 26
use of alternative sources of information pertaining to the study’s line of enquiry or
crosschecked against the results of different studies.[66]

The main archive method used in the study will be complemented by the case method
as used in social science research.[67] The case method provides the avenue for
understanding the nature of OBF in terms of the techniques, procedures, or systems in
which it is being employed. Where this work is concerned, the case method will be
employed to generate explanatory insights on OBF practices. The case method is
usually viewed to be effective in addressing the how and why of research issues.[68]
The interpretive case approach as used in this investigation will accordingly offer
theoretical generalisations. It will not therefore use a sampling logic but will instead
use replication and extension logic. The process will thus involve the transferability of
findings between different contexts.[69]

In respect of this work, the case study approach will have to be appropriately
modified and adapted to the research environment. As mentioned earlier, previous
research on OBF encountered difficulties in drawing out direct response from
members of the financial community in view of the sensitivity issue. So instead of
relying on interviews at case sites, this work will gather and analyse data obtained
from primary statute sources and rules handbooks as well as from secondary data
sources like annual corporate reports, government publications, and other data
accessible from the Internet. These include works and data from other research
disciplines for cross-checking purposes.

[66] supra note 64
Cheltenham, 2006. This text demonstrates the effective use of the case method in financial governance
studies; Bob, R., Scapens, R. W. & Theobold, M., ‘Research Method and Methodology in Finance and
For an effective undertaking of the case method, the formulation of a theoretical proposition or research question would be necessary. In the case of this work, the research question as derived earlier is formulated as follows:

‘Why and in what manner will the use of OBF generate legal implications for corporate directors, financial advisors, auditors, and financial regulators?’

The data gathering and analysis process for each case will therefore be guided by the above central proposition and the following sub-questions which operate as the ‘case study protocol’. This will ensure the systematic ‘interrogation’ of corporate data:

- What kind of OBF products are the company using?
- What are the reasons for their use?
- Why are they preferred over the more the traditional forms of on-balance sheet financing?
- Are controversies involved in their use by the company and if so, why?
- How is the company’s performance in terms of profitability and liquidity?
- Were there any significant threats to the company’s operations?

The use of the above case study protocol and the collection of a chain of evidence from different sources will thus contribute to the reliability and consistency of data gathering.\[70\] To produce a convincing text, all relevant issues would be explored and explained. The writing up of the case will involve the ensuring of a high level of procedural reliability; transferability; and the avoidance of selective plausibility to minimise biasness.\[71\] One other main weakness of case studies concerns the difficulty of limiting the boundaries of a subject matter. To deal with this issue, this study will

restrict the examination of OBF reporting case practices to the UK and US capital markets.

A comparative research approach has also been adopted for this study. This ‘…consists of a pluralist approach to methods and theories centred mainly, but not exclusively around the theme of comparing countries under the umbrella term ‘cross-national’ study.’[72] Four benefits have been identified with the undertaking of comparative research; namely the import-mirror view (IMV); the difference view (DV); the theory-development view (TDV); and the prediction view (PV).

The rationale behind IMV is the contention that a better understanding of a country’s own practices can be obtained through looking at the practices in other countries especially between those, which are broadly similar. From this perspective, the goal is lessons rather than the creation or the examination of theories. The DV is about variable historical conditions and the need to explain and appreciate the difference. The TDV considers both endogenous and exogenous factors. Endogenous factors are those, which are closely associated with the country under examination. In contrast, exogenous factors are those not peculiar to it, like global capital and global trade. Understanding the impact of similar programmes in other countries would improve the quality of the prediction of their outcomes in the country under study. The PV argues on the benefits of forecasting future consequences of current policies.[73]

As much as there are benefits associated with comparative research, the problems surrounding its use must also be appreciated. Constraints like handling the comparison of like with like will be adhered to closely. Care will also be taken so as

[72] May, supra note 62 (a), 152
[73] ibid, 157-159
not to assume that what is appropriate for UK culture is also likely to be acceptable in the US and vice-versa. Accordingly, meanings of common terms will be interpreted within the context of either jurisdiction.\textsuperscript{[74]} This comparative study is justified on the grounds that though OBF is used in both jurisdictions; the legal framework and circumstances surrounding their use appear to show some variations. Accordingly useful insights may emerge for future guidance of preparers, financial gatekeepers and regulators across the key capital markets of the world.

All said, the modified legal research method as developed for this study is to a significant extent multidisciplinary in nature as it borrows and distils insights from other disciplines, in particular economics, politics, and finance. In turn, the outcome of this work is expected to contribute relevant insights from legal reasoning to these said disciplines in various meaningful ways. This is supported by the current view that the interface between different sociological disciplines is not one but a two-way traffic.\textsuperscript{[75]}

\textit{Study Scope and Limitations}

This investigation will rely on primary data from statutes and secondary data of published corporate reports. Triangulation of data and perspectives will be achieved through cross-checking or verifications from alternative data sources where available. The study will also limit its investigation to the more commonly used forms of OBF instruments in the UK and US capital markets. This means that the study will focus on leasing; securitisation; and to a restricted extent, derivatives employed primarily to circumvent regulatory restrictions or accounting rules.

\textsuperscript{[74]} ibid, 159-163
\textsuperscript{[75]} Bonner, supra note 60
The investigation will, however, include other financial mechanisms involving the use of creative accounting to understate expenses, inflate sales, understate liabilities or overstate assets. This is because they too may have the ultimate effect of artificially raising corporate market capitalisation to provide unsustainable justifications for the funding of takeover activities or realisation of unjust high executive compensation.

Finally, only a brief reference will be made to some of the more relevant provisions of CA2006 concerning liabilities to directors and auditors. Nonetheless, a broad analysis shows minimum disruptive effects on this study’s findings[76]

Chapter Two

Corporate Financial Reporting and Financial Corporate Governance

Introduction

The purpose of this chapter is to provide the theoretical and practical background settings which shaped the use and reporting obligations of OBF. It will involve the analysis and evaluation of the function of financial information within the context of the accounting and financial regulatory environment in both the UK and the US. The discussions will take into account pertinent corporate and securities law prevailing in both economies. Further, financial corporate governance items, which bear upon the manner of use and reporting of OBF in both jurisdictions will also be compared and analysed.

The Role of Financial Information

The association between share prices and financial information is widely known in the capital markets of the UK and US. This has been attributed to the premise that investors and other financial intermediaries require financial information pertaining to the financial health and prospects of corporations for their investment decisions.[1] Demand for financial information is said to originate from seven user groups, namely; the management, the investors, the creditors, the financial analysts, business networks, the government and the public.[2] These users have been identified as those

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with reasonable rights to data concerning the economic status of corporations, which impact upon their interests.\[3\]

The monitoring of a corporation’s performance in terms of effectiveness and efficiency by investors, creditors and financial analysts is underpinned by the agency theory. This is perceived as the economic or contractual relationship between the shareholders (the principals) and management (the agents) wherein the former needs to use financial information to assist in the evaluation of management’s compliance with their general duties and obligations.\[4\]

It has been suggested that the principal’s use of the compensating function might not induce the flow of reliable information from the agent and that unless complemented by other optimal strategy, the former might not secure truthful information.\[5\] Assuming this can be achieved, such financial information can be used to gauge future events and uncertainties in order to implement various risk management strategies.\[6\] The more important users for this way of using financial information comprise hedge fund managers, pension fund managers, investment banks, and professional analysts.

The information content of financial information and its effects on share prices has consistently produced research findings’ support for the relationship between them.\[7\]

\[3\] ibid
Studies have also shown the material role played by the information content of financial information when corporations make various kinds of performance announcements as they comply with the dictates of the capital market. Previous research has, however, also demonstrated that changes in accounting methods may exert various effects on the income statement. These in turn may induce various consequences in the capital market.

Financial Information and the Capital Market

Irrespective of the specific needs of various users of financial information, the demand for greater financial and related information has been consistently on the rise and accelerating with each wave of financial crisis or financial scandals. This is not only confined to emerging economies but include those of advanced economies like the UK and US as well. Whilst there are various benefits corporations can gain from greater release of timely financial information in terms of positive publicity and so on, significant costs are also involved to generate and deliver such information.

Corporations respond to this either out of regulatory compliance or on a tactical basis. They, however, appear to respond differently in different economies as a result of the impact of differences in their accounting systems, which are in turn influenced by cultural and other factors.


Whilst the regulatory framework does shape the disclosure orientations of corporations, many do so tactically in the capital market. Various theories have been formulated for this phenomenon. An example is the ‘signalling’ theory, which contends that corporations tactically disclose financial information irrespective of the regulatory framework in order to reduce the perceived informational risks of investors. It is further argued that with risk reduction, investors are more likely to react more positively towards the corporations’ shares or their funding plans.

To add credibility to a corporation’s claims of its superior performance, some desired characteristic would be ‘signalled’ (flashed) out. Stock market values are one good example of such suitable objective market indicators. As management is deemed to have knowledge of economic characteristics relevant to the valuation of a corporation’s worth, it has the incentive to beam that information to the market. For the ‘signal’ to function as a reliable proxy, the net benefits have to be positively correlated with the level of economic characteristics in a corporation’s possession and the level of actual signalling.\[11\]

Studies have shown that the market reacts positively to tactical forecast disclosures from corporations with good news and negatively to those with worrisome ones.\[12\] This is because such tactically disclosed information reduced the informational uncertainties surrounding the stocks in question. A well-informed financial

community is considered more likely to act positively towards a corporation’s stocks due to the perceived reduction of information risk.[13]

For those corporations requiring external funding, tactical disclosures of information are perceived to reduce the risk of unsuccessful fund raising or are helpful in reducing their cost of capital.[14] Due perhaps to these very compelling motives, some management has chosen to disclose information selectively to minimise forecast deviations which are unlikely to be welcomed by the financial community.[15] Such suppression of information can endure only up to the level of mandatory disclosure obligations. At this point, the financial community would be able to assess the previous disclosed information critically and would respond accordingly in terms of lower valuation for the corporation’s shares and higher cost of capital for the corporations involved. This is the consequence of the manipulation and misrepresentation effects, where creative accounting in general and OBF reporting in particular may get entangled.[16]

Financial Information and Firm Valuation

Managerial theory suggests that management is likely to disclose sales and profitability data tactically in order ‘to signal’ to its interested constituents its achievements. This is perceived to provide them with the advantage of access to

cheaper sources of funds; attract support from trading partners and suppliers; enhance
corporate prestige, and through all these provide the basis for increased rewards.[17]
Management under pressure or in pursuit of ‘illusory growth’ to conjure financial
strength image or market size may also resort to tactical signalling. This is
occasionally implemented to enhance share valuation for the purpose of attracting
further support from the capital market or to ward off potential takeover threats.[18]

Where corporate ownership is fragmented, which is usually the norm in the capital
market, the behavioural school argues that management is unlikely to be guided by
the profit-maximisation objective, but will instead opt for a more satisfying goal. This
theory maintains that management would disseminate information to the passive
shareholding group that the latter’s interest would be safeguarded, and that there
would be no diversion to other constituent groups.[19] This version was taken a step
further by the principal-agency theory. Here, management was explicitly
acknowledged as an active partner to safeguard shareholders’ interests. Under this
model, financial reports were taken to be stewardship reports where management
would be evaluated by the shareholders for the calibre of their performance.[20]

The agency theory rests on a contractual relationship between shareholders and
management. In view of the conflicts of interest among the various constituents in

  for Standard Setting’, Accounting Horizons 13, December 1999, 365-83; Marris, R.,’; Hake, E. R.,
  ‘Financial Illusion: Accounting for Profits in Enron’, Journal of Economic Issues, Vol.XXXXIX, No. 3,
  09/2005, 595-611
  S.C. 7 Gavin, B. (eds.),’ Corporate Governance and Globalisation: Long Range Planning Issues’,
  Cambridge University Press: Cambridge, 2006, 13-36. Here, it is argued that disclosure can be justified
  on other grounds including the prevention of theft, investors’ protection, informed decision-making,
  accountability and legitimacy of corporate activities.
corporations, the monitoring and enforcing of the contracts between the key parties, namely the agents and the principals would involve the incurring of three types of costs. These are the monitoring costs expended on financial reports; the bonding costs associated with auditing; and share value reduction cost associated with the management practice of corporate resource diversion.\[21\]

Arguments are also raised that the relatively better informed economic agents may be stimulated to capitalise on their informational advantage. These are exemplified by insider trading scandals in the capital market even though such activities are supposed to be restrained by various deterrents. Such problems associated with asymmetric information when occurring too frequently may contribute to market failure or breakdown, justifying regulatory intervention by the state.\[22\] This is prevented from happening by the capability and incentives of market participants to make use of various mechanisms to deal with the asymmetric information problem.\[23\]

With the introduction of share option schemes as incentives or additional rewards for management, it has been further argued that management would endeavour to reduce uncertainties by disclosing relevant information, which could enhance share prices in order to benefit from these schemes.\[24\] Later events appear to show, however, that such tactical information disclosures could be carried to extremes involving the wilful distortion of data.

\[22\] Greenbaum & Thakor, supra note 11(a)
\[23\] (a) ibid; (b) Lev, B. & Zarowin, P., 'The Boundaries of Financial Reporting and How to Extend Them', OECD 1998, 18
Research has shown that tactical disclosure of financial information varied according to the characteristics of corporations in terms of their capitalisation structure, earnings potential, ownership composition, board structure, corporate reputation, existence of various incentives like share options and so on. Studies covering these and related phenomena have evolved continually over the years.\[25\] Where the broader interests of the public are concerned, there is justification for research to go beyond the mere interests of management, shareholders, and financiers, to include further insights on the behaviour and response of auditors, financial analysts, and regulators to the developments and changes occurring in financial reporting and the financial standards setting process.\[26\]

On this score, it is increasingly being recognised that financial reporting can be an imperfect tool for communicating with shareholders when management’s objectives are not in line with those of the former. As indicated earlier, there are pros and cons for management to undertake tactical information disclosure through delays or manipulative reporting. This limitation is, however, counterbalanced by accounting and disclosure regulations which improved the functioning of the capital market. Accounting regulations narrow management’s ability to record financial transactions inconsistent with shareholders’ interests.

Disclosure regulations work towards investors receiving timely and relevant information derived from appropriate financial reporting standards and as verified by the auditing gatekeepers. Nonetheless, the managing agents may still ‘game the


\[26\] Strong, supra note 11 (b), 243-257
system’ where they perceived the gains from non-compliance through manipulative earnings’ reports exceed the costs of compliance as derived from the risks of litigation and regulatory sanctions. In this sense, disclosure options are therefore the product of disclosure requirements and management’s incentives to disclose information tactically. [27]

**Auditing and the Quality Assurance Function**

Auditing began in the 19th century with the role of verifying the honesty of people entrusted with fiscal rather than managerial responsibilities. [28] Auditing then focused on the monitoring of management’s stewardship function. With further commercial developments, auditing went on to assume the function of checking underlying financial records and documents. [29] This subsequently paved the way to the establishment of the fundamental principles of auditing through the impact of case laws. Foremost, the courts made clear that auditors were professionally expected to exercise reasonable care and skill. [30] The courts also told auditors not to assume the posture that something was always amiss but rather to ensure that when such was the case, they should exercise care and skill to ensure that the underlying data and internal controls were dependable. [31]

The underlying conceptual framework for auditing appears to have been initiated with various postulates constructed in 1961. These dealt with the verifiability of financial

\[\text{[27] (a), Musa, supra note 25 (b); (b) Levitt, A., ’The Numbers Game’, Remarks at New York University Center (Centre) for Law and Economics, September 28, 1998, available at http://www.sec.gov/news/speeches/spch220.txt on January 11, viewed on 11/01/2005; (b) Verrecchis, supra note 7 (a)
[29] ibid, 264-265
[31] Irish Woollen Co. Ltd v Tyson and Others [1900]}

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statements to the independent status of auditors. Indeed, financial statement users began to rely on external auditors’ report for assurance that the accounting information provided by management is relevant and reliable for decision-making purposes.\textsuperscript{[32]} This is argued to be the product of conflicts of interest occurring between market participants; the serious consequences for various decision-makers; risks of misinterpretation and unintentional error arising from accounting complexity; and the remoteness preventing users from directly gauging the quality of the financial reports.\textsuperscript{[33]} The concepts of the feasibility and necessity of accounting was subsequently taken a stage further with the idea of audit as a control tool for ensuring accountability. \textsuperscript{[34]}

\textit{The Audit Function in the UK and US}

In the US, companies trading on a national stock exchange and companies that have over 500 shareholders and assets exceeding US$ 5 million are required to have their accounts audited. (This condition varied between different states). In the UK, a limited company is exempted from the submission of audit reports where it is a small company in compliance with the criteria set out in section 249A of the CA 1985, or where it is a dormant company defined under section 249AA. The former refers to a company with turnover not exceeding £1 million and with balance sheet aggregate not more than £1.4 million. Auditors in the US and the UK are nominated by the audit committee or committee of independent directors and approved by the shareholders.

\begin{footnotesize}
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\item\textsuperscript{[32]} Cosserat, supra note 30
\item\textsuperscript{[33]} ibid
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The auditors in the US are duty bound to express an opinion on the fairness with which the financial statements presents fairly, in all material respects its financial status, operational results, and its funds flows in conformity with GAAP. In the UK, the auditors are obliged to present an independent examination and opinion, for shareholders, on whether the financial statements give ‘a true and fair view’ of financial statements prepared in accordance with the CA 1985. The Accounting Standards Board (ASB) in the US issues the statements on auditing standards. The Auditing Practices Board (APB) comprising the six principal accountancy professions is the source of auditing standards in the UK.

Where fraud detection is concerned, auditors in the US are expected to evaluate the risk that fraud may contribute to material errors in the financial statements. Guided by such assessments, auditors are expected to design their work to give reasonable assurance of detecting errors due to fraud that are material to the financial statements. Similarly in the UK, auditors are required to secure adequate evidence to provide reasonable assurance that the financial statements are free from material mistakes, whether caused by fraud or other irregularities.\[^{35}\] To mount effective suits, US shareholders need only to prove that the audited statements were materially misleading and that the auditors were grossly negligent. In contrast, UK shareholders

\[^{35}\] Radebaugh, supra note 13, 324-337; Arnall, C. J., ‘Auditors’ Reports, Misconceptions and Third Party Disclaimers’, Tolley’s Journal of Professional Negligence, Vol. 18 No. 3 2002, 146-155. The researcher here suggested the use of a disclaimer to third party claims to avoid misconceptions of their obligations. Specifically, auditors in the UK could clarify in their reports that their opinions were intended for the objectives of Part VII of the CA 1985 and for the benefit of shareholders’ only; Hemraj, M. B., ‘The Detection of Financial Irregularities in US Corporations’, JFC Vol. 10 No. 1, 2002, 85-90; ‘The Liability of Accountants and Auditors under the Federal Securities Acts and the Racketeer Influenced and Corrupt Organisations (RICO) Act in the USA’, JFC Vol. 10 No. 2, 2002, 159-165. Here, it was pointed out that the US judiciary were divided on auditors’ failure to detect fraud emanating from accounting irregularities; but in general, should suspicions arise, auditors were expected to detect management fraud. However, statutory provisions from the SEA 1933 and 1934 and RICO (with no equivalent in the UK) may extend auditor’s liability to non-contracting parties, in both the civil and criminal spheres. These taken together with the use of class action suit partly led to the litigation explosion dilemma in the US.
will have to prove not only the failure of the auditor to exercise reasonable care and
skills, but also that they had relied on his work and that this reliance resulted in a
measurable loss. This restricted scope of auditor’s duty probably account for the
lesser auditing suits in the UK than the US.

The audit profession is still confronted with the issues of ‘expectations gap’ and
‘auditor independence’. With regard to the first, the Statements on Auditing Standards
assume the position that the auditors are responsible only for exercising due care in
the conduct of the examination. The standard of due care exercise may therefore be
inadequate to cover all forms of financial deception.\[36\]

This disparity between the users’ and the auditors’ perceptions of the quality of audit
functions is known as the audit expectations gap.\[37\] Owing to this, much more clarity
is being sought over the respective roles and responsibilities of auditors and directors.
Auditors unlike directors are not responsible for the preparation of financial
statements or the accuracy of data, or undertaking that the audited corporation would
continue as a going concern.\[38\]

Though management is responsible for the detection of fraud, the common view still
has this expectation of auditors.\[39\] It has also been suggested that the audit
expectations gap was partly the consequence of a failure to understand the external
audit as an audit of motivations. This refers to the auditor’s understanding of

\[36\] AICPA Professional Standards, Section AU 316.01-08
Business Research, 24 (93), 46-98
\[38\] ibid
\[39\] (a) Cosserat, supra note 30; (b) Panel on Audit Effectiveness, ‘Report and Recommendations’,
Public Oversight Board, 2000, 88
management’s motivation and their implications for potential weakness in the preparation of financial statements.[40]

Auditors have responded to the expectations gap by spelling out in greater details the nature of their work as well as their duties and responsibilities and those of the directors. Some have argued that this approach, which makes extensive use of caveats and disclaimers, have depreciated the value and purpose of auditor’s opinion.[41] Building from this, the suggestion to include a financial statement expectations gap could be helpful.[42] It is also more realistic to acknowledge the limitations of financial statements and proceed from this to other pertinent issues surrounding the communication of business performance and business risk.[43]

Audit is also viewed as type of comparative investigation of performance and expectation by a third party for monitoring and accountability purposes.[44] It is suggested that a bond of accountability can exist only when the two key elements of ‘an account’ and ‘a holding to account’ are present. The former is exemplified by a set of published financial statements, and the latter refers to the action, which can be taken to make the directors liable for matters connected with the preparation of these statements.[45]

The need for auditors to perform an independent function arises from the fact that

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[41] (a) Gray & Manson, supra note 40 (a); Chitty, D., ‘New Words for Old’, Accountancy, July 2001, 120-22
[43] Higson, supra note 42, 183
[44] supra note 34
there is a remoteness gap between management and users of financial statement. This is because users normally do not have access or the skills to query management who are accountable to them, and consequently has to rely on auditors who have the authority to access such information to function on their behalf.[46] In practice, auditors faced with the need to boost their own income may encounter difficulties in remaining independent. This is because of the fact that they may have to compromise with the same company in its capacity as a potential purchaser of other services, who might expressly or by implication require various compromises from the auditors in return. Nonetheless, because of market dictates, auditors are still inclined to report on material matters in order to sustain the value of their reputation.[47] This at times may lead to tensions between management and the auditors with consequential effects on their independent status.[48] In turn, the capacity of auditors to remain independent is affected by the size of non-audit based income and other factors.[49]

To address these various challenges, UK accounting bodies have issued the Statement on Integrity, Objectivity and Independence (SIOS).[50] The EU Commission concerned over the variations in the handling of the issue of auditor independence issued its recommendations particularly in respect of non-audit services. This prompted the ICAEW issuing a Best Guidance Code in 2002. The SOA in the US

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[46] supra note 32
prohibited the provision of nine non-audit services, and imposed six other requirements pertaining to issues like disclosure of non-audit services by the audit committee to rotation of lead partners every five years. The SEC has implemented these reforms.

Regulation of Financial Reports

Regulation of financial reporting in both the UK and the US are shaped by corporate laws, accounting regulators, the stock market, and best practice rules formulated by the accounting profession. The UK and US system shows a regulatory partnership between the public and private sectors. Generally, financial reporting regulations cover the disclosure of information; the format against which information is to be disclosed, and; the measurement and valuation of information. Regulations from the state focus on disclosure, whilst those from the private sector deals mainly with format, measurement and valuation. This distinction has been increasingly blurred in the last two decades, as both governments sought to respond to various large corporate scandals. Whilst the UK has opted for the principles-based approach as guided by best practices, the US has chosen a more state-intrusive approach involving greater reliance on prescriptive rules.

Parliamentary (UK) and Congressional (US) Acts

The current principal laws governing limited corporations in the UK originate from 1900. These were amended in 1981 to implement the EEC Fourth Directive. The CA 1985 repealed and put together the Companies Acts of 1948, 1967, 1976, 1980 and 1981. More importantly, it inserted the ‘true and fair override’ in corporate law. The CA 1989 addressed specific rules for the form and content of financial statements, valuation, publication of accounts; and the functions, duties, powers and
qualifications of external auditors. Section 226 as inserted by the CA 1989 requires
directors to prepare a balance sheet and profit and loss statement for each financial
year. The section stipulates further that these financial statements have to give ‘a true
and fair view’ of a company’s financial state of affairs. Schedule 4 of the section
specifies the form and content of these statements and additional information to be
conveyed via ‘notes to the accounts’. Section 226(5) also stipulates that where
compliance with schedule 4 is inconsistent with the true and fair view, directors shall
depart from this to the extent necessary to give ‘a true and fair view’, but “Particulars
of any such departure, the reasons for it and its effect shall be given in a note to the
accounts”. The CA 1989 empowers the Secretary of State or its delegated body to
initiate civil actions for companies failing to comply with accounting report standards
and to restate defective accounts

Rather than having a British version of the SOA, the UK approach has been through a
process of consultation with the private sector, which resulted in a series of targeted
measures, not many needing the force of statutes so as to achieve a higher quality of
financial reporting and independence audit. Where the Companies (Audit,
Investigations and Community Enterprise) Act 2004 (CAICE) is concerned, it has
expanded beyond its original focus on auditing. Of relevance to this study is Part 1 of
the CAICE which places additional responsibilities on the existing approved
professional bodies to ensure that auditing of public companies are independently
undertaken. The Financial Reporting Council (FRC) is now empowered to set audit
standards and enforcement and overseeing the approved accountancy bodies. Funding
for the tasks undertaken by the FRC is financed by contributions from members of the
London Stock Exchange (LSE), the professional community and the government.
Following Section 18 of CAICE, institutions which are assigned tasks by the FRC and financed by grants and their staff will be insulated from certain liabilities. This will imply that liability ‘only exists for misfeasance and acts incompatible with public rights’. [51]

Section 3 of the CAICE in effect allows the Secretary of State to set up a Professional Oversight Board of Accountability to regulate auditors. Section 4 empowers the Secretary of State to delegate further functions to this new body. In pursuance of the issue of auditor independence, section 7 requires the mandatory disclosure of other services extended by auditors and its related or associated remunerations in kind. Auditors under Section 8 now enjoy the powers to call upon a wider group of personnel than before to provide them with information and explanation that they need. It would also now be a criminal offence to knowingly provide or recklessly provide auditors with misleading, inaccurate, or deceptive information.

Directors will now be required to state in the Directors’ Report that they are not aware of material information not disclosed to external auditors. A director will also be liable to imprisonment or fine or both if he fails to assume reasonable actions to prevent the release of public information, which is deemed to be false or of reckless nature. In respect of this, the ‘ought to know’ test will apply. Indeed, this was already codified in section 214 of the Insolvency Act 1986 and subsequent common law decisions.

As for defective accounts, the Financial Reporting Review Panel (FRRP) will be empowered to apply to court approval to amend unreliable accounts, seek information from the Inland Revenue, and insist on the release of information pertinent to its tasks. Parties failing to accede to the request of the FRRP will be deemed to have acted in contempt of court. The Secretary of State will now be empowered to select an institution to issue new standards for a new form of formal operating report. This refers to the Operating and Financial Review (OFR) which was introduced and then withdrawn again in favour of a ‘Business Review’. Finally, the powers of the DTI Investigators and Inspectors are considerably enhanced under CAICE to improve their capacity to access information. To assist this work even further, whistleblowers will now be provided with immunity.

The Companies Act 2006 received Royal Assent in November 8, 2006 after some delays in Parliament over various contentious issues. The Act seeks to provide a comprehensive code of company law, and will replace almost the entire provisions in CA 1985, CA 1989, and CA 2004. The implementation time table for various sections of the new Act commenced on January 1, 2007 and is scheduled for completion on October 1, 2008. The FSA Transparency Rules (sections 1265-1273) and the new statutory basis of damages for false and misleading statements in directors’ reports came into force on January 20, 2007. The section on Takeover Panel statutory powers came into force on April 6, 2006. Basically, the CA 2006 when fully implemented will imply more codified obligations for directors and extra powers for regulators, auditors and other gatekeepers to ensure better compliance to financial reporting obligations.
Apart from the above, the Fraud Act 2006 has widened and integrated the offence of fraud now to include fraud by false representation (section 2), fraud by failing to disclose (section 3), and fraud by abuse of position (section 4). Where OBF disclosure practices are concerned, these new provisions carry with them probable significant legal implications. In practice, however as these provisions have transformed such misdemeanours into dishonesty-based offences various complex civil law issues might arise in the future.

Increasingly, limited corporations and in particular listed corporations in the UK are also governed by directives flowing from the European Union (EU). The European Community 4th Directive for instance represented an endeavour to standardise key aspects of the form and contents of financial reporting; the Transparency Directive (TD) demanded more explicit disclosure of major financial items, and; the 2002 International Finance Reporting Standards (IFRS) Directive required reporting compliance for this international reporting standard by 2005. The power to implement any EC directives on corporate governance applicable to listed companies is now delegated to the FSA under the CA 2006. Corporate governance is taken to refer to the manner wherein directors conduct themselves, and the relationship between shareholders and boards.

The US Federal Constitution provides the federal government with powers to regulate financial reporting of businesses with multiple state activities, but allows individual states to hold residual powers. The state laws governing financial reporting obligations are less onerous than those found in the UK, but for larger listed enterprises these are governed by far more detailed federal rules. The hitherto largely unregulated financial reporting in the nineteenth century was brought under federal supervision through the Securities Act of 1933 requiring registered issuers to make public disclosures on accounts and other relevant information as a consequence of widespread corporate fraud. The Securities Act of 1934 required annual and other periodic reports to the Securities Exchange Commission, which was created by the Act itself. The Investment Company Act and the Investment Advisers Act followed this in 1940. The former requires mutual funds to provide investors with financial statements and their investment policies. The latter regulates investment advisers managing assets exceeding US $25 million. Federal intervention in corporate and financial services laws became more onerous with the introduction of the Sarbanes-Oxley Act 2002 (SOA) to restore the fundamental integrity of US markets through the tightening of corporate disclosure rules and the prevention of serious conflicts of interests.

It has been contended that, ‘The SOA does not alter the substantive standards for indictment and conviction. Nor does it make anything new criminal that was not theoretically unlawful before. But, by substantially enhancing the sentences for white-collar crime in the current political and economic environment, the legislation will lead to more convictions and tougher sentences. Ironically, it will lead to more trials. Under the Federal sentencing guidelines, it has become very risky to go to trials, as
the prosecutor can charge one way for plea-with one set of outcomes under the sentencing guidelines-and another, harsher set of charges for an indictment and trial and judges have little power under the guidelines to ameliorate the resulting unfairness. However, if the possible sentence under this new legislation is so severe, then there is little incentive to plead and more trials to follow'.[53]

It has also been contended that the SOA is the product of political expediency and uneasy compromise and hence not a well-formulated policy in many respects. It is also further suggested that it would not have mattered much anyway, as corporate governance in the US is very much a state and not federal issue. In practice, the Delaware legislation sets the rules for the majority of listed corporations, which have opted for the low taxation and the more highly protective laws and judicial rulings in that state.[54]

Other than the creation of the PCAOB, SOA’s intrusions into the state control of corporate governance are not really substantive. For instance, audit committees already have the powers to appoint or to retain public auditors. It is also argued that the attestation provisions; the auditor rotation rule; the discouragement of organisational and incentive compensation conflicts of interest from security analysts; or the disallowing of auditor advisory services would in any case evolve through market forces as standard practice. ‘The corporate abuses of Enron…and the others were primarily a market problem and the role of the government should be to remove

impediments to market-like conflicts of interest and then let market do what it does best—respond to information with precision and efficiency. That is why the most significant change has been, appropriately on the market side’.[55]

After Enron and the introduction of the SOA, the early effects on US Board rooms appear to signify a shift in power away from the Chief Executive Officer (CEO) and the emergence of a climate of fear. ‘The old attitude of informal cooperation with the CEOs has been replaced by a new spirit of legalistic, often antagonistic, check-the-boxes formality’.[56] This is said to lead to a culture of blame, with a more formalistic approach for the management agenda and the acceleration of the downsizing of at times necessary informal management structures.

‘The downsizing of the CEO has led to a certain extent, to the super sizing of advisers. That’s not necessarily a cure for everything that ails corporate America. It is true that successful CEOs will have to be consensus builders in the future…The age of the absolute corporate monarch…is over.’[57] Thus the early effects of the SOA


appear to be somewhat divided. John Snow, the former US Treasury Secretary has cautioned against the dangers of over-regulation and the prosecution of CEOs for innocent mistakes.

The Federal Reserve Chairman, Alan Greenspan whilst conceding that in the aftermath of SOA, CEOs have become overly cautious resulting in less job expansion, maintains that ‘… the 2002 legislation had been surprisingly successful. It has significantly reinforced the principle that shareholders are the owners and corporate managers are entrusted to work on their behalf to allocate resources to their optimum use’. [58] It is interesting to note that Greenspan a year on in the face of global mounting criticisms of the SOA, voiced support for the reduction of some of its more onerous provisions.

The current US Treasury Paul Hanson took this a step further by setting up the Capital Market Regulations Committee to review and simplify some of SEC’s implementing provisions for the SOA. Its December 2006 report put significant blame on the onerous demands of the SOA for the lower pace of public listings in the US capital market. The Committee recommended further enhancement of shareholders’ rights; adoption of a more risk and principles-based regulatory approach by the SEC and other self-regulatory organisations; greater clarity for public and private enforcement, and; some implementation changes for Section 404 of the SOA.

The researchers here highlighted SOA’s direct and indirect intervention costs and advocated for self-policing quality enhancement. [58] Balls, A., ‘Greenspan Praises Corporate Governance Law’, available at http://www.FT.com, viewed on 16/05/2005
Meanwhile in the UK, the SOA has escalated the average price FTSE audit fee by some 12%. Accountancy firms and financial recruitment houses have been provided with the prefect opportunity to regain some of the public confidence lost in the immediate aftermath of the Enron scandal. This aside, the internal control weaknesses disclosures are now supported by empirical studies that these do transmit valuation-relevant information.\[59\]

The Financial Reporting Council (FRC) supervises regulation of financial reporting and auditing in the UK. The FRC undertakes the auditing regulation function through its oversight of the Audit Practices Board, which sets audit standards; the Professional Oversight Board, which generally oversees the regulatory responsibility of the profession, and; an Investigation and Discipline Board tasked with the responsibility of supervising public interest cases.

The FRC supervises financial reporting through the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP). The ASB is the country’s official standards setter. Corporations are required under the corporate laws to comply with these standards or provide reasons for departure from these standards in order to satisfy the requirement for the true and fair view principle in financial reporting. The FRRP enforces compliance to the accounting provisions of the Companies Act and the ASB’s standards. It can access court order for compliance where corporations failed to comply. In practice, most corporations accede to its instructions.

The government, the stock exchange, and the accounting profession fund the FRC’s activities jointly. The FRC has also identified itself as part of the private sector process of self-regulation with primary functions to guarantee the independence and integrity of the standard-setting process. This government’s imposition of the OFR in 2006, and its subsequent unilateral withdrawal without serious consultation of the FRC raised some doubts on this claim.\[^{60}\]

The primacy of law in financial regulation in the US is maintained through the legal instrument, which Congress used to set up the SEC. The federal legislature occasionally reminds the public of its ultimate authority when it enacts laws providing for detailed financial reporting rules. The SEC comprises five members appointed by the US President. Its main function is to regulate the stock exchange. In furtherance of this, the SEC requires all listed corporations to submit to it periodic financial reports which comply with US Generally Accepted Accounting Practices (GAAP). It can impose penalties and fines for non-compliance. The SEC has, however, delegated its GAAP formulation functions to a standard-setting organisation in the private sector, namely the Financial Accounting Standards Board (FASB). The FASB is funded by eight sponsoring organisations with interests in financial reporting. Though the ultimate determinants of accounting concepts and standards rest with the Board’s judgement, it is obliged to consider the views of all participants before entering a decision.\[^{61}\]

\[^{60}\] Pendelbury, M. & Groves, R., ‘Company Accounts: Analysis, Interpretation and Understanding’, 6\(^{th}\) edition, Thomson: London, 2004, 1-19; Jopson, B., ‘Setback for Regulator as PwC is Cleared’, The Financial Times, 09/01/2007, 17. This first publicly aired FRC disciplinary complaint against an audit firm for falling short of professional standards in its 2002 audit of Mayflower was dismissed by a tribunal. The FRC is currently investigating the work of accountants at MG Rover and Isoft, both the subject of extensive controversies.

Stock markets commonly imposed further reporting obligations for their members. For example, the UK stock exchange imposed further disclosure requirements on top of those required by the statute and accounting standards. Listed corporations, for instance are required to comply with the provisions of the Financial Reporting Standards (FRS) and to explain significant departures from these. The situation is broadly similar for the US, where its various stock exchanges also imposed further disclosure obligations for quoted corporations, especially those effected in response to guidelines provided by the SEC. Financial reporting obligations are also on occasions subjected to the influence of the ASB and FASB respectively in the UK and US; and through periodic consultations and dialogues. Finally, firm specific rules also exert influence on financial reporting practices. This appears in the form of the accepted practice for the ‘true and fair view’ in the UK, and the ‘present fairly rule’ for the US.

*The’ true and fair view’ and ‘present fairly’ rules*

Under these rules, preparers of accounts when addressing matters not regulated by a higher rule are compelled to formulate their own rules with assistance from their auditors. The Companies Act states that the requirement to observe the true and fair view principle overrides all its other provisions. When financial statements are prepared according to the provisions of the Companies Act do not provide ‘a true and fair view’ because of the effect of a particular provision in the Companies Act, then the preparer should depart from this provision because the general requirement to give ‘a true and fair view’ overrides this particular provision. Many Commonwealth jurisdictions and various EU member states also follow this rule. However, it has assumed an ambiguous role in UK accounting. As a legal residual clause, it seeks to ensure the compliance with both the spirit and the letter of corporate law. As a characteristic external to accounting, it helps to motivate the observance of good
principles beyond accounting; or it may just be included as part of generally accepted accounting principles.[62]

The relationship between accounting standards and the law in general, and the true and fair view rule in particular necessitates clarifications. Legal opinion on this issue was expressed in 1993 as follows; ‘…The Court will infer from Section 256 that statutory policy favours both the issues of accounting standards (by a body prescribed by regulation) and compliance with them: indeed section 256 (3)(c) additionally contemplates the investigation of departures from them and confers power to provide funding for such purpose. The Court will also infer in my view from paragraph 36A of Schedule 4 that accounts, which meet the true and fair requirements, will generally follow rather than depart from standards; and that departure is sufficiently abnormal to require to be justified. These factors increase the likelihood, … that the Courts will hold that in general, compliance with accounting standards is necessary to meet the true and fair view requirement.’[63]

Thus, ‘fairness’, ‘opinion’, and the concept of a flexible definition underpin the subjectivity of the true and fair view rule. This is beneficial in that experts can respond quickly with changes in accounting issues, and suitable exceptions to the rule are provided for peculiar circumstances. This, however, can lead to problems connected to the issues of consistency and comparability. This implies the necessity of detail analysis to ascertain actual transaction events against what have been

[63] Legal opinion provided by Mary Arden QC in 1993; Odeon Associated Theatres Ltd v Jones [1971] 1 WLR 442. This case supports the argument that the true and fair view is based on the application of commercial accountancy practices and not on the basis of revenue law criterion; Wilson, J., ‘International Accounting’ in John W. (ed.), ‘Current Issues in Accounting and Auditing’, Tudor Publishing Ltd.: Birkenhead, 1996, 41-44. The EU Fourth Directive requires the overriding of regulations where necessary to meet the requirements of the true and fair view.
assumed. This is where financial reporting standards become relevant. Still, as the true and fair view test is a legal one, advocates have called for definition and clarification of this phrase. The CA 2006 has ignored this, and indirectly showed the government’s preference for flexibility[64]. The FRC clarified in August 9, 2005 that the substitution of the ‘true and fair’ over-arching test by the ‘fair representation’ principle of the International Accounting Standards (IAS) would not affect UK’s position. This implies that the ‘true and fair’ principle still underpins UK financial reporting standards.

In sharp contrast, US auditors are required by their professional rules to state that the accounts that they have audited present fairly, in all materials respects, the financial position of the corporation concerned and in conformity with US GAAP, and the Statement of Auditing Standards No. 69. The US ‘present fairly in conformity with GAAP’ rule has to be followed. It is a disciplinary offence for US auditors to issue unqualified audit reports that do not comply with GAAP. The large numbers of rules released by the SEC following the introduction of SOA demonstrate clearly this approach.

Comparative Analysis of UK and US Financial Regulations

Where the UK is concerned, the body of rules adhered to by accountants for the

[64] Higson, supra note 42, 163-183; McGee, A., ‘”The ‘True and Fair View’ Debate: A Study in the Legal Regulation of Accounting”, MLR 54:6 11/1991 874-888; Ekholm, B-G & Troberg, P., ‘Quo Vadis True and Fair View?’, JIAAT, 7(1), 113-129. The researchers maintained that the phrase is made in relation to the concept of intrinsic value as applied in the efficient market theory and based on this, information provided to shareholders are also relevant to other users with economic interests. They further asserted that the overriding nature and flexibility of the true and fair principle plays an essential role as ‘a defence against creative compliance and the unsuitability of general rules in specific circumstances’.
preparation of accounts make up the UK GAAP. Its five components are, namely; the provisions of the Companies Act, the standards issued by the ASB; the Stock Exchange listing rules; professional recommendations; and the practice of leading professional firms and large corporations. Within this hierarchy, law exerts the greatest authority. Though ASB standards may occasionally override a specific provision in the Companies Act, the overriding capacity of the ‘true and fair view’ principle as set out in section 1 of the Companies Act assures law’s supremacy.

By comparison, strong political forces headed by the Congress and the SEC drive the FASB. For instance, in 1993 the FASB had to withdraw its proposal to require the treatment of share options as an expense item after serious lobbying by the SEC and Congress. Various interests groups in turn lobbied the latter two. This showed clearly that the SEC has to take into account the position of Congress in the discharge of its regulatory function. The FASB in turn has to accede to the superior authority of the SEC.

Thus, financial reporting in the US is highly regulated; geared towards the information needs of participants in the capital market; and displays a high level of disclosure obligations. In contrast, the UK system addresses wider aims and adopts a rather flexible approach underpinned by the ‘true and fair view’ principle. Research has shown that US GAAP measures of earnings for the period 1985-87 were much more conservative than UK GAAP earnings. On average, UK earnings were between 9 and 25 percent higher than the US earnings due to differences in accounting
principles.\textsuperscript{[65]} Such differences may narrow as both jurisdictions begin to converge through the influence of international accounting reporting standards.

\textit{International Accounting Standards}

Accounting systems vary across economies. To facilitate comparison and so on, multiple sets of statements might have to be prepared or the users might have to become more familiarised with each of these different systems. Either approach could be cumbersome. The accounting communities’ response towards this issue has been through the process of standardisation through imposition of a narrower set of rules or harmonisation through reduction of variations to increase the compatibility of accounting practices.

Harmonisation of the Anglo-Saxon accounting practice based on ‘general accepted accounting principles’ with those of the explicit legal text approach of much of continental Europe encountered a ten year delay; but by that time global harmonisation had become more of a priority. Besides, many EU corporations seeking to raise funds in the US capital market had to comply with US rules. Given these set of circumstances, the EU threw in its lot with the International Accounting Standards Board (IASB) where it enjoys some influence, and from where it hopes to exert more influence on the US GAAP.\textsuperscript{[66]}

IASB evolved from its predecessor, the International Standards Committee (IASC) in 1973 as an independent private sector organisation dedicated to the narrowing of variation for presentation of accounting data.\[67\] The IASB’s General Accepted Accounting Principles (GAAP) operates across national boundaries in contrast to say the UK GAAP or US GAAP. In theory at least, from the global capital market perspective, the IAS GAAP should be relatively more important. In practice, the SEC still holds sway when corporations try to raise funds in the US capital market.\[68\]

The EU issued IASs for listed European corporations through its regulation for accounting periods on or after January 1, 2005. This has the force of law without further action by member nations. The EU Commission will nonetheless decide the applicability of individual IAS within the EU. It may adopt an IAS only if: it is not contrary to the principles of the Fourth and Seventh Directives or the European public good policy; and comply with the principles of comprehension, reliability, relevance and comparability required of financial disclosures for making economic decisions and the evaluation of corporate stewardship.\[69\]

The Enron affair has provided grounds for the EU and others to argue that Enron and Enron-type scandals have shown clearly that it was not the question of compliance to US GAAP but rather inappropriate compliance, which matters. Hence, the EU has

\[67\] ibid, 173
\[68\] ibid, 173-174. The SEC is now said to be planning for the mutual recognition approach to facilitate cross-border listings and so on.
taken the position that there will be greater convergence if the US GAAP adopts a more principles-based rather than rules-based approach.\(^{[70]}\)

*Principles (UK) versus Rules-Based (US) Financial Reporting*

Specific details to answer as many potential contingencies as possible drive US accounting standards. These have made standards longer and more complex; and provided the flexibility for corporations to structure transactions to circumvent unfavourable reporting. Further, the tilt towards bright-line accounting rules shifted the focus from consideration of the best accounting treatment to concerns for satisfying the letter of the rule. For instance, ‘… with respect to Enron, the audit firm Arthur Anderson was charged with designing financial instruments that met the technical requirements of GAAP while violating the intent. Public disclosure of Enron’s procedures has given rise to a renewed debate over whether accounting standards should be based on rules or principles’.\(^{[71]}\) To allay these concerns, the SOA nominated the SEC to evaluate the feasibility of the principles-based approach.

Simply put, the principles-based approach provides a conceptual basis for accounts preparers to follow instead of a list of detailed rules. The Chairman of the FASB, Robert Herz explained that, ‘Under a principles-based approach, one starts with laying out the key objectives of good reporting in the subject area and then provides

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\(^{[70]}\) Alexander, supra note 66

guidance explaining the objective and relating it to some common examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles'.[72] Under the principles-based approach, accountants in the UK are given the professional discretion and responsibility for determining that the accounting statements show a true and fair value.

Opponents argued that a principles-based standard frequently transforms into a rules-based standard in order to enhance comparability and consistency for financial reporting users. The US SFAS 133 fair value principle for derivative and hedging activities for instance attracted no less than 22 statements to clarify the working definition of derivatives. In effect, the fair value principle transformed into a detailed rule with complex guidelines and exceptions giving preparers the opportunity to structure contracts for more favourable reporting.[73]

Conversely, the lack of precise rules might lead to inconsistencies in the use of standards for comparative analysis. For instance, preparers are required to recognise both an expense and a liability for a contingent liability that is probable and estimable. However, a contingent liability that is reasonably possible is only identified in the footnotes. Without precise rules, it is difficult for preparers to ascertain whether liabilities are probable or are only reasonably possible. In the absence of rules, the quality of financial reporting would be affected adversely due to the reduction of comparability and consistency. Additionally, it is widely believed at least in the US that many accountants prefer rules-based standards, as they perceive that the

[73] Shortridge, supra note 72
justification for lawsuits would be considerably reduced, once financial reporting conforms to accepted rules.[74]

The FASB’s October 2002 discussion paper on the principles-based approach acknowledged that its benefits outweigh its cost. Its adoption it argued would lead to greater convergence to the IASB already accepted in the EU. The FASB, however, favoured a gradual conversion to this approach because of the prior need to improve accounting concepts and develop an overall reporting framework; and the necessity to reduce the number of exceptions contained in its current standards. For example, the FASB plans to eliminate ‘application exceptions’, commonly granted to achieve desired accounting results to reduce the complexity of standards and reflect more explicitly the economic events of an entity.[75] The SEC nonetheless rejected the principles-based approach in its 2003 review because its adoption would provide inadequate guidance to auditors and corporations and caused the loss of comparability.[76]

Despite these limitations, arguments have been made that the benefits of the principles-based approach outweighed its drawbacks. For example, the proponents asserted that the US FAS 133 provisions were presented in 449 pages, not counting four further amendments as of July 2004. In contrast, the comparable IASB standard provisions, which adopt the principles-based approach, have only 289 pages and these include illustrative examples and implementation guidance.

[74] ibid
Another OBF example concerns the treatment for lease accounting. The US GAAP, which uses the rules-based standard, formulated four detailed benchmarks to distinguish between financial and operating lease. This was because in the 1980s many corporations were turning this into an abusive form of OBF. This did not work well, as corporations made use of the explicit rules to justify and carry on with its use as an OBF instrument. In sharp contrast, the principles-based International Accounting Standard 17 (IAS 17) states simply that a lease, ‘is classified as a finance (i.e. capital) lease if it transfers substantially all of the (the entire) risks and rewards incident to ownership’ to the lessee. In effect, IAS 17 does not provide corporations with the option to structure contracts that avoid minimum requirements. This in essence implies that it is difficult to structure contracts to permit OBF under IAS 17.[77]

Indeed, the principles-based approach merits support because its broad guidelines can cater to wide-ranging situations; results in simpler standards, and; reflects more accurately the underlying performance of businesses and more importantly curtail the opportunity for financial manipulations. Further, it does provide auditors with the opportunity and responsibility to exercise their professional judgements to ascertain whether financial reports they audited actually fairly represent its financial health and liquidity positions. The auditors’ hands would also be strengthened relative to corporate influence, as the latter can no longer argue that the former must attest that the corporate statements are fair as they conform to the rules of GAAP.

[77] supra note 75
This may, however, require an oversight to ensure that auditors who fail to act professionally due to a lack of probity or skill are effectively held to account. The debates over principles-based and rules-based accounting standards in the US are far from over, despite favourable official US opinions for the former. The lack of enthusiasms especially for practising accountants appear to be their inherent fear of losing their ‘shields’ in the form of explicit rules against lawsuits. It will require the firm resolve of all those connected with financial reporting; from preparers, standards-setters, auditors, and the wider public to effect the principles-based approach in the US assuming that such a choice is made.

Financial Regulators

UK: FSA

The Financial Services Authority (FSA) and the Serious Fraud Office in their own capacities or in conjunction with the Crown Prosecution Office for the more serious criminal cases enforced financial regulations in the UK. Generally, statute laws provide penalties for breach of the laws. The CA 1985 and 1989 along with the CA 2006 include a number of technical breaches such as failure to submit accounts on time, which results in minor criminal penalties or automatic penalties. Corporate frauds of a more serious nature carry more severe penalties. It would seem that the threat of criminal prosecutions encourage widespread corporate compliance with the law as only a handful of cases have been brought before the courts to date.

The FSA derives its powers from FSMA 2000 and these exceed those of its predecessors.\[^79\] The FSA has been given enforcement powers relating to its Code of Market Conduct. Participants who breached the market code will face penalties or have their gains disgorged. This civil route was not hitherto available in the previous financial regime. This new market abuse regime therefore aims to minimise financial crime and other sharp market practices. More than this is the convergence of the hitherto three financial clusters separated by custom, informal norms and cartels. Indeed, it is about the updating and modernisation of the financial services sector.\[^80\]

Given the wide legislative, investigative, disciplinary and prosecuting powers extended to the FSA, various mechanisms have been put in place to ensure that it will act responsibly and be held to account for all its actions. The FSA being an incorporated body is not directly answerable to parliament but to the HM Treasury, which has the power to appoint and dismiss its board and chair. The FSA is also required to present an annual report relating to; the discharge of its functions; the extent to which it has met its objectives; the degree to which it has complied with the principles set out to guide its work (section 2(3) of the Act); and any other matters directed by the Treasury. The Treasury via Sections 12 to 18 of the FSMA is also


empowered to commission reviews on FSA’s operations.[81] Despite this, some have argued that the scope for judicial review of its work would be constrained by the extensive, ’… subjective criteria to the way in which the FSA is required to discharge its tasks (section 2 (1) (b)).’ [82]

The FSA is shielded from suits other than for acts done in bad faith or in breach of the Human Rights Act 1998 (Schedule 1, Para. 19). The broad immunity from suit appears to be balanced by a robust independent complaints procedure (as set out in Schedule 1, Para. 7 (1) (b)). This is intended to provide redress for participants in the financial services sector hurt by inappropriate acts of the FSA.

The FSA is guided by four statutory objectives; namely the maintaining of market confidence (section 3(1)); the promotion of public awareness (section 4(1)); consumer protection (section 5 (1)); and financial crime reduction (section 6 (1)). The rest of the principles are concerned with the caution that the regulatory functions of the FSA should not provide unnecessary impediments to healthy competition or be stifling to innovations in the industry.[83]

[81] supra note 79 (a), 17-36
[82] (a) ibid, 24; (b) Omoyle, O., ‘Accountability of the Financial Services Authority: A Suggestion of Corporate Governance’, Company Lawyer 2006, 27(7), 194-203. Here the researcher asserts the limitations of existing mechanisms and suggests the incorporation of corporate governance practices as the way forward.
The FSA has no direct role in deciding on the contents of financial reports other than those for detailed regulation of prospectuses. The FSA’s concern in the contents of financial reports arises from its prudential supervisory responsibilities pertaining to capital adequacy and liquidity measures founded on financial data. High standards of financial reporting quality are connected, however, with the FSA’s objectives of protecting investors and the provision of fair, efficient, and transparent markets. As such, accounting and audit standards and in particular their enforcement are of crucial interests to the FSA.

The ASB, the accounting standards regulator, in contrast has no enforcement powers other than to apply to court for the resubmission of defective financial statements. This self-regulatory process appears to sit well with the business community as very few court orders have been made to date.

Where the Combined Code of Corporate Governance is concerned there are no tools available to enforce it, being a mere code of best practices. Nonetheless, most market participants keep well within its provisions to avoid unnecessary visits from the FSA. So far, some listed institutions have breached the code on the provision for the separation of the posts of Chairman and Chief Executive Officer (CEO), and on the recommendation that the former should not be appointed from a prior CEO. Ergo, as a self-regulatory code, and as long as corporations can provide good reasons for their departure from it, no penalties can come about.

[84] FSA 2000 Annual Report, 17
The SFO normally in conjunction with the DTI or the Crown Prosecution Office undertakes serious corporate fraud cases, but usually within certain parameters, like case size and degree of public interest. Thus far, the SFO has enjoyed mixed success. As a result of the collapse of a couple of lengthy and expensive trial cases in 2005, the SFO is now seeking reforms through the Attorney General for the use of the single judge route for complex fraud cases.

*US: Securities Exchange Commission (SEC)*

Banking activities are regulated by the Federal Reserve, the Federal Deposit Insurance and others. The Commodities Futures Trading Commission and primarily the SEC regulates securities activities. As financial products and services are generally regulated by function, the US regulatory system is ergo functional in nature. To facilitate comparison with the US system, the SEC is selected in this study for suitable comparison with the FSA. The SEC or the State Attorney General’s Office or both jointly supervise and enforce breaches of corporate and securities laws. Corporations in the US are established under state rather than federal laws.

There was therefore initially no national law governing the flow of financial information to investors. The 1929 stock market crash attributed part of the blame to inadequate information given to shareholders. The Securities Act of 1933 (SA 1933) stipulated the financial disclosure requirements for initial offerings, whilst the Securities Exchange Act of 1934 (SEA 1934) listed disclosure requirements for those already listed as well as those traded in over-the-counter market. These and other later federal acts superseded the state laws concerned. The SEC was set up under the SEA 1934 to administer these sets of regulations.
The SEC, an independent federal agency, relies on the FASB to develop GAAP.[85] Despite this, the SEC occasionally intervenes, when it finds the private sector not moving in the desired direction or proceeding too slowly. Since the 1970’s the SEC prioritised more on disclosure rather than measurement issues. The thrust of the SEC’s policy is the protection of individual investors and the safeguarding of the securities trading system.

The SEC has been concerned with various creative accounting practices in the capital markets, which have the effects of exaggerating revenue and profits or the understating of debts.[86] It implemented a four-point plan to address these issues. These involved improving the accounting framework; enhancing the statutory audit for listed corporations; beefing up the audit committee process; and pursuing the cultural change within the professional, financial, business, and related regulatory authorities. The SEC’s serious view of the then prevailing problems was articulated through various enforcement actions.[87]

To help improve the quality of external audit, the Public Oversight Board Panel on Audit Effectiveness issued numerous guidelines.[88] While the Treadway Committee recommended for a much stronger and more independent audit committee, the Blue Ribbon Committee made other recommendations on their nature and functions.[89] SEC’s message to the financial community appeared to have some positive effects as some changes have been observed. These did not, however, appear to be sufficient to

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[85] Accounting Series Release (ASR) No. 150
eliminate creative accounting practices altogether, as the perpetrators were pressured by stronger motives and forces. Enron and other related financial scandals, which unfolded from 2001 onwards, gave credence to this perspective.

Functioning like a regulatory champion in Wall Street, the New York State Attorney General, Eliot Spitzer mounted a series of high profile cases against CEOs, outside directors, auditors and financial advisers. Some were sent to jail for the wilful distortion and manipulation of financial reporting, but the bulk settled out of court with hefty fines. Aside from the high profile criminal cases, settlement was reached between the ten largest investment banks in the US and the SEC, the New York Attorney General, NYSE, and other state regulators. This 2002 Global Legal Settlement scheme involved a fine of US $1.4 billion on the accused financial institutions, with further undertakings by them to improve the quality of information in the financial markets. The latter requires these financial institutions to make their analysts’ recommendations public; and to contract with at least three independent research firms to provide research to their brokerage customers over a five-year period.


[91] Mishkin, F.S., ‘The Economics of Money, Banking, and Financial Markets’, Boston: Pearson Education, 2006, 202-203; In the Billing v Credit Suisse First Boston case, the Supreme Court held on 19/06/2007 that underwriters are entitled to ‘implied immunity’ from private antitrust suits for their actions in underwriting initial public offerings (IPOs). This means that whilst private plaintiffs may still claim under securities laws for alleged wrongdoing relating to IPOs, they cannot seek treble damages under antitrust laws or to avoid the heightened pleading standards of the Private Securities Litigation Reform Act of 1995; Rider, B., ‘Editorial: Minding Other People’s Wealth’, JFC Vol. 12 No. 3 2005, 198-199. The editor here highlighted the significant rise of obligations on professional advisers and intermediaries to ‘blow the whistle’ when they are or should have been suspicious.
Clearly, this was a direct response to the conflicts of interest generated by the key financial analysts involved in Enron and WorldCom. Some of the settlements made use of the deferred prosecution mechanism, wherein the state prosecution office would suspend prosecution in exchange for specific undertakings by the defendants. A good example of which was that imposed on KPMG for its alleged role in the construction of sham tax shelters for their customers. Apart from the payment of a hefty fine, KPMG had to undertake to be on good professional behaviour for one year, and be subjected to a mandatory review of its professional conduct by an independent consulting firm.\[92\]

Thus, a climate of financial reporting compliance fear developed in the capital market which appeared to promote greater professionalism and ethical behaviour. This was, however, rudely disrupted by the management share options backdating scandals unfolding in the latter part of 2006, despite the introduction of relevant provisions in the SOA for the reporting of share options.\[93\] Until the market corrects such deviant behaviour, investors might need to be more vigilant with assistance from securities regulation.

Comparative Analysis of UK and US Financial Regulators

The financial regulator in the US, namely the SEC was created through a statutory provision to ensure the protection of investors by making financial disclosures on a stipulated regular basis mandatory to corporations listed in the capital market. In

\[92\] US Department of Justice, Re KPMG-Deferred Prosecution Agreement, 2005; US Senate Committee on Finance, ‘Tax Shelters: Who’s Buying, Who’s Selling, and What’s the Government Doing About It?’, 21/10/2003, 108-371; Robinson, J. K. & Urofsky, P.E., ‘Deferred Prosecutions and the Independent Monitor’, IJDG, Vol. 2 No .4 2995, 325-347 This research reviewed questioned the value of these Deferred Prosecutions Agreements (DPAs) which have no formal or informal guidance on firm eligibility.

\[93\] Bawden, T., ‘American Economy Under Threat from Notes on A Scandal’, The Times, 09/12/2006, 66. The article stressed the seriousness of the problem as to date some 160 corporations became under SEC investigations and more are expected.
contrast, the FSA in the UK is structured as a corporation and hence governed by a Board of Directors instead of state appointed commission members as in the US. The powers of the SEC are drawn from the SA 1933 and SEA 1934, whereas the FSA derives its power from the FSMA 2000.

The SEC focuses mainly on the regulation of corporations listed on the capital market of the USA. It can act against US listed corporations as well as non-USA corporations listed there. Under the SOA, it can also take actions against infringement of its rules and regulations by foreign corporations, which have financial dealings with US listed corporations. The FSA’s duties and obligations go beyond corporations listed in the London Stock Exchange, as it has regulatory duties over the entire UK financial system. These include the banking and insurance business. It also enjoys rights to enforce actions against non-UK institutions and individuals who have used and abused the financial services sector in the UK.

The SEC is guided in its work by its mission statement as well as various related Acts passed by Congress. It is in a sense supervised by Congress as the latter determines its budget. In the case of the FSA, its work is mainly guided by the FSMA 2000, but it is also led by Eleven Principles, which overarch the regulations surrounding its tasks. Breach of these principles may lead to disciplinary action by the FSA, whilst breaches of FSA regulations may lead to civil suit. The activities of the FSA are monitored and scrutinised by a Parliamentary Committee and the Treasury. The latter wields considerable influence over the FSA as it determines its budget.

Where enforcements are concerned, both regulators have access to civil as well as criminal sanctions. Both also work closely with the Prosecution authorities, where
criminal liabilities are involved. On a comparative basis, it would appear that the SEC is more aggressive in its enforcement practices. This could be attributed to its aggressive use of plea-bargaining, which is not as yet available to the FSA. This approach is often taken, as the results tend to be quicker than via the criminal sanction route, which is hampered by the higher burden of proof associated with its use.[94]

Still, unlike its predecessors, the FSA has been given much broader powers under FSMA 2000, to pursue civil and criminal actions. The increasing pace of its disciplinary and enforcement activities already visibly shows some effects of these.[95]

Both regulators operate under a broadly similar financial system characterised by good corporate governance, transparency, accountability, and the rule of law. These are the ingredients, which have contributed to the success of their capital markets. Both also rely on private sector initiatives to safeguard and develop accounting standards, policies, and procedures. Despite these broad similarities there are some differences in terms of style and approach. For instance, the SEC has powers over the development of accounting standards, which have the force of law, even though it uses this only when it is not comfortable with private sector initiatives. In contrast, the 1985 CA provides the statutory backing for the accounting standards developed

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[94] The FSA disclosed in April 2007 that it is contemplating the adoption of US style plea-bargaining mechanism to strengthen its enforcement procedures; Fryer, P.A., 'Insider Dealing and Market Manipulation: A Comparative Analysis of Regulatory Enforcement in the UK and the US', PhD thesis, University of Wolverhampton, 2000, Chapters 5 and 6; Braithwaite, J, ‘Markets in Vice, Markets in Virtue’, OUP: Oxford, 2005; Rashkover, B. W. & Winter, C .B., ‘The Impact of Sarbanes-Oxley on SEC Enforcement in Public Company Disclosure Cases-Part 1 & 2’, IJDG, Vol. 2, No. 4, 2005, 312-324 & Vol. 3 No. 1, 2006, 49-58 respectively. The articles illustrated SEC’s use of SOA in its recent employment of large civil penalties (section 308(a)), expanded equitable remedies (section 305(b)), and the placement of so-called extraordinary payments to executives in escrow (section 1103). The SEC has also brought several cases alleging false certifications under SOA, whilst the PCAOB a SEC supervised agency also initiated two subsequently settled cases

[95] FSA 2006 Annual Report; Arnold, M. & Wiesmann, G., ‘Private Equity Checks for Banks’, Financial Times, 12/06/2007, 17. The FSA has announced plans to conduct a semi-annual exercise on banks’ exposures to leverage lending and to ‘investigate worries about conflicts of interests within private equity firms, such as between the buy-out funds and their own in-house advisory firms, which receive fees on services to the fund’.
almost entirely through the accounting and business communities. CA 2006 has 
maintained this position.

The extent and scale of financial scandals in the UK is comparatively less worrisome 
than that in the US over the last five years or so. This may be attributed to the various 
guidelines provided by various corporate governance committees; the alertness of the 
accounting profession to respond to various challenges confronting the integrity of 
their profession; and in particular its higher transparency for management stock 
options. The more interventionist mode of UK institutional investors in regard to 
matters like board composition, directors’ appointment, executive compensation 
schemes, and disclosure policies; and a relatively more shareholder friendly corporate 
legal regime also contributed to a more balanced engagement and mix of outside and 
inside board members to lend further influence on corporate directions and controls. 
However, matters can still be further improved upon through a more enhanced form 
of transparency in corporate reporting.\[96\]

Prior to the passing of the SOA, the regulatory framework in the US already has in 
place various specific rules governing the use of particular OBF instruments. This 
was, however, not integrated under a central principle as is found in the UK. 
Businesses have resorted to creative compliance to lessen transparency. As a result 
some corporations like WorldCom and Global Crossing have exploited the loopholes

\[96\] Owen, G., Kirchmaier, T. & Grant, J., ‘Corporate Governance in the US and Europe: Where Are 
We Now?’, in Geoffrey, O., Tom, K. & Jeremy, G. (eds.), ‘Corporate Governance in the US and 
Europe: Where Are We Now?’, Palgrave Macmillan: Basingstoke, 2006, Chapter 1; Yeoh, P., ‘The 
History of Corporate Governance: Key Lessons Never Really Learned?’, paper presented at 2006 SLS 
Conference at Keele University, 07/09/2006; Jopson, B., ‘Companies Make Patchy Progress on 
Reporting Performance’, Financial Times, 16/01/2007. This article cited the findings of the ASB, 
which found that only some 45% of the companies investigated produced financial report exceeding 
statutory requirements and that most were deficient in the provision of forward-looking information on 
fears of litigation stemming from good-faith forecasts that might turn out to be wrong.
to engage in various deceptive commercial activities. The US regulatory authorities have responded to this and related issues through specific provisions in the SOA.

By comparison, the UK has FRS 5. This is a specific financial reporting standard for OBF formulated in the mid 1980s in response to the corporate scandals prevailing then. This probably explains why the UK subsequently responded mainly with soft laws in the wake of huge corporate frauds prevailing in the 2000s in the US and the EU. The UK, however, has just updated and completed the reforms of its corporate laws. These included among other things, new provisions for corporate disclosure obligations, directors’ accountability and liability as well as auditors responsibilities and liability. It has to be mentioned that the UK is not entirely spared from the limitations and weaknesses of financial reporting. The recent Alfred McAlpine, MG Rover, and Isoft cases where faulty financial reporting have been alleged demonstrated clearly the need for continued vigilance on the part of investors and financial gatekeepers in the UK.

On an overall basis, the ‘light touch’ financial regulation in the UK is perceived to be working reasonably well with far less corporate scandals of the scale witnessed in the US. The UK stock market is about a fifth of the US capital market, but is more global in character with about 50% proportion of international companies compared to the latter’s narrower band of 30%. The UK stock exchange is also fast becoming a global beacon for the listings of large foreign corporations particularly from Russia, China, and India. The US Capital Market Regulation Committee raised concerns over the decline of US share of the global IPO market and the increased use of private equities.
over the public market. In response, it made ‘…32 specific recommendations in four key areas—shareholder rights, the regulatory process, public and private enforcement and Section 404 (Auditor Compliance Testing) of the SOA 2002—to improve the regulatory system and give US capital markets the competitive boost necessary to respond to the increasingly aggressive efforts of other countries to attract equity capital markets’.

The above development and similar development in the EU might spell the beginning of regulatory competition as stock markets across the world compete for business. Other than the alluded fear of the US that their stock markets have lost business to the UK; the latter itself has begun to entertain fear of losing business to less stringent financial regimes in the Netherlands and in Guernsey. Private equity funds and hedge funds in particular are loud on their calls for less regulatory intrusion in the capital market as their modes of operation prefer a less transparent type of financial reporting regime. On the other hand, the market prefers otherwise. The challenge for financial preparers regulators is to find a balance in financial reporting which can accommodate adequately both these needs. OBF reporting faces a similar dilemma.

Increasingly, however, growing recognition is given to the difficulties of transplanting governance protection from one jurisdiction to another. Indeed, dispersed ownership


particularly in the US creates managerial incentives to manipulate financial benefits resulting in the misappropriation of private benefits of control. In contrast, the predominant concentrated ownership as found in most of continental Europe attracts the low-visibility extraction of private benefits.\textsuperscript{[99]}

The UK being a member state of the EU is subjected to the influence of the development of EC corporate law. It has, however, been argued that EU company law directives and regulations exert little impact on corporations’ governance and management. They failed to address principal company matters like fiduciary duties and shareholder remedies; characterised by under-enforcement of rules which are implemented and construed differently in different member states, and; underpinned by optional rules which are said to be market-mimicking and of little relevance or avoidable. In contrast, national company laws such as those in the UK still regulate primary matters.\textsuperscript{[100]}

The US response to the financial scandals through the SOA is criticised as an over-reaction and knee-jerk in nature.\textsuperscript{[101]} Developments four years on seemed to give greater weight to this view. Accordingly, it is further argued that market participants like institutional investors which now make up two-thirds of all shares traded in the US, regulators, and enforcement agencies must deploy their power and influence to

insist on the proper performance of the fiduciary duties that corporate directors and financial intermediaries have in common.\[102\]

Evidently, the situation is different for the UK. Well before the onset of Enron or Enron-type debacles, respectable professional groups were already criticising and succeeding in the initiation of reforms to curb conflicts of interest and so on especially in the UK. This is said to help avoid the making of legal reforms in haste and without proper scrutiny.\[103\]

Changes made to the existing financial reporting framework by US, UK and EU financial regulators have contributed value. Among others, this includes more forward-looking information that reflects a corporation’s overall performance, risk profile, and expectations of future prospects. Nonetheless, it should further incorporate generic provisions common to all businesses and be of help to intra industry comparative analysis.\[104\]

As financial markets become more interlinked and market participants increasingly operate globally, regulatory issues can no longer be dealt with on a national or even regional level. To deter and prevent apparent isolated problems from disappearing and re-emerging elsewhere, financial regulators need to adopt a more global approach.

CHAPTER THREE

OBF Reporting Practices: Making Debts less Visible or Invisible and Earnings

Exaggeration

Introduction

This chapter will examine the forms and shapes that Off Balance Sheet Financing (OBF) has assumed over the years. It will also demonstrate how it can be put to improper use, and how the state and the professional community deals with some of the problems created by OBF in corporate reporting.

OBF Instruments

As OBF has no precise definition, financial instruments that can be treated away from the balance sheet, are captured in its classification. They all share the same characteristics that they do not result in the full disclosure of the underlying transactions. These are also structured to support specific financial strategies of a corporation. OBF surged significantly in the 1970s and 1980s partly because of high volatility in interest rates and foreign exchange rates. Banks responded with OBF products to enhance their customer relationship, but more importantly for the massive huge fee income. OBF items comprising options, standby letters of credit, loan commitments and guarantees and futures and forward contracts usage grew in popularity.

OBF instruments hence evolved mainly through the innovations of investment banks and other related professional groups. This study will examine those of concern and interest to the accounting regulators and investors. Where the UK is concerned, these
are found in the Application Notes of Financial Reporting Standard 5 (FRS 5),[1] which is specifically constructed to deal with some of the excesses of OBF instruments. These Application Notes are part of the accounting standard and are authoritative when used to help in its interpretation. The main thrust of FRS 5 is its emphasis of substance over form. In contrast, in the US for the pre-Enron era, specific rules governed the reporting obligations for each different type of OBF instruments rather than any specific overall OBF standard. It was only the SOA, which subsequently provided detail rules for the specific reporting of OBF transactions.

As no international standard has been issued for the accounting of substance over form, guidance is available mainly from the Framework for the Preparation and Presentation of Financial Statement.[2] In accordance with the guideline, transactions that meet with the specifications of an asset or liability are to be reported on-balance sheet irrespective of the legal nature of the transaction. In accordance with the said framework, assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.[3] From this perspective, control refers to the power to secure future economic benefits in respect of an asset and to restrict access to these benefits by other parties.[4]

In contrast, liabilities are the existing obligations of a corporation arising from past transactions, the satisfaction of which will result in an outflow of resources with

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[1] FRS 5, ‘Reporting the Substance of Transactions’, April 1994. FRS 5 is developed mainly through ASB’s Statement of Principles and deals specifically with transactions whose form is in divergence with economic realities.
[4] ibid, para 3
economic benefits. The focus is hence on the reporting of the underlying economic reality of a transaction rather than on the issues of legal ownership or assumption of legal responsibility for liabilities.

**IFRS Treatment of OBF**

As mentioned earlier, thus far no single international standard guides off balance sheet transactions. Nonetheless, where disclosure is concerned, the International Accounting Standard insists that, ’ …management should develop policies to ensure that the financial statements provide information that is …reliable in that they…reflect the economic substance…and not merely their legal form’. Elaborations are outlined in:

- IAS 39, Financial Instruments: Recognition and Measurement. This is accompanied by IAS 39, Implementation Guidance Questions and Answers
- IAS 1, Presentation of Financial Statements; and IAS 32, Financial Instruments: Disclosure and Presentation, and
- SIC-12 (The Standing Interpretations Committee of the IASC (to be replaced by the International Finance Reporting Interpretations Committee of the IASB))-Consolidation-Special Purpose Entities
- IAS 17, Accounting for Leases

UK listed corporations are required to present group accounts in line with IFRS approved for use in the EU commencing from January 1, 2005. IAS 32 and IAS 39 are meant to deter and prevent manipulation and abuse. It is still too early to ascertain

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[5] supra note 1, para 4
their effectiveness in regard to this objective. Nonetheless, flexibility offered by IAS 32 and 39 has raised fears that this might result in wide variation in practice and pose considerable difficulties for comparative analysis between businesses. Still, IAS has given practical guidance where many other standard setters have failed to grasp or do.[8]

**UK Response to IFRS**

Until the revision of the CA 1989, it is not possible to implement IAS 32 and IAS 39 in the UK. The law at the current moment allows both historical cost and alternative fair value accounting, but in broad terms liabilities are normally expressed at historical cost, and unrealised gains are generally not captured in the profit and loss statement. In contrast, IAS mandates that liabilities will have to be measured at fair value and that unrealised gains may be captured in the profit and loss statement in specified situations.

Other than the impending changes to UK’s corporate law to keep in line with the requirements of the international standards, the ASB issued ‘Financial Reporting Exposure Draft (FRED) 30 Supplement-Financial Instruments: Hedge Accounting for a Portfolio Hedge of Interest Rate Risk’ in August 2003. This helps to bring FRED 30 in line with the revised IAS 32 and 39. Despite these updates and revisions, questions have been raised and still left not answered adequately in connection with the issue that’… some financial instruments will be required to be measured at cost and some at

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fair value. The boundaries between the two will rely on subjective judgements of management'.[9]

**US Response to IFRS**

Ernst & Young reported that the accounts of 130 foreign private issuers submitted to the SEC showed more than 200 differences between the IFRS and the US GAAP. On account of this and other problems, the SEC is reportedly exploring the option of moving away from current reconciliation guidelines;[10] and towards an internationally set of reporting principles developed by the IASB.[11] The more practical solution out of this dilemma is for the SEC to opt for mutual recognition of accounting standards with those they have confidence in, and there are signs that it would probably move in this direction.

In pursuance of s. 401(a) of the Sarbanes-Oxley Act of 2002, the SEC now requires disclosure of off-balance sheet transactions in the Management’s Discussion and Analysis (MD & A) of Financial Condition and Results of Operations section of the SEC disclosure reports. This has to be effected in a separate presentation of the said document. It has defined off-balance sheet transactions to include any transactions or contracts with an unconsolidated special purpose vehicle, wherein a corporation has:[12]

- Any obligations under specified guaranteed contracts;

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• A retained or contingent interests in financial assets transferred to the 
  unconsolidated vehicle, which act as credit, liquidity, or market risk support to 
  that other corporation for such assets;
• Any current or contingent obligations under derivative instruments;
• Any existing or contingent obligations within a significant variable interest 
  possess by the corporation in the unconsolidated entity that extends financing, 
  liquidity, market risk, or credit risk assistance to the corporation, or partakes in 
  leasing, hedging, or research and development services with the corporation.

The comprehensive definition thus provided is to capture the common means used by 
businesses to carry out OBF, which are usually confusing and often unclear to 
investors and creditors. These prescriptions are meant only for contractual 
transactions and exclude preliminary negotiations and contingent liabilities flowing 
from litigation, arbitration, or regulatory actions. It is interesting to note that where 
this latter point is concerned, the biggest US supermarket was recently urged by the 
joint pleas of US and UK institutional shareholders to be more transparent about its 
contingent obligations arising from regulatory and related litigations.\textsuperscript{[13]}

\textit{OBF Reporting Practices}

\textit{US Position}

This analysis will cover major OBF financial arrangements like consignment stock, 
leasing, securitisation, and derivatives as well as certain relevant investment 
accounting and pension accounting schemes. These said schemes are sometimes used 
in conjunction with OBF instruments to provide corporations with the avenues to 
achieve financial window-dressing or worse still financial misrepresentation.

\textsuperscript{[13]} Financial Times, ‘UK-US Alliance Confronts Wal-Mart’, 02/06/2005, 1
The SEC has laid down six criteria for compliance before recognising revenue for sales with right of return attached (SFAS No. 45). For instance, where a distributor enjoys the right to return unsold copies of the products; and not to pay the manufacturer until sales of the products to final customers the ‘sales’ should not be recognised as revenue until the earnings process is completed and an exchange has occurred. Other than this approach, some corporations are known to have recognised revenues; when future services remained to be provided; before shipment or before customers’ unconditional acceptance; or even when customers are not obligated to pay. This OBF instrument is, however, not suitable for very large-scale financial manipulation due to customers’ warehousing constraints.

The classification of investments in debt and equity securities as trading, held-to-maturity, or available for sale provide opportunities for aggressive reporting practices. Where a corporation has significant control over the management of an investee corporation or has less than 50% of its shareholdings, then the equity method of accounting will have to be employed. This means the corporation’s investment account will be adjusted for its proportionate share of the investee’s income (or losses). On the other hand, if a corporation holds more than 50% of an investee’s

shareholdings, then it will need to employ the consolidation method. In this case, the investor corporation will have to substitute its investments account with the investee corporation’s assets and liabilities.

The important thing to note is that where the trading security position is taken, unrealised profits and losses are surfaced in the accounts. In contrast, where the available-for-sale is concerned, gains or losses are recognised only upon disposals. Hence, though both positions provide similar income over the period concerned, they recognise gains and losses differently for each year.[15] Though both approaches do adjust their investment accounts to reflect changes in fair value, it is more popular for corporations to adopt the available-for-sale method as it provides them with the flexibility on when to book in their gains or losses. This will imply that through this process, corporations can have the option to use such gains or losses to impact on their overall profitability position. As for the equity method, it adjusts the investment account by absorbing the corporation’s proportionate share of the investee’s gains or losses less any dividends received.[16]

Though classification has to be made at the acquisition point, it can be adjusted later due to changes in regulations or changes due to business combinations. Where such investments migrate between different categories, they have to be adjusted for fair value and/or reflected in reported earnings. ABC Bancorp in 1999 and AFLAC in 1998 engaged in such creative practices, resulting in the former boosting its income by US$ 59,000 and the latter recognising realised investment gains of US$ 1.1

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[15] supra note 14 (a)
billion Loss recognition of US$ 1.4 billion in 1994 was postponed by Quaker Oats Company through the same approach. Presidential Life Corporation broadly echoed this in 1997.[17]

The above involved the erroneous postponement of loss recognition. Companies can additionally ‘manage’ their earnings through strategic selections of their portfolio of investments for sale. IBM for instance, reported a gain of some US$ 4 billion from its disposal of Global Network in 1999. Similarly, First Union Corporation in the same year netted a gain of US$ 23 million from its sales of 14 branch banks, and in the process met with the capital market’s expectations [18]

Liabilities are undervalued on other occasions to inflate current earnings. These may involve the under-accruing of operating expenses as demonstrated in General Electric Company’s financials in 1998 involving the sum of US$ 100 million, and in the 1996 accounts of Centuri Incorporated by US$ 0.9 million. On the other hand, the understatement of accounts payable will help lower the cost of sales and hence boost profits. This appeared to be the reporting approach undertaken by Guilford Mills Incorporated in its 1997 income statement and balance sheet[19]

Understatement of liabilities and exaggeration of net profits can also occur when contingent liability is disregarded and not accrued when they ought to be. Basic accounting practices require such liabilities to be accrued when it is deemed probable that these have been incurred and their amounts reasonably estimated. Indeed, Lee Pharmaceuticals’ failure to accrue for its contamination costs resulted in significant

[18] Mulford & Comiskey, supra note 17
[19] Mulford & Comiskey, supra note 17
overstatement of its financial health. \[20\] Finally, various businesses rather than consolidation to avoid the absorption of debts mounting their subsidiary investments, which are making heavy losses, used the equity the equity method for investment reporting. \[21\]

The ‘creation’ of income through financial assets reclassification such as achieved by the above mechanisms is generally confined to businesses with active trading portfolio. Yet, as demonstrated by the examples given, various corporations have opted to boost their income through such means while not falling under this category. In most occasions, it would appear that the corporations involved were motivated to do this to inflate their earnings to stay in line with capital market expectations to help shore up their equity valuations.

\textit{Pension Financial Reporting}

The two basic types of pension plans are the ‘defined contribution plans’ and the ‘defined benefit plans’. The former involves the employer and at times the employees contributing specific sums of cash into a pension fund, the size and timing of which are usually determined by agreements between employees and employers. The cash benefits to be secured upon retirement will depend on the size of contributions and the efficiency of the pension fund in managing its investments. This naturally will not guarantee the amount of cash the retirees will receive. With this arrangement, the corporation will assume no long-term obligations of the retirees’ benefits resulting

\[\text{ibid}\]
\[\text{Ketz, J. E., ‘Hidden Financial Risk’, John Wiley & Sons, Inc.: 2003, Chapter 3. Here, the researcher illustrated the use of the equity method by Elan, Coca-Cola, and arguably WorldCom to understate the true extent of their external liabilities.}\]
consequently with the latter bearing the risks should a shortfall occur.\[22\] In contrast, ‘defined benefit plans’ will involve corporations having to assume long-term obligations for the amount retirees’ will receive. This means that employers will bear the risks when the plans have inadequate assets to pay.\[23\]

Pension costs vary in accordance with employers’ undertakings, interest rates, and pension plans modifications. The level of under-funding of defined pension benefit plans reflects the seriousness of the pension deficit problem. The Pension Benefit Guarantee Corporation (PBGC) stated that the deficit in 2004 stood at some US $353.7 billion. This has critical implications. For example, major US airlines and major automobile corporations with large work force may be compelled to petition for bankruptcies to liquidate their pension burdens. In response, the Senate struggled to pass a bill allowing airlines and other corporations to, ‘…spread their pension plan funding over a more manageable schedule of 25 years-instead of the current four years –and under more stable, long- range terms…’\[24\]

This proposal does not appear to have gone down well with the PBGC, as reflected by two fundamental questions raised through its executive director, Bradley Belt.

‘…Does it simply put off the day of reckoning and does it lessen or exacerbate the moral hazard in the system already? My concern is it would not satisfy either of those guide points’.\[25\] He went on to argue that the proposal would not entirely remove the risks to the PBGC. The airline industry, however, counterpoint on the grounds that the

\[23\] Epstein, supra note 22 (b); FASB, ‘Employers’ Disclosures About Pensions and Other Post-Retirement Benefits’, SFAS No. 132, Revised December 2003
\[25\] Abrams, supra note 24 (b), paragraph 8
massive legacy costs, astronomically high fuel prices and low capacity utilisation at that time have already seriously damage its profit performance. It will not therefore have the financial capacity to deal properly with the pension deficit issue without assistance from the government. The stark similarities between the PBGC deficit and social security was best summed up by David Walker, the Comptroller General of the Government Accountability Office, when he said, ‘The government does not have direct responsibility for the PBGC, but…on current trends, it would be highly likely it would face a taxpayer bail-out’. In any case, the Bill to shore up Private Pensions was passed on November 16, 2005.

The nature and size of the pension deficit problem probably explains why some corporations do understate the depth of their pension funding problems through various means. This it appears is commonly achieved through the hiding of pension gains and losses and amortisation expenses. One way of realising this is through increasing the interest rate assumption, which will result in the lowering of a corporation’s projected benefit obligation. Higher rates also reduced accrued pension liabilities and cut down on the net pension cost. It is nonetheless not financially prudent to net the projected benefit obligation and the pension plan assets to understate the negative impact of this.

In a nutshell, defined benefit plans have an off-balance implication, with vital information not directly shown on the financial statements. This is going on despite FASB’s guidelines that employer should disclose its liabilities to employees in

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[26] ibid, last paragraph
present value terms, and that they should also disclose the fair value of assets held in
their pension plans in view of various loopholes. An extremely worrying feature is
that, ‘Twenty-two of the 26 (Dow 30, inclusive of GM in particular) were
underfunded (under-funded) based on funded status—that is financial reality.
Seventy-three percent of America’s most successful firms really had underfunded
(under-funded) pension plans. The underfunding (under-funding) averaged $1.8
billion a firm, 46.9 billion (in) total. In other words, these companies reported
pension net assets of $119 billion, while in fact they were underfunded (under-
funded) by $46.9 billion—that is a swing of $166 billion that represent off-balance
sheet obligations’.[28]

Aside from the pensions’ issue, other post-employment under-funding is equally
serious also on account of its off-balance sheet focus. Both taken together do require
serious remedial actions given the depth of their liability problem in the US corporate
world.

Lease Financing
Lease arrangements come in two forms, namely; operating leases, which are purely
rental payments; and capital leases, which from a commercial reality perspective are
thinly disguised forms of purchases of assets. As the latter assumes liabilities on the
part of the lessee corporation, efforts are often made to divert them away from the
balance sheet proper.

105-106; Tunick, B., ‘The Looming Pension Liability: Analysts Focus on Problems that FASB Rules
Ignore’, Investment Dealers Digest, 14/10/2002; (c) Clark, G. L. & Monk, A. H. B., ‘The Crisis in
To deter and discourage lessee corporations from over-indulging in this form of financial camouflage, the FASB formulated four criteria for the recognition of capitalised leases. Based on this FASB guideline, where any one of these following criteria is complied with, then the specified lease arrangement will be deemed to be a capitalised lease:[29]

- Flow of ownership title to the lessee; or
- Availability of purchase option; or
- Where the lease terms are no less than 75% of an asset’s economic life; and, or
- Where the present values of the minimum lease payments are no less than 90% of the asset’s fair value.

Rules-based rather than principles-based accounting is clearly demonstrated in operating lease financial reporting. Bright-line tests, the euphemistic expression for ‘cookbook’ accounting are used to structure operating lease ignoring their economic substance. Lessee corporations circumvented the FASB rules for lease accounting through various ingenious ways. For example, by discounting cash flows at the usually higher incremental borrowing rate, lessee corporations can stay off the 90% rule and avoid having to capitalise on their leasing arrangements.[30] Another way lessee corporations can avoid lease capitalisation is by not guaranteeing the residual value of the leased assets. A further way of avoiding lease capitalisation is to structure

[29] (a) FASB Statement No. 13, ‘Financial Accounting and Reporting for Leases’, 1976; (b) supra note 16 (b), 467-468; (c) MacDonald, E., ‘Debt Hazards Ahead’, Forbes, 18/06/2007, 80-81. The FASB is reported here to be making plans to treat operating leases as any other loans by 2009 and that the IASB will also respond similarly. A study conducted by the Georgia Institute of Technology shows that corporate earnings per share (EPS) decreased significantly and the liabilities to equity ratio also rose significantly when corporations comply with this new reporting rule. For instance, BJ’s Wholesale Club’s EPS will drop from US $1.40 to US $0.28 and its debt equity ratio will rise from 95% to 226%.

[30] (a) Ketz, supra note 21 (b)Epstein, supra note 16 (b)
lease payment obligations with a hybrid of a fixed sum plus a contingency rental fee derived as a percentage of sales of a lessee corporation.\[^{31}\]

Leasing fraud occurring in the late 1980s in circumstances where there are intermediaries/third parties involved; where highly profitable ventures appear suddenly; where new products or financial arrangements are being structured; or where the contracts are with relatively unknown parties. Such leasing frauds may involve an illusory lessee, multiple financing, and connected foreign suppliers. \[^{32}\]

Fraudulent leasing conveys risks not only to the direct parties involved, but also to investors and other creditors in general. However, happening on a more widespread scale is the manipulative reporting of operating leases. These tend to feature more in airlines, which lease large fleets of their aircrafts; and in large retailing, which uses lease retail space a lot. The airline industry in the US is particularly fond of engaging in the camouflaging of its lease arrangements as operating leases to avoid the full glare of the capital market of their finances. For instance, when United Airline’s capitalisation structure properly accounts for its capitalised leases, equity constituted not more than 1% of its structure. This was long before it filed for bankruptcy proceedings. US Airways too met with the same fate shortly thereafter.\[^{33}\]


By opting for the understatement of their level of borrowings, lessee corporations hoped to project their operations as not being unduly burdened by debts and hoped further that enhanced profits would provide them with the means to pare these down. Whilst they are aware of the risks they would be taking, they have unfortunately deprived their other creditors and investors with the same platform to decide on their own.[34]

It has been estimated that, ‘…companies in the Standard & Poor’s 500-stock index, off balance sheet operating lease commitments, as revealed in the footnotes to their financial statements, total US $4,482 billion’. [35] The rationale for this upsurge in the use of operating leases is that besides boosting returns on assets, it lowers the conventional way of reporting debts. Investors have also argued that the 90% test drove the structuring of these deals and ignore economic realities; and above all FASB 13 amounted to all rules and no principles thus making it easier to manipulate even its apparent strict exceptions and criteria.[36]

Over the last few years, however, the leasing industry market penetration of business investment in equipment has remained stagnant at around 31%. The leasing market apparently has been constrained by a ‘…lack of consistent guidelines and changes under SOA and the 2004 Tax Act’. [37] The SEC apparently does not share this view because of the sizeable treatment of this form of debt only as footnote items. It is

[34] MacDonald, supra note 29 (c )
[36] ibid
making plans to require operating leases to be reported as on balance sheet items by 2008 or 2009.

**Factoring**

In factoring, a company can borrow as much as 80% of the face value of its receivables from the lending institution (or the 'factor') thereby receiving its fund in advance. A factor’s fee will be levied in addition to the interest charged on the loan amount taken. The amount used can be large as exemplified by Mattel’s disposal of some US$ 400 million of its receivables under factoring arrangements in 2004.

Factoring may be conducted with recourse, which means that the lending institution can look to the borrower for payment should the latter’s customers default on their obligations. Alternatively, it may be arranged without recourse, in which case the lending institution will have to assume the risks of bad-debt losses. Generally, the former is considered as one of the earlier form of OBF because receivables and liabilities are eliminated from the balance sheet, and at best the contingent liability is disclosed only as notes to the financial statements. Some companies have made abusive use of this loophole in financial reporting resulting in various untoward consequences.[38]

Weak market conditions and the pressure to meet up to capital market expectations sometimes caused listed corporations to factor away their receivables (debtors)

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[38] (a) Berk, J. & DeMarzo, P., ‘Corporate Finance’, Pearson: Boston, 2007; (b) Naser, K. H. M., ‘Creative Financial Accounting: Its Nature and Use’, Prentice Hall International (UK) Limited: Hertfordshire, 1993; (c) Jackson, C. W., ‘Business Fairy Tales’, Thomson: Mason, 2006. Jackson here provided some details on how Al Dunlap artificially boost Sunbeam’s income through the controversial ‘bill and hold sales policy and subsequently liquidated the associated receivables through without recourse factoring with a wholly owned subsidiary. This later required a restatement of Sunbeam’s financials because of sales and profit overstatements of US$ 95 million and US$ 71 million respectively. Dunlap had to settle personally in the shareholder class-action fraud lawsuit brought against Sunbeam. Additionally, he paid a penalty fine to the SEC and agreed to a permanent ban from serving as a director of quoted companies.
without adequate disclosures in order to jack up their sales. This was witnessed in one such US listed company, which resorted to this in the wake of weak market conditions and the production of unsuitable products.\textsuperscript{[39]} This caused revenue and profitability to be respectively overstated by US $42.1 million and US $17.6 million. Apart from filing the necessary restatements of its financial statements, the corporation also reached settlements with the SEC. In the administrative proceedings, the Corporation’s President, Controller and Vice-President of Finance, and Director of Distributor Sales agree to a cease-and-desist order.\textsuperscript{[40]}

\textit{Securitisations and the Use of Special-Purpose Vehicles/Enterprises (SPVs/SPEs)}

SPEs are business entities devised to perform specific or limited undertakings. The initiator or sponsor can create SPEs as partnerships, trusts, or business corporations. The basic form will entail the transfer of assets by the sponsoring company to the SPEs. The SPEs will reimburse the sponsoring company with cash invested by investors or lenders, and convey to the latter asset-backed securities.

Securitisations provide the sponsoring corporations with a much cheaper source of credit compared to direct borrowings principally because of the presence of well-defined streams of cash flows available in the SPEs for the investors. Another good reason for the use of SPEs is the assistance they give for the minimisation of tax liabilities of the sponsoring corporations. Good examples of these are synthetic leases, which allow the sponsoring corporations to treat them as operating leases for financial reporting and capital leases for tax purposes.\textsuperscript{[41]}

\textsuperscript{[41]} (a) Revsine et al, supra note 22 (a), 660; (b) Hartgraves, A. L. & Bentson, G. L., ‘The Evolving Accounting Standards for SPEs and Consolidations’, Accounting Horizons, September 2002, 242-258;
Some sponsoring companies like the use of SPEs as it allows them to enjoy off balance sheet debt liabilities. Technically, it is not appropriate as most SPEs are normally directed and control by the sponsoring companies even though they do not hold majority equity interests. Besides, the financial risks assumed in the form of guarantees provide further grounds for the presence of such debt liabilities on the sponsoring corporations’ balance sheet. Increasingly, corporations will also need to exercise more caution in the use of SPEs as tax avoidance vehicles less they become embroiled in tax frauds controversies as experienced by some.[42]

In response to the various corporate scandals in 2002, the FASB will now classify certain SPEs as ‘variable interest entities (VIEs)’ where their total capital at risk is insufficient to finance their operations (usually less than 10% of assets) or where they lack the ability to make decisions, the obligation to absorb losses, or the right to receive returns. In such cases, the VIE has to be consolidated with the entity which has the ability to make decisions, obligation to absorb losses, and the right to receive returns. This immediately dismisses the advantage of VIEs as financial window-dressing devices.[43] This appears to be a direct regulatory response to constrain the manipulative use of SPEs.[44] Still, there appears to be some room for manoeuvrability as the bright line threshold of 10% need not be observed where the SPEs can show evidence that they can fund their activities without additional subordinated financial

assistance; or their equity levels are as large as other similar businesses; and their equities are greater than estimated projected losses.\[^{45}\]

There were varying responses to the new ruling. Most large corporations voluntarily consolidated their SPEs’ debts.\[^{46}\] Sampra Energy, the parent of California Utility San Diego Gas and Electric was one such good example.\[^{47}\] The PNC Financial Group had to be compelled by the Federal Reserve Board to do so.\[^{48}\] Homebuilder, Hovnanian Enterprises viewed the new rules as not so suitable for the homebuilding industry involving land and lot options. It could perhaps turn to the use of ‘unconsolidated qualifying special purpose entities (QSPEs)’ as alternative VIEs to avoid the formal reporting of OBF, as is currently being pursued by Dell and others. The QSPE mechanism needs an independent, financially solvent entity with absolute control over the acquired assets. Such transfers are treated as sales to independent parties, resulting in the removal of the assets from the balance sheet and recognition of a gain or loss on sale.\[^{49}\]

Apart from corporations making financial restatements in order to account for their financial links with SPEs initiated by them, banks and financial institutions and others who were implicated for their roles have owned up to their indiscretions. They settled with creditors and shareholders class-action lawsuits brought against them. Citigroup agreed to pay respectively US $2 billion and US $2.58 billion to former shareholders of Enron and WorldCom for its role in helping these corporations disguise various debts through the use of SPEs and other off balance sheet devices. The financial

\[^{45}\] FASB, supra note 43 (b)  
\[^{46}\] Reason, T., ‘All in the Family: Fin 46 Made Companies Admit Paternity of Special Purpose Entities: But it also Resulted in Some Surprise Adoptions’, CFO, September 2004  
\[^{47}\] ibid  
\[^{48}\] Brown, K., ‘Creative Accounting: Four Areas to Buff Up a Company’s Picture’, WSJ, 21/02/2002, 1-4  
conglomerate does not regard such settlements as an admission of any legal wrong. The settlement decisions were taken ‘solely to eliminate the uncertainties, burden and expense of further protracted litigation’. [50]

Other banks and financial intermediaries are facing similar lawsuits from disgruntled shareholders and secured creditors for their involvements in similar and other cases also involving the use of SPEs or other off balance sheet device. These include JP Morgan Chase, Barclays PLC, Credit Suisse First Boston, Merrill Lynch & Co., Toronto Dominion Bank, Royal Bank of Canada, Deutsche Bank AG and the Royal Bank of Scotland. [51] Future problems appear to be lurking in the horizons because of the exceptions provided under the 10% equity threshold. Much depends on the manner corporations approached these exceptions as these can be manipulated into loopholes for the hiding of debts.

**Financial Derivatives**

Corporations, financial institutions, pension and mutual funds, and governmental units are the end-users for derivatives whilst large international banks, securities houses, and some insurance companies and corporations with sound credit ratings are the dealers. For the most part, users employ derivatives to manage their interest rate and currency exchange exposures. Although there are large numbers of derivatives users and dealers, some six banks or so account for something like 83 per cent of the market. This rather high level of market concentration is attributed to the necessity of

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[51] ibid
Derivatives are said to provide good benefits to end-users in terms of risk management, yield enhancement, costs, and portfolio diversification. Risks arising from substantial variation of interest and exchange rate or commodity prices are more efficiently managed through derivatives. Many professional fund managers also find it economical to trade in derivatives besides getting the opportunities to reap higher returns in the derivative market than in the cash market. The opportunities for bringing down funding costs are also available from derivatives like cash swaps.

Through derivatives like share index futures, corporations can enjoy the benefit of capital portfolio diversification more economically. Besides these, takeover bids by an offeror can be made more attractive through equity derivatives in mergers and acquisitions. Apart from functioning as financial instruments, derivatives do assist in the deepening of the financial and capital infrastructure of an economy. Finally, derivatives help generate useful price information. This is particularly useful for determining the values of the underlying instruments and commodities.\[53\]

High returns are normally associated with high risks. One view has it that the risks associated with the use of derivatives are no different from the other more traditional financial instruments. It is claimed here that, ‘Derivatives help to manage risks in new ways—an important economic function. Yet the risks involved in derivative activities


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are neither new nor unique. They are the same kind of risks found in traditional financial products: market, credit, legal and operational risks’.[54]

Market risk is normally associated with the business in which a corporation acts or in which a financial instrument is traded. Such changes in market conditions may cause a precipitation in the value of a derivative contract. Market risk is multiplied many folds where the leverage embedded in the derivative contract is enhanced. Proctor & Gamble (P&G) tried to lower funding costs by entering into a leveraged swap with Bankers Trust, but instead lost some US $157 million when interest rate rose in the United States.[55]

Excessive leverage and adverse interest rate gyrations coming together can cause crippling losses as happened to the Orange County in the US. The county found it convenient and easy to reap huge gains from the leveraging of its investment fund on bonds. Unfortunately, it borrowed beyond its pool of financial assets. It incurred heavy losses of some US $1.5 billion when interest rate rose. Investment houses liquidating their collaterals exacerbated the situation.[56]

Market risks also cover rollover, liquidity, and funding risks. Metallgesellschaft A.G.’s subsidiary MG Refining and Marketing (MRM) hedged against rising energy prices with short-term energy futures and over-the-counter swaps. This implied that it had to roll forward its contracts continuously to safeguard its position, and this it could achieve when spot prices were better than futures prices. As it transpired, the sharp fall in energy prices compelled MRM to post very high margins. When it

[54] Walker, supra note 52
eventually had to liquidate its position the losses were so massive that it necessitated a
US $1.9 billion resuscitating operation by some 15 banks to keep it afloat.[57]

The failure of counterparty to fulfil its contractual obligations can result in a
corporation sustaining heavy losses. This is usually referred to as credit risk. The
credit exposure risk in derivatives is dynamic in comparison to that of traditional
loans, which are static. Credit risk for exchange-traded derivatives like futures
contracts is minimal because clearinghouses guarantee the performance of
transactions. Likewise, as the counterparties to most over-the-counter (OTC)
derivatives have good credit ratings, the risk of default is minor. This makes credit
risk amount to only two to four percent of the notional amount.[58] Still defaults
resulting from the insolvencies of counterparties do occur as exemplified in the
collapse of investment bank Drexel Burnham Lambert.[59]

The risk of losses emerging from faulty systems, controls and other human errors are
referred to as operational risk. The classic example of this is when managers can
conceal losses from unauthorised trading due to the lack of internal controls and
supervision. This indeed was how Barings Futures Singapore caused the downfall of
Barings Plc.[60]

The risks of losses emerging from the non-enforceability of derivatives contracts are
referred to as legal risks. The risk comes into being when it is held by the judiciary
that a specified derivative transactions bear features that will not justify legal

Hedging Strategy, or Just Bad Luck’, Journal of Applied Corporate Finance 87, 1995, 86
[58] Waldman, supra note 55, 1032
[60] Brown, C., ‘Report of the Board of Banking Supervision’s Inquiry Into The Circumstances of the
Collapse of Barings’, JIBL 10, 1995, 446-450. The report held that the most glaring failing was the
freedom given to Leeson to manage both the front and back office.
protection.\[61\] This could be due to these transactions being against public policy, lack of legal capacity on the part of the counter-party or infringements of local gaming and wagering laws. Hence, legal risks associated with derivatives are far greater than other financial transactions due to the uncertainty it posed to the existing legal framework. Legal risks are normally classified as; jurisdictional risk (like the netting provisions contravening local insolvency laws); counterparty risk (like when counterparties lack capacities); or as selling risks (like arising from the misrepresentation of the benefits of transaction by intermediaries).

The effect of the failure of one institution may have on another or the entire financial system is commonly referred to as systemic risk. This can be effected through the domino effect of the failure of one institution on others or through the widespread reliance on continuous hedging strategies in the midst of market disturbance turning into an illiquidity-driven disaster. The risks of such contagious disorders have prompted international regulatory co-ordination of not only derivatives transactions but also other banking and securities transactions.\[62\] The scale and opaqueness of derivatives transactions and the illiquidity of customised OTC transactions bring about the concern of systemic risk over derivatives.

In the context of the above general risk types, concerns have also been raised that derivatives are far more risky and difficult to manage. ‘These general types (credit, market, legal and operational) of risks exist for many financial activities, but the specific risks in derivatives are relatively difficult to manage, in part, because of the

complexity of some of these products and the difficulties in measuring these risks’. [63]
On balance, it would appear that the far greater complexities and higher leverage of
derivatives magnify the various risks featured in derivatives, and helps explain the
massive losses borne by end-users.

However, by themselves, financial derivatives are neutral and not necessarily
inherently good or bad. Much depends on the objectives of their employment and how
they are actually used. Derivatives can provide corporations with an extremely
powerful instrument for sharing and shifting risk, including the means for transferring
money off balance sheet to hide the real extent of their financial obligations.
Institutions, which had the misfortune of mishandling the use of derivatives, have
found these to be overwhelmingly costly. As mentioned earlier, this was painfully
experienced by the Orange County in California, which went nearly bankrupt on
account of them; and Long Term Capital Management (LTCM), which had to be
rescued by the Federal Reserve Board.[64]

Where LTCM was concerned, it was a hedge fund. It traded in swaps and equity
volatility. It was operated by experienced Wall Street traders, and had two 1997
Nobel laureates on financial economics in its partnership. Against a capital base of US
$4 billion, it had massive derivative contracts of about US$ 125 billion. The value of
the underlying assets against which the instruments were based was even much larger.
Its capital base was alarmingly inadequate to provide the insurance the markets
needed. It could transfer risks but was not able to extinguish them. It was speculating

Accounting Office, May 1994, 9
that the price of the insurance the fund was selling would fall adequately fast enough for it to buy back with a profit.\textsuperscript{[65]}

As it turned out, things went horribly wrong, and it was pushed to the brink of bankruptcy. It would have fallen that way if not for the support of the New York Federal Reserve Board. The Board acted out of concern over the systemic effect the colossal collapse would have on the entire financial system. This scarred the derivative business considerably as it was supposed to be managed by experts, and led to massive public outcry over the destructive nature of derivatives.\textsuperscript{[66]}

As seen in the Barings debacle, derivative contracts can be problematic for banks if they engage in complex derivative contracts they do not fully understand, buy too much of one type of investment, or buy them out of greed.\textsuperscript{[67]} It must be emphasised, however, that certain derivatives are prudent and necessary for the banking system as it seeks to control risks. The reason for the derivatives market becoming so colossal is not because of slick sales campaign by dealers but rather because of their provision of economic value to their users. They contribute significantly to portfolio management by enabling pension funds and other institutional investors to hedge and adjust positions quickly and economically.\textsuperscript{[68]}

Nonetheless, unfamiliarity with the risks derivatives can generate very painful experience. The US $7.5 billion Orange County Investment Pool (OCIP) in Southern

\textsuperscript{[65]} Kay, supra note 64
\textsuperscript{[67]} Rodger, S., ‘Derivatives Good or Bad’, Savings and Community Banker, September 1994, 40-48; Landes, D., ‘Dynasties: Fortune and Misfortune in the World’s Great Family Businesses’, Penguin Group: London, 2006, 34-37. This study claimed that unlike 1890 when BB was rescued by the Bank of England and concerted efforts of all family members, on this occasion no similar efforts were made because of the relative larger size of the liabilities, the improbable contagion effect, and the absence of family enthusiasm as the bank’s equity was no longer dominated by family members.
\textsuperscript{[68]} Alan Greenspan, Chairman of the Federal Reserve Bank Testimony Before Congress on 19/05/1998
California announced in December 1, 1999 US $1.6 billion losses due to a highly speculative bet on interest-rate derivatives. Its investment manager, Robert Citron had with the help of various sales people from Merrill, CSFB, Stanley and Nomura leveraged the fund to the equivalent of US $21 billion and speculating on the belief that interest rates would continue downwards as they did throughout the latter 1980s and early 1990s. Initially, the fund achieved above average returns.

This turned horribly sour when the Federal Reserve raised rates from February 1994 onwards; but OCIP as a municipal investment fund was not a marked-to-market vehicle and did not have to reflect its losses on a daily basis until way too late. Orange County sued Merrill for the selling of risky securities in violation of state and securities laws. Merrill and others who were involved initially denied wrongdoings but chose to settle out of court later with US $437 million. Citron pleaded guilty to six felony accounts for making misleading statements in marketing securities, falsification of accounting records and redirecting investment funds.

As a final note, it has been claimed that the value of derivatives is not an imaginary notion. In a global market environment driven as it is by constant and changing market risks; instantaneous information relays; and immensely advanced technology; derivatives are essentials. They have acquired the distinction of becoming indispensable in the management of risk and is therefore of great importance to national economies and indeed the global economy. [69]

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Management Options Backdating

Options backdating is a form of financial manipulation, which affects shareholders’ interest adversely. It involves the backdating of the option price for management option shares to an advantageously low point relative to higher market prices, such that the exerciser will definitely gain from exercising the share option. A celebrated research detected their widespread employment in the US capital market in 2005. This research finding was subsequently communicated to the SEC which led to the beginnings of further probes of significant numbers of corporations, at first confined to those in the Silicon Valley, but later extended to other more traditional businesses[70].

Another recent study estimated that the average loss to shareholders was about 8% or about US $500 million per firm of those implicated in the scandal.[71] The extent of grant manipulation was found across 1150 firms or 12% of the firms examined for the period 1996-2005.[72] The SEC and the Justice Department is still in the process of investigating on this option scandal. So far, no less than sixty top executives inclusive of many CEOs have resigned over this alleged corporate wrongdoing.[72] The issue is one of lack of transparency or the non-disclosure of financial schemes, which have significant impact on shareholders’ equity interests.

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The UK Position

Investment banks and the corporate banking units of commercial banks are mainly responsible for the marketing of OBF schemes to corporations here. Due to the controversial nature of such schemes, they are usually not explicit and less transparent than the other more traditional forms of financing. The suppliers of OBF are motivated by their sales and profit objectives, whilst the users seek financing cost efficiency and liquidity enhancement; or simply to avoid breaching their borrowing limits. In practice, OBF providers usually target corporations with cash flow pressures or involved in takeover bids, as they are perceived to be more attracted to the general opaque nature of some OBF schemes.

Earnings Exaggeration via Consignment Reporting and Others.

Vehicles distributors use the consignment sales technique (CST) to effect OBF. The CST will involve the dealers paying the manufacturers only upon the sales of the vehicles involved and not upon delivery. In reality of course, the dealers are getting commercial loans from the manufacturers without having to capture them in their balance sheets. A variation of the CST is a form of synthetic sales arrangement (SSA), commonly used in businesses where the work in progress inventories take time to mature and where there is an overhang of over-supply, which deters financing from the traditional banking sector. Whisky distillations and wine production are good examples of these. Quite obviously, the finance companies are not interested in taking hold or delivery of such stocks and have their minds focus purely on the financial arrangements. This is solved by the provision of a buy-back clause or a repurchase option at future specified dates. Similarly, instead of excluding the assets and liabilities involved from their balance sheet, construction businesses for instance can
also elect to effect assignment of work in progress (AWIP) schemes, which may take a few years to complete. Such AWIP schemes are commonly structured to eliminate the companies’ obligations to pay the financiers direct. This means that they will not have to report this source of funding in their balance sheet; other than the disclosure of contingent liabilities by way of notes to the accounts.[74]

**Redeemable Preference Shares and Special Purpose Enterprises/Vehicles**

The CST, SSA and AWIP approach to OBF involves the tangible aspect of borrowing. There are two other versions of OBF, which serve nothing more than as synthetic devices to access funding without proper disclosure. This involves the issue of redeemable preference share mechanism (RPS) by subsidiary entities to financial institutions to secure borrowings for their parent corporations. The fixed dividends are usually set in accordance with the desired financial charges of these fund providers. Whilst the subsidiaries will have to account for this RPS, the parent company will need only to reflect these in its group accounts as minority interest. Since the normal focus of investors and creditors is normally on the subsidiaries, the parent company is able to assume borrowings without having to disclose it adequately. The more aggressive versions of using subsidiaries for the raising of funds are via the SPEs. As discussed earlier such business entities have the features of subsidiaries other than in name. Aside from the equity threshold criterion, the current principle is effected through the direction and control test irrespective of board composition.[75]

These earlier styles of circumventing the law where recognition of subsidiaries is concerned have over the years become more sophisticated and harder to detect. To

[75] Griffiths, supra note 74
pursue the same objective of not wishing to recognise business entities as subsidiaries, various more complex capitalisation structures and cross-shareholdings are used. These are usually far more difficult to decipher. The off balance sheet funding source is often relayed across the group structure through the off loading of current or fixed assets to financial institutions for cash.

Though there is nothing illegal about these transactions, the sponsoring companies are able to do as they pleased with the funds so obtained. Minority investors and other creditors will not be able to follow what these sponsoring companies are really using the money raised for. For instance, the MG Rover Group collapsed in 2005 despite receiving a resuscitation fund of £2 billion from the previous main shareholder. It is now under investigations by both accounting and financial regulators for alleged accounting irregularities through a complex corporate holding structure. Similarly, Farepak, a subsidiary of a financial services parent corporation became close to liquidation in 2006 despite apparently receiving full cash collections from its customers without the equivalent delivery of goods to its clientele nor its suppliers paid, implying diversion of its cash collections to unrelated business purpose. It was restructured in a rescue operation led by a friendly party.

Despite the adverse case examples, the proper use of SPVs for securitisation, ‘…is regarded as beneficial to the financial system, because it permits banks and other financial institutions to focus on those aspects of the lending process where they have a competitive edge. Some, for example, have a greater advantage in originating loans
than in funding them, so they sell the loans they have created, raising cash to originate more loans’.[76]

 Lease Financing

Like the US, various corporations particularly in the travel and leisure industries in the UK are also using leasing as an OBF device. Similarly, the difficulties have always been the manner in which operating leases are distinguished from financial leases. Again, many of these arrangements are shrouded in vague terms and conditions, which will not require them to be categorised as the latter. In line with IAS 17 most UK property corporations would have to restate some of their buildings from operating leases to finance leases, especially those with long lease terms or sales and leaseback arrangements commonly used by supermarkets.[77] Conversion from operating to finance lease is likely to cause some adverse impact on most of these supermarkets’ reported earnings. The UK penetration rate of the leasing industry at around 13.8% is far lower than that in the US. Guided by IAS 17 and FRS 5, lease accounting rules in the UK appears to be less cumbersome. This should facilitate the growth of the leasing industry at a healthy pace.[78]

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Factoring

Expanding sales and debtor balances enhances the use of factoring for clearing bank subsidiaries like Alex Lawrie of Lloyds TSB and HSBC Invoice Finance.\[^{79}\] Though not necessary appropriate for every business, factoring can prove to be crucial to those facing depressive market conditions.\[^{80}\]

The scandalous use of OBF by some prominent corporations in the late 1980s led to the introduction of FRS 5 in 1994 to tackle the problem head-on. This financial standard basically requires corporations to report on the substance of their transactions so as reflect upon the commercial realities of their transactions. This it was thought would discourage the widespread dishonourable use of OBF. The fact that now and then corporations and tax consultants have been cautioned over their aggressive use of OBF or OBF related activities serve to indicate that it is still being kept in practice by various corporations.

Pension Financial Reporting

One variant form of off balance sheet accounting, which is causing major concerns to regulators and corporation, is pension liabilities. This is already a huge problem in the US especially for global airline and global car-making corporations. Over here in the UK, the issue is gathering immense concern especially in the context of mergers and acquisitions activities. For instance, when Marconi sold its core business to Siemens, its pension scheme reported a deficit of £109 million under IFRS accounting rules. This masked the true deficit significantly. The Pension Regulator only allowed the transaction to go through after Marconi injected £185 million into the scheme and put

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\[^{79}\] Arnold, supra note 76, 594

aside a further £675 million into an escrow account. According to some financial experts, this is still inadequate as the deficit is estimated to be closer to £2 billion. It appears probable that the Pension Regulator preferred the scenario of a degree of under-funding compared to one where definitely the Marconi’s core business will become insolvent.\[81\]

It is difficult for corporations to evade their pension commitments as UK rules require employers to formulate plans ‘…to fill deficit schemes within 10 years, may not roll up a pension scheme unless there is enough money in it to transfer the payment of benefits to an insurer, and cannot increase debt or reduce assets without running the risk that the UK’s Pension Regulator will seek to recoup from company directors personally any shortfalls to the Scheme’.\[82\] To get round the pension liability problem, corporations either close their scheme to new employees or owned up to the risks that pension schemes faced and transfer these to the capital markets in securitised, derivatised and raw form as a hedging exercise.\[83\]

Pension accounting controversy arises from the difference between ‘accounting deficit’ and ‘buy-out deficit’. The former refers to the deficit estimated under UK’s FRS 17 accounting rules using a discount rate equivalent to that of long-term gilts; whilst the latter refers to the size of the deficit a corporation would need to cover if it plans to convince an insurance company to get it off its hands, and uses a discount

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\[81\] Cohen, N., ‘A Riddle Wrapped in a Mystery’, available at http://www.FT.com, 29/11/2006, 2; Selb, C., ‘Pensions Watchdog to Tackle Firms that Shift Liabilities’, The Times, 09/10,2006, 42. The Pensions Regulator warned corporations that it is monitoring those which transfer pension liabilities to ‘special purpose vehicles’. Deloitte found that the total deficit for final-salary pension plans for all UK companies is about £100 billion, with many struggling to pay off this deficit over the next 10 years despite increased contribution of around £20 billion.


\[83\] ibid
rate at least 50 basis points lower than that used by the former. This means that accounting deficits are usually about 70% of the buy-out deficit, but problematically for financial report users and the UK Pension Protection Fund (PPF), the former does not appear in corporate accounts.\[84\]

*Comparative Analysis of OBF Applications in the UK and the US*

OBF financial scandals in the capital market in the U.K. and the US are probably the product of self-deception, excessive greed, and weak regulatory supervision. The tools or mechanisms for their coming into being in the early nineteenth century were crude and involved the deliberate omission or distortion of financial data in financial reporting. The authorities responded with the introduction of more transparent reporting obligations through changes in corporate laws and accounting standards.\[85\]

In the 1960s through to the 1970s, creative accounting was used to enhance corporate ability to raise cheaper sources of funds from multiple sources or achieve positive window-dressing of their financial health. This was not to be enough as the need to improve upon the financial image of corporations became close to necessity when management of corporations began to be compensated with incentive-based employees’ stock options plans (ESOPs). Again greed and blind ambition began to take hold, as these high value stock options became very powerful incentives to

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[85] The US responded primarily through the 1933 and 1934 SEA, and the UK through the CA 1989 and updated FRS 5 in April 1994
artificially project earnings growth.\[86\] The UK and US authorities in the wake of these bad financial habits responded with stronger accounting policy measures.\[87\]

Aggressive accounting then took on a new face. Constrained to some extent by more vigilant policing by the regulatory authorities corporate executives had to seek new and better ways of achieving this. Coincidentally, at this time, investment banks were also looking for avenues to achieve higher growth and profitability. Recognising the needs of their corporate clientele, they embark on aggressive moves to expand on this market niche. To attract corporate users, which required cheap sources of funds without breaching borrowing limits, many investment houses began to introduce OBF to the former through various financial instruments.\[88\]

In its early forms, OBF were less complex. It acquired more sophistication as corporations needed to disguise the way they sourced and used their funds.

With massive profits staring in the eyes of all major participants in the capital market in the mid 1990s and fuelled by the massive flow of cheap funds from enthusiastic investment bankers, the ‘dotcom’ boom surfaced, ‘…in August 1995, when Netscape…went public, and it ended, for all intent and purposes, in April 2000, when the NASDAQ crashed. Between those dates, more than three hundred Internet companies went public.’\[89\] In comparison, the UK internet boom mirrored what

\[87\] The process in the UK began with the 1998 Dearing Report which culminated in the formulation of new reporting obligations. Despite prodding from the SEC and the General Accounting Office over the problems created by leasing, pension accounting and the SPEs, the FASB in the US responded only with modest efforts in 1990 with guidance for the dealing of SPE accounting and only after the Enron debacle through Interpretation Number 46 in 2003 to deal with SPE reporting abuse.
\[88\] Berenson, A., ‘The Number: How America’s Balance Sheet Lies Rocked the World’s Financial Markets’, Pocket Books: London, 2004, 87-95. The author showed how mergers financed by equities and OBF instruments increased merger and related fee incomes for individual institutions. These increased from 13% in 1980 to 32% in the 1990s. It was accompanied by many independent financial analysts compromising their research output.
transpired in the US a year or two earlier. In the face of extensive and colossal corporate scandals in the US from 2000 to 2001, the US Congress responded with very highly prescriptive disclosure rules for OBF instruments; whilst the UK responded with Turnbull’s Review Recommendation on risk management practices.\[90\]

Hence, comparatively the US relied on more detailed rules to tackle the indiscretions of OBF; whereas the UK appeared to make use of the principles-based approach. Both appear to have significant success in their own ways. The fact that the US appears to have a far larger share of gigantic financial scandals appears to suggest that the UK model is relatively more effective. The US approach appears to be encountering more problems, as many corporations were ingenious in finding ways to dodge the reporting rules. By contrast, UK corporations encountered more difficulties in circumventing FRS 5. Nonetheless, recent controversies of alleged creative accounting and OBF usage in MG Rover and so on served to remind investors of the risks of opaque transactions and the risks of creative compliance reporting.\[91\] Despite such negative occurrences, OBF continues to grow in sophistication and wider application.\[92\]

Financial reporting in the UK is shaped by shareholders’ rights to information and rights to vote to pressure for change. In the US, shareholders’ right to information and


\[91\] Financial reporting in these corporations was opaque and involved the use of complex SPVs.

rights of ownership are limited under many state laws. Federal laws intervened only to
provide for the disclosure of information for share transactions, and are naturally
inclined towards earnings analysis. The quarterly earnings emphasis in the US adds
relatively greater pressures to US corporations than those in the UK. This approach
contrasts sharply with that in continental Europe where greater emphasis is placed on
the return to capital analysis. Indeed, ‘A stock may be correctly priced, but legally
hidden inefficiencies or dubious expenditure may be hidden inside the company with
damage to shareholders’ interests’. Indeed, OBF’s flexibility for earnings
manoeuvrability helps to explain the persistent popularity of OBF despite tighter
reporting rules.

The use of creative accounting in general and OBF in particular may have probably
contributed significantly to the material rise in financial restatements from January
1997 to June 2002 in the US. This has been attributed to the declining cost of
acquiescence for financial gatekeepers (in part due to the decline in legal threats) relative to growth in benefits (when corporate management extended incentive
packages in the form of more consulting portfolios to gatekeepers to nurture better co-
operation). This is said to prompt financial gatekeepers to diminish their desires to
preserve their ‘reputational capital’. Placed in the increasing competitive environment
and the weakening market for ‘reputational capital’, they engaged in various

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undertakings involving conflicts of interest. For those in more serious cases, this attracted various legal implications thereafter. For instance, underwriters were found to be liable for not establishing due diligence defence under Section 11 of SEA 1933 in the WorldCom litigation.\cite{96}

In the meantime, it could be unwise to habitually use OBF for window-dressing as this may lead down the financial ‘slippery slope’,\cite{97} and caused those responsible to self-deceive that they were acting appropriately and disregard the risks of punishment.\cite{98} Indeed, many corporate fraudsters in the UK and more so in the US were already people of substantial means and did not set out to perpetuate fraud. ‘Instead they were tempted to ‘\textit{fudge}’ time and again, until a mere white lie became outright fraud. The ‘\textit{choices}’ that these individuals made were not choices as we commonly think of them, but decisions that were significantly constrained by the strong situational pressures that the market and its profit motive exerted’.\cite{99}

Other research have shown that in 1999 alone the SEC took 18 actions alleging that the purpose of these corporate frauds was to assist in the meeting of market expectations and compensation incentives. This implies that profits management can be undertaken within the confines of GAAP and fully disclosed to benefit from the

\begin{thebibliography}{99}
\bibitem{96} In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004). The outcome of this case has some implications for outside directors as under section 11 of the SEA 1933 they are required to conduct reasonable investigation of those portions of the registrations statement not certified by experts.
\bibitem{97} Ayres, F. L. & Logue, D. E., ‘Risk Management in the Shadow of Enron’, Journal of Business Strategy, July/August 2002, 37-40; Kennedy, I. & Grubb, G., ‘Medical Law’, London: Butterworths, 2000, 1968. The concept of ‘slippery slope’ is popularly used in medical ethics to highlight the risk of exposure to subsequent abuses. Similarly, this idea can be used to describe how financial window-dressing may lull their users with a false sense of security and caused them to act inappropriately.
\bibitem{98} Langervoot, D. C., ‘Monitoring: The Behavioural Economics of Corporate Compliance with the Law’, 2002 Columbia Business Law Review 71
\end{thebibliography}
flexibility offered by accounting standards or appear in more abusive forms resulting in the commission of fraudulent acts.\textsuperscript{[100]}

\textsuperscript{[100]} Mulford & Comiskey, supra note 17
CHAPTER FOUR
OBF: Financial and Legal Implications

Introduction

This chapter will commence by examining the nature and management of financial risk, and analyse in particular how and why the use or rather the excessive use of OBF may enhance such risk. This will be followed by a study of how and why excessive use of OBF may also lead to the implication of various kinds of litigation risks for corporate directors, auditors, financial advisors, and financial regulators.

The Nature of Financial Risk and Risk Management

Risk may be interpreted, ‘…as the possible variation in an outcome from what is expected to happen’. It is therefore concerned with variability, expectations of specified future events, and is linked to the variation between expected and actual outcomes. [1] Risks can appear in the form of pure or downside risk, and speculative or two-way risk. [2] The former is concerned with the risk of having events going the wrong way thereby causing losses of some kind. Normally such risks are taken care of by the purchase of insurance cover. The latter refers to the possibilities of either positive or negative outcomes. The usual response to this kind of risk is for corporations to put themselves in positions either to take advantage of favourable outcomes or minimise against unfavourable outcomes.

Corporations face the risks of sales, profitability and liquidity variations when they formulate and implement their business strategies. This is their business risk. Though arguments have been raised that higher operating leverage (translated to mean capital-

[2] ibid
intensive) corporations are more prone to business risk than labour-intensive corporations because of the inflexibility of their higher fixed costs, empirical evidence on this matter is inconclusive.\[3\] Business risks cover such things as product risk, macro-economic risk, technology risk, strategy risk and venture or enterprise risk. These are all basically two-way risks. It is, however, beyond the scope of this study to examine these in-depth but they will be referred to where they contribute to a better understanding of the phenomena under investigation.

Financial risk on the other hand refers, ‘…either to a firm’s risk of bankruptcy or to the effects of leverage on earnings and stock-price volatility. For a given set of risky assets and operations, a firm’s financial risk, under either definition, increases with its business risk. A firm’s business risk and financial leverage work in tandem to determine the risk of the firm’s equity’.\[4\] This implies that shareholders need to be more mindful not only of the way businesses are run but also the extent borrowings have been used.

Financial risk emanates primarily from factors external to the corporation. These cover things like credit risk, foreign exchange risk, interest rate risk, market risk, commodity risk, liquidity risk, gearing risk and capital adequacy risk. Only the last three named are of direct concern to this study. Liquidity risk refers to the risk of not being able to fulfil current obligations. Gearing risk refers to the extent of corporate borrowings in relation to shareholders’ funds. Capital adequacy funds refer to a bank or financial institution’s sufficiency of capital to support the level of its business.

\[3\] (a) Ogden, J.P., Jen, F. C. & O’Connor, P. F., ‘Advanced Corporate Finance: Policies and Strategies’, Essex: Prentice Hall Ltd., 2003, 262; (b) McCormick, R., ‘IBA Working Party on Legal Risk’, BJIBFL, Special Supplement, April 2004, Appendix 2, 33. Legal risk here is defined as the risk of loss to an institution (or individuals) which is caused primarily by amongst others defective transactions (as exemplified by some OBF schemes).
\[4\] Ogden, Jen & O’Connor, supra note 3 (a)
Often linked to financial risks are operational and event risks. The former refers to the negative impact arising from human or technological mistakes because of the inadequacy of internal processes and systems. The latter refers to downside risks, which are usually very difficult and costly to cover by insurance. These include disaster risk, political risk, regulatory risk, reputation risk and litigation risk.\[5\] This study will only cover the analysis of litigation, regulatory and reputational risks.

Since the 1970s, corporations have now become well acquainted with the increased volatility associated with wide fluctuations in exchange rates, interest rates, and commodity prices. They are now more concerned with the approach and instruments to deal with exposure to such risks. It is not that easy to identify the impact such volatilities have on a typical corporation. For instance, housing developers will be impacted upon very negatively when interest rates go up steeply irrespective of the size of their external borrowings. This is because steep interest rates affect the loan servicing capacity of house buyers adversely. Indeed, this factor will be of important consideration as financial statements on their own may not be able to disclose the nature of such risks explicitly.\[6\]

As business is about the taking of risks, it is not practical or financially prudent to insure all kinds of risks. Much of modern day management tasks now include management’s obligations and duties to have in place reliable internal control systems to prevent fraud and other forms of financial deceptions from happening. Hand in hand with this is the focus on operational risks and contingency planning. This has now been extended to cover the risks associated with the protection and safeguarding

of IT systems for the sustained competitiveness of corporations and the avoidance of fraud.[7]

Risk management, in particular financial risk management is now increasingly regarded as part and parcel of modern day corporate governance principles. Corporations now are increasingly required to review annually the systems they have in place for the better control and management of risk. Risk models by their nature can be very complex, ‘…and can appear to be black boxes to board members who fail to keep up with progress in risk methodology. Just as a patient is unlikely to accept being operated on with medical technology from the 1960s, so corporations today require board members who have a solid grasp of modern risk evaluation and management techniques…It is not a matter of board members acquiring an in-depth understanding of technical subtleties: it is a matter of leveraging their deep knowledge of business to engage in competent risk thinking as required by modern day corporation’. [8] In connection with this, it must be emphasised that the use of financially innovative instruments used in OBF cut both ways. They can leverage on both earnings and losses; depending on their particular nature; the context of their employment; the conditions of the economy and the conditions of the specific business involved.

Financial Risks in OBF

OBF can magnify the financial risks of inability of corporations to meet up with their credit obligations because of the opportunity these instruments provide for them to borrow beyond prudent means. Whether an external level of borrowing is ascertained to be at a healthy level or otherwise is dependent on existing debt servicing capacity, market competitiveness conditions, and above all easy access to alternative sources of funds.\[^9\] On the other hand, various pressures may induce corporations to prefer OBF over other traditional debt instruments. These range from financial window-dressing purpose to fund raising problems posed by poor business performance. \[^{10}\]

International financial institutions are very perturbed by the leveraging effects of OBF. It was one of the major contributing factors to the 1997 Asian Financial Crisis and the Russian Financial Crisis, which followed thereafter.\[^{11}\] The International Monetary Fund (IMF) commissioned a study to evaluate the systemic effects of OBF in mature markets especially in regard to the use of financial derivative and related instruments.

The study made the following conclusions, ‘Counterparty due diligence, market level surveillance and prudential supervision of individual institutions are currently constrained by the lack of a measure for off-balance-sheet leverage. The regulatory costs associated with the assuming of leverage on-the-balance sheet have prompted

\[^{9}\] supra note 6, 174-187. Here the authors designed a framework for the evaluation and selection of a viable financial mix; Clark, T., ‘Cycle of Crisis and Regulation: The Enduring Agency and Stewardship Problems of Corporate Governance’, CGAIR, Vol. 12 No. 2, 4/2004, 153-161. The researcher here argued that recessions uncover corporate excesses and booms hide them. This resulted in cycles of corporate governance crisis and regulatory reforms.

\[^{10}\] Ogden, Jen & O’Connor, supra note 3 (a), 513-542. Here, the authors highlighted the key determinants of a corporation’s choice of liability type.

institutions to take on leverage through off-balance-sheet operations. To judge potential defaults and to determine the potential for financial market turbulence it is necessary to gain an understanding of overall leverage, incorporating both, on- and off-balance sheet activities…The substantial off-balance-sheet leveraging activities and the limitations of current capital adequacy requirements for derivatives call for an appropriate capitalisation measure that accurately captures total exposure, on- and off-balance sheet’. Such a measure is still in the process of construction. This implies that the leveraging risks of OBF in the capital and financial markets are not easy to detect. Nonetheless, the non-disclosure of such risks where required may give rise to legal consequences.

Legal Implications of OBF to Directors, Advisors, Auditors, and Regulators

UK Position

Directors

Depending on the way OBF is formatted and presented, it may have the potential of misleading, distorting, or misrepresenting the financial health of corporations. In the UK in the 1970s and 1980s, the accounting community has already had misgivings about its employment. The ICAEW for instance highlighted OBF’s potential to mislead investors and creditors. This view was consolidated by the financial regulator, which took the stronger view that it was not a good practice as it distorts profitability returns. The ASB (or the ASC then) added further that financial institutions usually marketed such financial packages aggressively, even though such

apparently innovative financial products tend to disguise borrowings and have the potential to mislead users of financial statements.\textsuperscript{[14]}

This does not, however, imply that borrowers or their sponsors conspired to distort financial statements. This is because there could be other more compelling or honourable objectives as mentioned in the earlier section of this investigation. OBF could be used by borrowers for taxation objectives, for risks limitations or for bringing down their costs of accessing the use of external funds. Still, by limiting or omitting the disclosure of such financial packages through various means, borrowers may assume the risks that their financial statements are purposefully misleading and do not provide a true and fair view of their financial health.

This perception is not without merits. It is possible for accounts prepared in conformance with legal requirements which may not accord with the true and fair view requirement. It is also possible that misleading financial statements compiled within the letter of the law may not accord with the principle of fairness. Under those circumstances highlighted, it is possible for directors and corporate accountants to breach reporting obligations. They may also run the risk of facing litigations for breach of duty when found to be involved with the use of OBF which gives rise to misleading statutory accounts.

Where the Companies Act is concerned, there is no direct guidance on the meaning of a ‘true and fair view’. ‘Although accounting standards now have a statutory force,\textsuperscript{[15]} the Act does not require in so many words that a company’s accounts must comply with them, nor does it say that non-compliance will be one and the same as an untrue

\textsuperscript{[14]} ASC, ‘Exposure Draft (ED) 1487: Accounting for OBF’, Accountancy, April 1987, 166
\textsuperscript{[15]} By S.I. 1990 No. 1667 formulated under CA 1985, s 256(1), the ASB was made the standard issuing institution.
and unfair view. There is merely a very strong view that, [16] that is how the Act would be interpreted were a case to come before the courts. The Act does specifically require disclosure in the accounts where a company has not complied with applicable standards, [17] the reasons for non-compliance, and what the figures would have been had it done so'. [18]

‘We should note that more than one true and fair view might be possible at one time [19]: the word ‘a’ is important. Thus we can sometimes say ‘A is right but B is not wrong either’. [20] For example in the UK, declining-balance depreciation is much less common than straight-line depreciation, yet everyone regards it as a perfectly valid method of accounting…To such accounting choices involving professional judgement there can never be a precisely ‘correct’ solution.’ [21]

As it currently stands, corporate law requires corporations to adhere to accounting standards, and if they fail or depart from doing so they will have to provide reasons. This means that there is now an overriding provision for corporate or group accounts to give a true and fair view. [22] More details will thus have to be furnished where the mere compliance to the specific rules do not appear to be adequate. It will also suggest that corporations may have to depart from standards where such compliance will not result in giving a true and fair view.

[16] Leonard Hoffman QC and Mary Arden in 1983 stated jointly, that’…accounts which depart from the standard without adequate justification or explanation may be held not to be true and fair’, cited by Wainman, D. in ‘Company Structures’, 2nd edition, 1999, London: Sweet & Maxwell, 20
[17] s.227(6) CA 1985
[18] ibid
[19] Ashton, R. K., ‘The Agyrll Foods Case: A Legal Analysis’, Accounting and Business Research, 65 Winter 1986, 4. Here the court was not prepared to accept the substance of transaction to be consistent with a ‘true and fair view’ principle. This case might be interpreted differently to day in view of ASB’s release of’ FRS 5: Reporting the Substance of Transactions’ in April 1994
[22] s.228 & 230 of the CA 1985
Indeed, the usefulness and reliability of financial statements is not the product of rules compliance alone. ‘…The legislative provision of ‘true and fair’ specifies an overall quality standard for company accounts. It is an output standard. However, the accounting rules are…input standards…’[23] A true and fair view is underpinned by the consistent application of generally accepted accounting principles incorporating the appropriate measurement, classification, and disclosures of items expressed in the balance sheet and the profit and loss statement. It would probably suggest a mere compliance to accounting standard even though doing so may mean the divergence from current generally accepted practices. Until the judiciary gives its take on what a true and fair view really means, this overriding legal principle is subject to the interpretation of the accounting community.[24]

Schedule 4 of the CA 1985 and general accounting standards dictate five types of reporting requirements for corporations to follow, including disclosure and measurement rules.[25] It has to be highlighted here that there are conflicts between Schedule 4 of the Companies Act 1985 and UK’s accounting standards. They occur in: paragraph 3(2) on research and development; paragraph 3 (7) on proposed dividends; paragraph 12 on realised profits and pensions costs; paragraph 18 on residual value and investment properties; paragraph 20(1) on the capitalisation of development costs; paragraph 21 (2) on goodwill; and paragraph 21 (3) on the length of economic life of goodwill and intangible assets. [26]

Fair value provisions for derivatives under accounting standards will cause the recognition of unrealised profits whereas the Companies Act of 1985 operating under

[25] Myddleton, supra note 21, 60-65
[26] West, supra note 23, 176-180
the principle of financial prudence does not allow for the capture of such unrealised profits. Despite this, the principle of ‘a true and fair view’ as initiated in the UK is now more or less also fully embraced in the EU.[27] This indirectly appears to point to the need for discretionary self-regulation instead of statutory standards.[28]

Apart from the legal challenge posed by the overriding legal requirement of a true and fair view, directors will have to grapple with the honesty obligation enshrined under common law.[29] Directors are expected at all times to exercise their duties and obligations honestly. So, where OBF packages result in presentation of a corporation’s debt position lower than it actually is; or contribute to the circumvention of lending terms in financial covenants without disclosure, directors may have exercised their powers improperly and acted in breach of their duties to act honestly.[30] This may lead to a fine but can involve imprisonment where the offence is committed with intention to defraud or to deceive.

[29] Griffin, S., ‘Company Law: Fundamental Principles’, 4th edition, Pearson Education: Essex, 2006; Re City Equitable Fire Insurance Co. Ltd.[1925] Ch. 407; Though directors’ duties to companies are broadly similar to those in the US, the culpability standards is negligence instead of gross negligence and also unlike the US there is no access to the formal doctrine of the business judgement rule. However, the UK judiciary is generally reluctant to intrude into corporate decision-making or to hold directors liable for mere errors of judgement (Howard Smith Ltd. v Ampol Petroleum Ltd. [1974] AC 821).
[30] s.227 (3)-(6) of CA 1985; s.233 (1)-(5) of CA 1985; Gregory, R., ‘Directors’ Duty to Exercise Discretion’, Bicester: CCH Editions Ltd., 1998. Professor Gregory argued here that based on the decision of Erlanger v New Sombero Phosphate Co (1878) 3 App Cas 1218, directors are also expected to exercise a duty of discretion; and that this discretion should be exercised independently, be informed, and undertaken through a duly convened board meeting. This duty is codified under CA 2006 together with other 6 general duties (ss 170-180 CA 2006)
Where directors’ duty of skill and care is concerned, the law appears to be heading towards a more objective position. Further statutory provisions and court decisions appear to support this view. Directors of listed corporations are under statutory obligations to keep accounts drawn under specific format for annual audit by independent qualified auditors for presentation and approval by shareholders before filing with the Registrar of Companies. In conjunction with this, directors are to prepare such accounts so as to provide a true and fair view of the corporation’s financial health and a true and fair view of its profitability position for the financial year under review. Failure to comply with this provision will render a director guilty of an offence and liable to imprisonment, or a fine or both. Further, the annual audited financial statements have to be approved by a board and duly signed by a member acting on its behalf.

Where annual accounts do not comply with the requirements of the Companies Act that are approved and signed, all directors who are parties to the approval, and who are aware of this fact or who are reckless as to whether they comply will be guilty of an offence and are liable to a fine. Every director at the time of approval of the accounts are deemed to be a party to the approval, unless he can demonstrate that he

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[32] s.214 of the Insolvency Act 1986 especially subsection(4)(a); s.6 of the CDDA 1986.; The CA 2006 has now codified 7 general directors’ duties. It appears henceforth actions can be taken against directors even if they have not benefited from an alleged breach or have not shown bad faith as establishing negligence is sufficient.
[33] Sections 221 & 222 CA 1985 and the Combined Code require Directors to issue a responsibility statement before the auditor’s report outlining their responsibilities for preparations of accounts on a true and fair view and the taking of responsible steps to prevent and detect frauds.
[34] s.226(2) CA 1985
[35] s.221 (6)
[36] s.233(1)
took all reasonable actions to prevent its approval. These statutory provisions are perhaps the most telling way to render directors accountable to shareholders. Public disclosure of financial statements therefore helps to put the limited liability principle of corporations within a more balanced perspective.

Directors are in part facing litigation risks where the preparation of balance sheet and directors’ statement are concerned. The impact of OBF packages on these two documents can be material and cause them to be misleading either arising from omission of material information, inadequate disclosure of material information, or distortion of material. This will then raise the issue as to whether these documents can still project a true and fair view or are otherwise misleading statements.

Taking into consideration that the intentions behind the use of OBF can be based on both honourable and dishonourable objectives, litigation risks to directors will depend on the nature of their knowledge and whether they have taken reasonable steps to prevent the approval and presentation of financial statements which are likely to be misleading or false because of the omission of OBF schemes or their inadequate disclosures. Further, directors’ opinions as expressed in the directors’ statement accompanying the accounts can be construed to be misleading or even false where it fails to account for OBF in accordance with prevailing accounting standards; or departs from such standards without providing adequate details. Where such financial statements and directors’ opinions are deemed to be misleading or false, then the directors, being the makers of such documents could probably be liable for the tort of deceit.

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[37] s.233(5); ss 414 and 419 CA 2006
[38] The House of Lords held in Derry v Peek (1889) 14 App. Cas. 337 that negligence is insufficient condition for the tort of deceit. It must either be of wilful recklessness or dishonest intention.
Where the directors’ statement is deemed to be false on account of omission or distorted by OBF schemes, then the directors concerned may be held to account for a further criminal offence. The *mens rea* for this infringement is knowledge or awareness that the information omitted or distorted is or maybe materially misleading, deceptive or false.\(^{[39]}\) Where there is proof of intent to deceive members or creditors, then a director who publishes or concurs in the publishing of the accounts or statement, which to his knowledge is misleading, will be liable for a prison term of not more than seven years if found guilty of the offence.

It is also not necessary for the falsified document to be accepted or acted upon. ‘A document is ‘made’ for an accounting purpose where that is the purpose of the document; but a document may be required for an accounting purpose though made for some other purpose so long as it is required, if only in part, for an accounting purpose.’\(^{[40]}\) It appears that documents fall into two categories; (i) Those from the inspection of which jury, with such experience and knowledge of the world as jurors may be expected to have, could be satisfied that the document was so required and (ii) those from which no such inference could be safely drawn. In the second category, there must be evidence of the purpose of the document. The court or jury may infer from the circumstances that the document is so required\(^{[41]}\) but only if there is sufficient evidence for this conclusion to be drawn.\(^{[42]}\) Jurors must not be assumed to know about accounting practice’.\(^{[43]}\)

\(^{[39]}\) Sections 17-19 Theft Act 1968; Section 91 FSMA 2000 empowers the FSA to impose penalties on issuers or its directors for breaching the provisions of sections 397 (1) of FSMA 2000 where there is a pre-existing fiduciary relationship. Section 397 (2) provides for the obligation to correct false impressions.


\(^{[41]}\) Osinuga v DPP [1998] Crim LR 216, DC

\(^{[42]}\) Sundhers [1998] Crim LR 497

The statutory provision refers explicitly to officers of a body corporate or unincorporated association, which clearly includes directors. This offence is capable of being committed only if there is an intention to deceive members or creditors about the corporation’s state of affairs. The offence is said to be wide as, ‘…it extends to the publication of any written statement or account which may be misleading in a material particular. It is not necessary to show that there is any view to gain or intent to cause loss in publishing the statement or account, though no doubt either or both will often be present’.\[44\] Hence, knowledge of purpose upon which the document is being used is not critical for the mens rea.\[45\] It has to be emphasised that the offence only requires the intent to deceive and no intent to defraud is required. The statutory provision appears to have effect only when applied to the making of false or misleading statements by directors to existing members or creditors and not to potential investors.\[46\]

Where the meaning of ‘material’ is concerned, it has been interpreted to refer to things of importance or things, which matter\[47\]; or where it might affect the result of proceedings.\[48\] It has been, ‘…suggested that a particular is material when its existence is such that it might have an influence on the deliberation and subsequent conduct of a person reading it’.\[49\]

Section 70 of the Companies Act 1985 in contrast to the Theft Act 1968 is more explicit about the protection of intending or potential investors. The former stipulates

\[44\] ibid, 621
\[45\] Graham [1997] 1 Cr App Rep 302
\[46\] Leng, R., ‘False Statements by Directors and the Theft Act s.19’, Co. Law 06, 1985, 274
\[47\] Mallet [1978] 1 WLR 820
\[48\] Millward [1985] QB 519
that an individual authorising the issue of a prospectus containing an untrue statement will be guilty of an offence and liable to imprisonment, or a fine, or both, unless he can demonstrate that the statement so made was not material, or that there were grounds to believe up to the time of the issue of the prospectus that the statement was true.[50]

Upon confirmation that a statement is untrue, the CA 1985 places the burden of proof on the offending party to demonstrate, ‘…that he neither knew nor had reason to know about the falsity, whereas the Theft Act required (and requires) the prosecutor to establish knowledge’. [51] The Companies Act further elaborates that a statement is construed to be untrue where it is misleading in the form and context in which it is included in a prospectus. A statement is part of a prospectus if it is contained in it, or ‘…in any report or memorandum appearing on its surface or by reference incorporated in it, or issued with the prospectus’. [52]

Depending on the background of the situation, directors responsible for the publication of misleading or false statements may be charged under other provisions of the Companies Act. [53] A new statutory provision has also been introduced whereby directors can face criminal proceedings when they fail to disclose material

[50] ibid, footnotes at 23
[51] ibid; Birds, J. et al (eds.), ‘Boyle & Birds Company Law’, 5th edition, Jordans: Bristol 2004, 629. Here, the editors argue that, ‘Section 19 of the Theft Act 1968 must certainly be given at least as wide an interpretation by the courts so long as an intention to deceive can be established’. They further argued that the courts have taken this position in earlier cases under s.84 of the Larceny Act 1861, the predecessor of s.19 of the Theft Act 1968. They cited the two cases of R v Kylsant [1931] KB 442 (CCA), and R V Bishirgian (1935) 154 LT 499 (CCA) as support for this argument.
[52] s.71 CA 1985; section 47(1) of the FSA 1986 is very similar to this. Where listed securities are concerned, s397 FSMA 2000 will apply.
[53] sections 95(6), 110(2), 156(7), 173(6), 216(3), 89A(2), 450, 451, 577(4)
information, which they are aware of to the auditors concerned. The level of skill and care required is based on the objective test.\[54\]

Public corporations are said to be part and parcel of long chains of capital manipulation. ‘Corporations own the shares of other corporations in complex chains in which the agency of human beings seems dwarfed by the structures of capital holdings. The twentieth-century discussion of a collapse of a shareholder power over the management of corporations-the divorce of ownership of capital from control of capital-seems to suggest a recognition that the corporation is to be seen as the modern holder and embodiment, in itself, of capital; that capital is the actor whose instrument is the corporation’.\[55\] It is further argued that, ‘…for the task of controlling that economic power and humanising and socialising the use of capital are the directors…’\[56\] Much of the time directors in the UK operate without direct shareholders’ intervention, specific reference to employees’ interests, or trade

\[54\] s.9 of The Companies (Audit, Investigations and Community Enterprise) Act 2004 inserts a new s. 234ZA after s.234 in the CA 1985. This was cited by Haynes, A. in an IALS public lecture on, ‘The Companies (Audit, Investigations and Community Enterprise) Act 2004-Content and Effect’, in 18/04/2005; Omerod, D., ‘The Fraud Act 2006-Criminalising Lying?’, Crim. L. R. March 2007, 193-217. Sections 2 to 4 of this Act deal with disclosures of information. The author, however, regretted the undue emphasis put on dishonesty which would probably generate prosecution difficulties; Wilson, S. & Wilson, G., ‘Can the General Fraud Offence Get the Law Right?’, The Journal of Criminal Law, Vol. 71 No. 1 Feb. 2007, 36-52. Here, the researchers argue for greater publicity on the serious harm inflicted on society owing to extreme business opportunism. They stressed that despite these provisions, and unless more media coverage are provided, the wider society would not take such white-collar crimes seriously and would continue to treat them as victimless crimes resulting in low incidence of enforcement.


creditors. As noted earlier there are now some statutory and non-statutory intrusions into their freedom. The current codification of their obligatory duties and growing trend of shareholder activisms would help speed the change of management culture in respect of financial integrity in general and proper financial disclosure in particular.

Individual directors might also need to take note that increasingly the judiciary has demonstrated reluctance in accepting submissions based on collective board responsibility and has stressed that the standards of both care and skill will depend on the particular functions assumed by a director. The courts have nonetheless emphasised that the increasing emphasis on functional responsibility is tampered with by a degree of collective responsibility, and in particular pertaining to the statutory obligations of accounts preparation and disclosure.

The significance of functional responsibility is shown vividly in the case of non-executive directors who are envisaged to enrich corporate management by bringing in particular skills and experience and to provide a degree of independent and detached oversights on all corporate issues. ‘However, they can only consider and oversee the issues and information which are presented to them, which arise out of that

[57] Ingley & Walt, supra note 56 (b); Keay, A., ‘Company Directors Behave Poorly: Disciplinary Options for Shareholders’, Society of Legal Conference Paper, presented at Keele University in July 2006. The researcher demonstrated the difficulties shareholders will encounter when thinking of disciplining errant directors; Clinard, M. B. & Yeager, P.C., ‘Corporate Crime’, Transaction Publishers: NJ, 2006. The researchers here argued that directors have little risk of criminal convictions for their illegal actions on behalf of the corporation as they tend to be insulated by complex legal and social features. Issues of intent, direct knowledge and so on are said to inhibit the application of the criminal label to corporate offenders.


information, or which arise out of documents or information which they ought to have requested on being put on enquiry by the information given to them. If this limited function of non-executive directors, by reference to information and documents reasonably available to them, is accepted then there is no reason for any special standard or skill or care applying specially to them. Finally, directors now also owe a positive duty to disclose their own misconduct. The courts have used the policy doctrine to justify this.

Auditors

In keeping with the new expectation of the tasks of auditing, auditors’ access to corporate records and other information has now been strengthened further. They can now access information from all levels of corporate employees who are now required to comply without unreasonable delays. These individuals will also face criminal proceedings where they furnish information, which is misleading, deceptive or false.

Parallel to the enhanced expectations of their tasks and obligations, auditors have called for a cap on their liabilities for negligence. In line with this, the government is planning law reforms to, ‘…to make auditors liable if they are reckless and to enable them to negotiate contractual limitations to some aspect of their liability…’

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[62] s.8 of the CAICE 2004, which inserted new sections 389A and 389B to the CA 1985

Auditors’ accountability may arise under common law or statute. They may face possible actions for breach of audit contract and negligence from their clientele or even in specific circumstances to third parties to whom a duty of care is owed. Auditors may also face statutory sanctions if they breach various provisions of the Companies Act governing their duties and responsibilities. Other than these, they may also be sanctioned by their professional body for professional misconduct that may lead to expulsion from membership and practice.

Litigation risks for auditors have increased significantly over the past few years, mainly on account of huge losses suffered by investors and creditors over various large financial scandals. It is not difficult to see why this trend is growing. Investors and creditors found it beneficial to take on auditors where the chance and source of recovery from the more direct sources are remote or worst still no longer available. Auditors are liable to their clientele shareholders at common law and under the statute for their statutory duties and obligations. Auditors may face conspiracy fraud charges if they fail to provide qualified reports when accounts are distorted. On the other hand, they may face defamation charges from affected parties when they make serious errors in the making of qualified reports because of flaws in their auditing routine.

As discussed earlier, two landmark cases established the principle that as professionals they need only exercise reasonable care and skill expected of their profession. Where fraudulent acts are concerned, they will not be held legally liable when their suspicions are not aroused. In other words, they are to act as ‘watchdogs’
and not ‘bloodhounds’[64], and that they must not certify what they believe to be untrue and use reasonable care and skill before they attest that what they certify are true.[65]

The expectation from the auditing profession took a significant change in 1941 in the US and in 1958 in the UK. In the US, pressures for the change arose from the 1941 SEC Report on the McKesson and Robbins fraud case, which highlighted various weaknesses, associated with the auditing community and prompted increased responsibilities for the profession. Examples of these include internal control system examination and debtor circularisation. In the UK, it was prompted by Lord Denning’s assertion in the Formento case that auditors need to have an enquiring mind and to institute checking to ensure that no serious mistakes have occurred.[66] It has also become increasingly evident over the years that the courts now demand a higher standard of care from auditors than before.[67]

The growth in stature and complexity of the capital and financial markets from the 1980s onwards has contributed greatly to the huge growth of non-audit management services. These have acquired a stature rivalling that of traditional auditing in terms of demand and contract value. The changing financial environment has therefore helped sow the seeds of conflict for the profession, to surface later in the context of huge financial scandals in the late 1980s in the UK and the late 1990s in the US. Three change drivers are said to have shaped these newfound roles and expectations of

[64] Kingston Cotton Mill Co. (No. 2) (1896) 2 Ch. 279
[65] London & General Bank (No. 2) (1895) 2 Ch. 673
[66] Formento (Stirling) Ltd. v Selson Fountain Pen Co. Ltd (1958) 1 WLR 45
[67] Thomas Gerrard & Son Ltd (1967) 2 All ER 525
public auditing. These are the fraud and error detection factor; the audit independence factor; and extension of audit liability factor.\[68\]

In view of the special difficulties of spotting fraudulent acts in comparisons to errors, auditors are accountable only for; undertaking their tasks with a reasonable expectation of detecting material omission or misstatements of accounts brought about by error or fraud.\[69\] Auditor independence assists in the provision of objectivity to its attestation and monitoring responsibilities. Where non-audit services are provided and have been delivered without going against current standards and legislative rules, then auditors need to be more vigilant in not only having actual independence from the board, which effect their appointment or continuance of appointment, but also to ensure their own perceived independence as well. Such indicators include the resistance to depend unduly on particular audit clients, and the avoidance of incompatible duties.\[70\]

Where audit liability is concerned, the case of Caparo\[71\] seems to have shown the reluctance of the House of Lords to extend the proximity test found in the Hedley Byrne case\[72\]. The Caparo decision limits the boundary of the auditing profession’s duty of care to the company and existing shareholders collectively relying on their report and professional opinion. The House of Lords also held that auditors owed no obligations to potential investors or individual shareholders for economic loss suffered, not unless the auditors have provided indications that these shareholders could rely on the financial documents so audited by them.

\[68\] Cosserat, G., ‘Modern Auditing’, John Wiley & Sons Ltd.: West Sussex, 2000, 10-11
\[69\] Statement of Auditing Practice (SAS) 110: International Standard on Auditing (ISA), 240
\[71\] Caparo Industries Plc v Dickman & Others (1990) 1 All ER 568.
\[72\] Hedley Byrne & Co Ltd v Hedley & Partners (1963) 2 All ER 575
The Cadbury Committee on financial governance basically concurs with the decision in *Caparo*. They were concerned that the extension of auditors’ liabilities may deteriorate and open the floodgates for frivolous litigations.[73] The Committee’s position has not fully allayed the fears of auditors that they could be fully liable to the corporations they audit and their shareholders collectively in view of the expanding numbers and size of litigations they are currently facing. They are also fearful of the extension of their liabilities to other investors relying on their audited statements where they may have carelessly assumed responsibilities to the parties concerned.

Such concerns of the auditors appear to have some basis given the outcomes of some new cases. In the 1996 case of ADT, the court found against the auditing firm in the case as a senior partner had orally confirmed to ADT that he stood by the audited accounts, which later turned out to be defective. The court held that the audit firm by confirming the accounts had assumed responsibility.[74] Despite filing appeal, the firm settled out of court for a sum of £50 million. Similar litigations against auditors followed thereafter in the Maxwell and Barings Bank cases. In a Royal Bank of Scotland case, the court found against the auditor on the basis of requisite knowledge of the purpose of the audited financial statements by the plaintiff user. However, as

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[74] (a) French, Mayson, & Ryan, supra note 73 (c) citing ADT Ltd v BDO Binder Hamlyn [1996] BCC 808 and Equitable Life Assurance Society v Ernst and Young [2003] EWCA Civ 1114, [2003] 2 BLLC 603, [2004] PNLR 16, where the Court of Appeal stated that a company may argue that with the correct information from its auditors, it could have sought their advice which would have prevented it from acting in a manner to incur losses and in this sense the loss would be recoverable; (b) Jopson, B., ‘PwC Fined for Audit Failure Linked to TransTec Collapse’, Financial Times, 12/2006, 3 & 20. Here, the Accountants’ Joint Disciplinary Scheme fined PwC and Coopers and Lybrand £495, 000 for failure to carry out adequate audit procedures.
demonstrated in the Galoo and BCCI cases, the court showed general reluctance to extend the scope of auditors’ liabilities to creditors who may have relied on audited statements to provide credits. [75]

Still, the inconclusive position of the judicial tests for proximity and reasonable foreseeability and the fear of huge litigation claims have caused some audit firms like KPMG to incorporate their auditing work as limited corporations. Others have repackaged their insurance cover to meet with this problem or are taking steps to shield themselves through limited liability partnerships. [76] Others are waiting for DTI implementation guidance on the use of limited liability agreements provided under sections 532-539 of the CA 2006.

As mentioned earlier, there is an expectation gap where fraud and illegal acts are concerned; and differentiating between error and fraud involves judgemental call. [77] Error is unintentional and there is no objective for personal gains. Examples of these are mistakes in data entries, misinterpretation of facts, or careless misinterpretation of accounting policies and standards. In contrast, fraud is intentionally perpetrated for personal benefits. The auditor is primarily concerned with fraud suspicion, and leaves it to the courts to determine fraud and other competent authorities to deal with the issue. The primary responsibility for the prevention and detection of fraud, it must be said is in the hands of the board and management of a corporation. [78] Auditing is in no position to determine the corporation’s good faith and reliability. This is because

[75] (a) Royal Bank of Scotland v Bannerman Johnstore Maclay (a firm) 2003 SLT 181; (b) Galoo Ltd. v Bright Grahame Murray [1994] 1 WLR 1360; and (c) Bank of Credit and Commerce International (Overseas) Ltd. (BCCI) v Price Waterhouse [1999] BCC 351.
[76] Limited Partnerships Act 2000
[78] ibid
corporate management can tamper with the internal control system by overriding the controls.\footnote{79}

Auditors have the capacity and duty to perform their tasks such that a reasonable expectation of spotting illegal acts can be achieved. There is tussle between those who contend that the auditors are putting pressures on the courts and the public to accept lower standards of responsibility for fraud and those who argue that they can do more to assure the reliability of financial statements, like the provision of assistance to corporate management to have more effective internal control and risk management systems.\footnote{80}

The difficulties for auditors are magnified when they are also expected to examine the consistencies of Directors’ Reports as found in Corporate Annual Report with the audited accounts. Any failure on the part of the auditors to spot these material inconsistencies and to resolve these with the corporation concerned before audit endorsement may evoke serious legal implications for the auditor concerned.\footnote{81}

Authoritative guidance on minimum acceptable standards of professional conduct is available to deal with rules pertaining to independence, confidentiality, professional fees, and appointment.\footnote{82} Compliance to these codes of conduct is compulsory and detractors may even be expelled in serious cases. A statement of Fundamental Principles usually accompanies such codes of professional conduct. These usually

\footnote{79} Cosserat, supra note 68, 83
\footnote{80} Gray & Manson, supra note 77 citing the Audit Practices Board, ‘The Audit Agenda’, 1994
\footnote{81} S 458 CA 1985 where auditors may face the risks of being a party to carrying on business with the intent to defraud creditors or for other fraudulent aims.
\footnote{82} These are provided by the Rules of Professional Conduct (Association), the Guide to Professional Ethics (Institutes) UK, and the International Federation of Accountants Code of Ethics for Professionals.
refer to the principles of objectivity, integrity, competency, skill, care and diligence, as well the principles of courtesy. [83]

Auditors exercised professional judgements, which could expand their exposure to liabilities. However, ‘…tort’s law of deterring socially undesirable behaviour will not be served by disproportionately expanding auditors’ liability’. [84] Whilst the consequences of making auditors liable for their failures in assessing the quality of financial statements prepared by management is a major issue, case law in this area holds that auditors are not insurers against the failure or losses of a company. [85]

In the meantime, auditors in general are comforted to a large extent by the provisions in the CA 2006 which provides the avenue for capping auditors’ liability in joint consultation with their clientele; and post-Caparo decisions which generally accord with Caparo other than the distinguished Morgan Crucible case. [86] The UK government and the courts have therefore adopted a cautious approach; but the draft Community Directive in Company Law has sought to impose higher standards of liability for negligence on auditors and when made into law may expand the scope of auditors’ liability once again. [87]

Financial Advisors and Other Gatekeepers

Financial advisers operate as independent financial advisers or as consultancy extensions of accounting, banking and financial businesses. There appears to be no clear definition for financial advisers or their duties and functions for the moment. The courts provide a bare minimum glimpse of this, when they describe the profession as an occupation requiring intellectual dexterity, or surgical skills, which is substantially different from the production or sales or arrangements for the production and sale of commodities. They further added that the word as used traditionally to refer to the three professions in the Church, Medicine and Law has now acquired a broader meaning as the line of demarcation may change from time to time. [88]

In the area of professional negligence, professional status is accorded to a service or occupation, when; the nature of the work is skilled and specialised; the ethical principles attached to it are broader than mere honesty; there is an association to manage education entry and competency requirements, or adjudicate on errant misconduct; and when it has a degree of standing in the wider community. [89] Guided by these attributes, the law on professional negligence focused on standard white-collar occupations like architects, accountants, surveyors, lawyers, doctors, insurance brokers, and even managing agents at Lloyd’s. Somehow, financial advisers were not accorded similar recognition. This perspective tends to assume a general conceptual approach to the area of professional liability, underpinned by obligations flowing from contract, tort and equity. [90]

[88] Car v Inland Revenue Commissioners [1921] 2 All ER 163
For the moment, there does not appear to be a unified theory for professional liability. ‘There may be a common underlying theory which binds professional negligence and liability together, but it is one which needs an intelligent application to the variety of contexts in which professional functions are performed’. [91] This stand is substantially influenced by the decision in Caparo.

Financial advisers are individuals with this specialised calling or of other professional background (such as accountants and lawyers) providing financial advisory services as an extension of their main professional business. FSA 1986 gave recognition to the role and function of independent financial advisers and others concerned only with the dealing of financial products for the company they represent. Despite this, there are concerns about the wisdom of according status to a profession with liberal education and training stipulations. [92] This is of less concern to others who finds this argument unhelpful from the legal perspective as it is not important which specific group of financial advisers deserve the recognition of professional status.

This contrasting view holds that what is important in practice, ‘…is the holding out, by self-styled financial advisers and others, of knowledge and expertise in the provision of financial advice and information. That holding out is sufficient to attract the imposition of legal obligations and any corresponding legal entitlements of the intermediaries and professional financial advisers in the context of conflicts of interest are discussed extensively in this thesis.


customers who rely upon such information or advice, should it prove defective’. [93]

On this basis, it may be appropriate to include investment banks, brokerage firms, and accounting firms involved in the provision of financial advisory services either as ancillary services or through separate legal entities created for this expressed purpose.

The latter approach is derived mainly from the landmark decision in Hedley Byrne,[94] which is the bedrock of the law governing the provision of financial consultancies and information by advisers, especially in relation to insurance intermediaries as well as those in the legal and accounting professions. The critical element of the Hedley Byrne decision is the assumption of responsibility principle. This can be explained as follows; ‘That a person should be bound by legal duty of care to avoid causing economic loss to another in circumstances where a reasonable man in the position of the defendant would foresee that kind of loss and would assume responsibility for it’. [95] From this perspective, tort is the equivalent of the assumption of legal responsibility to another through a contractual or near to contractual relationship by a professional to undertake a service with care and competence to achieve an objective without negligence. If not, as a result of reliance, a claim can be filed for liability for direct economic loss.


[95] (a) Harvey, C., ‘Economic Losses and Negligence, the Search for a Just Solution’, 50 Can. Bar Rev. 600, 1972, 620; (b) However, Mayson, French, & Ryan supra note 77 cited the case of Commissioners of Customs and Excise v Barclays Bank plc [2006] UKHL 28 wherein the court held that where assumption of responsibility is inappropriate, then a ‘threefold’ test comprising reasonable foreseeable consequence, sufficient proximity, and fair, just, and reasonableness may be applied.
Five important principles emerge on the law of professional negligence as a result of Hedley Byrne and other cases: [96]

- Hedley Byrne set forth the principle in tort that law is derived from a defendant’s assumption of responsibility for the provision of professional services;
- The principle allows the concurrence of actions in tort and contract. Translated, this means that a party injured by a breach in contracts may in principle choose to claim in tort;
- Negligence in mis-statement is not necessary for the Hedley Byrne principle to apply, as negligent omissions are equally acceptable;
- Action founded on pure economic losses can no longer be restrained as the assumption of responsibility is the rationalisation or technique harnessed to provide the avenue for the recovery of losses arising from the negligent delivery of services;
- Irrespective of any contracts, assumption of responsibility is applicable to professionals. [97]

Other than the avenues provided by the law of torts, victims of economic losses can file claims for breach of statutory duty. There is, however, a distinction between causes of action restricted to private persons and those commonly available to any

[96] Nocton v Lord Ashburton [1914] A.C. 32; Henderson v Merritt Syndicates Ltd [1994] 2 A.C. 145. Lord Brown-Wilkinson states in this case that the duty of care imposed on directors, agents and others is the same duty which arises from the circumstances they were acting and not from their status nor description.; White v Jones [1995] 2 A. C. 207
person. The former for instance refers to breach of FSA rules,[98] whilst the latter refers to breach of FSA requirements.[99] Claimants may find the breach of statutory duty option route helpful as; it circumvents the requirement to prove that a duty of care should be recognised at common law; and more importantly this option provides a much explicit details of the appropriate standard of care peculiar to a particular activity. As it resembles a form of strict liability, the only default that needs to be shown is non-compliance with the statutory obligations.[100]

Though advantageous, the claim for breach of statutory duty under this heading must fulfil five critical elements, namely; (i) that the claim interest must be within the scope of protection of the legislation; (ii) that the legislation must explicitly or implicitly render the breach of duty actionable; (iii) that there must be breach of duty; (iv) that the claimant must have suffered damage; and (v) causation must be proved.[101] The use of this statutory scheme has been initiated in earlier cases under FSA 1986. One case concerned failed mainly on account of the fact that the claimant’s interest was outside of the scope of protection of the legislation concerned.[102] The other case failed as the claimants were deemed to be individuals outside the scope of the legislation’s protection.[103]

It has been argued that with the amendments made in the FSMA 2000,[104] where there is a clear shift in statutory language to person from investor, and the extension of protection of the legislature to cover dependents of customers and third parties, the victims comprising widows and surviving children would succeed under the same

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[98] s.150(1) FSMA 2000
[99] sections 20(3) & 20(9) FSMA 2000
[100] McMeel & Virgo, supra note 93, 188
[101] McMeel & Virgo, supra note 93, 188-190
[102] Norwich Union Life Insurance Co. Ltd v Oureshi [1999] 2 All ER (Comm) 707
[104] s. 150 (1) FSMA 2000
It has to be emphasised that these said claims were made on the basis that the professional service providers had dishonestly concealed relevant information. These developments generate serious legal implications for professional advisors. For instance, where they provided advice to invest in various equity or derivative products, which are off balance sheet and fail to disclose material information, which they are aware of, they could be caught under these statutory obligations. In the eventuality of such circumstances, the more usual practical way out for professional advisors is to file for contributory negligence.

In broad terms, the court’s approach to the handling of professional standards appears to be as follows, ‘There is no reason in principle why a professional person should not by contract (or assumption of responsibility) promise to produce a result rather than merely exercise skill and care to do so, but in the absence of promise the courts will be reluctant to hold that he has impliedly given such an undertaking. In practice, however, many claims brought against professional people are based on failure to carry out fairly simple…functions and proof of the failure itself will virtually guarantee success in these cases whether the action is frame in contract or tort (or statutory obligations). Nevertheless, in theory the standard is one of reasonable care’.

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[105] ibid
[106] s.47 FSA 1986
[107] (a) Law Reform (Contributory Negligence) Act 1945; (b) Bennett, C., ‘The Market Abuse Link between Shell & Enron’, Company Lawyer 2005, 26(6), 180-185. Bennett argues that behaviour in relation to abusive OBF appears to fall under the criteria amounting to market abuse
Compliance Risks in Financial Services Sector

Directors, auditors, and financial advisers may need to take cognisant of their professional conduct in the financial services sector, especially when they engaged in the dissemination of financial information, which may be distorted or manipulated by OBF reporting manoeuvring. This is because of the risk that they may be caught for the conduct of market abuse under the FSMA 2000. Of relevance to this investigation is the conduct of behaviour relating to false or misleading information, and in particular pertaining to the dissemination of information which gives, or is likely to give a false or misleading impression as to market traded financial securities by a person who knew or could reasonably be expected to have known that the information was false or misleading such as financial analysts and investment advisors. This problem can be accentuated when such professionals are found to be aiding the agenda of related personnel to the detriment of their clientele or of particular clientele against another in classic conflicts of interest situations.[109]

Opinions vary as to whether market abuse constitutes a civil or criminal offence. The distinction has important bearing for the ascertainment of the degree of burden of proof.[110] The Financial Services and Markets Tribunal (FSMT) appeared to concur with the FSA that the sliding scale principle would apply to determine the burden of

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proof, implying market abuse to be closer to a civil offence.\footnote{Arif Mohammed v the FSA, Financial Services and Markets Tribunal Decision of 29/03/2005} Subsections 397(1) and (2) and section 397(3) provides for the respective offence of making misleading statements and misleading practices. The former offence applies to the making of a statement, promise or forecast which a person knows to be misleading, false, or deceptive or dishonestly concealing any material facts. A person who is reckless as to whether the statement made by him is misleading, false, or deceptive will also be caught under this provision. Additionally, section 15 of the Theft Act 1968 covers the publication of statements by an officer of a company which to his knowledge is or may be misleading, false, or deceptive in a particular material. So preparers and disseminators of financial statements containing the manipulative use of OBF may be subjected to sanctions under these said provisions.

The AIT case was the first to be prosecuted by the FSA under section 397. This involved the making of a forecast on the basis of contracts, which did not exist at the time. Of the three defendants, two were found guilty of recklessness in the making of the misleading, false or deceptive statements and were subsequently jailed for 2-3 years.\footnote{R V Rigby, Bailey and Rowley, 2005 unreported.} So far, the more high profile examples pursued by the FSA concerns the Shell case involving material defects in the disclosure of its petroleum reserves in its balance sheet.\footnote{Bennett, C., ‘The Market Abuse Link Between Shell and Enron’, the Company Lawyer, Col. 26, No. 6, 180-185; Accountancy Magazine, ‘Shell Fined £17 Million Over Misstatements’, www.accountancymagazine.com, 10/2004} A less high profile case, but related to this study is the failure by Eurodis Electron Plc to notify the market of a drastic change in its financial condition but had instead presented a ‘clean working capital statement’. The FSA censured the

Financial Regulators

The tort of misfeasance in public office is acknowledged in courts.\footnote{[115] Dunlop v Woollahra Municipal Council [1982] AC 158; Craig, ‘Compensation in Public Law’, 96 LQR 413, 1980, 426-428} It refers to, ‘Damages…available for an ultra vires act if an official knowingly acts in excess of his powers or acts with malice towards the plaintiff’.\footnote{[116] Markesisnis, B.S. & Deakin, S.F., ‘Tort Law’, 4th edition, Clarendon Press: Oxford, 1999, 374; Wood, P. R., ‘A Hidden Lesson of BCCI and the Bank of England’, Butterworths JIBL, Vol. 21 No. 1 January 2006, 3. It is argued here that regulators should be allowed to make honest mistakes, without fear of liability if their judgements turn out to be wrong.} The rationale for the tort is to compensate those who have sustained losses as a consequence of improper or abuse of public power. It is underpinned by the principle that such power is to be exercised only for the public good and not for ulterior or improper purposes. Unlawful or unauthorised acts of persons holding office in public institutions like local authorities, government departments, or even Central Banks fall within this ambit, provided it is pursued with the requisite mental element. This tort in principle is extended to omissions provided these are conscious decisions not to act.\footnote{[117] Three Rivers 1 [2000] 2 WLR at 1267, per Lord Hutton} It may include the ignoring of obvious risks.\footnote{[118] Three Rivers Council v Bank of England (No. 3) [2001] 2 All ER 513}

The test to be adopted has been reaffirmed by Lord Steyn as representing, ‘…a satisfactory balance between two competing policy considerations, namely enlisting tort law to combat executive and administrative abuse of power and not allowing public officers, who must always act for the public good to be assailed by
unmeritorious actions’.\footnote{119} However, in conformity with the character of the tort of public misfeasance, ‘…the act must be deliberate, not negligent or inadvertent or arising from a misunderstanding of the legal position…a failure to act can amount to misfeasance in public office only where (i) the circumstances are such that the discretion whether to act can only be exercised in one way so that there is effectively a duty to act; (ii) the official appreciates this but nevertheless makes a conscious decision not to act; and (iii) he does so with intent to injure the plaintiff or in the knowledge that such injury will be the natural and probable consequences of his failure to act’.\footnote{120}

Under FSMA 2000, the FSA assumes the function of the listing authority for the UK capital market. To discharge this function, the FSA focuses ‘…on the admission of securities to the official list and on the continuing obligations relevant to the continued admission of securities to the official list. This includes admitting companies to be officially listed, and suspending or removing them from the official list, setting minimum standards, including monitoring the dissemination of price sensitive information, and keeping the listing rules up to date.’\footnote{121} Its other functions include; the regulation of sponsors; investigation of breaches of the listing rules and certain offences under the FSMA 2000; and disciplinary action against issuers, directors and sponsors.\footnote{122}

\footnote{119} ibid
\footnote{120} supra note 118, per Lord Millet; Tait, N. & Eaglesham, J., ‘Byers Viewed Railtrack as a Basket Case’, Financial Times, 13/07/2005, 4. Here, 49,000 shareholders accused the former Transport Secretary with ‘…a specific intention to injure the shareholders by impairing the value of their interests, and effectively expropriating their assets’. The court held otherwise.
Where the lack of disclosure or omission of information pertaining to certain OBF financial packages result in the clear generation of misleading or false statements, and for which the FSA as the UKLA fails to act, and this culminates in investors and creditors suffering losses, a case may be filed for public misfeasance by the victims. The complainants can make use of two procedures to challenge the FSA, namely; via judicial review; or where judicial review is inappropriate via civil proceedings for damages. Where the second option is pursued, it must be borne in mind that this line of action is constrained by the FSA’s statutory immunity against liability in damages.\[123\]

The circumstances of the case will decide on the choice of mechanism. Judicial review of the FSA or any other public body is not a simple process. The justifications for judicial review are very restrictive or limited as the courts have expressed a reluctance to look over the shoulders of public authorities and prefer to let these bodies get on with their tasks.\[124\] A successful action at judicial review will result in the courts making quashing orders, mandatory orders, prohibiting orders, injunctions, and /or claims. Damages are likely to be awarded only where there is some private law court of action. In respect of the FSA, damages claims are likely to be entertained where it acted in bad faith or breach conditions in the HRA 1998.\[125\]

Where judicial review is inappropriate, civil actions may be pursued. Such actions will encounter three challenges. Foremost, such actions will have to deal with the quantifiable claims arising from wrongs impacted by public misfeasance. Second, the

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\[124\] R v Securities and Futures Authority, ex p Panton (1995) CA LTL, 6/3/95, CA

\[125\] Deringer, supra note 121, 686
issue of statutory immunity for liabilities will need to be addressed. Third, other remedies may need to be reviewed as well.\[126\]

Statutory immunity from liability in damages for the FSA covers the institution itself, its employees and others acting on its behalf and in the course of executing its functions.\[127\] Acts in bad faith and those affecting human rights are, however, not covered by the statutory immunity. Bad faith is taken to refer to malice, knowledge of lack of power for the action taken or wilful omission of required action.\[128\] Courts will look towards the award of claims against public bodies whose actions are incompatible with the ECHR, and awards may become necessary to provide just satisfaction to persons affected.\[129\]

Other then the above options for filing claims against the FSA, which by nature are cost prohibitive and time-consuming; aggrieved parties may make use of the independent complaints scheme. The government as a counterweight to the statutory immunity shield extended to the FSA provided this additional option. This option is available to persons and institutions affected by the way FSA performed its statutory functions. Representatives of persons affected like solicitors can act on their own behalf.\[130\]

The government’s intention is to provide FSA with the competence to deal with sharp practices and other forms of more serious wrongdoings in the securities and related

\[126\] ibid, 687-688
\[127\] Sch. 1, paragraph 19 FSMA 2000
\[128\] These were stated in Three Rivers Disytict Council v Governor and Company of the Bank of England [2001] 3 All ER 1, HL; Company Lawyer, ‘News Digest: BCCI Liquidators Drop Bank of England Claim’, Company Lawyer (2006), 27 (3) 91. The case collapsed after the High Court held in November 2005 that it was no longer in the best interests of the creditors to continue. Deloitte, BCCI’s liquidator spend some £38 million and the Bank of England some 70 million on the case, which ran for 12 years.
\[129\] s. 8 (3)-(4) HRA 1998
\[130\] COAF 1.2.1 FSA Handbook
markets more efficiently and effectively, for ‘…without statutory immunity, the proper and efficient action of the regulator would be frustrated by lawsuits and red tape. Frivolous litigation could be an extremely easy ploy to distract or hinder the regulator. The absence or the weakening of the immunity could also have more dangerous effects on the industry. It could lead to a tendency to over-regulation with the FSA seeking to collect more information than it needed, setting tougher minimum standards than necessary, avoiding giving guidance or waivers or taking longer to reach decisions than it otherwise would’.\[131\] The concession it gave in the form of the complaints scheme has to be appreciated in this light as well as the fact that the FSA has got to file an annual performance report to the Treasury for review and that the bulk of its financial resource come from contributions and fines by participants in the capital and related markets. In other words, it has limited financial resources to deal with litigations against it.

Whilst errant actions of the FSA can be challenged, errant actions of directors, auditors and professional advisers can be disciplined by the FSA. In particular, directors may suffer liability to personal disciplinary action where they are knowingly aware of their corporation’s breach of the listing rules. The test is not likely to be a particularly high one.\[132\] The FSA can either issue a public censure or a fine to discipline the errant directors. It will review all relevant circumstances of the breach and the list of non-exhaustive factors contained in the Guidance Manual before taking a specific action.\[133\] Breaches of Part VI of FSMA 2000 may carry with them

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\[131\] Economic Secretary to HM Treasury in Standing Committee, 13/07/1991
\[132\] s. 417 FSMA 2000; McCormick, R., ‘Legal Risk in the Financial Markets’, Oxford: OUP, 2006, Chapter 10. It is emphasised here that senior management will be held accountable for ensuring that systems and controls are in place to manage market risk, credit risks, and related legal and reputational risks.
\[133\] Draft Guidance Manual, paragraphs 11.3, 8.3.4, and 8.8.3
criminal law implications.[134] Where the contents of listing particulars or material parts of them are untrue or misleading, civil liabilities may arise for the sponsors, issuers, auditors, and directors concerned to persons who have acquired the pertinent securities and who have suffered losses as a result of these untrue or misleading statements or the omission of details required.[135]

The work of the FSA as a single regulator since 1997 to promote efficiency and confidence in the capital and financial markets in the UK, are not without controversies. However, as John Tiner, the departing CEO of FSA puts it, ‘There are real benefits of scale, of intellectual capital and of simplicity when the markets have one regulator. Some people say that integrating prudential and market pose a conflict of interest because there comes a time when you are so worried about market confidence that you take actions that, in the short term, are detrimental to the consumer’s interest. But the end result may be better for long-term stability’. [136]

Others disagreed and have called for greater deregulation. They maintained that a lot of regulations benefit nobody. This argument even went as far as to suggest that FSA rules could easily be replaced by good standards of corporate governance, as there are not substantial differences between the two views. [137] The FSA’s CEO opposed this line of reasoning. He argued that the FSA based its standard of compliance on a set of high-level principles; and in particular; transparency, honesty, open communication and customer protection. These he added are the ingredients, which protects the

[134] Sections 93.85, 93.86 FSMA 2000
[135] Sections 80 & 81 FSMA 2000; Equitable Life Assurance Society v Ernst & Young [2003] EWCA CIV 1114
[137] Kochan, supra note 136 (a), 30 paragraph 6
London capital and financial market from abuse. As he further points out, ‘The City has really liked the distinctive focus on the principles-based system. This has been very good for maintaining market confidence in the City and promoting high standards’.\[^{138}\]

Indeed, the FSA further claimed that such principles could then be put into practice through the provision of detailed rules of behaviour. In the end, it is difficult to locate a universally popular financial regulator, ‘But as long as the FSA can demonstrate that its model is superior to others, the prospects of another great British intellectual export becoming the global model--along with privatisation and central bank independence--are more likely than not’.\[^{139}\] This is fast becoming a reality given the adoption or adaptation of the model in Poland, Germany, Japan, Hong Kong, Singapore, Scandinavia, Belgium, and the Netherlands.

As for the claim for compensation against the FSA or other public agencies, the House of Lords in Three rivers has clarified that ‘…the requisite mental element is either (a) ‘targeted malice’, i.e. conduct specifically intended to injure a person or persons; or (b) ‘untargeted malice’, i.e. conduct whereby a public officer acts knowing that he has no power to do the act complained of and that the act will probably injure the claimant, it being sufficient here that an act is performed with (subjective or inadvertent) reckless indifference as to the outcome. Liability extends for losses to the claimant actually foreseen as the probable consequence, not all reasonably foreseeable losses. If an officer commits the tort, the employing authority

\[^{138}\] Kochan, supra note 136 (a), 28 paragraph 1; Stewart, S., ‘Coping with the FSA’s Risk-Based Approach’, JFRC, Vol. 3 (1), 2005, 43-47. Driven by national legislation, FSA supervises through an increasingly transparent principles and risk-based approach, which it expects the regulated firms to follow. It, however, does not get involved with performance risk management.

\[^{139}\] Kochan, supra note 136 (a), 30 last paragraph
may be held vicariously liable unless the unauthorised acts are so unconnected with
the officer’s authorised duties as to be quite independent of and outside those
duties’. \[140\]

So far, there has been one successful high profile compensation case made against the
FSA, namely the case involving Paul Davidson (the ‘plumber’), Ashley Tatham and
Nigel Howard. The FSA had imposed hefty fines against the trio for engaging in
market abuse through their participation in spread betting to create a false market
impression of a particular AIM stock. The FSMT overturned the long drawn case in
late 2006 on the basis that the trio had not participated in the scheme to mislead the
market. The FSA also received considerable criticisms over the quality of its factual
evidence as it was also held by the FSMT that the seriousness of the charge will
require a much higher burden of proof. \[141\]

Prior to that, the FSA endured a series of well publicised adverse findings from the
2003 Hoodless and Blackwell case, the 2005 Legal and General case to the 2006
Baldwin case. This is counterbalanced by the recent settled cases with hefty fines for
market misconduct. These include the fines of £6.3 million against Deutsche Bank,
£13.9 million against Citigroup, and £17 million against Shell; and individual fines of
£290,000 in the Bonnier case, £350,000 in the Maslen case and £750,000 in the Jabre
case. \[142\] Nonetheless, the FSA has

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\[140\] Bailey, S., ‘Public Authority Liability in Negligence: The Continued Search for Coherence’, Legal
Studies, Vol. 26 (2) June 2006, 157-158
\[141\] Connety, J., ‘Courts in Davidson Declare Market Abuse a Criminal Act’, International Financial
July 2006, 9-10; Mason, I. & Cooke, L., ‘CLG and Jabre-The FSA’s Attitude to Market Abuse’,
Butterworths JIBL December 2006, 509-510
reaffirmed recently the commitment to its light-touch risk-based regulatory approach.\[143\]

**US Position**

**Directors**

Entrepreneurs in the US can select which state statutes will govern their corporations’ internal affairs, irrespective of where their business will be conducted or where the major shareholders have their domicile. The courts appear to look to the law of the state of incorporation when dealing with a corporation’s internal affairs. The courts refer to this choice of law principle as the internal affairs doctrine.\[144\]

Generally, businesses will flock to incorporate in those jurisdictions with the least restraints on management actions. This became know as the ‘race to the bottom’ theory. Others see this differently, and advocated the ‘race to the top’ thesis. They suggest that the competition between states to rake revenue and other benefits would result in the ability to provide better rules and procedures for protection of shareholder interests.\[145\] For the moment, Delaware is home to more than 50% of US quoted corporations and 60% of Fortune 500 in view of its competitive corporate tax regime and superior specialisation in corporate laws.

In the US, the board comprises the inside (the executive directors), and the outside directors (non-executive directors). Before the Enron debacle in 2002, the outside


\[144\] Revised Model Business Corporation Act 1991

directors mostly function as rubber stamps for the decision-making autonomy of the inside directors, which included the all-powerful CEOs. This has been attributed to time constraints and limited access of independent information. Left very much to their own devices, the inside directors have over the years consolidated their power and influence by appointing outside board members who are known to be sympathetic and supportive of their values and causes.\[146\]

The paucity of control by shareholders and the board has provided management with the opportunities to engage in controversial initiatives for self-enrichment rather than focusing on the prosperity of the corporation. Added to this are the dangers that such management may choose either to be ultra-conservative by not responding to the changing business environment (the shirking theory); or recklessly aggressive.\[147\] Both options will ultimately work against the interests of the corporation concerned. Increasingly, performance-linked compensation schemes and takeover threats have emerged to address these issues. Other than these, the SEC and various institutional groups have also been pushing hard for reforms in board composition and structure.\[148\]

\[146\] (a) Mace, M. L., ‘Directors: Myth and Reality’, HBS Press: Massachusetts, 1971; (b) Downes, M. & Russ, G. S., ‘Antecedents and Consequences of Failed Governance: the Enron Example’, Corporate Governance, Vol. 3(1), 2003, 83-85. This investigation supports the argument that the downfall of Enron was in large part to a lack of board ethics and board passivity rather than a lack of regulations; (c) Boyd, D. P., ‘Chicanery in the Corporate Culture: WorldCom or World Con?’, Corporate Governance, Vol. 3 (1), 2003, 83-85. This case demonstrated how and why board approval of ‘sweetheart loans’ to the CEO contributed to the financial malaise in the company.


The fiduciary duty expected of US corporate directors is the function of a duty to act carefully, a duty to act lawfully and a duty to act loyally. The duty of care underpins the tort of negligence. The US courts have, however, provided a slight modification to this conventional approach. This is partly contributed by variations in state corporation statutes. In particular, the Delaware Supreme Court has held in the Graham case that the directors had to restrict their supervision to broad strategic issues rather than operational matters. Some have argued that the issue is not one of directors being held to account for failure to supervise operational affairs but rather whether they have put in place a viable system of internal controls, which could have done the job.

Where directors are said to be making business decisions, which went bad, the consequences are subjected to what has come to be known as the ‘business judgement rule’ (BJR). This basically suggests that courts should not intervene and hold directors accountable for business decisions turning sour for the corporation; or for which reasonable minds might dissent. There is no official definition of this rule though it is given recognition in the 1984 Model Business Corporation Act and ALI’s Principles of Corporate Governance. As the BJR has been applied under different circumstances, it has shown some variations in its meaning and implications over the

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[150] Cary, W. L., ‘Federalism and Corporate Law Reflections upon Delaware’, (1974) Yale Law Journal Vol. 83, No. 4, March, 64; Lipman, F. & Lipman, L. K., ‘Corporate Governance Best Practices: Strategies for Public, Private and Not-for Profit Organisations’ John Wiley & Sons, Inc: NJ. 2006, Chapter 2. Fiduciary duties under Delaware Law incorporates a duty of care (covering a duty of care and a duty to stay informed); and a duty of loyalty (covering a duty to act in good faith, a duty of candour, and a duty to avoid conflicts of interests). Further, some 40 states other than Delaware allow directors to consider the interests of stakeholders other than equity holders in complying with their fiduciary duties.
[152] Section 8.30 of the Act explained that no codification or definition of the rule is provided on account of the continuing judicial development on this issue; The ALI Principles of Corporate Governance at section 4.01 (c ) provides elaboration for the BJR.
years. Its more common interpretation states that courts should refrain from reviewing corporate decision-making where reasonable diligence has been applied and where such decisions are exercised in good faith, and free of conflicts of interest.\[^{153}\]

The BJR seemingly appears to suggest that directors need not look over their shoulders when making business decisions. This might not always be the case as indicated in three 1980s cases and five other more recent cases.\[^{154}\] In one case, the ‘…court expressly imposes on directors a duty to monitor with regard to whether the corporation’s officers…comply with the law in connection with their activities related to the corporation.’\[^{155}\] Still, in general the BJR is widely recognised because of the difficulties associated with the second-guessing of business decisions.\[^{156}\] Indeed, the most probable reason for the justification of the BJR is ‘…based on the USA being a litigious country…and the fact that the US legal system consists of derivative suits, class actions, and contingency fees…These are unique features adding to the legal costs of the business products and services—be it as a result of direct legal costs or from insurance cost—and the competitors elsewhere have an unfair advantage as they do not incur such additional costs. The BJR enables the US directors to carry on with their function(s) unimpeded.’ \[^{157}\]

\[^{154}\] The 1980s cases were Francis v United Jersey Bank (1981) 432 A 2d 814, Smith v Gorkom (the Trans Union case) (1985) 488 A. 2d 858, and Hanson Trust Plc v ML SCM Acquisition Inc. (1986) 781 F 2d 264. The more recent cases were; Cede v Technicolor Inc. (1993) 634 A. 2d 345, Paramount Communications v QVC Network (1994) 637 A. 2d 34, re Caremark International Inc Derivative Litigation 698 A. 2d 959 (del. Ch 1996), Rothenberg v Santa Fe Pacific Corp. 1995 WL 523599, 21 Del J Corp L 309 Del. Ch Ct 5 September 1995, and Kahn v Tremont Corp 694 A. 2d 422 (del 1997). The last three cases were referred respectively as Caremark, Rothenberg and Kahn
\[^{156}\] Gevurtz, supra note 147, 289-301
Justification for the BJR aside and of greater persuasion is the argument that it is the threat and fear of litigation that renders directors to be more diligent and careful in the discharge of their duties. ‘The Enron saga has revealed that it will now be exceedingly difficult for directors to manipulate and use accounting tricks to show a business in a better state than it really is. Directors will have to do better and discharge their duties properly by realistically assessing their actions rather than shielding themselves against the BJR’.\[158\] The outcome of Enron and WorldCom gave support to this view, but two other recent cases in the Delaware court have reaffirmed its vitality as well as the deference given to good faith decisions.\[159\]

When the perspective of the shareholders’ is moved from owners seeking the fulfilment of obligations from their agents or directors to that of investors seeking honest and reliable information from management for the making of investment decisions, common law as well as securities laws do provide avenues for recovery of losses caused by false, incomplete or misleading statements. Under common law, where misleading statements are made, victims who suffer losses on account of these may void the contracts induced by such frauds, half-truths or misrepresentation and sue for recovery of monies from those concerned.

As common law gave only limited protection to investors misled into investing and did not extend to victims in ignorance, state and federal securities laws were enacted to deal with the latter situation. The 1933 SEA for instance, has withered away the common law fraud of scienter. Issuers are held strictly liable for any distortions in the

\[158\] ibid, paragraph 8
\[159\] In re Toys R's Shareholder Litigation and in re Walt Disney Company Derivatives Litigation No. 15452, 2005 Del. Ch LEXIS 113

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registration statement. Persons who signed the registration statement, every
director of issuer, every experts who certify on any part of the registration statement,
and the underwriters concerned will now assume liability unless they can prove due
diligence. The intention is to motivate these persons to ensure the accuracy of the
registration statement. The Act also carries liabilities for those involved without the
victims having to prove reliance.

Appropriate provisions were also made in the Act to extend liability to distortions
made external of the registration statement. The act of making fraudulent, false or
misleading statement in the initial issuance of securities is prohibited by the Act. Its
violation may lead to actions by the SEC for injunctive relief or criminal
proceedings. To address the transactions of stocks in the secondary market, the
1934 SEA was introduced. The significance of this Act lay with its strong focus
on disclosure requirements for securities as stipulated by the SEC. These refer to the
annual 10-k forms; the quarterly 10-Q forms; and the 10-k forms for the report on
significant events. Through the provisions in the 1934 SEA, a timely and constant
flow of information on widely held securities are assured to investors in the market.
Investors who suffered losses on reliance of information so disclosed which turned

[160] Section 11 of the 1933 SEA
[161] ibid
[162] Section 129 (a) (2); Gustafson v Alloyd Company, 523 US 561, 115 S.ct 1061 (1995); Where a
listed company is liable under federal securities laws for misstatements or omissions in documents filed
with the SEC, a director of that company may also be liable if the directors is judged to be in control of
the company; the director signed those documents, or; he fails to establish a personal due diligence
defence.
[163] The court in Aaron v SEC, 446 U.S. 680, 701-02 (1980) has held that subsection 17 (a) (2) and 17
(a) (3) 1933 SEA does not require a demonstration of scienter, and negligence will suffice.
[164] Section 12 (a) 1934 SEA requires securities traded on any national exchange to register the
securities concerned.
[165] Section 13 (a) 1934 SEA; Post-Enron, the SEC became more willing to invoke disclosure
obligations under Regulation S-K of the SEA 1934 to act even against independent directors. These
were reflected In the Matter of the Walt Disney Company, Admin. Proc. 3-11777 (20/12/2004), and
SEC v Chancellor Corp. et al., No. 03-10762 (Mel) (D. Mass.); Cheffins & Black, supra note 60 (b),
1392-1399. The 2 professors here argued that the US legal environment is uniquely hospitable to
litigations against directors in general. Despite this, outside directors of listed corporations in general
encounter only a remote chance of breaching corporate duties because of access to BJR.
out to be false or misleading might enjoy cause of action. The perpetrators of such misleading information will then have to assume the burden of proof that they have acted in good faith and have no knowledge of their untruthfulness.\[166\]

More important is Rule 10b-5, an administrative rule introduced by the SEC as empowered by Section 10(b) of the 1934 SEA. This has been used in claims against false and misleading statements.\[167\] Rule 10b-5 prohibits the making of false or material misstatements of material facts to induce transactions in securities. Failures to disclose all pertinent facts can lead to the making of misstatement even though such statements can be literally true on their own.\[168\] The making of overly optimistic or pessimistic opinions or estimates of financial projections is particularly susceptible to this charge.\[169\]

The Supreme Court has held that stock purchase victims could avail themselves of implied private cause of actions under Rule 10b-5 in addition to those remedies expressly made available under the provisions of the 1933 SEA.\[170\] Unlike actions by the SEC or federal prosecutor, private claims have to contend more with the issues of reliance, causation, and remedies. The complications are compounded by the fact that most Rule 10b-5 cases do not fall within the ambit of direct dealings between victims and perpetrators. They are more commonly associated with the issuance of misleading statements like arising from the improper reporting of OBF packages for instance.

\[166\] Section 18 (a) 1934 SEA
\[167\] This section makes it unlawful for the conduct of securities transactions to use any means of cross-commerce, inclusive of facilities in national securities transactions any manipulative instruments in violation of rule imposed by the SEC.
\[168\] SEC v Texas Gulf Sulphur Co., 401 F 2d 833 (2d Cir. 1968)
The Supreme Court resolved this issue, when it upheld a decision in a District Court case that relied on the commonly known ‘fraud on the market theory’, which is a presumption of law grounded in the efficient capital markets hypothesis.\[171\] The fraud on the market theory demonstrates a mechanism through which false statements can cause losses to victims who might never be aware of it. The 1995 amendments to the 1934 SEA have, nonetheless, placed the burden of demonstrating loss causation on the victims.\[172\] In other words, the victims will have to show that general economic factors could not have generated the same damage. This fraud on the market doctrine may be criticised for creating an incentive for investors to remain uninformed and ignorant resulting in a less efficient market.

Financial Advisors and Other Gatekeepers

Gatekeepers as adopted in this study refer to ‘intermediaries who provide verification and certification services to investors’. These cover verification of corporate financial statements by auditors; evaluation of corporate prospect by financial analysts or creditworthiness by debt rating agencies; and the work of solicitors in IPO and related functions. \[173\] Though corporations pay the evaluation and related fees paid to gatekeepers, the market recognises that the latter has less incentive to deceive than the former as they are said to pledge their reputational capital on the line. Theoretically, gatekeepers are argued to be unlikely to risk their hard-earned reputational capital for

\[171\] Basic, Inc v Levinson, 485 U.S. 224 108 S. Ct 978 (1988). The Supreme Court whilst formally endorsing the fraud on the market theory of reliance in cases of securities fraud also found that the presumption of reliance may be rebutted by the defendant demonstrating that the price was not affected by their misrepresentation, or that the plaintiff did not trade in reliance on the integrity of the market price; Affiliated Ute Citizens Utah v United States 406 US 128 (1972); TSC Industries v Northway Inc 426 US 438 (1976); Blackie v Barrack 524 F 2d 891; Duffy, M., ‘Fraud on the Market’, (2005) 29 MULR, 621-664

\[172\] Rule 21D (b) (4) 1934 SEA

any single client, as they do not share in the benefits from corporate fraud. The US courts generally uphold this view. \[174\]

Yet, the 1990s showed significant gatekeepers’ failure. The ‘general deterrence’ and ‘bubble’ theories seek to explain this. \[175\] The former suggest that both the threat of private enforcement and prospect of public enforcement declined in the 1990s. The former became about because of the shortening of the statute of limitations applicable to securities fraud; the Supreme Court Decision to eliminate private ‘aiding and abetting’ liability in securities fraud cases; the effects of the 1995 Private Securities Litigation Reform Act (PSLRA) and the 1998 Securities Litigation Uniform Standards Act (SLUSA). \[176\] The latter theory holds that in classic bubble situations, investors practically reduced their dependence on gate-keeping services because of their optimistic assumption that the extraordinary returns will persist.

As some gatekeepers may become more prepared to risk beating the system, the Supreme Court held that under Rule 10b-5 various gatekeepers might participate sufficiently in the deceit such that their own conduct might constitute the construction of a misrepresentation. \[177\] These are exemplified through the making of financial reports or expressions through opinion letters when they are aware that these will be used to perpetuate fraudulent acts in connection with securities transactions. \[178\]

\[174\] Coffee Jr supra note 173 citing the case of DiLeo v Ernst & Young 901 F.2d 624 (7th Cir. 1990)
\[175\] Coffee Jr supra note 173
\[177\] Gevurtz, supra note 147
\[178\] ibid, citing the cases of Anixter v Home-State Products Co., 77F 3d 480 (3rd Cir. 1994) and Kline v First Western Government Securities, Inc., 24 F. 3d 480 (3rd, 1994)
Additionally, omission may also lead to misrepresentation of material facts when corporations and connected gatekeepers fail to correct mistakes, which they have become aware of. This can constitute a form of violation of Rule 10b-5.\footnote{ibid, citing the case of Backman v Polaroid Corp., 910 F. 2d 751 (1st Cir. 1990)} Corporations and gatekeepers also have a duty to update statements, which have been rendered obsolete by subsequent events.\footnote{ibid, citing the case of Greenfield v Heublein, Inc., 742 F. 2d 751 (3rd Cir. 1984)}

Finally, it has been further argued that probably the higher competitive environment, enhanced conflicts of interest, and the perceived decline for the reputational capital market caused gatekeepers to become more prepared to sacrifice their reputational capital and hence assumed greater legal risks.\footnote{Coffee Jr., J. C., ‘Gatekeepers: The Professions and Corporate Governance’, OUP: Oxford, 2006} Unfortunately for them, they became the targets of various class action suits subsequently when the market boom subsided, due principally to their deep pockets.

**Auditors**

Four bodies are potentially involved in the enforcement of ethics and standards, namely; the State Boards of Accountancy; the SEC; the AICPA Professional Ethics Division; and the Joint Trial Board comprising the Ethics Division and the State Boards concerned. Members faced disciplinary actions in the form of expulsion, suspension or admonishment. Of critical importance to practising accountants are violations pertaining to state licensing statutes, which can lead to suspension or revocation from practising.

Blameworthiness is fast becoming the bane of the auditing profession. When corporations performed badly or worse still collapsed, investors and creditors not only...
looked towards directors but also third parties like financial advisers, attorneys and auditors for financial recovery.\[182] In most instances, professional service firms prefer to settle out of court because of the adverse impact on office morale and business ties.

In the United States, common law is state dependent. This means that courts in a particular state are not obliged to follow the case precedents in other states; but may borrow principles from other states where it does not have the pertinent precedents of its own. Courts are bound to follow statutes enacted by the federal or state legislatures unless these conflict with the federal or state constitutions. Courts will resort to their own interpretations where provisions of the statutes concerned are not explicit enough. In respect of audit statements and other related services, auditors may be liable for ordinary negligence, gross negligence, or fraud. To achieve these, the victims have to prove that they had relied and suffered damages arising from misstatements in the audited financial statements; and that adequate employment of Generally Acceptable Accounting Practices (GAAP) should have spotted such misstatements. The courts have reaffirmed the GAAP as the appropriate framework for evaluating fairness.\[183]

Ordinary negligence occurs when auditors fail to exercise reasonable care in their work. Gross negligence occurs when auditors fail to exercise minimum care. Fraud occurs when auditors issue opinions on financial statements or audit reports, which they know to be untrue. It differs from gross negligence in that the auditors not only

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\[182\] Konrath, L. E., ‘Auditing: A Risk Analysis Approach’, South Western Publication: Cincinnati, 2002, citing Arthur Anderson’s contributing negligence of US $220 million (WSJ, 10/12/1998, B15) in favour of Waste Management’s shareholders; BDO Seidman’s negligence payment of US $44 million over failure to detect any inventory overstatement (WSJ, 26/04/1999, B4), and Ernst & Yong negligence suit from Jackson National Life Insurance Company over failure to detect inflated sales (WSJ, 30/03/1999, B5); The Standard Securities Action Clearinghouse reported that in 1998, 235 corporations were identified as defendants in federal class actions securities fraud lawsuit.

\[183\] U.S. v Simon et al., 425 F. 2d 796 (2\textsuperscript{nd} Cir. 1969)

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lack reasonable foundation for their beliefs but also are aware of the falsity and intention to deceive. There is therefore a continuum of misrepresentation extending from innocent (belief with sufficient basis) to fraudulent (with awareness of falsity).\[184\] However, where there is collusion and senior management override of internal control systems and procedures, it is unlikely that auditors will be caught with gross negligence.\[185\] Nonetheless, gross negligence can occur where there is recklessness, and where adequate implementation of GAAP should have uncovered the errors or fraud (the Ultramares principle).\[186\] The case for fraud against auditors is founded on intentional deceit and auditor complicity.\[187\]

Within the context of contract law, auditors may face contractual liability to their clientele for ordinary negligence, gross negligence, and fraud. This is normally not extended to third parties because of the privity of contract principle. This limitation does not apply where a third party is known by the auditor to rely on the audited statement.\[188\] This was reaffirmed in another case where it was ruled that auditors should be held liable for negligence for careless financial misrepresentation, which is used by an actually foreseen and limited class of persons.\[189\] Even when an auditor’s opinion is attached with a disclaimer, this principle still holds.\[190\] The courts have also held that for privity to be extended to third parties; auditors have to be aware of the specified use of the audited statements by a specified third party and their reliance

\[184\] Konrath, supra 182  
\[185\] Konrath, supra note 182 citing the case of Cenco Inc. v Seidman & Seidman, 686 F. 2d 449 (CA 7 1982)  
\[186\] ibid, citing the case of Ultramares v Touche, 225 N. Y. 170, 174 N. E. 441 (N. Y. Ct. App. 1931)  
\[187\] ibid  
\[189\] Konrath supra note 184, citing the case of Machata v Seidman & Seidman, 644 So. 2d 114 (Fla. App. 4 Dist, 1994)  
\[190\] Konrath, supra note 184 citing the case of Rhode Island Hospital Trust National Bank v Swartz 455 F. 2d 847 (4th Cir. 1972)
on these for those expressed purposes. The California Supreme Court has also made provisions for the possibility that third parties specifically identified in audit contracts as beneficiaries could sue under suitable conditions. All these implies that the law involving auditors’ negligence to third parties is still evolving not least in states which had to grapple with the issue, but also those which have yet to address it.

Both the 1933 SEA and the 1934 SEA expanded auditors’ liability to third parties beyond the boundary of common law. Here, the plaintiff will not need to prove reliance, but instead the defendant will have to demonstrate that the former is aware that the disputed section of the reported document is false. Section 10(b) of the 1934 SEA and Rule 10b-5 are also wide enough to create an implied liability for auditors, but unlikely to attract strict liability due to the Supreme Court ruling that negligence was not adequate to violate Rule 19b-5 as there must be scienter.

Errant conduct of auditors may also attract criminal liability, principally under the securities fraud and false-filling statute under the 1933 SEA. In particular, Section 32(a) of the Act prohibits violations with intent of any provisions of the 1934 SEA or

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[193] ibid, citing the case of Bily v Arthur Young & Co., No. S017199 (Cal. Aug. 27, 1992): Hemraj, M. B., ‘Taking Stock of Caparo’, Company Lawyer (2006) 27 (3), 82-89. Here, the researcher argues that, ‘The Courts in the US, in their attempt to limit the indeterminate class of people to whom an auditor may be liable, require the plaintiff to rely on the audit report which was not foreseen but also acknowledged by the auditor. Besides the plaintiff, being a known user of the financial statement, a third party claiming reliance would succeed if the sole reason for audit work should be for their benefit. Further more, the relationship between them has to be equivalent to privity-based on direct communication and representation’.
[194] Guy, Alderman, & Winters, supra note 188; s. 119 a (o) 1933 SEA
[195] Gervutz, supra note 147 citing S. 11 1933 SEA, which does away with the common law requirement of scienter and perpetuators are held strictly liable for any misrepresentations in the registration statement
[196] Gervutz supra note 147, citing the case of Ernst & Ernst v Hochfelder, 425 U.S. 185, 96 S. Ct. 1375, 47 I. Ed. 2d 668 (1676).
of SEC rules under it.[196] For such criminal proceedings, the U.S. Justice Department or the state attorney general will file for violation of a criminal statute as plaintiffs. The primary defence available for auditors in this situation is to argue on the basis of good faith and the demonstration of due care supported by thorough documentation of the audit.[197]

For the express purpose of overseeing public accounting firms, the SOA provided for the establishment of the Public Company Account Oversight Board (PCAOB).[198] The PCAOB is, however, not entirely autonomous as the SEC has some level of oversight over it.[199] In line with PCAOB’s primary objective, all audit firms performing work for listed corporations are required to register under it.[200] The PCAOB will levy a registration fee, which will vary from time to time for this purpose.[201] The main obligations of the PCAOB are the setting up of auditing, quality control, ethics, independence and other related standards in connection with the compilation of audited statements.[202] Foreign public accounting firms are also subjected to the Act and the oversight of the PCAOB.[203] Sanctions in the form of censure to financial penalties can be imposed on errant firms.[204]

[196] Guy, Alderman, & Winters, supra note 188. Here, the researchers explained that auditors may also be criminally prosecuted under the mail fraud statute; s. 24 of the 1933 SEA; s. 404 of the Uniform Securities Act; various state criminal fraud statutes; Rule 102 of the SEC’s own internal rules which empowers the SEC to sanction those who engaged in improper or unethical conduct from practising before it. The relevant partners of Deloitte & Touche and Arthur Anderson respectively auditors of Fine Host Corporation (in 2001) and Sunbeam, Inc (2003) were barred from practising for 2-3 years.
[197] Konrath, supra note 184
[199] Backer, supra note 198, citing s. 107 (a)
[200] Ibid, citing s. 102 (a)
[201] Ibid, citing s. 102 (f)
[202] Ibid, citing s. 103
[203] Ibid, citing sections 106 (a) (1), 106 (c)
[204] Ibid, citing sections 104-105
To deter and prevent future conflict of interests between auditing firms and their clientele, the SOA widens the prohibitions of non-audit services, which can be offered to audit customers.\[205\] It even excludes tax services not pre-approved in advance by a corporation’s audit committee.\[206\] Similar to much of the other provisions in the Act, exemptions from these provisions are nonetheless available.\[207\] Further in order to enhance objectivity in audit work, an audit partner can now serve only for five financial years on rotational basis.\[208\]

**Aggressive Enforcements**

Post-Enron saw an apparently unprecedented series of fast-paced fraud enforcement cases made against corporations and high profile corporate leaders in the US. It has been argued that the charges avoided accounting matters and seems to fall into the categories of non-accounting behaviour (like electricity trading fraud); behaviour consequential to core accounting issues (like failure to declare tax liability and obstructing justice); and behaviour incidental to executing accounting practices (like wire fraud and aiding and abetting). Whilst effective in securing convictions in many of these corporate cases and providing perhaps good deterrent lessons for corporate America, it fails to give the signal against the use of manipulative accounting devices for unjust enrichment or other improper agenda. Such creative compliance practices could be deterred to some extent by the use of deferred prosecution agreements and the extra-legal developments of ‘corporate social responsibility’.\[209\]

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\[205\] ibid, citing s. 201 (g)
\[206\] ibid, citing s. 201 (h)
\[207\] ibid, citing s. 201 (b)
\[208\] ibid, citing s. 203 (j)
however, needs to be used with more thought due to recent judicial criticisms that overzealous prosecutors in the KPMG tax cases may have violated the constitution.[210]

UK and US Comparative Positions

The use and disclosure of OBF packages in the US and the UK are converging along common themes in the aftermath of the Enron and related financial debacles. The US has responded mainly through the SOA and the UK through various reviews of its corporate governance code (as exemplified by the reviews conducted by Derek Higgs and John Smith), which culminated with the 2003 Combined Code and subsequently further modified in June 2006. The main thing to note where corporate governance is concerned is that the US basically adopts the market-pricing framework in contrast to the modified stewardship model embraced by the UK and various parts of Europe. Flowing from this, the concern in the US is about rules, which corporations have to certify that they have complied with. Whereas in the UK, the focus is on how corporations are being managed, risks management, and whether and how such matters are being communicated to the shareholders.

The most distinctive difference is that in the US prescriptive system, public listed corporations are required to comply with prescribed rules, certify that they have done so, and report these accordingly to the relevant oversight bodies. In the largely

Prosecutions and the Independent Monitor’, IJDG, Vol. 2 (4) 2005, 325-347. Here, the researchers also question the value of such agreements in the context of uncertainties over eligibility criteria, sanctions limits, and the cost of maintaining an independent monitor
principles-based UK system, there is reliance on ‘the comply or explain’ mechanism. Hence, it is said that in the US it is about compliance, certification and reporting and in the UK it is about doing what is right for the corporation.

The US also puts greater relative emphasis on the separation of owners and management by insisting upon having majority independent directors, and 100% independent membership of its nominating and remuneration committees. The UK merely requires balanced representation for its board and other board committees. This often results in the UK having a more balance orientation from its board.

Flowing from this, it is claimed that judgement on people issues is allowed to flourish. ‘It’s the soft issues around board dynamics, body language, which supports a more entrepreneurial approach’.[211]

The UK argument for balanced representation on the board is based on the premise that it will provide for greater accountability to ensure stability and long-lasting value for shareholders. In contrast, a US board is commonly dominated by a powerful CEO. This will mean that the board will hear from only one voice, and when his actions become fraudulent, but still appears to comply with the rules, then it will be difficult to detect these, let alone challenge them.[212]

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[211] (a) Perry, M., ‘How UK and US Differ on Corporate Governance’, Finance Week, 13/07/2005, 15; (b) Vasilescu, A. M. & Russello, G. J., ‘As Gatekeepers, Independent Directors of Public Companies Faced Additional Security and Liability in the Post-Enron/WorldCom World’, IJDG, Vol. 3 (1) 2006, 3-15. This research demonstrates that independent directors in the US are now taking actions and exercising their powers in the wake of settlements in WorldCom and Enron and SEC’s recent enforcement actions under the SOA. These twin developments indicate the vulnerability of independent directors to real financial, regulatory and criminal liability if they fail to execute their duties properly.

[212] Keenan, J., ‘Corporate Governance in UK/USA Boardrooms’, Corporate Governance, Vol. 12 (2) April 2004, 172-179. This research indicates that some 75% of S & P 500 US corporations have the functions of the CEO and Chairman residing in the same person, whilst this is not usually the case in the UK; Class actions in 2005 against outside/independent directors in the US (10 in WorldCom settling with US$ 50m, and 18 in Enron settling US$ 13m) have caused them to respond by taking greater charge of corporate affairs when confronted with regulator scrutiny. These are exemplified in Computer Associates (SEC Litigation Release no. 18891 (22/09/2004) and AIG (AIG Press Release, 21/04/2005)
This probably helps explain partially the higher incidence of frauds in the US in comparison to that in the UK as powerful inside directors and financial intermediaries collude to circumvent the rules to manipulate earnings report for improper agenda. A more precise comparison between financial governance as updated by the Turnbull Committee in the UK and by the SOA is provided below: [213]

- UK: Guidance should not be confined to financial reporting but should cover all internal controls.
  US: There is focus on financial reporting controls.
- UK: There should be no restrictions on corporations’ strategies to employ the guidance in manners appropriate to their own respective circumstances. The ‘comply or explain’ principle should continue to be in use.
  US: All corporations are required to comply with all rules.
- UK: It is not appropriate for board of directors to comment on the effectiveness of a corporation’s internal control system in its annual reports and accounts.
  US: Directors have to personally attest to the effectiveness of internal controls in the annual report and accounts. CEOs and CFOs in particular have to certify on the truthfulness and fairness of annual financial statements.
- UK: External auditors’ responsibilities in respect of a corporation’s internal control statement should not be extended.
  US: External auditors are required to attest the effectiveness of the internal controls of corporations.

[213] supra note 211 (a), paragraphs 9 & 12
The broad financial governance framework appears to dictate how OBF packages have to be handled in financial reports. The UK in adopting the principles approach has come to rely on substance or commercial reality principle when dealing with the reporting and disclosure of OBF packages. However, this has been permeated to some extent by the rule-based approach on account of the adoption of the IFRS, which are to some extent rules-based especially in respect of IAS 32 and IAS 39 as discussed earlier.

Where legal implications are concerned; directors, external auditors, financial advisers, and financial regulators are all exposed to litigation risks in varying degrees. Cases like Enron and WorldCom in the US have demonstrated that rules for the reporting of OBF packages have been circumvented in various ways. The UK on the other hand witnessed much less errant behaviour in respect of the reporting and disclosures on OBF after the introduction of FRS 5. This financial standard was formulated for guidance after various financial debacles in the 1980s.

It is as yet inconclusive as to whether FRS 5 will completely eradicate the incidence of financial misrepresentation, as shown by the financial debacles in Barings, Independent Insurance Group, Farepak, and Transtec after its introduction.\[214\] This has become to some extent academic, as the UK has now embraced IAS 32 and 39, which operate more in the US rules-based tradition, at least where some OBF schemes are concerned. Early indications appear to show that the overall impact of IFRS on UK financial reporting is not unduly disruptive.

\[214\] Jopson, B., ‘PwC Fined for Audit Failures Linked to Transtec Collapse; ‘How Transtec’s Troubles Tarnished PwC’’, Financial Times, 14/12/2006, 1 & 20 respectively
In comparison, early evidence on the impact of new rules introduced by the SOA has resulted in a significant increased of Financial Statement Restatements but moderate increase in prosecution of various financial indiscretions. Again, further analysis is necessary to have a more conclusive understanding of the impact of the new OBF reporting rules in order to appreciate their legal implications for direct and indirect parties involved in their employment and financial reporting.

Not all earnings and liability disclosures are illegal acts.\textsuperscript{[215]} ‘It is precisely because earnings management is not per se illegal, and the valuation of assets and liabilities often contains an element of legitimate subjectivity that the line between aggressive accounting and violative conduct requires careful attention’.\textsuperscript{[216]} The conflicts of interest between management and shareholders at times cause public corporations’ reported financial performance to diverge from their actual performance. The liability of those directly and indirectly responsible may then be evaluated under the legal standards of financial fraud. These are of serious legal implications to corporate directors, auditors, financial advisers, and financial regulators; particularly where the intention to defraud is established.

Whilst those associated with the use of OBF and the manner it should be reported have to be mindful of the legal implications, the confidence and integrity of capital markets can be sustained only if corporate financial disclosure is reasonably explicit and reliable. ‘Thus, the boundaries of acceptable accounting must be policed

\textsuperscript{[215]} DeAngelo, H. et al., ‘Accounting Changes in Troubled Companies’, Journal of Accounting and Economics 7, 1994, 113; Norris, F., ‘High and Low Finance: Forcing reality in Accounting of Tiny Firms’, New York Times, 13/10, 2006, C1. This article noted that the total number of restatements went up in 2005 and early 2006 especially among smaller firms. It suggested that this may be attributed to the effectiveness of the work of the Public Company Oversight Board on larger companies.

aggressively. Given the motives for deceit that will always exist, opportunity for fraud must be limited by the constant refining of our standards in the light of commercial reality'. [217]

The US authorities have effectively used deferred prosecution agreements and plea-bargaining to confront corporate wrongdoers and in the process achieved higher enforcement success rates. In contrast, the UK authorities mainly through the FSA prefer the civil route because of the relatively higher hurdles they faced in serious white-collar crimes. The continued obstacles faced by the Serious Fraud Office (SFO) is reflected by its December 14, 2006 decision to cease its investigation of alleged improper financial misconduct perpetuated by BAE and various members of the Saudi royal family. The Attorney-General emphasised that the SFO’s decision ‘…was taken out of necessity to balance the need to maintain the rule of law against the wider public interest, and that no weight had been extended to commercial interests or to the national economic interest’.[218]

It is to be noted here that about a week prior to this, the Saudi authorities had indicated that it would withdraw future contracts for BAE if the SFO does not cease its investigations and that would have meant the loss of a lot of jobs and export

[217] ibid, 997; Green, S. P., ‘Lying, Cheating, and Stealing: A Moral Theory of White-Collar Crime’, 2006, OUP: Oxford. The flexible US judicial approach for modern misleading offences in the US (like mail fraud, securities fraud and theft by deception) recognises that a statement that is literally true may constitute fraud as long as it is both material and made with the intent to deceive. These include, ‘…representations as to the past or present, or suggestions and promises as to the future (Durland v US 161 US 306 (1896), 313-314)’, and disclosures required by securities laws which are’…measured not by literal truth, but by the ability of the material accurately to inform rather than mislead prospective buyers (Lucia v Prospect Street High Income Portfolio, Inc 36 F 3d 170 (1st Cir 1994), 175’; McMahan v Warehouse Entertainment, Inc, 900 F 2d (2nd Cir 1990); Langervoort, D. C., ‘Half-Truths: Protecting Mistaken Inferences by Investors and Others’, (1999) 52, Standford Law Review 87. This article addressed treatment of half-truths, misrepresentation, and nondisclosure in securities fraud cases.

income. Despite this episode, and the proliferation of the use of SPEs or secret trusts in British tax havens in Jersey and the Cayman Islands, regulatory enforcement of financial services laws in the UK is still comparatively less subject to political intrusion than that in the US as indicated in earlier discussions.[219]

At this current stage, FSA in comparison to the SEC is facing some criticisms over its handling of illegal insider trading. This casts doubts on the regulator’s enforcement effectiveness and with it some apprehensions over its long-term effects on the integrity of the UK capital market. Whilst the SEC has filed more than 300 insider trading cases since 2001 against more than 600 corporations and individuals, the FSA took actions only on 8 cases since 2001 and none for the first half of 2007.

The FSA pointed to the difficulties of enforcement and enormity of the tasks involved; but more importantly the reality that it lacks the tools SEC has, partly because UK law prohibits it from using plea bargains or deferred prosecutions agreements. FSA’s own annual ‘market cleanliness’ surveys since 2000 suggests that illegal insider trading may have occurred prior to 25% of announced deals.[220] Illegal insider trading like OBF deceptive and manipulating reporting is market abuse offences. This suggests that FSA’s enforcement of OBF wrongdoings may also require a more robust approach. In this respect, the idea of making OBF a category of monitored activity may merit further study.

Finally, directors, auditors, and financial advisors in the US in comparison to those in the UK in general face a legal environment uniquely conducive for litigation against them. These have been attributed to the widespread use of class action and derivative suits in the US; the treatment of plaintiffs’ attorneys as entrepreneurs seeking out legal violations and suitable clientele; and the fact that US litigants have to pay their own legal expenses regardless of case outcome. As a counterbalance, however, US directors and in particular inside directors are shielded from out-of-pocket payments by the access to the BJR, corporate charter provisions that eliminate liability for breach of duty of care, indemnification, and D&O insurance. In contrast, the shields against liability for directors in the UK are comparatively weaker, but lawsuits are also of lesser significance.[221]

Still, to allay the fears that the UK may go the US way because of the emergence of case likes Equitable Life and Independent Energy Holdings where non-executive directors were made to pay out-of-pocket expenses, the UK 2004 company law amendment provides for the advancement of legal expenses and indemnification in third-party suits and the purchase of better D&O protection. As for the possibility of US style ‘send a message’ lawsuits, it has been argued that this is unlikely to gain a foothold in the UK because ‘Politics is less likely to come into play with British public sector pension scheme since the trustees are nominated by members rather than selected by politicians (as in the US) and the trustees delegate management of investments to advisors’.[222]

[221] Cheffins & Black, supra note 60 (b), 1419
[222] ibid, 1420
Chapter Five

Case Analysis and Discussions

Introduction

The previous analysis of various corporate scandals in both the US and the UK has suggested that some businesses have been motivated by financial greed and the need to hide poor performance as they manipulate the use of OBF. Such actions have generated serious financial and legal implications for the preparers, auditors and advisors involved in corporate financial reporting. The analysis has also shown how the initial use of OBF for financial window-dressing can lead down the slippery slope to less honourable applications under heightened commercial pressures. These are, however, counterbalanced by those who are able to use OBF in more constructive ways for liquidity enhancement and lower financial costs. This chapter will examine more closely the motivations and legal risks associated with the manner of OBF applications by undertaking the cross-case analysis of three pairs of UK and US listed corporations.

The first pair in each jurisdiction comprised corporations using OBF with fraudulent motives; the second pair for window-dressing of its financials, and; the third for beneficial economic reasons. Intra-country cross-case analysis will compare and contrast the three pairs of cases within each jurisdiction. To compare and contrast the cases between each jurisdiction, inter-country cross-case analysis will be undertaken thereafter. A summary of the cases used in this study is provided in Annex 1 (One). Further details are located in the researcher’s working file.
US Cross-Case Analysis

**Manipulative Use Cases**

Analysis of the first two cases namely, Enron and WorldCom appears to suggest that OBF mechanisms were used in fraudulent ways. Both corporations started off as well run profitable companies involved in dominant global scale businesses. It would appear that their initial success resulted in massive support from Wall Street and from the corridors of political power in Washington. Their success through massive acquisition strategies appear to produce phenomenal growth and profit results.

Investment bankers, financial underwriters, rating agencies and analysts also acknowledged Enron and WorldCom as global innovative corporations of the future. Their consequent powerful support drove these corporate stocks to dizzy heights. These financial intermediaries and the executives and directors of the two companies made huge profits. For as long as the profits made were factual and above board, no significant harm came to investors and creditors.

Problems arose when the reported profits could not be sustained as a result of weakening market conditions for their core businesses and huge losses amassed by their substantial acquisitions. The resulting huge losses and further acquisitions had to be funded by further debts and equities. To avoid downgrading by the rating agencies which would have disastrous effects on their stock values and future capacity to raise funds both corporations chose to make massive use of OBF and related creative accounting techniques to manipulate their financial reporting. The cover initially provided by the SPEs was finally removed by internal whistleblowers relaying information to the internal audit committees of both corporations and by the
emergence of some negative media reports. Under pressures of investigations by the SEC, both corporations had to make financial restatements.

Normally, financial adjustments are made over errors caused by genuine judgemental errors over accounting policies or conventions. In their case, however, it became clear to the financial community that both corporations had resorted to use OBF and in particular SPEs and aggressive revenue reporting for financial manipulation. When their financial charades were exposed, both corporations’ stock values took severe beatings. This prompted further cash flow problems, which finally resulted in their bankruptcies.

The downfall of both corporations resulted in massive financial losses for investors, creditors and suppliers and massive loss of jobs. The huge public outcry especially over Enron’s scandalous failure and the exposure of improper financial governance prompted Congress to introduce the SOA to safeguard investors’ interest with a comprehensive package of reporting and governance measures. This aside, the SEC in conjunction with the state prosecution offices concerned began to launch civil and criminal proceedings against various perpetuators of the corporate scandals.

Consequently, various key directors and executives in Enron and WorldCom were finally charged with criminal offences under sections 11, 15, and 10(b) of the securities regulations for making false and misleading financial statements. It should be emphasised that in both cases, the acts of the defendants involved the use of OBF and other instruments for the deliberate understatement of huge debts as well as the falsification or misrepresentation of financial reports.
The use and proper reporting treatment of OBF instruments for liquidity enhancement and access to cheaper funding are considered in some quarters to be innovative funding tactics albeit on the aggressive side. Both corporations were initially pursuing such beneficial economic objectives. However, the directors and management also succumbed to the temptation of share riggings and insider trading to accumulate massive wealth. Once this agenda became tied up with the desperate need to cover the huge corporate losses, a series of illegitimate acts had to be perpetuated to shield the corporations’ fractured finances from the capital market.

For some reasons, the key directors deceive themselves that their actions were appropriate and that they were behaving altruistically rather than greedily. This probably account for their complete disregard to the risk that they may loose everything from wealth to personal reputation. Their undertakings of such massive corporate frauds resulted in subsequent huge fines and long-term jail sentences imposed on them by the state. Indeed, instead of beating the system through the deceptive and reckless use of OBF, the key directors of both corporations became victims of their own financial greed, reckless management behaviour, and self-deception.

The management’s ability to perpetuate corporate fraud was considerably assisted by very co-operative actions from financial consultants and credit suppliers. These institutions and individuals gave support and credence to the deceptive financial schemes devised by the management, resulting in the initial euphoria and huge profits for every direct and indirect participant. Their collusions and abetments to such fraudulent schemes generated serious legal implications for themselves. The
seriousness of each varied in accordance with the specific nature of their conduct. Most of them were investment banks and institutional brokers which had provided consultancies or funding for the financial shams.

Subsequent to the demise of Enron and WorldCom, these institutions were financially disciplined by the state through hefty fines reaching billions; and are still facing or settling with liquidators over their breach of fiduciary duties as well as the federal securities laws. Fortunately, for some of them, the US Supreme Court on June 18, 2007 held in the case of Credit Suisse Securities (USA) LLC v Billing that securities laws implicitly precluded application of the antitrust laws to agreements among underwriting firms relating to initial public offerings. Otherwise, the fine imposed would have been three times of those imposed through the securities laws.

All the institutions concerned in both cases chose to pay hefty fines through plea bargaining rather than go through long trials. Such arrangements allowed them to avoid conceding guilt, eliminate stress on staff morale, and the quick return to business as usual without serious damage to their business reputation. However, they were required under the agreed arrangements for deferred prosecutions to subject themselves to proper professional conduct certification for appropriate durations by approved external consultants.

The auditor of Enron and WorldCom was Arthur Anderson (AA). The financial deception and false accounting were perpetuated in both listed corporations through the use of SPVs and other creative accounting techniques. Evidence unfolding slightly before the demise of both corporations seems to suggest some level of collusion on the part of the auditing firm. The shredding of audit papers by Arthur
Anderson staff in the case of Enron made matters worse. In both cases, financial restatements submitted for their previous two to three years’ fiscal positions indicated the vast extent of material misrepresentations in their earlier submissions. These constituted good grounds for legal actions against the corporations and the inside directors for infringement of section 11 of the Securities Act. The SEC also made enforcements against external directors, which were settled through the latter’s own pockets. This was uncommon during the pre-SOA period.

Similarly, AA had to face class action suits from investors for providing unqualified audit opinions in the registration documents. It was alleged that AA’s audit of these corporations’ accounts had not been conducted in accordance with industry practices. AA’s position during the trial process became untenable against the onslaught of mounting civil suits, investigative SEC actions, and the mass exodus of its clientele to other auditing firms. Ironically, it was only after the demise of AA that the Supreme Court ruled in its favour principally on the grounds that the audit firm did not possess the intention to materially mislead when it gave unqualified opinions to the materially defective audited statements.\(^1\) This incident showed why audit firms become viable financial targets for victims of corporate fraud particularly when the affected corporations have become insolvent.

Auditing firms have long argued that corporate frauds are perpetuated by key executives or directors who through collusions among themselves and with other professionals were able to prevent fraud detection. They further argued that it was not their professional duty to prevent financial crimes. On the other hand, it can be counter-argued that whilst audit firms are not expected to be able to prevent financial

\(^1\) Lane, C., ‘Justices Overturn Anderson Conviction’, Washington Post, 01/06/2005, A01
scams, greater public confidence can be secured when audit firms adhere closely to their professional standards and by being more vigilant as financial gatekeepers. Hindsight aside, it is difficult to understand why the controversial treatment of OBF and other related items were merely glossed over, despite their sheer size, and their potentially high default risks. Serious questions could have been easily raised further on the reported cash flows which are not in proper alignment with the reported profits. Answers for such unwarranted lapses of concentration may be found in the profitable consultancies extended to AA in both cases.

Until these cases, no audit firms of AA’s size have been seriously indicted for exceeding the limits of US Securities and related laws. The usual punishment involves monetary fines, which firms like AA have covered through insurance. This more than anything else helps to explain the occasional cavalier attitude displayed by AA and others in the course of their audit. Such over-confidence may have contributed to fault lines in the profession. Unfortunately, this time around such lapse of focus and attention became too costly and the firm failed long before the outcome of its indictment or civil suits.

It has been claimed through anecdotal evidences that Enron and WorldCom were not the primary cause of AA’s demise. Instead, Enron was the trigger for the slow form of professional suicide that had begun some years earlier. The primary causes have been attributed to intense competition between the Big Four international audit practices, the fight for market shares and consultancy earnings, and above all

serious conflicts of interest at the expense of audit standards and overall business ethics.

Despite the aftermath of Enron and WorldCom and the presence of SOA, many pertinent searching questions about the profession still haunt the corridors of financial governance circles.\[^3\] In the face of public criticisms, the accounting profession has strived to improve its professionalism, but what it requires most is a stronger ethical base to deter professional conflicts. This poses difficult challenges, given the dominance of the big four in the industry and the absence of a viable alternative for the financial system. The fear of another ‘big four’ collapsing probably explained the political interference for the withdrawal of prosecution against KPMG in January 2007 over various tax shelter scams. Nineteen of their senior executives including its chief financial officer are, however, still facing indictments.\[^4\]

**Financial Window-Dressing Cases**

The Boston Chicken (BC) and Sunbeam Corporation (SC) cases unlike the previous two are not so clear-cut in terms of financial fraud. The facts and events surrounding the two cases appeared to suggest that the management actually perceived that they had complied with the reporting rules for the OBF schemes that they had devised. In the case of BC, its new principal directors and shareholders were from a capital market and big business background, and ergo considerably familiar with the workings of the stock market. Their strategy was to use the good access to funds in the capital market to fund a rapid growth strategy. Accordingly, they developed the

\[^3\] ibid, 591
\[^4\] The Economist, ‘Business’, The Economist, 22-28/10/2005, 9. The firm itself had to pay a hefty fine to the state, and to agree to be put on professional probation for a year pending assessment by an independent consulting firm.
concept of ‘area franchisors’ (AFs), whereby experienced franchisees were appointed
to host more than a dozen or so of other sub-franchisees. This way the number of
franchisees was able to multiply manifold in comparison to the traditional concept of
franchising. Also unlike traditional franchising, AFs needed only to finance twenty
percent or so of the funds required. The rest of the finance in the form of convertible
equity options were provided by a SPV indirectly controlled by BC through
representation by its senior executives.

The US accounting standard guideline clearly stressed that the test for consolidation is
the control and direction of an involved enterprise and not the twenty percent
threshold, which BC had interpreted to its convenience. Initially, BC had
shrewdly strategise to convert their options into majority equities only when the AFs
were making money but not when they were losing money. This meant that only
profitable AFs were consolidated as subsidiaries and those which were not were kept
out of BC’s consolidated financials even though BC was liable for their losses and
debts.

Consequently, critics claimed that BC had understated the true extent of their huge
debts. BC had, however counter-argued that this arrangement had been made explicit
in the footnotes of their financial documents. This contention has not been well
received as critics claimed that investors at large tend to look at key data
especially that of earnings and earnings growth, and that such crafty reporting in
essence has distorted these indices. BC’s choice of reporting for AFs as such did not
go down well with some financial analysts and they became increasingly less
supportive of its business and financial reporting. This subsequently provided
pressures to BC. In terms of actual performance, many AFs and even BC itself were
facing losses on account of intense competition in the market place. To keep up with the charade, more AFs were signed up in the hope that things would turn for the better. Without close management attention, this did not come about. Under pressure from analysts and others in the capital market, BC finally had to own up to the losses in the AFs and with that, and with further commercial setbacks the company went under.

BC’s use of OBF mechanism was therefore primarily undertaken to fund the AFs. Unfortunately, the corporation growing at fanatical speed lost track of its principal agenda, which was to run a high quality healthy fast food business. The excessive reliance on AFS in fact transformed its business essentially to that of a financial service, which required a different management format and approach. BC failed to acknowledge and respond accordingly. Thus, the initial advantage provided through the use of OBF was withered away by excesses and a loss of business direction. The company had therefore used OBF instruments beyond viable economic parameters.

Where SC is concerned, it was originally underperforming but had low debt levels. The company then appointed Dunlap as its new CEO, hoping to transform its ailing business. Dunlap was a cost cutting and turnaround specialist and in the first year of his tenure instituted severe job trimmings to achieve cost efficiency. Despite the reported financial improvement, he was not successful in selling the business as the company was operating in a mature competitive business environment. Dunlap then decided to grow the core business through an aggressive selling policy involving the use of ‘bill-and-hold sales accounting’, which allowed customers to take delivery of
goods ordered over an extended period of time but with sales immediately recognised as revenue. This effectively boosted the company’s turnover even though much of these products could be returned as unsuitable or for other reasons. Further growth through expensive acquisitions of related businesses on the unusual basis of revenue rather than the traditional earnings multiples was also undertaken simultaneously. The artificial sales mechanism and costly acquisitions became a financial burden to the company and had to be financed by huge expensive debts. When BC and these acquisitions failed to perform, the company became insolvent under the weight of these debts.

Under pressure of SEC investigation, both companies had to file for accounting restatements. This prompted class action fraud lawsuits against them and their respective CEOs. In addition, the CEOs had to settle with the SEC over allegations of accounting fraud. The degree of blameworthiness of directors, auditors, and investment advisers vary. In both cases, the CEOs were dismissed and had to face various litigations. The investment advisers and financiers in BC and SC had to settle their civil litigation with compensation payouts to affected shareholders. The auditors involved on this occasion came out relatively unscathed.

The litigation outcomes for both cases were short-circuited by out-of-court settlements. Nonetheless, the main lesson to be drawn from both cases is that when OBF instruments are used for financial window-dressing to understate debts and over-state growth and earnings it would be unsustainable and may result in disastrous financial consequences. Its excessive use and over-aggressive financial reporting may also lead to various legal implications for directors and those who collaborated in
their manipulations through funding or gave assistance and advice in the design of these dubious schemes.

This second pair of cases differed from the first pair in terms of much lower scale of debts and lesser financial complexities where the use of OBF is concerned. Whilst they appeared to be complying to reporting rules, in practice they were heading down the slippery slope of financial window-dressing into illicit financial schemes. As a consequence, the executive directors and advisors had to endure SEC and private litigations for their part in the filing of defective financial statements, which arose primarily from defective reporting of OBF and other over-aggressive revenue recognition methods.

Financial Benefit Cases

Microsoft Corporation (MC) and Worldmart (WM) are two global giants operating with impressive profits in their respective spheres of business. MC has in the initial phase of its operations made substantial use of employees’ stock options plans (ESOPs) as incentives to attract and retain highly skilled personnel. This was common practice particularly in the Silicon Valley in the 1980s until the unravelling of the options backdating scandals in 2006.

In the wake of the Enron turmoil, the financial world became more concerned with the use of ESOPs as it had been recommended by financial regulators, that such options should be treated and reported as expense items, and not buried deep in accounting footnotes. They further argued that this would discourage management from resorting to questionable tactics to drive up earnings reports in order to benefit quickly from such stock options.
MC in 2002 opted to withdraw future use of ESOP and switch to the award of direct stocks as financial inducements for its personnel and directors. Fortunately, the recasting of its affected accounts to take account of its previous ESOPs were easily accommodated by its huge actual earnings reserves. A relatively small amount of OBF in the form of guarantees were only used to support new start-ups it helped launched as well as other business partnerships. All these are captured in the footnotes of the company’s accounts. Where the use of derivatives are concerned, the corporation appears to use them for hedging purposes. However, it is more likely that these are used to enhance earnings as they account for a high 30% of the corporate total. This is, however, financially justifiable given the corporation’s high free cash reserves.

MC used OBF mechanisms for the attraction and retention of scarce talented high-tech skilled personnel but did not make undue use of them. The company rightly focused on the key essentials of its business and it was the effective execution of these that led to its sustained robust revenues and earnings growth. Its profitability was driven by market share dominance and regular infusions of product innovations, and not by financial engineering as seen in the previous four cases. The corporation was also willing to switch to the use of direct stock awards and to expense stock options when granted to keep in line with mainstream accounting practices. It now uses OBF instruments sparingly to assist new venture start-ups and business ventures collaborating with its strategic programmes. Indeed, MC’s forward-looking policy to scrap the use of ESOPs may have help kept the company away from their possible misuse as encountered in 2006 by Apple Computers and others.
WM too used OBF instruments in various SPVs which are complementing the operational aspects of its business, such as its supply chains. Even then, it has been careful enough to keep these within strict limits and for business improvement purposes. Hence, hereto like MC, OBF instruments are used in a small way for proper business objectives and not for improper financial objectives as was the case of the previous four examples. When used in this manner, OBF instruments are justifiable as suitable financial devices for growth seeking enterprises. They can also be of appropriate use to those who need to use them for viable financial restructuring schemes or liquidity enhancing securitisation purposes.

Overall, the manipulative cases showed strong evidence of fraudulent intentions where the use of OBF is concerned, whereas the financial window-dressing cases under sustained commercial pressure and excessive management ambition went beyond their original aims and into reckless and probably illicit activities. In contrast, the operationally well-run companies were seen able to sustain their proper and effective use of OBF for financial savings or liquidity purposes.

**UK Cross-Case Analysis**

*Manipulative Use Cases*

The first set of two cases, involved two financial institutions, namely BCCI and Barings Bank (BB). They became insolvent because of excessive financial leverage carried out with some help from OBF mechanisms. Though these banking institutions showed much similarity in terms of the wrongful application of OBF instruments, they do exhibit some shades of differences in terms of business strategy and management styles. BCCI wanted to reach out to the world markets through social
and political networks; whereas BB wanted to introduce financial innovations in emerging economies by making more and wider use of its core investment banking expertise.

BCCI started its business with the laudable vision of providing financial assistance to new businesses neglected by traditional banking. It also wanted to cater to the needs of the newly emerging economies in Asia, Africa, the Middle East, and South America. These sectors were of high profit impact, but they were also of high risks and required a high calibre of credit analysis and supervision. As a relatively new entrant, its skills in these dimensions were suspect. BB in contrast already had the investment banking expertise in its home market, and had the capacity to leverage this core skill in the emerging markets of Eastern Europe, South America and the Far East on a gradual selective basis.

BCCI’s founding CEO opted to grow fast internationally to achieve the status of a large international bank with global reach. He found that he could achieve this by amassing huge deposits at high interests and on-lend to borrowers neglected by the established traditional banks but who were prepared to pay higher interests in view of various background limitations. This strategy works under the assumption that the level and size of delinquent accounts could be contained effectively. In practice, such high risks accounts were difficult to manage, and the bank soon came under severe stress. This was further weakened by the massive squandering of bank assets as favours to leading politicians in the US, UK, Asia, and elsewhere; and including the personal enrichment of both the founding CEO and his allies. Such massive cash outflows had to be funded by illegal money-laundering activities, and the churning of new deposits.
As BCCI got deeper into such illicit activities, OBF mechanisms like special vehicle companies were regularly used to transfer funds between operations to hide the extent of debt exposure. Artificial loss in derivatives trading was used to cover money siphoned off. In short, reckless financial management involving the use of OBF mechanisms was undertaken to distort the true state of the bank’s financial health.

BB, in contrast was already acknowledged as a reputable investment bank. In the face of intense competition the bank chose to enter the fast growing and lucrative financial derivatives market in the early 1970s.

Whilst the bank did put in place a risk management system, it could only be effective with sufficient management alertness and a high level of personnel honesty and integrity. Leeson who had earned the trust and confidence of BB’s senior management after completion of a difficult assignment in Indonesia was given the authority not only to head BB’s subsidiary in Singapore but also given the dual role of trading and backroom administration. This later turned out to be a fatal management misjudgement.

The collapse of BB has been attributed by the Bank of England primarily to the corporate fraud perpetuated by Leeson, the ‘rogue trader’. Leeson never had initial trading experience when he was first posted to Singapore. He soon found the reporting of high profits from securities trading rewarding, financially in terms of higher personal earnings; and emotionally in terms of enhanced reputation as a high performer in the bank, even though these profits were manufactured and illusory. Soon, he became numb to the growing losses he had begun to accumulate in the now infamous ‘88888 account’, which he secretly used to his advantage.
In essence, this special account functioned like a special purpose entity (SPE) for Leeson’s sole use and manipulation. It was a clear case of criminal breach of trust by a lower rank employee and not by any member of the board or even senior management team. This is the sharp contrast between what happened in BCCI and BB. In BCCI’s case, OBF instruments were used to camouflage its drug-trafficking and money-laundering activities in offshore havens. This was reflected for instance in the indictment of BCCI officials in Tampa Florida and the mounting of fraud charges against its executive directors for misappropriation of bank assets and other criminal misdemeanours. Directors may incur personal liabilities where they breached pertinent statutory duties, engaged in wrongful or fraudulent trading, or not complying with specific disclosure requirements.

In the case of BB, Leeson pleaded guilty to deceiving the bank’s auditors and of cheating the Singapore International Monetary Exchange (SIMEX) and was accordingly sentenced to six and a half year’s jail. Leeson’s use of the unsupervised 88888 account to hide the losses by the artificial creation of false debtors showed how the concept of the special purpose vehicle can be modified for deception purposes. Where the executive directors of BB in the UK are concerned, they were found to have neglected their duty of care and skill to the bank. In other words, notwithstanding their particular experience and ability, they could be evaluated on objective standard of the skills required of reasonable directors. This was found in the judgment of Lord Justice Morrit when he said, ‘Directors have, both collectively and individually a continuing duty to acquire and maintain a sufficient knowledge and

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[8] ibid
understanding of the company’s business to enable them properly to discharge their
duties as directors. Whilst directors are entitled…to delegate particular functions to
those below them in the management chain, and to trust their competence and
integrity to a reasonable extent, the exercise of the power of delegation does not
absolve a director from the duty to supervise the discharge of the delegated
functions’.[9] This appears to emphasise on the objective rather than the subjective
test. It also signals the potential but small litigation risk to non-executive directors in
the common law duty of care and skill. The BB case also showed the willingness of
the judiciary to disqualify directors on the unfit criterion where they fail to properly
discharge the duty of care and skill expected of them.

Inevitably because of the massive fraud, which took place in both cases and the
collapse of two banks of some importance, investors and depositors as well as
creditors were badly hurt in financial terms. Public outcry over the failures of the
auditors to detect the fraudulent activities in both cases led to legal actions against
them by the respective liquidators. KPMG, the liquidator for BB launched
proceedings against Deloitte and Touche for the failure to detect the fraudulent
activities conducted by Leeson. The High Court nonetheless ruled in 2003 that the
failure was attributable to BB’s officials rather than the auditors. The auditing firm
was ordered to pay £1.5 million on minor technical faults instead of the compensation
sum of £131 million sought by BB. The Bingham Report, however, reprimanded the
auditor for not making sufficient concerns to the Bank of England (BE).[10]

at 648; In Equitable Life Assurance Society Bowley and others [2003] EWHC 2263 [Comm.], Justice
Langley said that companies may reasonably look to non-executive directors for independence of
judgement and supervision of the executive management.
From a governance perspective, the audit firm’s role displayed strong signs of professional conflicts of interest. Its consultancy was actively engaged in the financial restructuring package scheme worked out for BCCI. The lack of urgency on the auditor’s part may be attributed to its belief that the bank could be saved by this said scheme. This was further complicated by the fact that the firm was known to have prior knowledge of BCCI’s irregular activities with connected parties.[11]

The Bingham Report was also highly critical of the BE’s role over the collapse of BCCI. The flow of vital information about serious weaknesses at the bank, the dodgy reputation of its founder CEO, and the difficulties of regulating a bank as complicated as BCCI were communicated to BE long before Price Waterhouse did.

However, the BE as the regulator then had to exercise prudence to avoid causing a run at the bank which may engender systemic risk for the entire financial system. Introspection of various weaknesses at the BE resulted in the introduction of newer preventive safeguards to deter and prevent future occurrences of such massive fraudulent activities. This apparently was inadequate. With the fall of BB, the BE was subjected to another internal inquiry. Nonetheless, concerns have been raised that a more rigorous inquiry had been avoided because of this.[12]

In the meantime, Deloittes the liquidator mounted an £850 million misfeasance suit against the BE over its failure to handle the supervision of BCCI properly. The trial which began in January 2004 had by the third quarter of 2005 costs tens of million of

[11] (a) Mitchell, A. et al., ‘The BCCI Cover-Up’, Association for Accountancy and Business Affairs: Basildon, 2001, 32-33; (b) Accountancy Age, ‘BCCI: Auditor Was ‘Deceived’, Chairman Says’, Accountancy Age, 20/04/2006. Keiran Poynter, PwC’s Chairman claimed here that the criminal convictions proved that it was deceived. He also said that the firm accepted the fine of £150,000 on the basis that ‘to continue to contest the matter further would have been an expensive distraction from which no useful lessons would emerged’ . More importantly he stressed the JDS ruling did not say that PwC should have concluded that the relevant BCCI accounts failed to give a true and fair view.

[12] Mitchell, supra note 11 (a)
pounds in legal fees. Deloittes had alleged that BE officials acted in bad faith, and with a knowing disregard for depositors’ interests. The case collapsed on November 3, 2005, some 12 years after the writ was issued, upon the High Court’s decision that it was no longer in the best interests of creditors for litigation to proceed further. As a consequence, creditors ranging from local authorities to petty traders had to assume legal fees of about £100 million. The liquidator had already recovered some 81% of their losses, and it was thought then that the risk of losing £100 million was worth the possibility of recovering a further £850 million from the BE.

Prior to the commencement of trial, questions had always been raised on the immunity status of financial regulators from civil suits. Depositors in regulated institutions have hitherto asserted the claim that they enjoy the right to assume that financial regulators have checked the bona fides of licensed financial institutions and their managers. The House of Lords had earlier ruled that under some circumstances a case of public misfeasance might be brought against such institutions.

Still, immunity for regulators is argued to be necessary as otherwise, ‘…regulatory decision-making would become slow and conservative in order to avoid litigation’. The outcome of this case seems to suggest that compensation suits against banking regulators for public misfeasance and the like are unlikely to be sustainable. The issue, which would then arise is what safeguards can be installed to ensure that regulating bodies discharge their functions properly, if they are not to be

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[14] Accountancy Age, ‘Deloitte To Pay Bank £73 Million Over BCCI: Award Brings Closure to Marathon BCCI Case’, Accountancy Age, 08/06/2006; ‘BCCI Claim Is ‘Most Expensive Fishing Expedition in History’ ”, Accountancy Age, 22/06/2006. Here, the Governor of the BE criticised BCCI’s liquidator Deloitte for taking up the case, and he also said that it demonstrated that the UK legal system is unable to bring speedy resolutions to commercial disputes.
[15] supra note 13
disciplined through compensation suits but only through judicial review which is time-consuming and possibly subject to political interference.

*Financial Window-Dressing Cases*

The next set of two cases, namely Polly Peck International (PPI) and the Robert Maxwell Group (RMG) showed how OBF instruments initially used for assisting strategic growth degenerated into their employment for distortion and misrepresentation of financial performance reporting. The key founding immigrant CEOs of both operations were both corporate leaders with charismatic personalities. Both, however, work through different avenues to transform hitherto medium enterprises to large international conglomerates of some standing in the capital market. Whilst Maxwell had his reputation tainted by a prior DTI inspection report, describing him to be unfit to lead listed corporations, Nadir in PPI appeared to launch his entrepreneur career with a clean sheet.

Maxwell redeemed his reputation subsequently through hard work and significant business success. His initial growth through acquisitions strategy was effective. His powerful social and political networks in high places also aided considerably his business interests. Consequently, he cultivated strong ties with professionals, businessmen, and political leaders, which mattered to his business. He also secured good support from his company auditor, which enabled him to make effective use of creative accounting and in particular OBF instruments to hide the extent of personal and corporate debts. Maxwell’s corporate and personal debts rose dramatically to help fund his plethora of acquisitions. Maxwell’s growth through acquisitions strategy as funded by the capital market in the later stages became unsustainable when many of
them failed to perform. They began to bleed the corporate group instead of making contributions. This drove Maxwell to engage in the raiding of pension funds in his listed vehicles and the use of illegal share ramming activities to shore up stock prices. The latter had to be undertaken as much of his corporate shares had already been collateralised. OBF instruments had to be put to manipulative use to generate a positive spin of the group’s performance to avoid the scrutiny by its bankers and the capital market regulators.

Through such activities, Maxwell was exposed to various legal risks. For instance, his misappropriation of corporate assets provided strong evidence of criminal breach of trust. He could have also been put on further investigation for infringing the IA 1986 for wrongful trading under section 214 or fraudulent trading under section 213 of the same act.[17] Or he could have been held personally liable for misrepresentation of disclosure obligations or as a joint tort feasor with the corporations he was involved in. [18]

Where Nadir of PPI was concerned, he too had started well initially by working hard to grow his pioneering operations. His subsequent over-ambition and impatience led to his downfall. He selected to use his new found access to capital market funds to fund his acquisitions growth strategy. Initially, the strategy worked well and corporations led by him were rewarded with high stock prices. At the later stage, when many of these acquisitions were not performing to market expectations, the stock prices came under pressure. This put additional pressure on him because of margin calls by the lending institutions involved. Instead of coming clean on the

[18] Standard Chartered Bank v Pakistan National Shipping Corp (No.2) [2002] UKHL 43. Here, a director was held liable for making deceptive statements relating to falsely dated bills of lading to secure payment.
inevitable insolvency of his business operations, Nadir sought to remedy the problems by engaging in financial deceptions through the use of SPEs in off-shore financial havens. When the group losses escalated severely, even the use of such illicit schemes became inadequate. Finally PPI went into liquidation. Nadir was charged with theft and false accounting but fled to Northern Cyprus after jumping bail. The legal questions surrounding the complex case will remain unanswered until the resumption of the trial process. This is probably unlikely given the stand of Cyprus in respect of extradition proceedings.

Therefore, unlike the first set of two cases where relevant directors and managers had to face various punitive disciplinary measures for corporate fraud; legal issues pertaining to the second pair of companies remained unanswered as one founding CEO was found dead and the other had fled the country. Notwithstanding this, it would appear at least on common law principles and corporate statutory duties under the Companies Act and securities disclosure obligations, both CEOs would probably have faced punitive actions. Still, it may not be that cut and dry. Maxwell’s younger son for instance was absolved of all legal charges even though as a close co-director he was to some small degree implicated in many of Maxwell’s financial scams.

Sharp criticisms were levelled at the auditing firms surrounding the financial statements of both MGC and PPI. In respect of the former, Chalmers Impey (CI), the auditor of one of the former’s member companies, namely Pergamon was reprimanded for its defective audit procedures. This had resulted in stock overvaluation and consequent inflated profit of some £2 million in its 1968 accounts, after financial investigation by Price Waterhouse. This became a subject of a Board of
Trade enquiry after the Takeover Panel began looking at the Leaseco Pergamon merger exercise. The July 1971 DTI report had asserted that Maxwell relied extensively on reckless distortion of financial statements to shore up profits of his business and that he could not be relied upon to manage listed corporations. The subsequent two other DTI reports in April 1972 and November 1973 were equally critical. After the collapse of key companies in the MGC, the subsequent 2001 DTI report maintained that Price Waterhouse, which had succeeded Coopers and Lybrand Deloitte as auditor should bear some significant responsibility for failing to report fatal pension funds accounting flaws to the trustees.

Other than reputation damage, Price Waterhouse was fined £3.5 million by the Joint Disciplinary Scheme and had to settle out-of-court with the liquidators for £68 million and a further undisclosed sum for the defrauded pension funds. The use of dummy and offshore companies to transfer funds and assets between them and other businesses in the MGC stable through off-balance sheet mechanisms and the unauthorised or improper use of pension funds assets could arguably have been detected by the auditors had they perform their audit work on a more robust and professional basis. Their readiness and willingness to settle out-of-court gave some indications signals about the weaknesses of their audit work. To be fair to the auditors at the time of the Maxwell affair, they were supposed to function only as ‘watchdogs’ of commerce and not ‘bloodhounds’. [19]

Their prime task was to ensure that the implemented internal control systems upon which companies rely on to produce financial statements are reliable for the

[19] Judge Lopes in Re Kingston Cotton Mill Co {No. 2} [1896] 2 Ch 279, CA at 288
generation of ‘a true and fair view’.\textsuperscript{[20]} It is never their task to detect fraud, other than when it shows up in the course of their investigation of the underlying internal control systems. They needed to report on any shortcomings and can choose to remain silent if they are satisfied with the internal controls.

Public consternations over the Maxwell and other fraudulent affairs led to the creation of the Accounting Standards Board (ASB) as the official issuing organ for the Statements of Standard Accounting Practice (SSAPs), and subsequently the Financial Reporting Standards (FRSs).\textsuperscript{[21]} With the introduction of these accounting standards, auditors were now required to assess whether their clientele have complied with all the applicable standards, and to state reasons for non-compliance in order to ascertain a true and fair view of their clientele’s financial position. Unfortunately, in the case of the MGC businesses, no mention of breaches of any kind were highlighted in their audited statements despite the high probability that such was the case in some of the cases involved especially those connected with pension funds.

Where PPI is concerned, its auditor Store Hayward was criticised for not being more careful in their evaluation of PPI’s overseas business interests and had relied completely on the work of PPI’s overseas local auditors. As it turned out later, the latter failed to exercise proper professionalism. The difficult trading conditions for PPI’s key operations in Cyprus and Turkey and their highly depreciated currencies should have alerted the auditor’s attention that the reporting of high profits were improbable. Their failure to respond to this huge problem provided good grounds for civil actions by affected parties.

\textsuperscript{[20]} CA 1985, sections 235-237  
\textsuperscript{[21]} S.I. 1990 No. 1667 made under CA 1985, section 256(1)
As for the role of financial advisors and lenders, the two cases suggest strong indications of conflicts of interest. Goldman Sachs in particular appeared to play a crucial role in the share ramming exercise conducted by Maxwell. Besides acting as Maxwell’s adviser, it also acted as his financier. They stood to gain in terms of millions of pounds through specially devised options schemes, which Maxwell had used for share price manipulation purposes and for which the bank is likely to have knowledge of. This was asserted in the 2001 DTI report. Though Goldman Sachs settled with the Securities and Futures Authority, the Joint Disciplinary Scheme, and the pension funds without the acknowledgement of guilt, the case facts showed the greed for easy profits behind their dual controversial roles as financial advisor and financier. When advisors and financiers compromised their professionalisms, they are likely to assume significant legal risks.

It was also unlikely that the financiers for Nadir’s share ramming exploits in PPI were totally unaware of the reasons behind Nadir’s borrowings. The abrupt and clumsy way Nadir went about with his abortive plans to take PPI private again should have also put these financiers on higher alert. The dumping of PPI’s shares at the later stage probably reflected the extent of their worries and the risks they had been assuming despite the apparent lucrative nature of these controversial transactions.

In contrast to the first set of two earlier cases, this second set of two cases demonstrated the high risks of using OBF techniques with improper motives even though the likely wrongdoings of the executive directors, the auditors, and the financial advisers and lenders were never proven in court. It also demonstrated that the use of OBF for financial window-dressing is seldom transition in nature as
intended by under-performing companies hoping to reverse their purpose when things turn for the better. This was seen in all these cases as things worsened under the combined weight of the extra debt burden and deteriorating market conditions. The out-of-court settlements by the parties concerned would suggest strong elements of improbity and financial misrepresentations. Hence, when the improper use of OBF mechanisms is combined with the falsification of accounts and other financial deceptions and in most cases they do, the perpetuators would likely face fraud charges.

Financial Benefit Cases

The third set of two cases highlighted the viable use of OBF instruments. In the case of Tesco (TC), it makes use of OBF instruments like sales and leaseback to release liquid resources from its physical warehousing and retailing properties to help with the funding of its acquisitions and expansions both locally and abroad. This strategically holds down the level of its external borrowings. TC also maintains the conservative financial policy of keeping its contingent guarantees for the funding of linked associates and subsidiaries at very modest levels. This was clearly disclosed in its financial footnotes.

Unlike Enron, TC makes use of off-balance sheet contingent guarantees for the pursuance of proper business objectives. Such guarantees are extended to assist related businesses to gain access to financial resources for their working capital and other similar needs. Financial derivatives are in turn used by TC for hedging and not for trading purposes and would therefore not carry with them any significant risks.

As TC is rated highly in the financial and capital markets because of its excellent
sales and profits records on a consistent basis, the corporation enjoys access to a wide range of cheap financial instruments including OBF instruments like securitisation. So far, it has exhibited strict financial discipline in managing its financial assets and liabilities in a responsible, effective and transparent manner. It has no good reason to succumb to the exploitation of the features of OBF for improper agenda. The vastly successful supermarket giant does not need to do this. Moreover, it is cushioned annually by £1.5 billion of annual suppliers’ credit.

The case of Rentokil Initial Plc (RI) shows how a cash strong company is able to cope with media pressure over performance and boardroom problems. Unlike other listed corporations, which succumbed to the use of OBF for improper window-dressing in the face of poor operating conditions, RI continued to employ this for financial savings despite being put under strong competitive pressure over the last 5 years. In this respect it is assisted considerably by the cash rich nature of its business. This gave the operations considerable liquidity strength, which made it unnecessary for RI to window-dress its debt exposure levels.

Still, the boardroom drama arising primarily from power struggles was also not helpful to the company’s cause. Fortunately, despite the misgivings over its last few years soft sales and profit trend, RI is still making decent profits of around £230 million annually. It would appear that the capital market had grown accustomed to RI’s past decade’s 20% annual growth stemming from a good flow of high performing acquisitions, but which had become increasingly difficult to find. Added to that, the low market entry barrier of its core business had also contributed to intense competition and lower earnings for RI. This made it doubly difficult for RI to replicate its 1990s high earnings growth records.
As the company adapted to its new competitive environment and with different corporate leadership at the top it became the subject of an abortive takeover bid. The takeover in the event failed because of the absence of a well co-ordinated plan. This gave the opportunity for the board to formulate fresh strategies to enhance its future operations.

The main reason therefore which contributed to the sparing use of OBF in RI was and still is its strong cash position. This provided it with a comfort zone to continue with its traditional popular policy of paying attractive dividends without needing to rely significantly on external borrowings. Also, the market has got used to its negative equity position brought about largely through a £1.9 billion shares buy-back policy. RI, however, in recent years indicated to the market that it prefers to return money to its shareholders and consolidates on its existing businesses rather than continuing with its past acquisitions policy. Given this strategy, RI never found the issue of borrowings to be an issue. It also endeavoured to convince the market to evaluate its performance on the basis of its ability to generate good cash flows.

This position nonetheless changed in late 2004 when RI had to comply with the new EU financial ruling that it needs to have adequate financial reserves for the distribution of dividends. Due to the share buy-back programme, which the company initiated in 2000, its equity and reserves had already been exhausted. RI was compelled under the new EU ruling to undertake a corporate financial restructuring programme. This resulted in a new holding company with £2 billion distributable reserves to sustain its dividend distribution policy. Whilst it can comply with the new EU ruling, the new financial landscape may motivate RI to pay some attention to the size of its shareholders’ funds in the future, and with it the issue of gearing. Until
then, RI makes minor use of derivatives for hedging purposes and some leasing for financial savings. This case shows that when a company enjoys strong free cash flows, it is unlikely to undertake the conduct of OBF activities with improper underlying motives even when pressed with capital market expectations issues.

This final pair of case showed that businesses with successful dominant competitive strategies like TC or those service-based business with strong cash positions like RI are unlikely to use OBF for window-dressing purposes. They used them to effect financial cost savings.

The cross-case analysis of the three pairs of listed corporations in the US and the UK, confirmed the underlying motives behind the use of OBF in each of these pairs. The first set of corporations showed that there were clear intentions to defraud major participants in the capital market through the use of OBF and other related illegal financial activities. The second set showed that when OBF was used for over-aggressive financial window-dressing, it risked breaching financial reporting rules and under strong commercial pressures may even degenerate into its manipulative applications. The third set of corporations showed the viable use of OBF instruments when businesses are running nicely or when they are engaged in service industries with strong cash flow features.

**Comparative Cross-Country Case Analysis**

**Manipulative Use Cases**

The two pairs of cases in the UK and US, which made use of OBF instruments to perpetuate financial fraud and deception comprised Enron and WorldCom and BCCI
and BB respectively. All four shared certain common characteristics. In the first instance, all four were highly profitable and successful operations in the early years of their corporate history. All four also employed the growth by acquisitions or diversification strategy. These four corporations also funded their growth or expansion with high on and off balance sheet financing.

Leveraging growth through high debt levels is commonly employed in Japan and elsewhere and embraced the internal control form of governance. This is not so commonly associated with listed corporations in Anglo-Saxon economies which rely on the external market for capital controls. Those of the former order believes that in their case, debt management can be better handled because the banking creditors are usually represented on the board and are therefore quicker to respond to financial pressures arising from business downturn. Anglo-Saxon capital markets, in contrast frowned upon excessive debt exposures more so for underperforming companies, and discipline them either by takeover mechanisms or by charging higher financial charges.

Usually when much of their acquired and traditional businesses fell apart, these highly leveraged corporations had to shield such heavy losses from public view in order to deflect the concerns of their financiers and to get continued support for their stock prices. High stock prices were necessary as large chunks of their shares had been used as collaterals for their hefty borrowings. Any serious fall in share prices might either result in margin calls or the need to provide further collaterals to the banking creditors. At this stage, they were normally not in a position to comply with either.
The corporate leaders in charge obviously knew that the usual form of financial window-dressing (to portray a picture of sound financial health with minimum debt risks) is only sustainable over the short term and is unlikely to do the job. To ensure the longer-term effect of financial window-dressing, they made use of special purpose vehicles (SPVs) and other forms of creative accounting. The intention was to use these to conjure up a rosy picture of high profitability and sound financial health. Enron achieved this by making the SPVs they created to absorb the high debt liabilities and financial expenses. They did not consolidate these SPVs despite having control over their management.

WC capitalised its line expenses when the proper financial standard is to expense these against its income statement and also made use of fictitious ‘management companies’ to absorb further debts and expense. BCCI made use of sham off-shore companies and other money-laundering devices to divert away their liabilities and expenses. BB or rather Leeson employed a secretive account to hide huge losses and exaggerate profits. Thus, all four cases demonstrated that OBF mechanisms were used in conjunction with other forms of illegal financial deceptions. They differed only in scope and scale.

The wrongful use of OBF to help understate liabilities and inflate profits illegally exposed those who were directly involved as well as those who were indirectly involved to high litigation risks. The key directors involved other than those in BB had to contend with criminal and civil suits. Those in BB were disqualified from holding office as directors for not exercising adequate internal controls over the use of speculative assets. Comparatively, the US directors received more severe fast-tracked
penalties because of its more hospitable litigation landscape for class action and derivative suits as well as extensive use of plea-bargaining. For example, Enron and WorldCom directors had to pay US $40 million of their own money to settle litigations against them. Similarly, the auditors and financial advisers were made to compensate with hefty fines. Investment banks, which appeared to have collaborated with Enron’s fraudulent partnership schemes, have settled with state prosecutors over their deeds. One clear example is the purchase of ‘Nigerian Barges’ by an investment bank from an Enron SPV. This was in fact a loan camouflaged as investment because of the buy-back arrangement clause at a hefty premium. This was a highly profitable, but was fraudulent in nature.

The initial quick punitive actions taken in the US had been attributed to the actions of state prosecutors like Eliot Spitzer of New York rather than the SEC which acted more aggressively somewhat later. Spitzer, in particular was singled out as the foremost active state champion for enforcement against fraudulent acts. It turned out later that Eliot’s enthusiasm was in part motivated by his desire to run for the office of State Governor. The existence of such state regulatory champions in the US implied high litigation risks for those who used OBF and related techniques to breach securities and corporate laws. This probably explains why many UK directors are against the current practice of extraditions to US courts to face such charges. The case of the ‘NatWest Three’ who were indicted by the US Department of Justice for wrongful participation in an Enron-related SPV scam, is a good example of this.

Though the SEC was criticised severely in various circles for sleeping on their watch as financial gatekeepers, those injured by the demise of these huge corporations could not muster the resources or find enough legal basis to sue it. In contrast, the Bank of England was taken to court by BCCI’s liquidators on the grounds of public misfeasance. The latter withdrew its suit subsequently when no sufficient evidence was forthcoming. Though the case showed the willingness of the House of Lords to entertain such action suits, it showed the immense difficulties in taking the central bank or other financial regulators to court over the way they managed their policies.

The Enron debacle led to the introduction of the SOA in the US, which tightened regulatory obligations on directors, auditors, financial advisers, financial analysts, and solicitors. New provisions were also made to ensure fuller transparency where OBF is being specifically employed. The SEC acting under the SOA thereafter began to enforce more vigorously to include and target even external directors.

The onerous regulatory obligations for director and auditors in particular have been criticised as these not only enhance considerably the costs of financial reporting but also the litigation risks exposure. Section 404 of SOA appeared to be the most feared provisions within corporate boards in the US and those outside having dual listing status in the US capital market. A Korn-Ferry survey put the estimate at an average of US $5 million for SOA financial compliance costs for Fortune 1000 firms. One UK nationals to be extradited to face the harshness of US federal justice for white-collar crimes. This was deemed unfair for those engaged in international business because of the aggressive stance of the latter and the exclusion of the need to provide prima facie case evidence; Tait, N., ‘Businessman Wins Battle Against US Extradition’, Financial Times, 29/06/2007, 6. The district judge ruled here that it was unjust and oppressive for a UK businessman to be extradited to the US to face a fraud trial. This together with the recent decision of the House of Lords to hear the appeal in another extradition case is said to spell the beginning of some checks and balances for the fast-track extradition process.
academic study singled out SOA for the market loss of US $1.4 trillion in the US.\[24\] This prompted the establishment of a Capital Market Regulation Committee (CMRC) to explore the potential for watering down some of the more onerous provisions of the SOA.\[25\]

In the meantime, preliminary moves by the New York Stock Exchange (NYSE) to takeover the LSE has induced the apprehensions of UK issuers that the SOA will be introduced through the backdoor. To ensure that the UK stock market is insulated from this, the UK is reported to be planning a new legal provision to ensure that the FSA will retain its right to promulgate and enforce rules pertaining to UK capital markets.\[26\] This in turn has raised concerns in the US over the race to the bottom by competing financial regulators.\[27\] The LSE in response made it clear that it has its own safeguards in place, and that its success could be attributed to the FSA’s light-touch and principles-based regulatory regime and other advantages which London offers.

The limits of the monitoring board and the focus on shareholder value have also been cited as serious contributing factors to the downfall of Enron and Enron-type debacles. Instead of propounding enhance monitoring role for the directors as what the SOA appears to do, suggestions have been made that it might be better to adopt

\[24\] Capital Market Regulation Committee December 2006 Report
\[25\] ibid
\[27\] Ethical Corporation, ‘Europe: Corporate Listings—Seeking Regulatory Asylum’, available at http://www.ethicalcorp.com, 12/10/2006. Such concerns appear to attract some sympathies as reflected by the quick and sharp decline in share values after listing in AIM for Betcop, European Islamic Investment Bank, Burst Media, and Chariot. These companies were reported to be facing various difficulties shortly before their listings.
the stewardship model where directors take responsibility for ensuring the sustainability of corporate assets over time.[28]

The US case of Enron and WorldCom also showed the dangers posed by stock options in executive compensation. Such options tend to make managers prefer risks for obvious reasons. ‘So managers with a rich load of options have incentives to get the stock price high by any means necessary, fraud included…Both pathologies—fraud and costly risk-taking—appear to have occurred in Enron. Enron became a hedge fund, taking leveraged bets in exotic markets that if successful would produce a huge, disproportionate bonanza for its executives’.[29]

The BCCI and BB debacles in their own ways tightened the BE’s supervision procedures. More importantly, they contributed in some ways to the introduction of FSMA 2000, and the emergence of the FSA as UK’s super financial regulator with enhanced regulatory enhancing powers. The offence of Market Abuse introduced in the new legislation includes the liability for providing misleading financial information. This is pertinent to those who opt to use OBF in the Enron/WorldCom manner. It means speedier flow of punitive actions through the less burdensome civil route which FSA can choose to take. Responding to criticisms over its low incidence of enforcement cases, the FSA is now exploring the use of deferred prosecution agreements and other methods successfully employed in the US.

Financial Window-Dressing Cases

The second pair of UK/US corporations pertained to those using OBF for financial window-dressing purposes. Sunbeam Corporation (SC) and Boston Chicken (BC) were the US corporations investigated; whilst the Robert Maxwell Group (RMG) and Poly Peck International (PPI) represented the UK corporations under this category. Other than SC, which was underperforming in the intensely competitive household goods retailing sector, the other three had been performing well in the initial stages. All four, however, chose to grow via the corporate acquisition route, which required funding from the stock exchange and high debt levels. It also meant the need to sustain high share prices as much of these were used as collaterals for bank loans. OBF and related mechanisms were used to help shore up the share prices.

SC used aggressive sales reporting (bill-and-hold) and BC used so-called area franchising developers (AFDs). The former essentially locked in artificial sales and factored the debts through a wholly owned subsidiary; whilst the latter funded 80% of franchisees’ funding needs and also have effective control of operations. Though the corporations provided footnotes to provide partial explanation for their accounting policies, these were considered as poor and even misleading financial reporting. Believing that they had not breached securities regulations, these corporations began to use such devices more and more to fund huge losses incurred. This was the financial slippery slope which led them to further improper actions taken in order to turn things around but in reality made things worse. Bankers and connected financial analysts helped them to employ such devices to the level of deception.
In the end, the key directors, auditors, and connected financiers had to pay punitive fines to the financial regulators or the state as settlements for causing the dissemination of unreliable financial information. These US cases showed how easy it was to get down the slippery slope of financial manipulation on false confidence derived from creative compliance to regulatory rules. Indeed, it was the OBF instruments, which provided them with the false sense of confidence and enhanced the litigation risks for key board members and the financiers who collaborated with them.

In contrast, the UK equivalent of such OBF employment opted for the use of SPVs in offshore jurisdictions where financial regulations are either sparse or not being properly enforced. This pair of UK corporations used SPVs and a range of shell-case entities to shield the extent of their debts, inflate incomes and understate liabilities. As these are perpetuated in off-shore domains the perpetuators grew confident over their employment as their main core activities were at least said to be free from wrongdoings. This caused them also to over-exploit such OBF mechanisms to dangerous levels prompting fiscal and litigation risks to the key directors responsible for their creation and usage. On top of this, RMG also made improper use of corporate pension funds and assets. On paper, pension fund assets appeared as proper loans to other companies in the group; but these were not properly documented and the trustees were appointees of the CEO and not at all independent as required.

Both these UK corporations also used funds generated by OBF to ram up share prices illegally. Maxwell died under mysterious circumstances, whilst PPI’s CEO absconded. Actions taken on other board members failed. The auditors were slapped
with punitive fines, but some financers who appeared to have collaborated with the
offence got away for lack of sustainable evidence. Despite this, these cases showed
that when OBF are used for financial window-dressing on regular basis, it is but a step
down the slippery slope of financial manipulation. This is because of the false
certainty, which OBF generates for the users and collaborators.

It must be emphasised that these two UK cases contributed to the tightening of
corporate disclosure rules. In fact, they are said to help result in the formulations of
new disclosure standards for connected parties’ transactions, and the introduction of
OBF disclosure standards in the UK in the late 1980s. It has been argued that it was
the early introduction of such disclosure standards for OBF that probably explained
the lower incidence and scale of OBF manipulation in the UK when compared to the
US from the late 1990’s onwards.

Financial Benefit Cases
The third pair of UK/US corporations under examination here refers to those using
OBF in proper manner to realise enhanced liquidity, savings in financial charges and
tax benefits. Microsoft Corporation (MC) and Wal-Mart (WM) were the US
corporations represented; whilst the UK corporations concerned were Tesco
Corporation (TC) and Rentokil Initial (RI). Both MC and WM use contingent
guarantees and SPVs to provide financial support to some of their suppliers. They do
this for beneficial operational reasons. Both also claimed to be using derivatives for
hedging purposes.
However, in the case of MC about one third of its net income originated from
derivatives earnings. It is, however, unlikely to run any financial risks as its
participation in this area is funded mostly by free cash flows. This is understandable
as it can enhance its earnings through this with manageable risks. MC has also
stopped using employees’ stock option plans (ESOPs) since 2003 in response to
criticisms in the market. This turned out to be a wise move, as the company was not
affected by the 2006 options backdating scandal.

Like its US high performing counterpart, the UK corporations also employ OBF
instruments to enhance liquidity and effect financial savings. TC uses sales and
leaseback to unlock funds from its fixed assets to fund its growth plans in the UK and
internationally. RI showed great financial discipline in the face of its current
operational and boardroom problems by continuing to use OBF instruments to effect
liquidity enhancement and financial savings rather than for extreme financial window-
dressing.

It did the right thing by not succumbing to this temptation despite pressures from the
market to show better financial numbers. This third pair of listed UK/US corporations
has therefore used OBF instruments properly and productively. Much of this may be
attributed to their strong performance and in particular their strong free cash flow
position (which Enron and WorldCom and the rest hardly had).

The striking difference between this third pair of US and UK corporations is that the
latter tend to make more extensive use of the ESOPs, which had its origin in the
Silicon Valley. One estimate suggests that as much as 90% of US corporations used
stock options. These were developed as financial incentives or compensations for talented technical personnel taking low remunerations at the entrant stage of newborn corporations. Stock options provide executive directors, senior management and other employees with the right to purchase shares at a certain price; and if the share price climbs after the options are granted, profits can be huge.

The Enron and WorldCom debacle has shown only too well how this can be exploited by corporate management to the point of fraud when pursued through excessive greed. The SOA has mandated enhanced transparency where this is concerned by changing the deadline for insiders to report any trading in their companies’ shares to within 2 days of the execution date of the transaction. The UK has much similar safeguards. It is thought that with this new provision, which requires companies to disclose ‘on a rapid and current basis’ additional information deemed necessary about a company’s financial operation, the abusive use of ESOP will be history. This was not to be.

Options Backdating

Greed again reared its ugly head, when the practice of options backdating was raised to the attention of the SEC. Options provide the holder with the right to purchase stocks for a fixed price at some date in the future. This exercise or strike price is normally the market price when the options were issued; but where it is subsequently backdated to a time when the shares were cheaper, then the holders will make handsome profits. The CEO of Capital One for instance made £134 million in 2005 by exercising his options. This was the good news about stock options.

However, when share prices plummet below the exercise price of the options (and they do in reality) then companies either issue more options or re-price existing ones. The latter practice has caused many US corporations into actions close to fraud. It also gave the erroneous signals to management that even if their companies underperformed; they can still stand to gain. It has now been widely acknowledged that stock options are not effective incentives for enhanced corporate performance, because management loses nothing if stock prices go down; but have every incentive to take disproportionate risks to raise share prices through reckless acquisitions or investing in projects of dubious potentials. These have been amply substantiated by the findings of this study.

Federal prosecutors and the SEC are currently investigating whether some 125 corporations from blue chips like Apple Computer and Home Depot and smaller technology-based enterprises have ‘backdated’ or otherwise manipulated the dates they granted options to make them more profitable. So far, the CEOs of Brocade Communications and Converse Technology are facing criminal and civil charges for their participation in manipulating options; and the CEOs of McAfee and CNET have resigned over the timing of stock option grants.[31] Options backdating eats into equity funds, which are rightfully for a corporation to use to help enhance performance. It is an off balance sheet device designed for illegal purpose and should therefore be roundly condemned.

Hidden Share Ownership

Another form of off balance sheet device of some concern to financial regulators in the UK and now the US is the increasing emergence of ‘empty voting or hidden (‘morphable’) ownership of shares which (are) either clearly or likely to impact (on) voting rights’. The worry centres on the increasing ability of hedge funds and other sophisticated investors to accumulate large voting positions through share borrowing and unregulated equity derivatives while having little or even negative economic interest in an enterprise. This will seriously undermined the link between ownership and voting rights.

The UK Takeover Panel has already responded to this problem in 2005 by requiring certain derivative holders to disclose their identity during an offer period if their stake exceeds 1 %. The SEC is still working on the appropriate response. This issue has serious implications as CEOs may be removed through this non-transparent process by secret warfare waged outside the purview of the public. This might motivate them to react by using OBF and other creative accounting techniques to drum up performance to ensure shareholders’ support.

Other UK/US Differences

The comparative cross-country case analysis showed how and why many US corporations are more inclined to play the financial numbers game because of the incessant focus on shareholder value in part fostered by quarterly financial reporting

[34] ibid
Excessive management greed to profit quickly from the capital market further reinforced this temptation to manipulate earnings report through OBF and other creative accounting techniques.

Overall, the comparative case study also showed how US corporations tend to make greater use of SPVs within its borders, whilst are fond of using offshore jurisdictions in Bermuda and elsewhere for structured finance and securitisation because of ‘…the willingness of their governments to address the legitimate needs of the international business sector of their economies and to keep regulation light but effective and their laws, particularly company laws, modern’.\[35\] Others have expressed concern over the use of these jurisdictions for the masquerading of money laundering and other illegal forms of financial transactions in the guise of legitimate securitisation.\[36\]

Corporate directors, financial intermediaries, investment advisers, auditors, and financial regulators may have to be more mindful of the legal implications arising from the risks of such occurrence. Nonetheless, due to the strong US stance against offshore havens with poor quality legal enforcement frameworks which might attract money-laundering and related activities over the last few years, things have improved considerably. This is due to these jurisdictions’ competitive need to fight for foreign investments and not be let down by negative international publicity.

Where the issues of conflicts of interests in the capital market are concerned, the SOA introduced further stringent rules to be observed by key market participants. The UK in contrast continues to rely primarily on soft laws like the Combined Code on


corporate governance and the risks-based style of regulatory administration. It has been increasingly acknowledged that this has a relatively greater deterrent effect on the improper use of OBF or other forms of negative creative accounting, as it is generally more difficult to indulge in creative compliance within a principles-based financial disclosure system.

In the end, past corporate fraud histories in both jurisdictions have shown that both hard and soft laws cannot realistically stamped out financial manipulations.[37] Powerful motivational factors will continue to induce corporate financial reporting behaviour in particular directions. Occasionally, even highly successful corporations may run foul of financial reporting regulations because of competitive pressures, management ambitions, or conflicts of interest.[38] Under such situations, some directors, financial advisors, and auditors became more prepared and willing to take undue risks as they believed from their perspectives that they were doing the right things and that the benefits of their actions were greater than the costs involved. They were as such not entirely motivated by the greed factor but by the need for recognition and self-actualisation in the eyes of the political and business communities as exemplary corporate leaders.[39]


For better effects, regulatory supervision needs to be strengthened by appropriate ethical foundations, based on checks and balances, and openness and transparency in financial reporting.[40] It has been argued cogently that it is ethical dilemma which needs to be addressed. Ethical dilemma is not about deciding when to break the law. It arises when a wrong decision could be made within the bounds of the law as is often the case where OBF is concerned.[41]

The ethical framework should be further consolidated by professionalism from all market participants, be they insiders or outsiders. Professionals like auditors, financial analysts, and financial advisors must give objective and expert advice not tainted by personal biases and should above all be undertaken with independent judgement. The policy prescription ‘…is simple: regulators must align incentives to foster ethical conduct and to make it clearer when companies shirk this duty. Ever since Sarbanes-Oxley was passed, there have been those in the business community who have said that the regulatory response to corporate misconduct went too far and that markets should be allowed to work. Yet we have seen that markets, left to their own devices, create in some cases precisely the wrong incentives: options backdating, ‘pretexting’ at HP, accounting misconduct, and more. Regulation allows bad actors to be sanctioned, but more than that, it helps turn around a race to the bottom’. [42]

A ‘free market’ regime necessarily interferes with choices to some extent, meaning the use of a degree of regulation. The option becomes then not about between ‘regulation’ and ‘no regulation’, but ‘between the kind and degree of regulation that we will have’.

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[43] ibid, footnote 84
Chapter Six
Conclusions

Background

OBF is a debt instrument which may be partially visible or not at all in a user’s financial statement. Depending on the reporting approach taken, this may lead to varied opinions of the underlying profitability and financial health of a business. This controversial feature of OBF from a global perspective prompted the undertaking of this research. As most prior studies tended to be either fragmented in nature, of narrow finance-focus, or blurred with the intensity of other research agenda, this work was initiated to investigate OBF from a more integrated approach. It sets out to build from a largely financial dominated field to include and integrate with a legal perspective. In particular, this research chose to focus on the legal implications of OBF applications for, financial preparers like corporate directors; financial advisers like investment banks and other financial intermediaries; and financial gatekeepers like external auditors and financial regulators.

The research direction developed involved the need to ascertain how and why particular motivations behind OBF’s employment may generate different legal risks to corporate directors, financial advisers, auditors and financial regulators. Guided by preliminary and brief insights of some prior works this study argues that principally businesses employ OBF; for the more honourable objectives of financial savings and liquidity enhancement; for financial window-dressing to safeguard continued access to capital markets and share value enhancement purposes; or inappropriately as tools to assist in various forms of financial misrepresentations or deceptions.
As the study was structured to give emphasis to the legal perspective, the research approach adopted relied mainly on the traditional doctrinal research method. Nonetheless, this was complemented by the use of a modified case study approach in order to generate insights to help answer how and why OBF generates different risk implications to financial reports preparers and financial gatekeepers. This involved the investigation of three sets of listed corporations covering, first; those which had used OBF for fraudulent purposes; second, those which had used them controversially for financial window-dressing; and third those which had used them for viable economic reasons.

Motivation and Manner of OBF Applications

The findings of this study suggest that UK and US listed corporations employed OBF instruments fraudulently when faced with severe financial stress and onerous business conditions. This is often reinforced by senior executives’ greed to pursue unjust enrichment irrespective of actual conditions. More importantly, some of these errant executive directors also managed to deceive themselves that their actions to sustain the competitive position of their businesses were appropriate (even though illusory) and that they were ergo conducting themselves altruistically rather than greedily. They were therefore to a significant extent motivated by their need for public recognition of their corporate leadership.

This higher Maslow hierarchical need probably caused them to completely disregard the risk of punishment or the loss of their personal fortunes and reputation. Indeed, this self-actualisation and recognition need is not confined to those running poor performing businesses but those managing high performing companies as well. They therefore manipulated the use of OBF not only to help lift stock prices to derive hefty
financial gains but also to project strong positive market leadership and image of their corporations despite the contrary in reality. The stock prices had also to be sustained at high levels to safeguard against margin calls of stocks put up as collaterals for debts incurred by the corporations and their CEOs. Under such conditions and further deterioration of business conditions, Enron and Enron-type corporations became bankrupt. The case analysis also showed that US corporations used OBF on a comparatively larger scale and extent due to their relatively greater preoccupation with the quarterly earnings report to comply with market expectations.

This investigation also showed that the perpetuation of OBF by corporate management was considerably aided and abetted by bankers, financial advisers, and financial analysts. These institutions and individuals had participated widely for corporate profits and personal gains against a background of interest conflicts. Financial gatekeepers like auditors and financial analysts were also found to be more prepared to risk their reputational capital as they began to perceive, especially in the US lower legal threats because of some judicial decisions and securities litigation reforms in the 1990s. The study also showed that the UK is associated with lower incidence of OBF usage scandals partly because of the earlier introduction of OBF reporting standards in the 1980s and partly because of its principles-based financial regulatory approach.

Findings from this study’s case analysis showed that the use of OBF to inflate earnings and understate liabilities can cause corporations to succumb easily down the slippery slope of financial window-dressing to financial manipulation and deception when further induced by enhanced business deteriorations and other enhanced
management motivations. Often for companies under this category, the financial window-dressing practices intended for the short or transition term could not be curtailed because of the need to meet up with market expectations or because of the false confidence developed that the financial gatekeepers would not catch them and that they could therefore continue to game the system. Though accounting footnotes were provided for OBF in many instances, these did not appear to be fully or properly digested for their risk implications by the financial gatekeepers primarily because of connected interests or conflicts of interest; and investors chained by ‘irrational exuberance’ in booming market conditions. This probably helped to explain why the improper use of OBF appeared to be condoned by the wider financial communities until way too late.

The study also showed how US corporations were associated with the greater use of creative compliance to respond to the country’s test-based prescriptive regulations; and in the process indulged in falsification of financial information. The use of special purpose vehicles’, ‘bill-to-hold’ and the ‘area franchisor developers’ are good examples of such practices. UK financial reporting in contrast for the comparative period was guided by the principle-based FRS 5 which rendered the more abusive form of OBF reporting more difficult. FRS 5 was introduced in the UK in early 1980s to deal with the key problems caused by OBF.

This investigation also demonstrated clearly that OBF need not always be associated with its use as a device to go round financial regulations for improper agenda. The innovative and financially beneficial features of OBF have been put to good use in business and financial circles probably much more widely than those who put them to
abusive applications. OBF instruments are widely used in businesses to effect financial savings and liquidity enhancement to fund growth and expansion.

Banks and financial institutions for risks hedging purposes or the leveraging of earnings within a more viable risks management regime have also employed them extensively.

Finally, findings from this investigation suggest that OBF instruments may manifest itself in newer forms to meet with the growing complex needs of the business and financial communities. Such financial innovations will no doubt give access to cheaper fund sources to assist in the healthy growth of businesses across the world. However, financial gatekeepers might need to be more vigilant and resourceful to deal with those with harmful consequences for the economy. The 2006 stock options backdating scandal involving around a hundred or so large and profitable US listed corporations is a case in point. Here, senior executives benefited financially at the expense of shareholders because of the lack of transparency over compensation deals. This incident additionally demonstrates one again that a minor few highly profitable companies may indulge in flawed financial reporting because of the excessive ambition of management either for unjust personal enrichment or for other business competitive reasons.

**Legal Implications**

Institutions using OBF with proper financial agenda and disclosing this in accordance with regulatory disclosure requirements or best accounting practices are unlikely to encounter legal problems associated with its use. The case studies illustrated further that the proper use of OBF appeared to be associated more with high performing and
cash rich businesses, which were not so bothered with its financial window-dressing appeal. They focused on its financial savings and liquidity enhancement attractions. Using OBF within this contextual framework insulated such businesses from compliance risks litigation.

The case study also demonstrated that when OBF was used to hide losses, inflate earnings, or understate debts especially in conjunction with other forms of creative accounting gimmicks, they are likely to lead to various civil and criminal implications. It also showed that the flow of legal actions is not confined merely to the corporate directors involved but may also implicate others who could have knowingly participated in the financial scams. These included banking and financial institutions which provide the source of the OBF; investment banks which provided advice on the design or formulations of the OBF schemes; auditors who were negligent in giving the affected institutions clean bills of health or who were instrumental in aiding the creation of the deceptive OBF devices; and financial regulators who were alleged to have looked the other way when they should have been put on more serious enquiries.

This comparative study also showed how and why the legal environment in the US is relatively more hospitable to litigations against directors, financial advisors, and auditors. This has been attributed partly to litigants having to pay only for their own legal expenses irrespective of case outcome. This is in sharp contrast to that in the UK where the losers may have to pay substantial part of the successful party’s legal costs, which often deterred some claims. More importantly, class action and derivative suits are commonly used in the US as devices for solving collective action issues. Class actions are not in practice in the UK and procedural rules governing the use of
derivative suits are also more difficult and complex in the UK. Finally, unlike the UK, the US legal system accommodates plaintiffs’ lawyers as entrepreneurs seeking out legal violations and appropriate clientele and rewards them with a percentage of the class recovery.

The more robust and aggressive enforcement approach maintained by US financial regulators in comparison to those in the UK was reflected also in this study. In part this was attributed to the fervent political ambitions of some US financial regulators; and in part through the more enhanced political and financial media pressures. The case studies also highlighted the effective intervention of state regulatory champions and the wider use of plea bargaining and deferred prosecution judgements.

Indeed, apart from inside directors who have committed frauds and punished by hefty fines or long imprisonment or both; some independent directors have also been legally pursued for conflicts of interest or flawed professional conduct and have settled early through their own pockets; something uncommon prior to SOA. The study also showed how the more aggressive US financial regulators and prosecutors apply a wider range of mechanisms to deal with the more serious corporate miscreants than their UK counterparts.

The case study also indicated that though auditing firms and investment banks have reduced the cost of financial information for users through the increasing economies of scope by diversification into many multiple services, these have created potential costs in terms of conflicts of interest. It is a type of moral hazard problem when a professional or professional institution has multiple interests or objectives, and as a
consequent faces conflicts between these objectives. Indeed, competing interests of these services have caused some financial conglomerates or auditing cum consulting firms to conceal information or disseminate misleading information. Financial regulators in both the US and the UK frowned upon such practices. This is because of the fact that conflicts of interests tend to omit or distort vital financial information in the capital market and accentuates asymmetric information problems and prevents the orderly flow of funds for viable investments. This results in misallocation of resources in the economy. This is the primary reason why securities laws in the US and the UK are formulated to deal with such wrongdoings on the market.

In this connection, OBF played a significant role in providing the opportunities for manipulative financial reporting. This was seen in those cases where the brokerage and underwriting divisions of some investment banks dished out different information to their different clientele comprising security-issuing firms and security-purchasing investors. In other cases, investment banks take advantage of conflicts of interest by blocking under-priced IPOs to senior corporate directors in return for future businesses. Audit firms selling consulting services are also seen in some of these cases to have compromised their professionalism with biased audits for the same reasons. Such unprofessional and reckless conduct attracted civil and criminal litigations. Liquidators of collapsed businesses strategically looked at auditing firms and investment banks as viable sources for financial recovery. Such case findings served to reinforce the deep pocket theory associated with selective litigations against auditors and bankers. The case study showed the ready willingness of these institutions to settle because of the advantage of settling without admission of guilt,
the realisation of reputation limit control and the elimination of negative personnel moral effect.

Financial regulators normally are shielded from risks of litigation because of the general reluctance of the judiciary to second-guess the policy actions of policy-makers and regulatory enforcements. The UK position showed the willingness of its judiciary to hear those situations connected with the public misfeasance of financial regulatory agencies. Though the first of such OBF related cases fell apart after a lengthy trial process, this did not imply the guarantee of insulation from future litigations. For instance on October 12, 2006 the FSA was ordered by the Financial Services and Markets Tribunal and subsequently by the judiciary to reimburse the legal costs of an individual it had tried to penalise with a £750,000 fine for market abuse conduct.\[1\]

This study also indicated that the legal response thus far to the problems created by OBF and other forms of bad creative accounting practices through the tougher SOA rules- prescriptive regime in the US or the more principles-based Combined Codes have led to mixed consequences. In the case of the former, it has led to prohibitive costs for the installation of complex internal risks control systems to cope with the onerous disclosure obligations imposed. Corporate directors in the US are now reported to have become more risks averse because of the heightened fear of regulations compliance risks. This aside, some non-US dual listed corporations have

\[1\] Paul Davidson & Ashley Tatham v. FSA (FSMT : Dr. A.N. Price (Chair), C.A. Chapman, and J. Parsloe) Date of Decision, 16/05/2006; Tait, N., ‘Why the Plumber’s Victory Could Prove Draining for FSA’, ‘FSA Says Defeat Will not Halt Enforcement’, Financial Times, 17/10/2006, 3 & 4; Timothy Edward Baldwin & WRT Investments Ltd. V FSA (FSMT: Andrew Bartlett QC (Chair), NW Douch & TC Carter) Date of Decision, 24/01/2006. In these cases, the Tribunal rejected FSA’s allegation of market abuse for lack of rigorous evidence.
started to de-list from the US capital markets. New listing aspirants are also observed to be migrating to the widely perceived ‘light-touch’ UK capital markets. This prompted the US to initiate a review of the SEC’s enforcement procedures under the SOA ostensibly for the aim of simplifying compliance procedures but more in reality to regain the competitiveness of the US capital market.

Suggestions for Future Research

Future research could look into OBF practices in the emerging economies, where financial governance is known to be relatively less demanding. Useful insights may also be generated for a study on the employment of off balance sheet financial conduits, which contributed to the sub-prime woes originating from the US but now having a serious impact on global financial markets.

Concluding Remarks

All said, OBF instruments are double-edge financial tools with good and bad consequences depending on the manner of their applications. As shown in this study, various litigation liabilities can arise from its bad consequences. Finally, this study also demonstrates that OBF can appear innovatively in newer forms to cope with the complex and sophisticated needs of businesses; but that it can also mutate to uglier forms or put to misguided use. To deter such improper uses of OBF, ethical and responsible corporate leadership and vigilant financial gate keeping will be essential.
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To enable the development of a chain of evidence and facilitate comparative and cross-case analysis, the case study protocol as developed in chapter one has been adhered to in the compilation and analysis of case data. Discussions would be made on the corporate background, manner of OBF application, and legal implications arising thereof for each of the following 12 cases. Case data were sourced from primary sources (statutes and judicial case reports); and secondary sources (annual corporate reports, annual filings to financial regulators, academic journals, professional journals, mainstream newspapers and financial newspapers). Data triangulation was conducted through crosschecking within and between both sources as well as cross-perspective analysis.

**US Cases**

**Enron**

*Background*

Enron emerged as a merged entity in 1985, with Kenneth Lay as its chairman. The corporation prospered quickly within the next sixteen years of deregulation in the energy sector.[1] Indeed, by 1998, the corporation became more diversified and was ranked within the top ten US elite enterprises.[2] It derived its growth and profits through energy trading and recurring asset sales, with the latter accounting for about 70% of its business.[3] It transpired later that the latter was largely realised through the deceptive use of special purpose entities (SPEs).

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Andrew Fastow, the company’s Chief Financial Officer (CFO) devised these SPEs for the enhancement of Enron’s credit ratings to prop share prices and to maintain the confidence of the company’s financiers. The SPEs were in practical terms used to distort the true financial position of Enron, especially the company’s high debt ratio.\[4\] When this acquisitions-driven growth strategy became unsustainable due to lack of viable projects in the market for absorption, the hidden losses of the corporation surfaced in its 2001 third quarter financial returns. Responding to the SEC’s request for more information, Enron filed financial restatements, which reduced the company’s equity by about US $3.2 billion. The restatements also revealed Fastow and others profiting more than US $42 million from their participation in the SPEs.\[5\] This crashed Enron’s stock price from US $13.90 on October end 2001 to a mere US $0.26 by November end 2001.\[6\] The end came with Enron filing for bankruptcy under Chapter 11 in December 2001.

*Use of OBF*

The saga of Enron is not easy to unravel principally because of the highly complicated manner in which the corporation shrewdly chose to structure its business. It took advantage of major regulatory loopholes in accounting, financial trading, and energy trading. Enron transformed itself into a commodity-trading operation, and at the same time masked its escalating weaknesses, losses, and debt accumulation.\[7\] Its capacity to engage in various forms of market manipulations and deceptions was

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\[5\] Filing returns of the company to the SEC, www.sec.com
\[7\] supra note 1, 144
aided by various Wall Street co-conspirators, but these went largely ignored by the financial and other related regulators.\[8\]

Enron’s demise may be attributed to many causes. Primarily, however, it fell because of its profit-sapping investments, ‘…in power plants in Brazil and India…in failing telecom companies, (and) in fiber-optic networks that didn’t have traffic’.\[9\] It had to shield these losses and the debts associated with their funding. Otherwise its corporate market image and credit ratings would crumble and destroy its high market valuation and weaken financial market support. The company’s management and various financial supporters were all rewarded by the benefits generated by these financial scams as they indulged in various conflicts of professional interest.\[10\]

The deceptive financial charade finally ended through the transmission of information to Enron’s internal audit committee, heightened enquiries from the media and investigations by the SEC. As Chapter 11 was filed, thousands lost jobs and money. Some commentators attributed the fall of Enron to the fraudulent response to a flawed business strategy.\[11\]

The original game plan of Kenneth Lay was to run a vertically integrated energy company and in pursuance of this, the company incur huge investments in pipelines across the US. This ‘asset-heavy’ strategy was later substituted by the ‘asset-light’ strategy of Jeff Skilling through the trading platform Energy Gas Services (EGS).

\[8\] ibid, 145
\[11\] Chatterjee, S., ‘Enron’s Incremental Descent into Bankruptcy: Strategic and Organisational Analysis’, Long Range Planning, 36 2003, 133-149
This was a ‘gas bank’ designed to smoothen the supply risk by contracting for supplies with large numbers of financially weak producers.[12]

Unlike the other diversified businesses, EGS performed well as it was able to contract for cheap gas supplies from depressed producers and reselling them at good prices. This asset-light strategy enhanced the profits of many Enron-related energy plants. Enron took early advantage of this by disposing them at substantial profits. These asset sales amounted to two-thirds of the group’s wholesale business, but were recorded as recurring profits with no objections from its external auditor. This became Enron’s convenient device to drive its sales from then on.[13]

Unfortunately for Enron, this apparent financial innovativeness developed fault lines. Encouraged by the favourable reception from the financial community, the company moved further and further away from its risk and trading expertise into uncharted territories. This sowed the seeds of its destruction. Primarily, Enron failed to adhere to the key success factors underpinning the asset light business framework, namely; product homogeneity; seamless national distribution network, and so on. Other reasons include the unwise decision to diversify into other unrelated businesses; and; above all the controversial employment of SPEs for financial manipulation to cover its true performance and financial position.[14]

The FASB had previously clarified that for SPEs to be created; it requires an external independent party to invest a minimum of 3% of total capital (varying according to project risk characteristics); its assumption of substantial risks and rewards of ownership, and; holding ultimate control over it. Enron, however, chose to comply with these rules with serious differences. For instance, Chewco a new partnership

[12] ibid, 139-140
[13] ibid
[14] supra note 11, 140-147
company led by senior Enron employees was financed by Enron to acquire 3% of
JEDI, a bona fide Enron created energy project, which was losing money and
substantially in debt. The obvious aim was to wipe off this debt from Enron’s balance
sheet. Enron used this SPE mechanism to avoid consolidation of JEDI’s losses and
debts, which in fact it should given the explicit FASB rules. This process was
repeated or adapted in various other similar transactions. It became a tool to cover up
strategic mistakes that ultimately brought the company down.[15]

*Legal Implications*

From a legal perspective, the downfall of Enron has been attributed to the company’s
appalling state of corporate governance and general gatekeepers’ failures. Board and
financial intermediaries’ failures stemmed primarily from various conflicts of interest.
Audit failure occurred when professionalism was compromised by lucrative non-
auditing consultancy incomes. Doubts were also raised on the monitoring
performances of the NYSE and the SEC.

Many external Enron directors were unable to stay independent and free from
conflicts of interest when they profited through lucrative consulting fees, highly
profitable business contracts and insider trading of stock options.[16] Details of such
misalignment of shareholders’ interests were uncovered in the ‘Powers Report’.[17]

Oxford, 733-770
Insolvency Lawyer, 06/11/2003, 214-225; Campbell, D. & Griffin, S., ‘Enron and the End of Corporate
[17] Powers Report (Report of Investigation by the Special Committee of the Board of Directors of the
One example concerned Michael Kopper’s management role in Chewco without evidence of approval from its board. Another involved the managerial and investor involvement of Fastow in the LJM partnerships.\[18\]

Enron’s six-member audit committee, which could have exerted a better oversight of these contentious issues also failed to carry out their tasks properly. At least 2 members had their functions tainted by consultancy fees and connected donations. The committee’s chairman for instance participated in the controversial disposal of stocks in January 2000 and October 2001. This became a subject of a lawsuit relating to insider trading.\[19\] Between January and May of 2001 Lay and Skilling cashed in their stock options at the height of the company’s share price in the knowledge that the company was already close to financial disaster.\[20\]

Fastow who turned state witness was eventually found guilty of fraudulent misrepresentation and other misfeasance by the court, but only sentenced to six years’ jail after agreeing to provide assistance to the prosecution for the other cases.

Lay and Skilling were found guilty of broadly similar charges but sentenced to more than 20 years’ imprisonment. Lay died in August 2006 from a heart attack, whilst Skilling lost his court appeal, and has begun to serve his jail term.\[21\]

Arthur Anderson, Enron’s auditor tried to deflect the blame of Enron’s controversial downfall to other capital market participants.\[22\] However, its failure to qualify

\[18\] ibid, 148-172
\[20\] ibid
Enron’s financial statements despite serious reporting flaws became a subject of extensive criticisms.[23] Signs of conflicts were evident in the firm’s active involvement with Enron’s accounting policies and the structuring of its various controversial transactions. Under intense pressure from the SEC, AA admitted the shredding of documents connected with Enron.

When Anderson’s lead auditor for the Enron account admitted to obstruction of justice, the beginning of the end of Anderson began to take shape.[24] A Houston jury shortly thereafter pronounced the firm guilty of obstruction of justice. The conviction meant that Anderson was no longer allowed to perform audit work for listed corporations under SEC rulings.[25] A year on, the Supreme Court squashed this decision a year on grounds that Anderson did not have the intent to obstruct the course of justice. This came too late as the global firm had by that time been restructured and sold or merged with various third parties.

As the drama in the demise of Enron began to surface, the conflicting roles played by various financial institutions in the financing of Enron’s many dubious SPV ventures became more apparent. One such sham transaction involved the purchase of Nigerian Barges by Merrill Lynch from Enron in 1999, on the understanding that Enron would repurchase them from the former at a premium of US $12 million. The SEC later charged the four Merrill Lynch senior executives for aiding and abetting Enron to manipulate its earnings reports. In the end, the bank dismissed these four executives

and paid US $80 million in fines to the SEC. ‘…Deutsche, CIBC, Barclays… were all found by the (bankruptcy) examiner to have aided Enron officers to breach their fiduciary duties by participating in window dressings, SPE-related deals, or asset parking’. [26] In many instances, these resulted in out of court settlements involving large sums of fines by the SEC.

It was only after the happening of Enron that the FASB responded with Interpretation No. 46 to deal with the reporting challenges posed by the SPVs. Blame has also been put on the SEC itself for not overseeing effectively the glaring failures emerging from big corporations like Enron. Often cited is the failure of the SEC to review Enron’s convoluted filings in 1998, 1999, and 2000, in particular Forms 10-k. However, a more probable explanation is SEC’s lack of financial resources and slowness in recognising the FASB as the accounting standards board. Early recognition of the latter would have enabled the FASB to expedite guidelines for reporting standards to deter and prevent the abuse of financial reporting obligations. [27]

The courts have also been blamed for sending the wrong signals to financial advisers when they dismissed the 2002 lawsuit against WorldCom on grounds of prejudice [28]; and much earlier in the 1994 Supreme Court ruling that professional advisers knowingly aiding and abetting securities fraud are not liable to victims. [29] These decisions probably helped fuel the reckless actions of auditing and investment firms as they engaged in intensive competitions. It was only in the aftermath of Enron that

[29] Central Bank of Denver v First Interstate Bank of Denver

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the courts began to take a much tougher stand.\footnote{Eichenwald, K., ‘Enron Ruling Leaves Corporate Advisers to Lawsuits’, New York Times, 23/12/2002} The severe criminal penalties imposed by the court subsequently on key Enron officials and the hefty fines imposed in deferred prosecution judgement cases contributed significantly to the return of market calm and credibility to the US capital market.\footnote{Elliot Spitzer, the New York state Attorney-General was particularly effective in disciplining various financial intermediaries through the use of deferred prosecution agreements.}

**WorldCom (WC)**

*Background*

WorldCom grew from its small 1984 base to become by 2001 the second-biggest US telecommunications and data communications corporation after sixty fast-tracked acquisitions.\footnote{Jeter, L.W., ‘Disconnected: Deceit and Betrayal at WorldCom’, 2003, John Wiley & Sons Ltd.: West Sussex} However, the sector’s over surplus capacity in late 1990s brought severe beatings to its share price, which became worse after its abortive merger attempt with Sprint its major competitor. Plagued by this; class action lawsuits over billings disputes; dismissal of its auditor Arthur Anderson; and more importantly over media reports of accounting irregularities, WC’s CEO Ernie Ebbers resigned in April 2002. Scott Sullivan WC’s Chief Financial Officer followed suit thereafter. The situation aggravated shortly thereafter with WorldCom’s financial restatements showing cash flow overstatement of some US $3.85 billion.\footnote{New York Times, ‘WorldCom’s Financial Restatements’, New York Times, 26/06/2002} When SEC charged WC for defrauding the capital market in late June 2002, the corporation reeled under it and had to file for protection from creditors under Chapter 11.\footnote{Beltran, L., ‘WorldCom Files Largest Bankruptcy Ever’, CNN Money, available at http://www.cnnmoney.com, 22/07/2002}

WC resurfaced under the new corporate name of MCI in May 2004 together with a
reconstituted board. Prior to that, Sullivan conceded to the charges of fraud and conspiracy and agreed also to turn prosecution witness against Ebbers who was faced with similar charges. Ebbers was found guilty of fraud and conspiracy in March 2005, and sentenced to 25 years jail in July 2005.\[35\]

Use of OBF

WC provided connectivity to more than 100 countries, and owned and managed 75 data centres across five continents.\[36\] In the process, the company spent US $60 billion on 65 acquisitions from 1991 to 1997. These were financed by equities and debts of some US $41 billion.\[37\] The dotcom boom facilitated WC’s growth through acquisitions strategy by placing high premiums on the company’s shares. WC’s high market valuation won further support from the capital market and it accordingly provided it with further financial resources to sustain the expensive acquisitions of MFS Communications and MCI Communications.\[38\] Whilst WC’s growth through acquisitions makes great investment stories they became disastrous when not properly managed.\[39\]

The company’s downfall was reflected in the plunging of its stock price from US $72 to less than US $1 within four years. This has been attributed to mismanagement, massive debts, and accounting manipulations. ‘Much of it (the US $37 billion debt) was used to pay for legitimate, if overpriced, acquisitions…and some of it was used

\[36\] Available at http://www.worldCom.com/global/about/facts, viewed on 23/01/2003
\[37\] Kurt, E., ‘For WorldCom, Acquisitions were Behind its Rise and Fall’, New York Times, 08/08/2002
\[38\] ibid
\[39\] Supra note 32
The employment of massive debts was accompanied by significant use of OBF mechanisms although less than the scale of those in Enron. The personal loan of US $341 million to its CEO strained further the company’s financial reputation. Such ‘sweetheart loans’ to senior executives were then not uncommon in Wall Street. What disappointed the market was that it was the largest by far, and undertaken merely to avert further dumping of the CEO’s shares in the market. The board’s controversial move and the efforts of whistleblowers attracted enquiry from the SEC

With a high debt structure to service and not much to offer by way of performance, the company resorted to the use of creative accounting devices to distort its earnings and financial performance. In particular, most of its acquisitions were grossly underperforming due to surplus capacity in the sector. WC artificially expanded the merger expenditure with the cost of the acquired company’s expenses expected in future accounting periods. These inflators from post-acquisition reporting can only continue to operate with bigger deals to keep them going.

This accounting approach allowed WC to write-off the business goodwill over some forty years instead of around four years under normal GAAP. It also meant that earnings in the company would be reduced by much smaller increments. This enabled

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[40] Supra note 26
[42] Lublin, J. S. & Young, S., ‘WorldCom Loan to CEO of US$341 Million is the Most Generous in Recent Memory’, WSJ, 15/03/2002
[43] Young, S., ‘Big WorldCom Loan May Have Spurred Inquiry’, WSJ, 14/03/2002
the company to overstate for instance its 1997 pre-tax profits by US $209 million. Such financial manipulations were magnified upon its abortive merger plans with Sprint.\[45\]

WC in the early 1990’s betted heavily on the potential of the telecommunications services market by contracting on long-term lease agreements with various telecommunications carriers to gain access to their networks. WC under these arrangements had to service fixed monthly obligations to these carriers irrespective of actual use of the leased facilities. These line costs were therefore the fees that the company incurred with local telephone companies to carry the calls of its clientele. Such line expenses had to be capitalised from the latter half of 2002 onwards with the worsening market conditions for the company’s products in order to understate operating expenses and exaggerate earnings. This, however, was against GAAP reporting guidelines.\[46\]

WorldCom employed this form of tactical reporting from the first quarter of 2001 through to the first quarter of 2002. This exaggerated the company’s earnings, total assets and net worth. This clearly violated the accounting standard for treatment of line costs.\[47\]

Steven Brabbs, the company’s Director of International Finance and Control maintained that Sullivan was aware of this wrongdoing. ‘…What we agreed to do was to create a ‘management company’ (Not a legal entity) and post it there…but I was making it clear that I did not see it as a journal entry that I could support from a legal or US or local accounting perspective.’\[48\]

\[45\] ibid, 30
\[46\] Supra note 45, 31
\[47\] ibid, 33
\[48\] ibid, 36
Via the above scam, WorldCom reported, pre-tax profits of; US $1.6 billion in 2000 (when in fact it was only US $365 million); US $2.4 billion in 2001 (as against an actual loss of US $662 million), and; US $240 million for the first quarter of 2002 (as against an actual loss of a minimum of US $557 million). In short, these accumulated massive losses were transformed into earnings adequate to satisfy the expectations of the capital market. Over and above these items, WorldCom had also effected other improper off balance sheet arrangements involving the sales of certain specific receivables to a wholly-owned bankruptcy remote subsidiary. The subsidiary’s funding was provided by US $1.5 billion advances generated through a securitisation process funded by several banks and financial institutions. The pressure of Wall Street expectations therefore drove WC’s use of OBF and other related creative accounting gimmicks.

Legal Implications

Whistle-blowing pressures of the above financial irregularities by WC’s internal auditor necessitated financial restatements for the company’s 2001 and first quarter 2002 accounts. Though Anderson denied knowledge of the defective accountings prior to June 2002, email records from Brabbs showed that they were informed of these adjustments in early April 2000. On the basis of the facts as stated, Magistrate Judge James C. Francis IV held that there was probable cause to conclude that a criminal conspiracy to commit securities fraud had existed at WC. Accordingly, ‘… he signed warrants for the arrest of the alleged co-conspirators, Sullivan and Myers. On September 26, 2002 Myers pled guilty to a three-count criminal information charging conspiracy, securities fraud, and false filing charges…Sullivan pleaded
guilty to fraud and conspiracy in March 2004 and consented to testify against Ebbers on similar charges. On July 13, 2005, a New York Judge sentenced Ebbers to 25 years …Ebbers filed appeal thereafter’. [52]

The collapse of WC could therefore be attributed to over-aggressive acquisitions without proper follow-ups; display of serious conflicts of interest; overcapacity in the ICT sector and the manipulative use of OBF. The Thornburgh Report in particular cited the disproportionate compensation handed out to Board members. [53] Further, ‘An unusual ‘retention bonus program was implemented in 2000 including US $10 million payments to Ebbers and CFO Scott Sullivan’. [54] This was made worse by general failure of the audit committee to address or monitor serious financial irregularities highlighted by the company’s internal audit division. [55] Similarly, Anderson also failed to do likewise. [56] ‘The working papers supporting the 1999, 2000, and 2001 audits show that Arthur Anderson considered WC to be a ‘maximum risk’ client, based on the company’s prior misapplication of GAAP, and its use of multiple billing systems. [57]

The SEC Chairman Arthur Levitt Jr. in 1998 described auditors and analysts as participants in a game of nods and winks. [58] Subsequent events in WC’s corporate history showed that Anderson had not objected to various accounting

[55] ibid, 510
irregularities, which contributed to the company’s eventual downfall. Citibank and Solomon Smith Barney benefited tremendously from WC’s many acquisitions. Ebbers in turn found easy financial support from the Citibank Group for his other private businesses. The mutual support displayed strong elements of conflict of interests. For example, ‘Since the loan to Ebbers was collateralized by his equity holdings, Ctigroup had reason to prop up WC stock. And no one was better than Jack Grubman, Salomon Smith Barney’s telecommunication analyst. Grubman first met Bernie Ebbers in early 1990s…The two hit off socially, and Grubman started hyping the company’.

New York’s Attorney-General, Eliot Spitzer filed proceedings against Bernard Ebbers and other senior executives for failing to disclose their respective allocations of ‘hot’ IPO shares and the nature of the investment banking relationships; unjustly enriching themselves and violated Article 23-A of the General Business Law (‘the Martin Act’) and section 63(12) of the executive law. The charge sheet alleged that Smith Solomon Barney (SSB) allocated hot IPOs to the defendants through a ‘spinning’ process whereby such shares so obtained were subsequently liquidated in the active market with huge profits; and SSB in return was allocated lucrative investment banking business.

On October 11, 2002, the SEC filed charges against Ebbers and Sullivan for violating Sections 11 and 15 of the Securities Act; SSB as underwriters for violations of Section 11 of the Securities Act; Anderson for violations of section 10(b) of the Exchange Act and Rule 10b-5; and SSB and Grubman for violations of section 10(b) of the Exchange Act and Rule 10b-5; and Citigroup and Salomon for

[61] As per 1 & 2 of the charge sheet filed on 30/09/2002
violations of section 20(a) of the Exchange Act.

For his controversial and conflicting role in the whole episode leading to the downfall of WC, Jack Grubman was required to resign from his US $20 million a year job, and barred from securities transactions for life by the SEC along with a fine of US $15 million.\[62\] Citigroup which controlled SSB agreed to compensate WC’s investors’ law suit with US $2.575 billion.\[63\] Anderson agreed to settle out of court for a cash sum of US $65 million; 20% of any distribution to any of Anderson’s 1,700 partners; and a further confidential protection for the class in the event of a bankruptcy proceeding by Anderson.\[64\]

The total amount recovered for the WorldCom investor class came to about US $6 billion. Apart from the recovery from various banks and financial institutions, it is interesting to note the personal settlements of US $4.5 million from WC’s former Chairman Bert Roberts;\[65\] and other former outside directors.\[66\] As for Ebbers, he was sentenced to 25 years jail on being found guilty of all seven counts of filing false documents by the federal court.\[67\] SEC’s power to distribute WC penalty funds to injured investors though challenged by unsecured creditors was upheld by the court.\[68\]

\[62\] supra note 60, 8
\[63\] Financial Times, 11/05/2004
\[65\] Office of New York State Comptroller (Alan G Hevensi), ‘Hevesi Announces Settlement with Former WorldCom Chairman Bert Roberts Final Director Defendant to Pay from His Own Pocket’, available at http://www.osc.state.ny.us/press/releases/mar05/032105a.htm, Press release on 21/03/2005
\[66\] ibid
\[68\] WSJ, ‘Court Upholds SEC Plan for WorldCom Penalty’, WSJ, 04/10/2006
Sunbeam Corporation (SC)

Background

SC is involved in the manufacture of durable household consumer items. The sustained under-performance of the company in the first half of the 1990s saw the appointment of turnaround specialist Albert Dunlap as its CEO in July 1996. Upon joining, Dunlap downsized SC’s personnel and product offerings, and wrote-off more than US $100 million of inventories. This cost-cutting turnaround strategy apparently transformed SC’s loss-making performance of US $2.37 per share in 1996 to US $0.77 earnings per share in 1997. The market responded favourably resulting in the rise of SC’s market capitalisation to about US $50 per share.[69] Dunlap’s initial plan to dispose the company after the share price rise found no takers from the market owing to weak market sentiments.

Dunlap’s alternative investment play was to project SC’s double-digit growth through acquisitions. Done in haste, these became very costly to the company.[70] Dunlap also tried to boost higher market valuations through further stories of more acquisitions, but this did not work well. He was eventually forced to resign in May 1998 when information came through that the impressive earnings in 1997 was the result of financial report doctoring. The company had to file for Chapter 11 bankruptcy protection when its equity eroded to a negative US $1.9 billion under a pile of massive debts.[71] To enable the company to recover from its financial plight the

court provided interim relief for the company to access further finance for its domestic businesses.\[72\]

Use of OBF

The Centre for Research and Analysis (CFRA) believed that large portions of 1997 expenses were taken up in 1996, making the financials in 1996 looking far worse than it really was, and the reverse picture for 1997. The mechanism employed to engineer this appeared to originate from the special restructuring charges created in the fourth quarter of 1996. Such items under normal accounting conventions should have been capitalised and progressively written-off.\[73\]

The CFRA also found it odd that SC’s huge improvements in net income resulted in a deteriorating operating cash flow for the company. Indeed, ‘…As a result the CFFO (cash flows from operations) to net income shortfall widened by US $97 million for the quarter and by US $103.2 million for the nine months’.\[74\] CFRA further attributed the deterioration in operating cash flow to the sharp rise in accounts receivable growth by some 21 days.\[75\]

SC tried to meet market expectations through various accounting gimmicks. When these failed, Dunlap then turned on the reserves created by the company’s US $300 million restructuring charge. Such reserves were used to cushion the slip in

\[73\] Center (Centre) for Financial Research and Analysis (CFRA), ‘Sunbeam Corporation’, available at http://www.CFRA, 18/12/1997
\[74\] ibid, 3
\[75\] ibid, 3-4
earnings. Despite this, SC’s earnings failed to fall in line with the market’s expectations, and SC’s stocks fell by some 10% to US $37,625.[76]

Analysts became concerned with SC’s trade debts, which grew by 36.42%, and was therefore climbing faster then revenue growth of 18.69%.[77] Notes to SC’s 1997 Annual Report on two key items, provided some clarifications of this apparent inconsistency. In respect of revenue recognition, the company explained that its ‘bill and hold policy’ had contributed about 3% of its consolidated revenue. The other pertained to SC’s real growth in debtors, which had been understated by the level of trade receivables sold to its wholly owned subsidiary at the end of 1997.[78]

Pressures mounted much stronger in the second quarter of 1998, when the company’s internal audit team raised alarms over the company’s accounting policies. The pressure piled further when SC’s public relations manager resigned on the day of SC’s planned release of its financials.[79]

The above inconsistencies and other accounting matters forced SC to submit financial restatements for fiscal 1996, 1997 and the first quarter of 1998. [80] The restated earnings filed to the SEC showed significantly higher losses than reported earlier. Sunbeam’s stock price, which had hit a high of US $52 fell over 9% on March 9 when profit warnings were issued. Subsequent profit warnings and news of accounting

[77] Laing, J.R., ‘Dangerous Games’, Barron’s , 08/06/1998
[79] supra note 76, 14
inconsistencies and SEC’s investigations plunged the stock to US $6. The company was eventually de-listed by the NYSE in 2001.

The company turned to the use of OBF securitisation and factoring facilities when its earlier cost-cutting turnaround tactics and ‘bill and hold’ policy lost their usefulness. All these financial window-dressing efforts were undertaken to support the upbeat story fed to the market by the CEO. His actions were driven by the need to shore up the company’s market capitalisation to justify further funding support. In the end, the company collapsed under a pile of heavy debts, when both the company’s core business and acquisitions failed to perform. Whistle blowing of the company’s controversial accounting policies and eventual SEC investigation contributed to the acceleration of the demise of SC.

Legal Implications

The SEC in the face of mounting criticisms and evidence of financial irregularities at SC pursued litigations against Albert Dunlap, Russell Kersh and other senior executives of SC, and an Arthur Anderson audit partner. The SEC maintained that, ‘The illegal conduct began at year-end 1996 with the creation by Kersh and others of inappropriate accounting reserves, which increased Sunbeam’s reported loss for 1996. These ‘cookie-jar’ reserves were then used to inflate income in 1997, thus contributing to the false picture of a rapid turnaround in Sunbeam’s financial performance... Dunlap, Kersh and others caused the Company to recognize revenue for sales, including ‘bill and hold sales’ that did not meet applicable accounting rules. As a result, for fiscal 1997, at least US $60 million of Sunbeam’s reported US $189 million in earnings from continuing operations before income taxes came from
accounting fraud. They had therefore misrepresented or caused the company to misrepresent its performance and future prospects in its Form 10-Q filings; its bond offering disclosure materials; its press releases; and in its communications with analysts.

The consent judgement barred Dunlap and Kersh permanently from serving as officers and directors of public corporations. It also required Dunlap and Kersh to pay respective civil penalties of US $500,000 and US $200,000.

SC’s Vice-President of Sale, Lee Griffith was similarly required to pay a civil penalty of US $75,000.

Phillip E. Harlow, a partner at Arthur Anderson was prosecuted for authorizing unqualified audit opinions. Arthur Anderson for its part agreed to pay US $110 million in April 2001 as settlement for the litigation. Meanwhile, Ronald Perelman mounted a separate but related suit against Morgan Stanley for faulty advice on the SC merger deal. The Florida jury in May 18 ordered the investment bank to compensate Perelman US $1.45 billion. Morgan Stanley’s case was weakened by its failure to provide all relevant documents to the court and explanations for its changed of counsellors.

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[81] SEC, ‘Former Top Officers of Sunbeam Corporation Settle SEC Charges: Dunlap and Kersch Consent to Fraud Injunctions, Permanent Officer and Director Bars, Civil Monetary Penalties’, Litigation Release 17710, 14/09/2002
[82] ibid
[83] ibid
[88] ibid, 4-5
Boston Chicken (BC)

Background

BC has been described to be the most successful in transforming a ‘larger societal trend into a practical business concept’. [89] George Nadaff and two other former Blockbuster Video executives took over BC in 1988 and grew it to 35 outlets in the North Eastern region by 1992 through a strategy of market dominance and fast growth. [90] To help fund its rapid expansion, it entered the capital market through an IPO in 1993. Its share price then climbed steadily on account of the company’s fast growth and the high profile activities of its CEO. [91]

The main driver for BC’s rapid growth was attributed to its ‘Franchise Area Developers ’ (FAD) model. This involved the linking up with area franchisees with the capacity to manage at least ten outlets each. These FADs were assisted in the funding of their operations of up to 75% of their capital needs by BC. In turn, BC tapped on market funds to finance these FADs.

Though BC had management controls over these FAD operations, their impact on BC was unaccounted for. [92] In effect, the FADs became BC’s SPVs for the hiding of debts and losses. Nonetheless, when some US $754 million of loans to FADs became irrecoverable, BC owned up to this by converting them into company-owned locations. This spelt the beginning of the downfall of BC.

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[89] Chun, J., ‘Spunky Chicken: Lessons from Boston Chicken Could Help Your Franchise to Take Wing—Includes Information on Gourmet to Go—Company profile’, Entrepreneur, August 1996, 1
[90] ibid, 2
With reporting of huge losses, BC’s shares nosedived from its IPO entry price of US $40 in 1993 to US $3.02 in 1998.[93] When matters got worse, BC filed for Chapter 11 reorganisation and closed 178 locations thereafter.[94] McDonald’s acquired the majority of BC’s assets for a consideration of US $173.5 million.[95]

Use of OBF

In the initial phase, the fast growth achieved by BC through the FADs attracted financial support from the financial community and also helped to boost its share price. The FAD concept collapsed, when ‘…Boston Chicken’s finance department failed to keep a sharp eye on the profitability of the restaurants, whilst its strategists failed to preserve the unique focus of the concept’. [96] Despite some prior concerns, various financial intermediaries and analysts continued to rate BC positively.

Not all participants were, however, oblivious to BC’s pressing problems. Restaurant experts, short-sellers and national publications such as Fortune and Business Week had already been troubled by BC’s aggressive accounting techniques for the greater part of 1997. Their main concerns were targeted at BC’s accounting policy for not factoring in shortfalls at the franchises when determining profits. ‘The company’s financial structure is designed to decouple reported earnings from reality’. [97] BC publicly conceded facing market competition problems, but these had nothing to do with accounting. [98] As it turned out later, much of BC’s problems had everything to do with its misplaced aggressive accounting policy.[99]

[94] supra note 92
[98] ibid
BC’s massive losses, the FAD loans, and increasing capital and working capital expenditures were all funded by equity and debts from Wall Street. ‘The company was basically re-circulating money raised from public shareholders and debt-holders and claiming it as profit while the underlying stores operated at a loss well off the company’s balance sheet’.\[100]\ The BC franchising format had transformed it into a credit institution, which needed other core skills BC did not have. These were compounded by serious operational problems.\[101]\ 

On February 9, 1998 the company made special charges of between US $250 and US $350 million against fiscal 1997. The company explained that these charges were related to bad loans to franchisees and write-downs connected with its strategic business shift. The former involved some US $700 million in loans considered to be potentially irrecoverable, whilst the latter involved the taking over of those 743 franchised stores failing to pay its debts to BC.\[102]\ 

Reporting pressures on BC increased after a whistleblower informed the SEC of its accounting irregularities. For instance, under accounting guidance BC was required to review its loans portfolio and to make adequate provisions for doubtful accounts. No loans were ever considered to be in doubts by the company in its correspondence with the SEC.\[103]\ 

From mid-1996 thereon, BC began disclosing the total losses incurred by the

\[100]\ supra note 99, 2
\[101]\ ibid
\[102]\ Victoria, G., ‘Bad Loan Charge at Boston Chicken’, Financial Times, 10/02/1998, 18
\[103]\ Richards, B. & Thurm, S., ‘Boston Chicken Case Mirrors Enron Failure’, WSJ, 13/03/2002, C1
franchisees, which for each year exceeded BC’s own net profits. The new auditors, PricewaterhouseCoopers, concluded that the company should have recognised no less than US $630 million as delinquent loans at the end of 1997. The earlier contention by Anderson that such loans were okay had excluded rent and advertising expenditures in its assessment of the franchisees’ profitability.[104] Despite the strains posed by BC’s losses and those of the FADs, the company’s annual filings of its financials from 1993 to 1997 showed no signs of financial problems. This had allowed BC to prolong its inevitable demise.

*Legal Implications*

From an accounting perspective, the FADs were merely BC’s investments as it has equity interests of up to 20% in most cases. In all cases, however, BC had the right to convert its loans into equity, and these usually were set beyond 50% of each FAD’s shareholdings.[105] Despite this and BC’s control over their management, the company chose not to reflect these FADs’ financial effects on its financial statements.[106] Instead, BC argued that as it held less than 20% equity in these FADs, it was not necessary for it to use the equity method.[107]

BC largely faded away with the sale of its Boston Market chains in 2000, other than the continuing lawsuits mounted by the company’s bankruptcy trustees. This included their case against Anderson for creating ‘a façade of corporate solvency’ by not disclosing the losses amassed by the FADs. The trustees argued that these FADs were

[104] supra note 99
[105] ibid
only nominally independent and were in reality predominantly controlled by BC to manipulate its consolidated accounts. In February 26, 2002, Arthur Anderson (AA) paid US $10 million to former shareholders of BC.

The bankruptcy trustee also sued key officers and executive directors of BC as well as the underwriters for BC’s IPO. The suits were based on, ‘…the claim that the defendants violated federal securities laws by issuing false and misleading public statements relating to BC’s business position and future prospects’. Most of these suits were settled out of court by hefty compensations to the bankruptcy trustees and BC’s shareholders.

This case shows that when financial window-dressing is pressed to the limits, it tends to degenerate into various forms of financial manipulation capable of breaching securities laws or other types of soft laws to attract civil and criminal sanctions. Direct and indirect participants of such defective financial reporting are implicated, albeit to varying degrees of culpability.

**Microsoft Corporation (MC)**

*Background*

The history of MC began with an initial contract with Micro Instrumentation and Telemetry Systems (MITS) in 1975. Thereafter, the company grew phenomenally

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to be the world’s dominant software development giant and in the process made Bill Gates, the world’s richest man.\[110\]

MC’s sales reached US $140 million within a decade of its operations, resulting in net income of US $24 million. Sales soared over the next decade to US $6,075 billion in 1995. This culminated with a net income of US $1,453 billion.\[111\] MC’s revenue reached a spectacular US $39,788 billion in fiscal 2005 resulting in a net income of US $12,254 billion. All these looked deceptively easy under the founder’s stewardship. In reality, the tasks were formidable considering that during the three decades of its existence, the company had to face two very serious anticompetitive charges, which nearly saw the split of the company into two businesses.\[112\]

Unlike other corporations which reported high revenues and high net incomes amidst a background of general illiquidity, MC is totally and distinctively different in view of its spectacularly high cash reserve strength. For instance, its current ratio for fiscal 2005 stands at more than three is to one, with liquid or quick assets representing close to 80% of its total current assets. The company’s long-term debt equity ratio at less than 0.1:1 is hardly noticeable.\[113\]

The main threats to MC’s dominance in the market appear to emanate from its brushes with the law over anti-competitive or anti-trust issues.\[114\] It may also have to...

\[111\] Microsoft Home Page, available at http://www.microsoft.com, viewed on 08/08/2005
\[112\] ibid
\[113\] ibid, The ratios were calculated from the company’s audited statements
\[114\] The Times, ‘Microsoft Agrees to Pay US $761 (£ 435.8) Million to Settle with Rivals’, 12/10/2005. Microsoft over the past few years have settled some US $3 billion with IBM, Sun Microsystems, Time Warner and others over its anti-competitive behaviour.
address the competitive challenges posed by Google and others who are now nibbling at its various market segments at rapid pace.

To neutralise its domineering image, MC has now initiated steps to allow shareholders to have greater influence in the appointment of directors. Gates has also announced retirement within the next two years to allow for orderly and early succession in the giant corporation.

*Use of OBF*

MC courted some minor controversies over its substantial use of employees’ stock option plans (ESOP’s), especially at the early formative stage of its corporate history. In the early cycle of the Silicon Valley phenomenon in the late 1970s, it was common practice for many high-tech and internet-related companies to provide stock option schemes as a form of fiscal incentive to lure highly talented executives to work with low pay for substantial future rewards.

The controversy surrounding ESOP’s concerns the way it is treated in the company’s accounts. Though mainstream accounting practices would treat such stock-based compensations as expense items, the majority of US-based listed corporations ignored this convention. This approach was highly criticised by financial analysts as an off-balance sheet mechanism to inflate current profit reporting.

ESOP supporters argued that stock options do not entail cash outlay.

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[115] SFAS No. 123, paragraph 11 issued in 1995 allows a choice of accounting methods, with one using ASB Opinion No. 25 where the compensation expense is only disclosed as a footnote at its fair value, and; the other involving the measuring of the fair value of the stock option at grant date and treating this as an expense item.
Its deductions will therefore unfairly understate earnings. Additionally, the reductions of earnings through such subtractions will drive share prices down; reduce the use of such fiscal incentives for attracting talents to high-techs and hurt entrepreneurship in the process. Opponents argued that the expensing of such grants will reduce the incentives for key executives to manoeuvre short-term earnings report to push up share prices to realise their option gains.\[116\]

Some even argued that corporate profits could have been overstated by as much as 10% because of this reporting practice.\[117\] In 2001, Microsoft practically gave away one quarter of its net income in options to its employees. In 2002, the company gave option grants that can be converted into 41 million shares. Bear Sterns estimated that overall, S & P 500 companies gave away US $47 billion of their net income in options in 2001. The link between options windfalls and financial reporting manipulation had also become very real.

The financial excesses of the late 1990s especially the huge financial frauds perpetuated in Enron, WorldCom and others where ESOP’s were managed improperly led to massive calls for the reinstatement of stock options as an expense item rather than as a footnote item in financial statements. The former Fed Chairman Alan Greenspan asserted that ‘In principle, stock-option grants, properly constructed can be highly effective in aligning corporate officers’ incentives with those of shareholders. Regrettably, the current accounting for options has created some perverse effects on the quality of corporate disclosures that arguably is further

\[116\] Borrus, A. et al., ‘To Expense or Not to Expense’, Business Week, 29/07/2002
complicating the evaluation of earnings and hence diminishing the effectiveness of published income statements in supporting good corporate governance’.[118]

The Council of Institutional Investors supported his position, when it called for changes to avoid companies turning this into Ponzi Schemes.[119] Standard & Poor’s also introduced a new definition of operating earnings, which it termed core earnings wherein stock options would have to be expensed automatically.[120] With the writing on the wall, nearly 500 major quoted corporations by 2003 began to expense stock options voluntarily to comply with best accounting practice.

MC responded with a proposal for new restricted stock grants which would give the company’s employees a more balanced range of returns than holding stock options.

‘One source of particular anguish for many technology workers has been the requirement to pay tax when they exercise the options, even if they do not sell the stock. For workers who chose to hold their stock, only to see the market collapse, the tax payments became a painful cash drain’. [121]

Critics have argued that had Microsoft displayed stock options as an expense in its accounts in 2002 and earlier, ‘…employee costs paid in the form of options at Microsoft would have amounted to US $11 billions or so in the year to end-June 2000. On that basis, employee costs would have absorbed 77 per cent of the published

[118] Greenspan, A., ‘Corporate Governance’, Public Lecture at the Stern School of Business, New York University, 26/03/2002
pre-tax profit. The comparable figure for the whole technology information sector was 73%. This compared with a figure of just under (fewer than) 20 per cent for the survey sample of 325 of the largest US listed companies’.[122]

MC broke ranks with other high-tech firms by putting an end to its stock options schemes in July 2003 by offering its employees direct stock grants henceforth, which it will duly treat as expense items.[123] In April 2005, the SEC announced that SFAS No.123 (R) will be effective for annual reporting periods beginning on or after June 15, 2005. As MC had adopted fair value recognition July 1, 2003 and had restated previous periods at the time for all awards granted to employees after July, 1, 1995, the new accounting ruling did not have material impact on MC’s accounts.

MC disclosed in its 2005 financials that where its other primary off-balance sheet arrangements were concerned, the company had furnished a guarantee of US $51 million for the repayment of yen denominated bank loans of Jupiter Telecommunication Ltd., a Japanese Cable Company. Though MC has provided indemnifications of varying scope and amount to specified customers against claims of intellectual property infringement made by third parties arising from the use of its products, it has not encountered material liabilities as a result of such obligations and has accordingly not accrued any liabilities to such indemnifications.[124]

For derivative instruments designated as hedges, hedge ineffectiveness was deemed not to have material impact on the company’s earnings for financial years 2003, 2004,

[122] Pender, J., ‘Shareholders’ Glory Days May be Numbered: Going off the Rails’, 29/01/2003, 11. This was the findings of London-based research firm of Smithers & Company. According to the firm’s recalculations of the profits of 100 of the largest US listed corporations, the latter’s profits should have been 30% lower than reported in 1995 and 36% lower in 1996
[124] SFAS No.5, ‘Accounting for Contingencies’
and 2005. MC’s internal control system received unqualified opinion from its auditors, Deloitte & Touche. Where lease accounting was concerned, the company has properly followed the accounting conventions for its capital and operating leases.

MC’s excellent growth and financial performance have given it the strength to refrain from excessive financial window-dressing. Its early ESOP reporting approach has now been purged in favour of restricted options grants. The company has generally employed OBF instruments in a responsible manner and usually for business strategic reasons and some fiscal advantages.

Legal Implications

In the second half of 2005, the SEC started to investigate irregularities pertaining to the execution and recording of option grants in Silicon-based firms upon promptings by an academic study on 2000 top S & P companies. Findings from this study suggest that, ‘It was impossible for market insiders to predict share price movement ahead of time—so some of it must have been backdating’. It seems that some 29% of companies that granted options to top executives between 1996 and 2005 had manipulated such options in some way.

SEC’s preliminary investigations led to charges against a few firms and their senior employees for possible improper backdating of executive stock option grants. Some further 100 odd companies are currently under SEC’s investigation. Apple Computer represented one example of this, and the company is in fact still reviewing the extent

[125] SFAS No. 133
of the financial impact of such stock option-related charges.\[128\] MC is, however, for the moment unlikely to face the challenge, which others are facing in the Silicon Valley, as it had withdrawn from the use of stock options grants and replaced these with other financial incentives.

**Wal-Mart (WM)**

*Background*

Sam Walton launched WM as a discount general retailer in Arkansas in 1962 but took it to the NYSE in 1972 for its expansion plans. By the end of the 1970s, the company grew to 276 stores in eleven states. Sam’s successful formula was won by WM giving customers, what they expect from WM stores. This meant making available extensive range of good quality products at lowest possible prices and so on.\[129\]

The next phase of WM’s spectacular growth was achieved at the end of the 1980’s when its 1,400 stores achieved turnover of US $26 billion. The first warehouse Club, namely SAM’s Club was opened in 1983. The opening of ‘Supercenter’ in Missouri 1988 accelerated this growth momentum further.

Having achieved the status of being the biggest retailer in the US in 1990, MC then turn on its international market ambitions. Its initial foray in Mexico was followed thereafter by investments in Canada, China, the UK and Puerto Rico.\[130\]


\[130\] supra note 129
The WM group is managed through five major retail formats with three retail divisions. [131] WM’s business objectives are not just about mergers and acquisitions albeit an important prong of its competitive strategy. They are more about keeping the company’s customers happy with the right sort of products at competitive prices and an unbeatable WM shopping experience. It is primarily through the consistent application of the founder’s beliefs and vision that the WM continues to enjoy such global success. [132]

By 1997, its turnover had surpassed the US $100 billion mark and by 1999 its employees numbered 1,140,000 making it the largest private employer in the world. The world’s number one retailing giant went on to achieve a turnover of US $285.2 billion in 2005. By now the company employs some 1.3 million workers in the US and some 410,000 overseas. [133] Despite its spectacular business success, WM has received criticisms for some of its controversial business practices. For the moment, however, and probably in the immediate future, WM’s business operations will not be threatened unduly.

*Use of OBF*

Despite being the global leader in retailing, WM still has to leverage regularly on its competitive advantages as other global players, like TESCO, Carrefour, and Ahold are constantly at its heels. The intense competitive pressures have compelled WM to continue to seek growth internally through its own stores and externally via acquisitions and mergers. WM’s operating performance thus far shows that the

[131] ibid
company has responded effectively in most instances other than isolated pockets of failures like its 1998 unsuccessful foray into the German market.\textsuperscript{[134]}

Of particular interest for WM is that its operating profit growth is expanding faster than its sales growth, and its inventory growth is less than its sales growth. The cumulative effects of these resulted in the company achieving return on assets of at least 8% annually since 2002 despite its high asset base. Earnings per share have also increased from US $1.47 in 2002 to no less than US $2 in 2004 and 2005.\textsuperscript{[135]}

As a result operating cash flows from continuing operations have continued to maintain their annual growth trends.

This stable and impressive financial performance has provided WM with the confidence to disclose its OBF applications in accordance with best reporting practice. For instance, it has recorded two separate issues of US $500 million debts with embedded options within the current liability of its consolidated balance sheets. The company has also disclosed the use of financial instruments for hedging and non-trading purposes; and the risk mitigation measures it has taken in respect of these instruments.\textsuperscript{[136]}

Where the use of leasing instruments are concerned, the company has capitalised and disclosed its non-cancellable operating leases as part of its long term debts together with the long term portion of its capital lease obligations. Details on guarantees and other financial commitments provided by the company for transactions with third parties were also disclosed by the company.

\textsuperscript{[135]} Developed and calculated from WM’s 10b-k SEC Filings  
\textsuperscript{[136]} supra note 135
Other than the above, WM has also complied with other OBF related reporting guidelines issued by FASB. These include, among others;[137]

(a) FASB Interpretation No. 46, ‘Consolidation of Variable Interest Entities (SPVs)’. WM has explained that as the net sales and total assets of entities affected by this ruling is less than 1% of the company’s net sales and total assets, its adoption will have no material impact on the company’s financial instruments;
(b) FAS No.123, ‘Accounting and Disclosure of Stock-Based Compensation’. Its adoption by the company since 2002 has resulted only in a reduction of profits of around US $100 million.

WM does not make extensive use of OBF instruments. Its use of OBF mechanisms like leasing, stock options, and SPVs are principally made in pursuit of fiscal advantage and other strategic business considerations like financial support for its local suppliers in emerging economies to secure their supply lines. The company’s restatements in 2004 and 2005 to account for the impact of ESOP have also not caused material damage to its financials or its reputation.

Legal implications

WM’s rationale and manner of OBF applications clearly demonstrated the company’s appreciation of the risks and benefits associated with their usage. The company has used them in limited ways and adhered to their proper disclosure rules. More importantly, the company has exercised great financial discipline by not using them excessively to leverage on their earnings as some other corporations have done. This indirectly reflects on the corporation’s responsible behaviour towards risk

[137] ibid, 23
management. By using and reporting on the use of OBF and other related instruments in its current manner, any legal implications arising from their employment are likely to be of no material significance for WM’s management and financial gatekeepers.

UK Cases

Bank of Credit and Commerce International (BCCI)

Background

BCCI’s non-bank holding company in Luxembourg owned the two separate financial networks incorporated in Luxembourg and the Cayman Islands, despite its huge London presence. Events unfolding later strongly suggest that this was undertaken deliberately to cause maximum confusion about the way the bank conducted its business across the world. As the holding company was not regulated, consolidated supervision of BCC by the financial regulators was difficult to achieve. [138]

Under the leadership of its founder Agha Hassan Abedi, BCCI achieved phenomenal growth as it ventured into lucrative but high risks lending and shady deals with drug barons and other money-launderers across the world. Its controversial activities attracted the attention of financial regulators. Against compelling evidence from dictator Manuel Antonio Noriega, BCCI conceded to money-laundering charges in the US in early 1990. The bank was put under probation for five years and fined US $14 million. In the second half of 1990, the federal jury found five BCCI officials guilty of money laundering, and in the third quarter following this, Abedi was forced to resign from BCCI. [139]


[139] Wearing, R., ‘Cases in Corporate Governance’, Sage Publications: London, 2005; The whistle-blower was Jack Blum the attorney who served on John Kerry’s Committee on Drugs and Terrorism
The 1991 Price Waterhouse report to the Bank of England (BE) alleged extensive fraudulent activities at BCCI. The UK government thereafter ordered a public inquiry under Lord Bingham into the affairs of the bank. Subsequently, Sheikh Zayed, BCCI’s de facto controlling shareholder was requested to inject further equities to safeguard the interest of depositors. When this did not come about, BE executed the shutting down of BCCI’s operations on July 5 1991 in a well-coordinated operation across multiple economies to avoid and prevent further illegal erosion of the bank’s remaining assets. In reply to criticisms over its delayed response, BE argued that it, ‘…needed some objective proof before it (the BCCI) could be closed’.\[140\] In the end, the shut down of BCCI was achieved with minimum financial disruptions to key financial centres across the world.

*Use of OBF*

Where banking institutions are concerned, off-balance sheet transactions are contingencies extended and received. Banks make money through the provisions of such obligations in the form of upfront or periodic fees. Such contingencies extended by the bank do not carry with them immediate exposures, as there are no funds outflows at origination points; but they do generate credit risks in view of the possible future applications of the contingencies given. Outflows take place conditionally on the fate of the counterparty. Also where customers begin to employ unused credit facilities, the off-balance sheet items become an on-balance sheet loan. As discussed previously, derivatives in the form of swaps, futures contracts, and options now form an important component of banks’ off-balance sheet instruments.\[141\]

BCCI’s financial problems began in the late-1970s when it had to reluctantly respond to the financial difficulties of a major customer, namely the Gulf Group shipping corporation. The losses from this and other delinquent loans were covered through various financial scams. In fact, senior internal executives were perpetuating fraudulent undertakings involving falsification and fabrication of accounting entries and financial reports. These managed to hide otherwise huge losses away from the views of the creditors, and other capital market participants. This allowed BCCI to continue receive support from depositors and the financial markets to enable it to carry on with its charade longer than justified.[142]

BCCI’s downfall was precipitated by various circumstances and events. These have been attributed to the excessive falsification of accounts; revelations by whistle-blowers from within and without; dogged pursuit by a couple of US law enforcement officials; and the pressures on the auditors and the BE to finally act upon discovery of very serious financial irregularities.

Legal Implications
The downfall of BCCI brought major changes to banking regulations and supervision. In the US, this led to the International Banking Act (IBA) of 1991, which was ‘…aimed at strengthening federal supervision and examination of foreign bank operations in the US’.[143] In the UK, the Banking Act was amended, ‘…to give the BE the right to close down the UK operations of an international bank if it feels the overseas operations of the bank are not being conducted properly’. At the

[142] Spollen, A. L., ‘Corporate Fraud: The Dangers from Within’, Oak Tree Press: Dublin, 1997. The researcher here argued that BCCI’s commission of ‘almost all the cardinal sins against professional corporate governance’ precipitated its downfall. The research also highlighted that internal employee. committed most of the larger corporate frauds.

international level, the Basel Committee issued a subsequent set of minimum standards for supervision of international banks in response to the BCCI scandal.\[144\]

Price Waterhouse, BCCI’s auditor displayed various weaknesses in its gate-keeping role. It, however, became more proactive when key officials of BCCI were indicted in the US in 1988 for securities breaching activities. The case prompted the auditor to express its concern to the BE over the bank’s future especially in the context of alleged financial distortions in the latter’s 1990 accounts.\[145\] The BE apparently could not respond immediately with specific actions without solid evidence as it could not risk a run on the bank.\[146\]

Meanwhile, the consultancy division of Price Waterhouse proposed a rescue operation with injection of further equity funds from the Abu Dhabi shareholders. Whilst awaiting this, the auditor had to furnish details of fraudulent activities at BCCI to the BE in mid-1991. By then, the matter had reached beyond crisis proportions. With this overwhelming evidence and the transmission of further damming information on BCCI and its senior officials from the US, the BE decided to act more swiftly. Despite arguments by the consulting auditor that BCCI could be restructured to a more viable footing, the BE shut down BCCI’s entire operations in conjunction with other regulators where the bank had strong presence.\[147\]

Both the BE and Price Waterhouse were severely criticised by the 1992 Bingham Report. The former was criticised for failing to act after receiving a series of

\[144\] Hefferman, S., ‘Modern Banking in Theory and Practice’, John Wiley & Sons Ltd.: West Sussex, 2000, 280-282; (b) Howells & Bain, supra note 138 (a)
\[146\] ibid
\[147\] Accountancy, December 1992, 17
warnings of financial improprieties at BCCI. The latter was criticised for failing to fully brief the BE about the extent of the fraud it had found in early 1991. The US Kerry Report also criticised the two for their delayed response and lack of cooperation with US financial regulators.\[148\] Additionally, Price Waterhouse (UK) was criticised for not informing its US counterpart about the unusual facilities extended by BCCI to the parent company of First American Bank. It was claimed that this could have resulted in earlier remedial actions.\[149\]

The Treasury and Civil Service Committee (TCSC) concluded after weighing the Bingham Report that, ‘…it is incumbent on the BE to accept responsibility for its failure as the supervisor of BCCI, as demonstrated so clearly in the Bingham Report. Furthermore, we regard the absence of any disciplinary action of any kind against any of the individuals involved as undermining the future effectiveness of the bank, because it may lead staff to conclude that failure to carry their responsibilities effectively carries no adverse consequences for them as individuals’.\[150\] Nonetheless, the Chancellor of the Exchequer and in particular the Bingham Report stressed that the ‘…prime responsibility of course rests with those who devised, directed and implemented the frauds which were practised’.\[151\]

The TCSC, however, felt that the Bingham Report ‘…unlike that of the Treasury—does not exclude the possibility of some responsibility being attributable to others

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\[148\] Supra note 144, 282. Since its appointment as BCCI’s sole auditor in 1988, Price Waterhouse had submitted 10 reports to the BE including two outlining widespread corporate fraud.


\[151\] Bingham Report, paragraph 2.484
such as the auditors or the United Kingdom authorities'. [152] The TCSC also made the further conclusion that, ‘…the Bingham Report demonstrates conclusively that the BE ‘failed to discharge its supervisory duties in respect of BCCI’. [153]

Encouraged by these findings, the liquidator of BCCI mounted a compensation suit against the BE on the grounds of public misfeasance. The court trial collapsed in November 2005 as events unfolding were turning very much against the plaintiffs. Nonetheless, the House of Lords’ decision to allow the case to be heard on claims of public misfeasance suggests that legal risks still exist for regulators for failure to act. [154] The US justice Department indicted BCCI, Abedi, and others in late 1991 for engaging in racketeering and conspiracy pertaining to the illegal ownership of US banking institutions. [155]

**Barings Bank (BB)**

*Background*

BB began operations in London in 1762. It prides itself as an international investment bank with good knowledge of emerging economies. In fact, 1/3 of its employees were based in Asia and another half outside the UK. However, ‘Just as exposure in Latin America had led to its near ruin in 1890, so exposure in the Far East was the cause of Baring’s downfall in 1995’. [156]

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[152] Supra note 150, xiv
[153] ibid, xv
[155] Supra note 138 (b)
Unbeknown to the top echelon in the bank, its corporate culture was split between the new fast-moving Barings Securities (BS), and the other slower-paced traditional investment-banking arm. The clash of business cultures between the two divisions contributed significantly to the poor understanding of the derivatives business and in particular the kind of huge losses the latter is capable of inflicting upon the bank. The fall of BB has been attributed mainly to the reckless undertaking of highly speculative derivatives trading by BB’s Singapore operations manager, Nick Leeson nicknamed ‘the rogue trader’ by the BE. Nick Leeson was promoted to head Barings Futures Singapore (BFS) in 1992 after a successful supervisory stint in Jakarta.[157]

Being in charge of both trading and backroom activities, Leeson became able to engage in illegal trading activities without direct monitoring. Cash support from London to BFS had accumulated to some £742 million in February 1994, almost two times the then stated capital of the entire Barings Group.[158] Concerns expressed by the Bank for International Settlements (BIS) in Basle and the CEO of Salomon Brothers Hong Kong over rumours of derivatives problems at BB were flatly denied by BB.[159] Part of the problem was that none of the bank’s senior figures understood derivatives or derivative trading sufficiently.

Leeson’s illegal trading losses of some £800 million wiped up BB’s equity funds of around £200 million. The UK government was unwilling to bail out the bank and the initial interests showed by some white knights had also evaporated upon learning of the massive losses. The collapse of the bank led to an investigation by the Board of

[158] ibid, 176-177
Banking Supervision of BE. The outcome of the investigation in July 1995 placed the blame primarily on Leeson, ‘the rogue trader’. Other causes identified were the internal control weaknesses in the bank; and the failure of its auditors to spot Leeson’s fraudulent activities.

*Use of OBF*

The new capital requirements introduced by Basel 1 significantly increased the regulatory costs of bank intermediation and help tilt banks like BB more towards off-balance sheet banking techniques such as securitisation and the highly profitable but also highly risky derivative trade. Such off-balance sheet undertakings involved the use of financial instruments to generate income from fees and loan sales. This provided BB with attractive profits but yet do not have to be visible on its balance sheet. Income as a percentage of assets from the conduct of such undertakings had doubled from 1979 to the early 1990s.[160] It was difficult for BB to resist the temptation from expanding in such profitable ventures. The issue was really about the balance between profits and risks taking, and in this regard BB failed miserably because of the board’s general ignorance of the scale of risks involved and their preoccupation for personal windfall gains.

The fall of BB was the consequence of unlimited exposures in the derivative trade, but it has been contended that there was nothing complex about such derivatives. Leeson was an arbitrageur, and as such was incumbent upon him to be able to identify the differences in the prices of futures contracts and achieved profits by buying

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futures in one market and simultaneously selling them on to another. ‘Mr. Leeson was supposed to have been trying to profit by spotting differences in the prices of the Nikkei-225 futures contracts listed on the Osaka Securities Exchange (OSE) and the Singapore Monetary Exchange (SIMEX)...rather than hedging his positions, Leeson seems to have decided to bet on the future direction of the Nikkei index. By 23 February, when his actions came to light, Leeson had purchased US $7 billion in stock index futures and sold 20 billion worth of bond and interests rate futures contracts. Most of the losses came from the stock index futures’.\[161\] Under pressure by his superiors to show a good profit picture for the last week of February, Leeson had by that time betted the fate of the bank with further purchases of futures.\[162\]

Asymmetric information analysis of the principal-agent problem probably provides a better explanation of Leeson’s reckless behaviour and BB’s risk management lapse. ‘By letting Leeson control both his own trades and the back room, it increased asymmetric information because it reduced the principal’s (Baring’s) knowledge about Leeson’s trading activities. This lapse increased the moral hazard incentive for him to take the risks at the bank’s expense, as he was now less likely to be caught. Furthermore, once he had experienced large losses, he had even greater incentives to take on even higher risks because if his bets worked out, he could reverse his losses and keep in good standing with the company, whereas if his bets soured, he had little to lose since he was out of job any way’.\[163\]

At the end of it all, going big into the derivative trade was not the sole action of

\[161\] Hefferman, S., ‘Modern Banking in Theory and Practice’. John Wiley & Sons Ltd.: West Sussex, 2000, 284
\[162\] (a) Solomon, J. & Solomon, A., ‘Corporate Governance and Accountability’, John Wiley & Sons Ltd.: West Sussex, 2004, 53; (b) Howells & Bain, supra note 138 (a)
\[163\] Supra note 160, 238
Leeson. Despite the generally held belief of the rogue trader theory, Leeson could not have gone the distance without the lapse of supervisory attention and controls. His superiors were all chasing big profits for the bank and for personal gains. Leeson had shown them the way through the enhanced use of derivatives albeit under false pretences and misleading data.

**Legal Implications**

The bank’s lapse of management attention and lack of proper internal control procedures suggest an absence of responsible board behaviour. Also, account 88888 may be treated as a type of special purpose vehicle manipulated by Leeson to hide losses and unauthorised trading. It remained arguable whether senior management of BB was completely ignorant of the presence and conduct of account 88888. From various circumstantial events, it would appear that despite some signs of weaknesses in BB’s internal control system, the appropriate response was not put in place by senior management of the bank, and not sufficiently insisted upon by the external and internal auditors.\[^{164}\]

The Bank’s Group Treasury and Risk division set up in late 1994, had also failed to highlight the absence of gross position limits on proprietary trading conditions in Singapore.\[^{165}\] This was despite concerns raised in the industry and in particular the BIS. The BE may also have contributed to the ease with which Leeson was able to carry out his reckless speculative endeavours. Under existing EU regulations, UK banks need BE’s approval if more than 25% of their shareholders’ funds are placed into a single investment or transferred out of the UK. This was clearly the case for BB. Indeed, throughout 1993 and 1994 other than the April-June 1994 quarter, the

\[^{164}\] Financial Times, ‘Problems at Barings Singapore’, 04/03/1995, 18
\[^{165}\] Supra note 161, 286
bank’s exposure to the SIMEX and Japanese markets exceeded 25% of its shareholders’ funds.

George Maclean, BB’s Head of Banking Group, had highlighted this drawback to Geoffrey Barnett, the CEO of Barings Investment Bank. Maclean later reported that Thomson (a BE supervisory official) had advised him that the matter was buried reasonably deep in his in-tray, and that he was, ‘…happy with Barings having reported the situation and that we should continue to exceed 25% of our capital base from time to time’.[167] The ‘slip’ may probably explained why, ‘The granting of the BE’s nod and wink of approval was never documented’. [168] The BE concluded in its report, ‘…(a) that the losses were incurred by reason of unauthorised and concealed trading activities within BFS; (b) the true positions were not noticed earlier by reason of failure of controls and managerial confusion with Barings; (and) the true position had not been detected prior to the collapse by the external auditor, supervisors or regulators of Barings’.[169]

The auditor Cooper and Lybrand despite criticisms was only required to pay damages of £1.5 million as a consequence of negligence on relatively technical matters. The UK High Court attributed the failure to detect fraudulent trading by Leeson to management failure at BB. The BE came under severe criticisms by the TCSSC over various financial regulatory weaknesses, and was urged, ‘…to ensure that the type of laxity of management illustrated at Barings could not still go undetected under the

[167] Leeson & Whitley, supra note 166
[168] Ibid
new regime’. In 2000, regulatory powers on banking and financial institutions were removed from the BE and placed under the purview of the Financial Services Authority (FSA).

BB’s Executive Board members were found guilty of negligence over the management of the bank’s affairs and were duly disqualified as directors for various defined periods, on being found to be unfit for the office of directors. As for Leeson, he was found guilty of criminal charges and sentenced to six and half years’ jail in Singapore.

Maxwell-Related Group of Companies (MRGC)

Background

Robert Maxwell was a self-made publishing entrepreneur with tremendous networking skills. Despite reputation damage arising from the abortive 1969 Leaseco Data Processing (LDP) merger with Pergamon Press (PP) because of a $2 million profit overstatement in the latter; Maxwell recovered through the impressive performances in PP and Maxwell Communications Corporation (MCC) for much of the 1970s and 1980s. Maxwell also became very adept in raising funds from the capital and financial markets. He had additionally acquired the art of supporting shares at high prices through the assistance of friendly financial analysts and

[171] Re Barings plc (No.5), Secretary for Trade and Industry v Baker and Others (No. 5) Ch D [1999] 1 BCLC 433
connected financial institutions as well as inflated reports of quoted corporations under his control.[174]

Nonetheless, squeezed to the corner by the massive funding needs of his huge complex business structure, Maxwell was compelled to resort to illegitimate means to contain the crisis. This was reflected in one incident disclosed by a Maxwell employee where he had to engage in loading dummy stocks.[175] Falsification of financial reports could only temporarily prevent withdrawal of finance and support of stock prices. They cannot provide the fresh funds needed to sustain his many operations. Inevitably out of desperation, Maxell started to raid on the larger pension funds from listed corporations under his control. However, when things did not improve fast enough, financial market support began to wither away through forced selling of his collateralised stocks. Maxwell’s business empire crumbled under the weight of massive debts and losses. Shortly thereafter, he died under mysterious circumstances.

Use of OBF

The financial irregularities in PP’, which were uncovered by three DTI reports in 1971 to 1973 demonstrated Maxwell’s willingness to engage in financial reporting manipulation for business gains. When these reports described him to be ‘unfit for stewardship of listed corporations in the UK’, Maxwell responded through hard work and clever manipulation of his political networks to regain the trust and confidence of the business communities. Still, Maxwell shielded his business interests from public scrutiny by integrating the ultimate ownership of PP and MCC in Maxwell

[174] ibid; Financial Times, ‘High Prices’, 31/03/2001, 7
Foundation, a Liechtenstein entity he secretly controlled through a Swiss front man.\textsuperscript{[176]}

Maxwell’s personal feud with Rupert Murdoch his main business rival led him to expensive acquisitions’ which weakened his financial resources terribly. Commencing mid 1985, Maxwell began to make unauthorised use of pensions funds under his indirect control via the employment of connected authorised investment management. It was alleged later that Coopers and Lybrand Deloitte, the external auditor and consultants to most of Maxwell’s business interests were privy to such activities.\textsuperscript{[177]}

The connections between his businesses and the pension funds were opaque in nature and never provided information that these transactions were often made against the interests of the latter. Lending from the pension funds to his private business was usually window-dressed at fiscal year-ends. Beneficial ownerships of shares were also purposefully delayed in order to cause maximum confusion. In short, the use of off-balance sheet financing mechanisms by Maxwell originated in the mid 1980s.

Financial pressures began to mount in the latter part of the 1980s when his private interests had to take up the rights portion of MCC’s flotation in 1987 through a £300 million loan. This rose to £1 billion in 1989 because of further expensive acquisitions made by Maxwell. This debt was secured against MCC shares. MCC itself because of further expensive acquisitions had to assume an enlarged debt of US $3 billion. Maxwell switched funds deceptively from one company to another, and between the listed and private side of his business. This made it difficult for analysts,

\textsuperscript{[176]} (a) Thomas, R.J.L. & Turner, R.T., ‘Mirror Group Newspapers Plc: Investigations Under 432(2) and 442 of the CA 1985’, available at http://www.dti.gov.uk, DTI 2001, 4; (b) Kay, supra 173 (a)
\textsuperscript{[177]} Thomas & Turner, supra note 176 (a), 6-7; (b) Treanor, J. & Denny, C., ‘Maxwell Scandal Reignites’, The Guardian, 12/02/2001, 23
investors, and creditors to appreciate fully the financial health of the quoted corporations linked to him directly or indirectly.\textsuperscript{178}

The summer of 1990 was particularly difficult for Maxwell, as he had to juggle financial pressures affecting both the private and listed sides, and in particular MCC. On some occasions, Maxwell had to sell some assets belonging to the pension funds and used the proceeds to meet the needs of his various businesses. His attempts to sustain the price of MCC included secret purchases not disclosed to the stock exchange. Unable to stabilise his liquidity problems much longer, Maxwell had to resort to the flotation of the Mirror Group Newspapers (MGN) in April 1991. With this underlying objective behind the flotation exercise, it became increasingly apparent that assets and funds in MGN continued to be used by Maxell to support his various business interests. His problem was compounded by the fact that he had to continue to buy both MCC and MGN shares in order to support their prices. This was of huge importance as he had used both of these shares as collaterals for bank borrowings.

Despite the flotation of MGN, and the abusive use of its assets and those of MCC, Maxwell was still unable to contain the financial squeeze impacting on most of his operations. Hence, when Goldman Sachs and Citibank dumped MCC’s shares because of servicing failure, its price plunged disastrously. Matters were coming to a head when Maxwell suddenly died under mysterious circumstances in November 5, 1991. Upon his death, his business empire fell apart completely, reflecting a

\textsuperscript{178} Supra note 176, 8-9
conglomerate built on debts and financial deceptions. Some £450 million was also found missing from various Maxwell-controlled companies’ pensions funds.\[179\]

**Legal Implications**

The Maxwell financial scandal was highly criticised for its lack of punishment for key participants involved. Maxwell’s sons, Kevin and Ian were exonerated in the court trials which followed. There were some criticisms in the City for the absence of some kind of disciplinary actions on various financial institutions and individuals said to be closely involved with the Maxwell saga.\[180\]

The stock market regulators were also criticised for allowing MGN to be floated despite prior warnings about Maxwell’s personal integrity and trustworthiness.

‘MGN should never been allowed to float as the prospectus (prepared by Coopers & Lybrand Deloitte (CLD)) was materially inaccurate and misleading’.\[181\] In fact, it has been argued that CLD’s ‘…annual audit (of Maxwell’s businesses) was the loss leader to sell their more profitable consultancy services’\[182\].

The investment bankers’ roles in the whole Maxwell saga have also received critical comments. ‘Goldman Sachs, Wall Street’s top investment banker, organised Maxwell’s manipulation of his companies’ share prices until he assumed significant majority control of the shares. It tried to maintain that Maxwell lied to them, but the DTI inspectors clearly thought the bank was lying…Senior management must have

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\[181\] Shaoul, supra note 180

\[182\] (a) ibid, 2; (b) Sikka, P., ‘Maxwell Auditors and Self-Regulation: The Verdict’, available at http://visar.csusatn.edu/aaba/auditmaxwell.htm, viewed on 05/06/2005. Professor Sikka argued that this was a case of audit failure despite the audit industry’s attempts to assign the blame entirely on Maxwell.
known that Maxwell was behind the overseas buying by Liechtenstein trusts (where Maxwell’s private companies were registered) but did not tell the regulator, the (DTI) report said\(^{[183]}\).

MGN’s merchant bank, Simon Montagu was also not spared from criticism for its role in preparing the flotation of MGN. The bank, ‘…did not ask the right questions. If they had, the flotation would have to be abandoned’.\(^{[184]}\) The corporate lawyers were also criticised for not carrying out proper checks and the directors and trustees in the Maxwell business empire were unfavourably commented upon for not acting with sufficient independence and for condoning Maxwell’s controversial activities. Despite such failings, no board members or trustees had to answer for their flawed corporate behaviour.

On balance, the Maxwell episode did lead to substantial changes in corporate governance practices through the recommendations of the Cadbury Committee in 1992 as well changes in financial reporting practices thought the setting up of the ASB. Where the use of OBF is concerned, the case showed clearly the dishonourable intentions behind their use. Large numbers of Maxwell corporations were used more like ‘special purpose vehicles’ for the illicit transmission of funds between related listed corporations and Maxwell’s private businesses. Unfortunately, because of the untimely death of Maxwell, it was not possible to pinpoint more precisely the extent of violation of corporate and securities laws.

\(^{[183]}\) (a) Supra note 182 (b) ; (b) Kane, F., ‘Layers of Guilt Peel off to Reveal Vipers in the Square Mile’, available at \url{http://www.guardian.co.uk}, 01/01/2001, 1-3
\(^{[184]}\) Supra note 183 (b), 3
Poly Peck International Plc (PPI)

Background

PPI, a small modestly profitable listed textile corporation came under the control of Asil Nadir, a London-based entrepreneur of Cypriot Turkish origin in 1980. Nadir was able to transform this modest acquisition of less than £300,000 into an investment worth some £1 billion by 1990, primarily by fascinating the stock market with his Cyprus political connections and the prospects of lucrative financial deals from large international acquisitions undertaken by him.[185]

Capital market preferences motivated him to seek high and rapid growth corporate acquisitions. So in 1989, he expanded PPI through hefty acquisitions, which enhanced the group’s market capitalisation to over £731 million.[186] In fact by July 1989, PPI’s market capitalisation exceeded £2 billion.[187] On the other hand, such acquisitions also piled up the company’s debts to perilous levels. To contain the increasing financial pressure and the excuse that PPI’s valuation was held down by biased media reports of his Greek Cypriot problems, Nadir announced his intention to take PPI private in August 1990.[187] When he retracted five days later, some £0.6 billion of PPI’s market valuation was wiped off on the back of market rumours that the real reason was his inability to secure funding for the exercise.[188]

Two subsequent events caused the LSE to suspend PPI’s shares in September 20 of the same year. One pertained to the news that the SFO had raided a company owned

[188] ibid
[188] ibid

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by a Nadir family trust and that Nadir himself had been interviewed by the serious fraud enforcement agency for alleged impropriety in the dealing of PPI shares. The other was in connection with the dumping of the company’s collateralised stocks by PPI’s main bankers, and in particular Citicorp Investment Bank (Switzerland) with its disposal of some 7.9 million shares.\cite{189} The company then sought the help of senior politicians to demand an inquiry by the DTI over the actions of the financial regulators. This was turned down.\cite{190}

To aggravate matters, suspicions were also raised on the possibility that Nadir was using PPI’s funds for personal investments and that insider dealing has occurred. Also seeds of doubts on Nadir’s personal financial position began to worry many bakers having business relationship with the company or Nadir personally. More importantly, doubts are now raised over the financial health of PPI itself due to the persistent rise in debt levels despite the reporting of continued profits and the disposal of various corporate assets.\cite{191}

However, by then the PPI group was by now heading towards financial collapse. ‘According to one banker, PPI’s problems were largely attributed to the structure of the group’s debts. PPI had historically relied extensively on borrowings, a large proportion of which (\textit{in excess of £100 million}) was short-term revolving lines of credit, which lenders could renew at their discretion. The remaining portion of PPI’s debts consisted of long-term loans for which Nadir had offered Polly Peck’s shares as collateral. As the stock market declined, the value of these shares fell to less than one-fourth of the related outstanding debt. In response to the uncertainty regarding PPI’s

\begin{footnotesize}
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  \item \cite{189} ibid
  \item \cite{190} ibid
  \item \cite{191} ibid
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ability to renew its existing lines of credit, Moody’s Investor Service…downgraded PPI’s short and medium-term debt from Ba1 to Ba3 (and) from Ba2 to Ba3’. [192] In the end, it was the combined actions of the rating agency and PPI’s bankers, which helped to push the company into administration in October 1990.[193]

**Use of OBF**

The use of OBF by PPI was carried out through a special purpose vehicle called Polly Peck International Finance (PPIF) set up in the Cayman Islands in 1987. The initial idea behind this was to raise funds through bonds issue and other financial products to on-loan to PPI. All borrowings raised by PPIF on this basis would be serviced and guaranteed by PPI, and reported only in contingent guarantee liability notes.[194] With access to such competitively priced loans, PPI went on an acquisition spree.[195]

It was also reported that a major contributor to PPI’s spectacular growth was from three cash-rich subsidiaries in Turkey and northern Cyprus. The Joint administrators appointed later found that over £700 million due from them had disappeared and were wholly irrecoverable. It was further alleged that Nadir stole a large amount of this money via a bank account in Jersey. Thus PPI, which had reported net assets of £933 million at 30 June 1990, was found with a creditors’ deficiency of £551 million the following year.[196]

The use of special purpose vehicles to secure the benefits of lower cost

[192] Ferris, supra note 186, 2
[194] Re Polly Peck International (in administration), [1996], 2 All ER 433
[196] Supra note 195, 1-2
funding is not uncommon in corporate circles. Indeed, the separation of PPIF and PPI as legitimate separate legal entities was recognised by the courts, which held that ‘The common commercial use of corporate structures to limit liability or simply organise corporate affairs or enable funds to be raised thus does not constitute a façade’.\[197\]

Special purpose vehicles such as PPIF therefore can be created legitimately. In PPI’s case, however, it was probable that Nadir may have intended to misappropriate the funds raised through OBF for the short term to finance the losses at PPI and his own business interests but in the end he could not reversed the situation when his acquired businesses continued to suffer huge losses. This probably led subsequently to the unhealthy application of OBF for manipulative and deceptive purposes.

**Legal Implications**

A week after PPI was put under administration, the Serious Fraud Office (SFO) with police support searched PPI’s head office in London and came out with the conclusion that the company had piled up debts of more than £1.3 billion and that much of its financial reporting was highly irregular. This resulted in the arrest of Nadir in December 1990 for financial theft and reporting deception. Naidr was in fact made bankrupt a month prior to this event.

In the meantime, Nadir got frustrated over the protracted delays in court proceedings. He broke his bail conditions and fled to Northern Cyprus in May 1993, and from where he initially launched vigorous campaigns against the SFO for alleged abuse of process. Through his solicitors, Nadir also vowed to return to the UK to clear his good name. Nonetheless, till today, he never bothered to return. As for the three auditors

who were involved in the auditing of PPI’s main operations in Cyprus and Turkey, they were fined a mere £10,600 by their regulatory bodies after pleading financial hardship. [198]

**Tesco Plc. (TC)**

*Background*

The commercialisation of new superstores in the recessionary period of the 1990s and the entry of continental discounters like Aldi and Netto resulted in the overcapacity of the food retailing industry in the UK. [199] Under Terry Leahy’s stewardship, TC proceeded from its earlier successful 1992 market transformation process to embark on an ambitious expansion phase through a four-point strategy, ‘…to continue to grow in the UK; to push more strongly into non-food; to diversify into services; and to expand overseas’. [200]

Following this, additional retailing space was added. Expansion in the non-food segment closely followed with TC’s increased involvement in personal care products, home entertainment and apparels. As a result non-food retailing space exceeded 36.3% of the company’s total retailing space as it headed towards year 2000. TC’s entry into the financial service sector commenced with its partnership with the Royal Bank of Scotland in 1997 and by 2001 the venture reported pre-tax profits of around £40 million from credit cards and motor insurance policies. TC successfully entered the emerging markets of Eastern Europe and Asia by collaborating with indigenous hypermarkets. The 174 stores operated in these targeted economies accounted for

[199] Owen, G., ‘Corporate Strategy in Food Retailing’, Centre for the Analysis of Risk and Regulation, LSE, 02/2003, 12
[200] ibid, 13
about 42% of TC’s total retailing space by 2002 and are envisaged to rise with additional acquisitions.\[201\]

TC thereon continued to pay close attention to the UK market, which became its most important profit contributor. TC’s strategy was to sustain its dominant position in the home market through continuous innovations, as the management believed that, ‘…unique differentiation is a prize that can only be won by continually being first’.\[202\] Thus, much of the successful redirection of the company on this and other matters from the mid 1990s onwards could be attributed to Leahy’s skilful positioning of the company in the ever-competitive industry as well as the careful use of its distinctive capabilities.\[203\]

Recognising that the one size fits all standardisation approach, pioneered by earlier global branders may not work for its type of industry; TC took the ‘think global, act local’ strategy to a new level. ‘Its approach—call it ‘’glocalization’’—hinges on deep understanding of and responsiveness to the cultural vagaries and habits of foreign customers. Wal-Mart has made modest concessions to European customers…but no one tries harder to adapt to local conditions than Tesco does’.\[204\] The highly competitive corporate culture, which sustained the company’s dominant market position was inspired by the ‘Balanced Scorecard’ (BS) strategy.\[205\]

For now, the company managed 1,779 stores in the UK and 586 outside. Its total market capitalisation on August 31, 2005 was £25.3 billion, the largest outside of the

\[201\] supra note 200, 14
\[203\] supra note 199
US.\textsuperscript{[206]} It is set to grow further internationally, as it downplays its 30\% dominant position in the UK. As Leahy puts it, ‘…Tesco was only about 20\% into its international expansion plans, which last year (2004) generated £370m profit on £7.6 billion of sale’.\textsuperscript{[207]}

Use of OBF

Though it enjoyed an excellent reputation as a global retailer of some means, TC knew from past experience that environmental changes can cause it to lose its lead position in the UK market and its competitiveness in the overseas market territories. It was therefore of strategic sense for it to have access to sufficient liquid resources to enable it to respond quickly to changes in its external environment.

Given this premise, it would be financially prudent for the company not to rely excessively either on equity funds or borrowings. Conscious of this limitation, the company decided to use OBF instruments to enhance its liquidity strength.

One of TC’s earlier use of OBF was brought about by its joint-venture with British Land in 1996. Under the arrangement, the joint venture was injected with equity contributions of £35 millions from both partners. The joint venture then entered into a sales and leaseback arrangement with TC. This provided the group with liquidity and continued use of retail space.\textsuperscript{[208]} Aside from this, TC did not have to consolidate the borrowings assumed by the joint-venture entity. The financial arrangement consequently did not affect TC’s debt carrying capacity.

The company’s treasury strategy is to fund its operations, ‘by a combination of

\textsuperscript{[206]} Harding, J., ‘Tesco Proves its World-Class Credentials’, The Times, 04/10/2006, 55  
retained profits, long and medium debt capital market issues, commercial paper, bank borrowings and leases, with the objective of ensuring continuity of funding… and to maintain sufficient un-drawn committed bank facilities so that maturing debt may be refinanced as it falls due.\textsuperscript{[209]} With gearing of less than 0.6:1 and over £13.191 billion in fixed assets TC has further scope to undertake further sales and leaseback arrangements to for funding future growth activities.\textsuperscript{[210]} This does not include the annual £1.5 billion trade credit the group secure from its many suppliers.

\textit{Legal Implications}

TC’s use of OBF at this stage is kept to a minimum because of its impressive operational and financial results. It is used primarily to unlock the use of idle fixed assets for more productive applications like the funding of expansion and growth in the domestic as well overseas markets at competitive costs. Whenever they are used, proper accounting standards and disclosures rules have been followed without compromise. In view of this, TC is unlikely to face any legal financial disclosure compliance risks, or for that matter any operational financial risks over the use of OBF instruments.

\textbf{Rentokil Initial Plc (RI)}

\textit{Background}

Using its listing advantage in 1969, RI expanded on its core business to become UK’s largest pest control contract specialist. It also diversified into many unrelated businesses and expanded internationally. Under the stewardship of Sir Clive Thompson, RI grew at an annual rate of 20% in the 1980s and early 1990s through the

\textsuperscript{[209]} This was reported under the Funding Section of its Home Page, available at http://www.tesco.uk.co
\textsuperscript{[210]} Calculations derived from financial data in TC’s Home Page, available at http://www.tesco.uk.co.
employment of the dual strategy of dominance in its traditional core business and acquisitions of very high growth businesses.\[^{211}\]

The acquisitions of strong brand names resulted in the need to write-off of high levels of goodwill. This together with its traditional high dividend payout policy turned its equity funds negative. The company had to restructure its capitalisation to enable it to sustain its traditional high dividend policy due to current EU Directive, which requires EU-based corporations to pay dividends only from earnings and a positive equity base.\[^{212}\]

RI’s growth through acquisitions strategy was faltering from the late 1990 onwards when its earlier acquisitions and its own core business both began to under-perform.\[^{213}\]\[^{213}\] Under pressure, the company responded with key changes at the company’s top management structure. The controversies surrounding various setbacks induced an abortive takeover attempt in the third quarter of 2005.\[^{214}\] To respond to this and future challenges the company formulated new business plans to put its businesses back on track for further growth and profitability. To-date, RI continues to make decent earnings but is still unable to replicate its 1990s high growth high earnings record and consequently continues to fall below market expectations.

Use of OBF

RI’s current earnings and the general service-nature of its business provided it with strong cash flows to support its traditional high dividend payout policy without having

\[^{212}\] ibid
\[^{213}\] RI Internal Management Survey, Spring 2005
\[^{214}\] Davoudi, S., ‘Robinson in Rentokil Retreat’, Financial Times, 22/10/2005
to make serious use of capital market funds. The market was also familiar with the reasons for its negative equity structure before its 2000 capitalisation restructuring. Consequently, RI has very little need for financial window-dressing particularly in view of its low debt levels and high cash generation.

For the moment therefore, the company is more concerned with the perking up of its market capitalisation through significant improvements in growth and earnings rather than financial window-dressing. In fact, its current acquisitions disposal programmes have further enhanced its cash reserves. Accordingly, it only used OBF instruments sparingly for tax advantage and some fiscal savings. This is reflected by its finance lease obligations of only £3 million in 2000. Its operating lease expensed out also amounted to only £36 million. By way of comparison, its un-drawn borrowing facilities then amounted to £578.7 million. RI also complied fully with the reporting requirements for lease applications.[215] The Finance Director’s Review since 2000 continued to maintain that the company used derivatives for hedging purposes only.[216]

Despite displaying double-digit growth for much of the 1990s, the company had been a subject of regulatory scrutiny; in 1988 from the Office of Fair Trading (OFT) for displaying monopolistic business behaviour, and; in 2001 by the FSA for its controversial 14.8 million shares buy-back a day before it reported increased sales and profits. It was released for its undertaking for enhanced transparencies on the former matter by the OFT in March 2, 2003 with evidence of more competition in the pest

[215] Derived from RI’s 2000 Annual Report
[216] Ibid, Finance Director’s Review
control industry. The latter issue represented RI’s new financial strategy of enhancing market price through shares buy-back. This was in sharp contrast to its previous fast earnings strategy in the 1990s. This was embarked upon in view of the more difficult market conditions in the 2000s. The company survived the FSA enquiry.

The company continued to court controversy with high executive compensation in the face of falling earnings and share prices. The company attributed the higher executive compensation to the inclusion of payments to the ousted Chairman and CEO. The 2005 abortive bid was ergo mounted within a scenario of frustration in the capital market brought about by board tussles and uncertainty over the future direction of RI in the first quarter of 2005. After the unsuccessful bid, RI’s management began to settle down to focus on corporate turnaround.

Despite the beginning of the decline in sales since 2000, the company was quick to emphasise that the goodwill of £2.4 billion previously written off had helped to generate very high returns on operating assets of over 233%; provided interest cover of seven times, and; strong statutory free cash flow exceeding £226.2 million in 2001. The company, however, acknowledged that its low level of operating assets was reflective of the nature of its service-based business.

This is not unusual in support service industries where the focus of analysis is on cash

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[217] Letter from John Vickers, Director-General of Fair Trading to Secretary of State of Trade and Industry, 02/03/2003, 2
flows rather than capitalisation structure. This perhaps helps explain why the company is not using OBF more enthusiastically even when confronted with pressure from the capital market.

The adoption of IFRS and the new European legislation in the UK requiring the availability of distributable reserves for dividend payments compelled RI to undertake a major corporate restructuring scheme. This involved the creation of a new holding company with reduced capital but sizeable available reserves for distribution of dividends. This is important to RI’s traditional high dividend payout policy; which incidentally is the key attractive feature of its shares.

The company’s existing distributable reserves had already been exhausted by its £1.9 billion shares buy-back exercise, made worse by the recognition of its pension deficit of some £285.6 million under IFRS requirements in 2005.\[222\] The formation of the new holding company was successfully completed in June 2005, and in the process raised its distributable reserve to around £1.8 billion.\[223\] RI’s restructured equity position and the high cash nature of its business will probably enable the company to continue to employ OBF only for the purpose of financial savings benefit and not for liquidity enhancement nor window-dressing purposes.

**Legal Implications**

Despite the current downturn in its main business sector, RI is still the dominant pest control business in the UK, with strong international presence. More importantly it is still making profits though not at the rate it enjoyed in the 1980s through to the early 1990s. It is also able to maintain its high dividend policy because of this and the

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\[222\] RI, ‘Notice of EGM and the Court Meeting: Recommended Proposals for the Formation of a New Holding Company by Means of a Scheme of Arrangement Under Section 425 of the CA 1985’, 23/04/2005

\[223\] RI Interim 2005 Annual Report.
service nature of its business, which does not require massive investments in fixed assets. RI has also shown that it only uses OBF sparingly for financial savings and not for the sake of liquidity enhancement or financial window-dressing. This probably explained why it has no problems in disclosing its use in accordance with standard accounting practice.