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ETHICS OF THE FIRM'S RELATIONSHIP WITH ITS SHAREHOLDERS

The ethics of the relationship between the firm's owners (shareholders) and those employed to manage the firm's assets on their behalf (managers) involves issues of deontology—written (and unwritten) duties and obligations, rights of shareholders, and the trade-off between the manager's self-interest and that of shareholders.

Most business practitioners and academics would agree that shareholders—the legal owners of a business—are a corporation's most important stakeholders. People invest their scarce capital in the business; they bear the risk and are therefore entitled to a reward for doing so. This assumption, taken for granted in the economics and finance literatures, is at the foundation of most business studies in finance. However, it is only an assumption, and it is questioned in the business ethics literature.

The finance and economics disciplines have developed an enormous body of rigorous theory driven by the assumption that the purpose of business is to maximize profits. Milton Friedman (1970) clearly articulated this point of view in a celebrated and controversial article. In this article, he argued that the sole responsibility of managers is to maximize shareholder returns so long as they stay within the law, and anything less—specifically, an attempt to engage in philanthropic activity—would constitute a breach of their fiduciary duty unless it served the purpose of increasing shareholder profits. This point of view has sparked a lively and unresolved debate around the relative importance of other stakeholders—some arguing that, in essence, Friedman is right, whereas others take the view that a corporation is not merely the property of its shareholders but is a social entity in its own right, with multiple responsibilities to multiple stakeholders. The latter view is criticized on theoretical grounds for its vagueness and lack of rigor, particularly when compared to financial economics theory.

The competing claims of shareholders relative to other stakeholders arise vividly in downsizing decisions, where the interests of shareholders should be weighed against those

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employees who lose their jobs. A collective agreement may specify the layoff process, including rights of seniority. However, this simply moves the ethical decisions from the time of the layoff to the time of negotiation of the agreement. When production is moved from one plant to another (e.g., in a developing country), the costs borne by the former employees who lose their jobs have to be weighed against not only the shareholders who benefit from lower production costs but also the people employed in the developing country, who may otherwise have no employment.

The Northeastern Mutual Life case illustrates several of these issues. Because of falling profitability, the chief executive officer of this large insurance company has to evaluate the rights of various stakeholders as he plans to reduce staff. He must quantify in dollar terms the moral claims of shareholders and various other stakeholders and apply ethical analysis where legal requirements are unclear. In particular, he must decide how to manage the layoffs and the implications to the company of the payout of pension benefits.

A second ethical problem associated with shareholders arises from the nature of the agency relationship between shareholders and managers. The capitalist system is driven by an implicit assumption that people are driven by their legitimate self-interest. Agency theory, the theoretical foundation of much of academic accounting, assumes that managers are self-interested and are not burdened by ethical considerations; therefore, the central problem for shareholders is to put controls in place to ensure that managers do not expropriate excessively the shareholders' wealth for themselves.

To protect the legitimate interests of shareholders from the self-interest of its managers, who may have different objectives from shareholders (e.g., in their willingness to take risks) and who generally have better information about the business than its shareholders, the owners put in place management accounting, control, and financial reporting systems. These define management objectives in terms of contractually measurable performance criteria, such as an increase in stock price, meeting budgets, and so on. They also reward managers in the form of bonuses for achieving these performance targets. For example, managers are given stock options—as a result, their wealth increases along with that of shareholders when the stock price increases. Incentive compensation schemes are supposed to align the interests of managers with shareholders. Unfortunately, control systems are imperfect and often create incentives for perverse behavior. For example, if meeting budgeted profit targets is a performance criterion, managers can reduce the degree of difficulty of the budget (sandbagging) or can manipulate actual performance, most easily by deferring discretionary expenditure to beyond the end of the budget period. Managers can also manipulate the measurement of performance by stretching the definition of revenues (upwards) and expenses (downwards). WorldCom, for example, eliminated several billion dollars of expenses by reclassifying them as assets.

A particular concern arises when the rewards for aggressive behavior are very high. For example, suppose that a sales manager has to meet a particular level of sales in a year. If she meets this target, she receives a substantial bonus—say, \$25,000—but if she misses it, she receives nothing. Suppose also that with 1 week to go to the end of the year, she is \$10,000 short of the target. She faces all kinds of unreasonable pressure to meet that target, “no matter what it takes.” (Clearly, buying the product herself and throwing it away is better than just missing the target and is by no means the most unethical choice!) Many of the cases in this chapter provide an opportunity to debate and decide the best decision for a manager in this situation, as well as an opportunity to explore the morality of that work situation—for example, how it might arise and how they as managers might correct it.

Fraudulent financial reporting has been at the center of debate over business ethics for several years. Enron and WorldCom were merely the most visible of frauds that seem to take place with alarming regularity. Because accounting rules are somewhat flexible (though not as flexible as WorldCom and others had evidently wanted them to be), the preparation of financial statements requires professional judgment. Therefore, a certain degree of discretionary aggressiveness (or conservatism) is legal and consistent with generally accepted accounting principles. Nevertheless, is it ethical? Does it make a difference if the flexibility is used solely to enhance management bonuses? To what extent do managers have the right to benefit themselves, within the rules of the control system, when they know that it is at the expense of the shareholders?

The Enron Corp. case provides documentation of one of the most spectacular and sudden corporate failures in recent American history. Arguably, Enron is not a good case for class discussion because all the evidence suggests that the actions taken by those responsible were clearly and unambiguously unethical. There is little to debate. Yet, it does raise some important questions. What is the responsibility of top management? Who is ultimately responsible for the financial statements, and how could an auditor detect financial statement irregularities? What obligation do managers have to ensure that the environment for which they are responsible minimizes the risk of fraud?

The Acme Hardware case provides an example of a probable accounting manipulation, from the point of view of an auditor. The auditor is planning the audit of its new client, Acme Hardware. While preparing the audit plan, he becomes aware of the possibility that certain managers might be using accounting flexibility to aid them in qualifying for incentive bonuses based on profitability. The areas are inventory and advertising. The case provides an opportunity to discuss the morality of the managers engaging in this behavior, the nature of the flaws in the reward system and the incentives they create, and the responsibility of senior managers. The auditor must decide what action, if any, to take. The Fardo Industries case also documents an ethical dilemma for an auditor in the context of flexibility in accounting rules and includes issues of personal versus professional relationships. The partner of an accounting firm must decide how to advise a client, who has not understood the implications of this flexibility, to amortize the goodwill involved in an acquisition. The decision will significantly affect the acquisition price to be paid to a former client, who is a friend of the accountant.

In the Ontario Capital Group case, the branch manager at a branch of the Ontario Capital Group has to decide what to do about one of his investment advisers. Over the past 3 months, an investment adviser had apparently been injecting his own capital into a client's account that had been losing value. However, the market had now recovered, and the client had made a profit. The branch manager takes a utilitarian view—he thought to himself, “How did this go unnoticed? But no harm has come to anyone—why should I do anything about it?” The main teaching objective of this case is to explore corporate responsibility for promoting ethical behavior. The role of control systems in promoting various types of behaviors and the scope of control applied can be discussed. Other objectives include the responsibility of the individual to various stakeholders in the organization. In the Jeffrey Verde Account case, also in the securities industry, a newly licensed futures investment adviser at Securities Trading Company has just received an order from Jeffrey Verde, a regular client of a colleague and of the company. The firm's research department is recommending that those contracts be sold. On further investigation, she realizes that the client has a high trading limit that he regularly exceeds and that he also has a high level

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of exposure. She must decide how to handle this situation responsibly. This case, written from public documents, is based on an actual court case, although the names of the persons and firm involved and the dates have been disguised. The case highlights ethical and compliance issues that arise in the securities industry; the dangers of failing to comply with regulations, even though they may constrain profit and be tiresome; and the challenges of having to deal with the consequences when things subsequently do go wrong.

REFERENCE

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NORTHEASTERN MUTUAL LIFE: PREPARING FOR EMPLOYEE TERMINATIONS

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INTRODUCTION

On the 7th of March 2000, Gordon Gillingham, president and chief executive officer (CEO) of Northeastern Mutual Life, had to decide how to reduce costs at his company. Northeastern Mutual Life's return on equity had declined steadily in the past four years and had triggered calls for cost cutting measures. Gillingham knew that staff reduction at the Calgary head office would be a large component of the cuts and wondered how he would balance shareholder and employee interests.

NORTHEASTERN MUTUAL LIFE

From its beginnings in northern Alberta selling small life insurance policies, Northeastern Mutual Life now marketed a full range of financial service products across the country and in many parts of the world. Northeastern Mutual

Life was the major subsidiary of the Calgary Insurance Group, which operated life insurance, reinsurance, general insurance and investment, and other activities in North America and internationally. Calgary Insurance Group was a publicly held Canadian corporation, which owned 98 per cent of the shares of Northeastern Mutual Life.

In Canada, the company had more than three million individual and business customers, and was one of the largest providers of life insurance to Canadians. The company also provided retirement savings and disability insurance to individuals, as well as group life, pension and health products to businesses in Canada. In 1996, a new subsidiary, the Trust Company of Northeastern Mutual Life, was established to broaden the range of retirement savings products for customers and strengthen the company's relationship with its customers.

In 2000, Northeastern Mutual Life's investments totaled more than \$15 billion, and included mortgages for tens of thousands of Canadians. The company's investments also provided financial support for a wide variety of Canadian

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industries and governments. Significant investment subsidiaries included the National Care Corporation, which developed and operated retirement homes, Doran Properties Limited, which owned commercial properties and Edmonton Park Limited, an office, residential and hotel complex.

Almost 3,000 people were members of Northeastern Mutual Life's Canadian sales organization, the largest among insurance companies in Canada. Of approximately 9,000 employees, Northeastern Mutual Life had about 2,600 administrative staff. Northeastern Mutual Life relied heavily on its public image and reputation for new sales—selling insurance was difficult even in the best of times.

IMPETUS FOR CHANGE

Since 1996, Northeastern Mutual Life's return on equity had declined steadily from 11.5 per cent to seven per cent (see Exhibit 1). The dividends on profit participating whole life

policies were also declining, and as a result, sales were suffering. Whole life policies paid dividends to holders that were based on earnings on the whole life section of the business; in the case of Northeastern Mutual Life, this accounted for over 50 per cent of the total. An insurer's rate of dividend payments on whole life policies was a very important part of the sales pitch to sell whole life (policyholders) policies, as it allowed for comparison between insurers. As a result, a lower yield rate would directly affect sales. In early 2000, a meeting of Senior Management Partnerships (SMP), the management body of Northeastern Mutual Life, decided that administrative costs had to be cut by 20 per cent and that an acquisition of a U.S.-based rival would permit additional increased efficiencies. Since employee salaries formed the largest component of administrative expenses, staff terminations were being discussed by the SMP: who would they terminate and how would the terminations affect the pension plan fund surplus and liabilities?

	2000	1999	1998	1997	1996
Total Revenue	\$9,455	\$8,345	\$7,563	\$6,702	\$5,909
Income to common shareholders	\$103	\$113	\$125	\$128	\$132
Returns to policyholders	\$301	\$317	\$320	\$334	\$350
Net Income	\$108	\$120	\$133	\$145	\$150
Shareholders' Equity	\$1,497	\$1,450	\$1,398	\$1,360	\$1,306
Total Assets	\$18,925	\$17,796	\$16,413	\$15,650	\$140,029
Total Assets under administration	\$28,698	\$27,031	\$24,453	\$21,541	\$19,740
Life Insurance in force	\$101,605	\$98,777	\$100,398	\$98,783	\$99,653
Number of employees and field staff	9,010	6,927	6,795	7,334	7,499
Return on Common Equity	7.20%	8.20%	9.50%	10.60%	11.50%
Number of Common Shares outstanding (millions)	40	40	42	42	42

Exhibit 1 Financial Highlights (amounts in millions, except per share amounts)

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Northeastern Mutual Life had a defined benefit pension plan with a 1997 surplus of Cdn\$85 million and a 1999 surplus of Cdn\$35 million. Under Alberta law, if a restructured company with a pension fund found itself with a substantial reduction in staff, it may voluntarily (or be required to) do a partial windup of the pension for all terminated staff or it can try to avoid the legislation. A partial windup involves the payment of a full pension at age 65 to any employee (known as a qualified employee) whose age plus years of service, on date of termination, is 55 or over. A partial windup also includes a payment of a substantive portion (or all) of the pension surplus to any employee whose position is terminated.

The cost of a partial windup is substantial. It requires an employer to assume (for the purposes of the pension) that qualified employees actually worked to age 65, notwithstanding their ages at date of termination. Also, the present value of the pension liability is much higher than the contribution amounts that the company would otherwise give to the employee on termination. A partial windup would also require that a share of the surplus be paid to qualified employees.

PENSION PLANS

Historically, pension plans were established because the plan sponsors (employers) expected to be in business indefinitely and a pension plan provided an incentive to attract and retain employees. As a result, the plan operates for the benefit of its members and the company, unless business circumstances warrant a windup of the pension plan.

Pension plans are of two types. A typical defined contribution plan simply collects contributions from employees and their employer and invests them. The employee bears the financial risk and benefits of the investment performance. In contrast, a defined benefit plan, such as the Northeastern Mutual plan, promised a pension based on a fixed percentage of final salary, based on years of service. Both the employee and employer contributed prescribed amounts

(typically percentages of salary) to the fund. However, since the employer bore the financial risk, if insufficient contributions were collected to meet the expected pension liability (or returns on the fund were low), the employer would have to contribute additional funds to meet pension commitments. Conversely, if the fund was well managed and returns on the fund assets exceeded expectations, the fund would have a surplus. In such a case, there might be no need for the employer to contribute the prescribed amount for a period of time. Northeastern Mutual Life had been in this fortunate position for over 20 years.

Pension plans required careful investing by the plan manager to ensure that they could meet their future obligations to plan members. Normally, the present value of future pension obligations (from the employer's standpoint) was less than the cumulative value of contributions, until the employee reached approximately 10 years of service. After that point, the present value of future pension obligations to employees increased at a greater rate than the cumulative contributions for each additional year of service. This is illustrated in Figure 1.

Using the example given, if an employee were no longer employed with the company after three years of service, the present value of benefits would be much less than the cumulative contributions made by both parties. However, after 15 to 20 years of service, the present value of the employer's future pension obligations would be much higher than the contributions made to the fund. There is normally a contribution surplus versus pension liabilities for short-term employees and a contribution deficit for longer-term employees. Under a well managed plan, however, the cumulative value of contributions, in aggregate for all employees (compounded), should equal the future value of pension obligations to all employees at any moment in time. Therefore in practice, it was hoped that the returns from investing exceeded discount rates.

Most company pension plan benefits were paid out in the form of an annuity, a fixed monthly payment for the rest of the employee's life. The formula used to calculate company

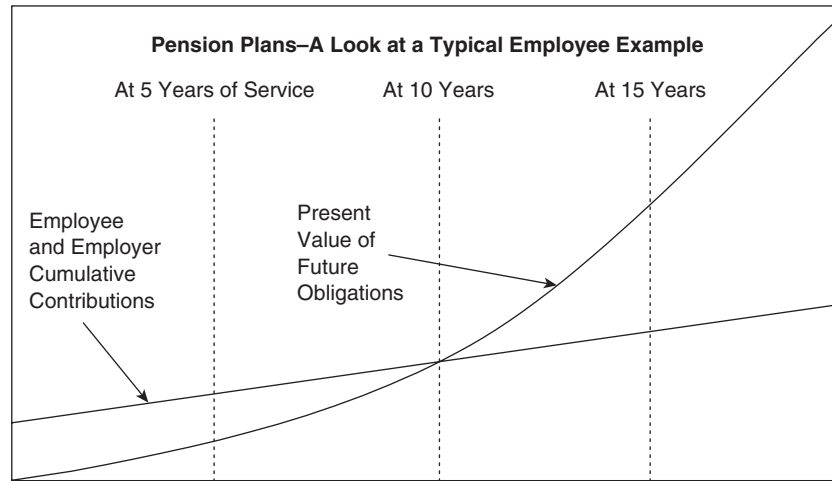


Figure 1 Cumulative Value of Contributions, Present Value of Future Obligations and Years of Service

pension plan benefits was typically the employee's final salary multiplied by years of service multiplied by a fixed percentage rate (often two per cent). Therefore, moving from job to job and plan to plan could be costly for employees and beneficial for employers. All else being equal, the "loyal company employee" was rewarded while the job-hopper suffered when this formula was used.

When employees left their jobs or were terminated, the company returned all cumulative contributions (the total of the employee's and employer's actual costs prescribed, whether or not they had actually been paid in) without (or with minimal) interest or compounding. Northeastern Mutual Life's pension plan terms were written so that terminated staff were given the contribution amounts plus nominal interest which was much less than the present value of their future pension and health benefits. This was due to the fact that most terminated employees over the company's 125-year history had been fired with cause.

There was also considerable public debate as to whether pension surpluses belonged to the employer or the employees. In Northeastern Mutual Life's case, the company had not made

any actual contribution to the pension since 1983, due to the outstanding investment performance of the fund. Their employees, for their part, had made no contributions since 1989. Prior to 1989, employees had contributed three per cent to four per cent of their salary and bonus per year into the pension plan. However, in 1989, the pension payout rate was also changed; the payout percentage was reduced substantially from two per cent of final salary to 1.4 per cent and employees were no longer required to contribute.

Choosing From the Pool of Staff

Administrative salaries at Northeastern Mutual Life averaged \$45,000. Gillingham looked at the numbers that his team had generated, detailing the number of staff, tenure and percentage of managers within each group (see Table 1). As Sales staff were commission-based, they would not be included in the layoff decision. The administrative ranks included accountants, secretaries, investment operation managers, information system managers, vice-presidents—almost any employee who was not a salesperson. Many of the administrative staff performed duties that were

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<i>Tenure</i>	<i><1 year</i>	<i>1–5 years</i>	<i>6–10 years</i>	<i>11–15 years</i>	<i>15+ years</i>
Administrative Staff	800	600	500	400	300
Sales Staff (commission-based)	1,800*	600	375	125	100
Percentage of Administrative Staff in Management	10%	20%	30%	50%	80%

Table 1 Staff by Years of Service

Note: It was typical that within the first 12 months of being hired, approximately one-third of the sales staff would leave the company.

unique to Northeastern Mutual Life operations. These skills were not easily transferable to other companies within the Calgary region. Gillingham wondered if Northeastern Mutual Life was obliged to retain these longer-term employees because of the non-transferability of their skills.

Gillingham knew that Northeastern Mutual Life needed approximately 80 per cent of its staff to continue operations without substantially affecting service. However, Gillingham knew that even if 20 per cent of 2,600 administrative employees were chosen for termination, Northeastern Mutual Life might eventually need to look elsewhere for additional cost savings. Furthermore, he was aware of government regulations stipulating that if a substantial percentage of a company's staff were terminated or left voluntarily, the Alberta Pension Commission could order a partial windup of the pension fund.

If a windup was required, Northeastern Mutual Life would be forced to pay qualified employees the full pension of age 65. This was an amount whose present value was estimated to be worth substantially more than the cumulative nominal contribution of those employees.

Last, Gillingham was aware of regulations (independent of Alberta pension legislation) that stipulated a company had to file reports to the Alberta government if it planned to lay off more than 50 people per month. He wondered if there was a way to avoid this additional bureaucratic step.

THE PENSION COMMISSION OF ALBERTA

In 1987, Alberta's pension legislation was substantially revised and new measures were introduced to strengthen the employment pension system in Alberta. The reforms improved members' rights to benefits and the way benefits were funded. It gave members rights and entitlements, such as access to more information about their pension plan. The Pension Commission of Alberta oversaw and enforced these rulings.

Windups for pension plans occurred for a variety of reasons. Often a windup is caused when all or a significant number of members have ceased employment. When all employees cease employment, the entire pension plan must be terminated or wound up. When a significant number of pension plan members are terminated, the pension plan can be partially wound up voluntarily by the company or under an order of the pension commission. (Those members unaffected by the restructuring, who continue to be employed following the downsizing, are not included in the partial windup and their membership in the plan continues without change.) Some reasons for pension plan windups include:

- The employer has decided not to operate a pension plan and ceases to remit contributions to the pension fund.

- The employer fails to make contributions to the pension fund as required by pension law.
- There has been a plant closure or downsizing of operations and a significant part of the business at a specific location is discontinued (this may require a partial or full windup).
- Plan members cease to be employed as a result of the discontinuation of all or part of the business or reorganization of business operations.
- The employer has sold all or part of the business or the assets of the business to a purchaser, and the purchaser does not provide a pension plan for the members of the pension who become employees of the purchaser.
- The employer is bankrupt (or insolvent).

The pension commission legislation also required that terminated employees in a partial windup receive their share of any pension plan surplus. This penalized companies who might otherwise take advantage of the situation by terminating employees just prior to retirement.

Most employers involved in these situations voluntarily windup their pension plans. In some cases where the employer does not take steps to windup the plan voluntarily, the Pension Commission of Alberta may order the windup to comply with the requirements of Alberta's pension law. Simon Donato, vice-president of corporate lending, stated:

But in every case, where the company does not voluntarily do a partial pension windup, the Pension Commission must be petitioned by the employees to order a partial windup, and the employees need to provide strong evidence of a lot of terminations and that the rules for a partial windup are met. The Pension Commission, which is an agent of the government, must then agree to a windup (and they don't do so very often, especially in a conservative, pro-business environment). The purpose of the mandatory windup legislation is to protect the interests of the long-term pension plan members and ensure the safety of their pension benefits.

It was estimated that if a partial windup was required at Northeastern Mutual Life, it would cost the pension fund an extra \$62,500 per qualified employee that was terminated.

DECISION TIME

On average, there was a 30 per cent difference in salaries, between the older (at least six to 10 years in tenure) and the younger (less than six years in tenure) employees. Thus, excluding the potential extra cost to the pension account of the partial windup, Northeastern Mutual Life would reap the same nominal savings from either laying off 100 older employees or 130 younger employees.

Also, firing older employees and hiring new recruits to replace them would mean fewer layoffs in total, as the cost savings would be, on average, greater per person. This would be true unless a partial windup was voluntarily agreed to by the company or ordered by the Pension Commission. Gillingham did not wish to voluntarily order a windup of Northeastern Mutual Life's pension plan. A partial windup (without calculating the share of surplus issue) could add \$25 million to \$50 million to Northeastern Mutual Life's current pension liabilities (or \$62,000 per employee on average) if the senior staff were terminated. If a substantial number of the employees was terminated, he might be required to submit the results to the Pension Commission for scrutiny. But if he did not submit the results (and did not voluntarily windup the pension fund or was not ordered to do so), he would reduce the company's current pension liability by \$45,000 per employee (on average).

Many questions remained in Gillingham's mind. Could he stagger the terminations over a couple of years? Did Northeastern Mutual Life have a moral obligation not to terminate employees close to retirement? Would he ever have to explain the substantial numbers of terminated employees to the Pension Commission? And would he ever have to personally face the cost of a partial windup and the bad publicity? And how would he keep his senior executives enthusiastic throughout this period?

Ultimately, Gillingham knew that, in the interests of shareholders, he had to reduce costs now. He wondered what his plan of action would look like.

ENRON CORP.¹

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INTRODUCTION

In late 2001 and in 2002, investors, securities regulators, the energy industry and the capital markets watched as the details behind the collapse of Enron Corp. (Enron) came to light. Enron's was the largest corporate collapse in American history, with the company's share price losing almost all of its value in the ten months preceding its bankruptcy petition. George Calvert, like virtually all of Enron's shareholders, was very unhappy with his losses. He wanted to know how, in light of all the supposed checks and balances in the financial reporting system, this had apparently happened so suddenly and with so little warning. He depended upon management, the board of directors, its audit committee, the auditors and various financial analysts, among others, to protect his interests and, at the very least, to keep him appropriately informed. How had Enron seemingly fooled so many people so quickly? Calvert wondered, could the system be relied upon to protect him and what should he do in the future if he wished to continue investing in the capital markets?

THE U.S. NATURAL GAS INDUSTRY

The natural gas industry in the United States was regulated by the Federal Energy Regulatory Commission (FERC), an independent regulatory agency within the Department of Energy. FERC's mission was to regulate and oversee energy industries in the economic and environmental interest of the American public. FERC's vision was to have dependable, affordable

competitive energy markets that would support a strong, stable national economy.² FERC was created in 1977 as part of President Jimmy Carter's response to the 1970s energy crisis; the new agency replaced the Federal Power Commission, which regulated electric power.

The natural gas industry underwent deregulation in the 1980s. The energy industry had been run as a regulated monopoly for decades; regulation started in the early 1900s when the electricity industry argued that its utilities were a "natural monopoly" because the economies of scale and the large capital investment needed to build multiple transmission and distribution systems made competition inefficient. Electricity also became regarded as a basic service to which the entire population should have guaranteed access. By the 1980s, pressure had grown to allow the market to determine energy prices. Deregulation was supposed to introduce competition to these industries; it was believed that in the long run, competition would force companies in the energy business to operate more effectively and efficiently than the regulated monopolies, thereby lowering the end price to consumers.

In 1985, pipelines essentially had a monopoly on the natural gas market. Their business of buying natural gas from producers and reselling to local distribution companies required a method of transporting the gas from one place to another. Only the pipeline companies could provide natural gas to the local distribution companies because other firms could not obtain approval from FERC to build their own pipelines and there was no other cost-competitive way to transport the gas. In October 1985, FERC Order 436 was issued. Pipeline companies were forced to become open-access transporters, allowing

other companies to transport natural gas on their pipelines.

Deregulation further developed in the 1990s, with FERC's Order 636, enacted in November 1993. Order 636 required interstate pipeline companies to unbundle their sales and transportation services, and revised the method of determining rates for transportation services. One effect of Order 636 was the creation of a reseller market for transportation and storage capacity, enabling the marketing of unused or underutilized pipeline capacity.

A period of consolidation followed Order 636; by 2001, 14 corporations accounted for more than 85 per cent of interstate natural gas pipeline activity. Electricity deregulation also progressed in the 1990s. The electricity and natural gas industries began to converge, as companies with strong ties to the electric power industry acquired natural gas pipelines as natural gas explorers and producers divested themselves of pipeline assets. Natural gas was increasingly used to fuel electricity generation plants. In the United States, consumption of natural gas was 22.8 trillion cubic feet in 2000; projections for natural gas demand growth suggested that consumption could reach 29 trillion cubic feet by the end of the decade and 35 trillion cubic feet by 2020.³

ENRON'S HISTORY

Enron was formed in July 1985 when Houston Natural Gas merged with InterNorth, a natural gas company based in Omaha, Nebraska. This merger integrated several pipeline systems to create an interstate natural gas pipeline system. Kenneth Lay, who had been the chief executive officer (CEO) of Houston Natural Gas, was appointed Enron's chairman and CEO the following year. Enron's company vision at the time was "to become the premier natural gas pipeline in North America."⁴ Through 1985 to 1990, Enron's revenues came mostly from its regulated pipeline business. Its activities were mostly the purchase of gas from producers and reselling the gas to local distribution companies while shipping the

gas through the company's pipelines. The natural gas pipeline business was under regulation that affected rates, accounts, records, the addition of facilities, the abandonment of services and facilities, the extension of services in some cases, in addition to other matters. The company's revenues in 1985 were less than \$5 billion.⁵

As the natural gas industry was being deregulated, Enron set up separate businesses to buy, transport, sell, explore and produce gas. Pipeline companies at the time tended to be vertically integrated; with the separation of business functions, some of their functions remained regulated while others faced new regulations or became deregulated. Subsidiaries and affiliates allowed Enron to participate and take advantage of the newly unregulated markets for natural gas.

In the late 1980s, with deregulation changing the way natural gas was contracted in the wholesale market, Enron developed a host of services to help reduce the risk of price swings. A precursor of its massive trading operations in the future, GasBank was launched and Enron began trading natural gas commodities. GasBank allowed producers and wholesalers of natural gas to lock into long-term supplies of natural gas at fixed prices and to hedge price risk in the new spot market for natural gas.

Meanwhile, energy markets around the world were opening up and natural gas was gaining ground as a clean burning, cheap and plentiful fuel. In 1990, Enron's company vision changed; Enron's mission now was "to become the world's first natural gas major." Shortly after the United Kingdom had deregulated its energy industry, Enron began construction on a gas-fired heat and power facility in England. Enron also built or began construction on power plants in other countries, including the Philippines, Guatemala, China, India, Turkey, Brazil, Puerto Rico, Italy, Poland, Guam and Dominican Republic. Enron acquired a pipeline company in South America in 1992, with plans to expand its commercial presence on that continent. Enron's English power plant was operational in the spring of 1993; it was the world's largest gas-fired heat and power facility, and the second largest project financing ever completed in the United Kingdom.

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In 1995, Enron adopted a new strategy and a new corporate vision: to become the world's leading energy company. This, Ken Lay explained, meant, "We don't necessarily mean to be the largest or the most profitable—at least not now. We just aim to be the leader in all the businesses we're in worldwide."⁶ In 1995, Enron's business segments were Exploration and Production, Transportation and Distribution, Retail Energy Services, Wholesale Energy Operations and Services, and Corporate and Other.⁷ Between 1995 and 2000, revenues from Exploration and Production declined, while revenues from Corporate and Other increased but continued to account for less than two per cent of total revenue. Transportation and Distribution and Retail Energy Services had modest revenue growth of several billion dollars per segment, but Enron's revenues from Wholesale Energy Operations and Services grew more than 1,200 per cent, with reported revenue growth of more than \$87 billion in that period (see Exhibit 1).

ENRON'S WHOLESALE ENERGY OPERATIONS AND SERVICES

Enron's dramatic revenue growth between 1995 and 2000 was fuelled by revenue growth in its

Wholesale Energy Operations and Services business segment; this segment included its energy trading operations and its sales of risk-management products. Enron's natural gas commodity trading operation (financing for oil and gas producers (1989), trading of electricity (1994), power and gas trading in the United Kingdom (1995) and commodity transactions using weather derivative products (1997)) grew out of GasBank.

Prior to GasBank, standard gas contracts were traded on the New York Mercantile Exchange. The prices of these standard contracts were all based on delivery to one place (usually Henry Hub in Louisiana.) Thus, these contracts were useful in hedging against changes in gas prices, but were not practical for the actual buyers and sellers of gas, whose transactions required natural gas to be physically delivered to or from various locations. Factors based on location that could influence price included regional differences in supply and demand and laws particular to a state or country. With the deregulation of the natural gas industry, producers, distributors and other parties now participating in the market required some way of managing the risk of price swings in natural gas. Through GasBank, Enron created a market for natural gas commodities that established future prices on long-term supply contracts through the trading of these forward commitments.

	1995	1996	1997	1998	1999	2000
Exploration and Production	\$759	\$824	\$897	\$884	\$526	\$408
Transportation and Distribution	\$813	\$725	\$1,416	\$1,849	\$2,032	\$2,955
Retail Energy Services	\$400	\$528	\$685	\$1,072	\$1,807	\$4,615
Wholesale Energy Operations and Services	\$7,697	\$11,904	\$18,022	\$27,725	\$36,287	\$94,906
Corporate and Other	\$19	\$14	\$55	\$516	\$740	\$(2,095)
Total Revenue*	\$9,189	\$13,289	\$20,273	\$31,260	\$40,112	\$100,789

Exhibit 1 Enron's Revenue by Business Segment (Before Restatement): 1995 to 2000
(in millions of dollars)

Source: Company Annual Reports.

*Intersegment eliminations account for the differences between total revenue and the sum of business segment revenue.

In 1999, Enron introduced, alongside its telephone-based trading system EnronOnline, the first global Internet-based commodity-trading site. EnronOnline revolutionized the energy-trading business, at huge risk to the company; rather than being a neutral forum as traditional exchanges were, Enron served as the counterparty to every transaction, guaranteeing the liquidity of every deal. This role of being the buyer or seller of every transaction accounted for Enron's spectacular revenue growth; whereas a neutral trading operation would only book its commissions as revenue, Enron, taking actual possession of the traded commodities, could book the entire value of each trade.

By 2001, Enron traded a wide variety of products, including oil, natural gas, electricity, coal, pulp and paper, plastics, metals, bandwidth, water commodities, energy-related derivatives and derivatives for weather-related insurance risk, pollution emission credits and commercial credit. By this time, its Wholesale Energy Operations and Services were generating more than 94 per cent of the revenue Enron was reporting. Enron's Transportation and Distribution activities, the company's standard regulated gas-pipeline business when it was formed in 1985, accounted for around 80 per cent of the company's revenues in 1990; by 2000, Transportation and Distribution was a mere three per cent of reported revenues.

After FERC Order 636, energy trading became a standard and important business for all of Enron's major competitors. Many interstate pipeline companies, forced to separate their transportation business from their buying and selling business, divided their marketing units into affiliated marketing subsidiaries. These subsidiaries then managed the buying and selling of natural gas to customers who, before Order 636, purchased gas directly from the pipeline company. As was the case with Enron, these energy marketers came to trade more than simple natural gas commodities; in 2001, the Department of Energy's Energy Information Administration reported that of the 14 companies that accounted for more than 85 per cent of interstate natural gas pipeline activity, all 14 had energy marketing activities that were an "important enterprise" within the company.⁸

While energy trading had become a common and significant business for all the major pipeline companies in the United States, Enron was considered the leader, being the world's largest marketer of natural gas and the first to introduce online trading.

GROWTH OF ENRON'S REPUTATION

Enron's transformation from a natural gas pipeline company to an online energy-trading giant was closely watched by investors and the capital markets; before its collapse, Enron was widely held as a model of how "old economy" firms could transform themselves into powerhouses of the technological, fast-paced "new economy."

Each of the six years from 1996 and 2001, Enron won *Fortune* magazine's "America's Most Innovative Company" award among the magazine's list of Most Admired Companies. Enron was also one of America's fastest growing companies; its double-digit revenue growth in the late 1990s became triple-digit revenue growth once EnronOnline was launched in late 1999. With this dramatic revenue growth, Enron vaulted up the Fortune 500 list of companies, jumping from 18th in 1999 to seventh in 2000. Despite declaring bankruptcy on December 2, 2001, Enron's reported revenues from its first three quarters still made it the fifth largest company on the Fortune 500 that year. Only Wal-Mart, Exxon Mobil, General Motors and Ford were larger.

Enron's revenue growth was accompanied by profit growth (see Exhibit 2). Management's communications about the company's performance and ambitions for the future were confident and positive. All this made Enron a true market darling; in 2000, when most technology stocks lost value, Enron shares returned around 90 per cent. Thirteen of the 18 analysts covering the stock in the spring of 2001 gave it a "buy" or "strong buy" recommendation; some of these positive analyst recommendations would continue right up until December 2, 2001, when Enron declared bankruptcy (see Exhibit 3). From 1998 through the end of 2000, Enron's stock price soared (see Exhibit 4).

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	1997	1998	1999	2000
Revenue	\$20,273	\$31,260	\$40,112	\$100,789
Net Income	\$105	\$703	\$893	\$979
Earnings Per Share* (Basic)	\$0.32	\$2.14	\$1.17	\$1.22
Total Assets	\$22,552	\$29,350	\$33,381	\$65,503
Total Liabilities	\$16,934	\$22,302	\$23,811	\$54,033
Total Shareholders' Equity	\$5,618	\$7,048	\$9,570	\$11,470

Exhibit 2 Selected Data (before Restatement) from Enron's Audited Financial Statements: 1997 to 2000 (in millions of dollars)

Source: Company Annual Reports.

*Earnings per share calculations based on the following average number of common shares (millions): 272 (1997), 321 (1998), 705 (1999), 736 (2000).

Date (2001) and Relevant Events	# of Analysts Following Enron*	Recommendations			
		Strong Buy	Buy	Hold	Sell
Oct. 18—Two days after Enron announced its \$618 million third quarter loss, \$1.2 billion write-down of shareholders' equity and restatement of earnings through first half of 2001, and as scrutiny intensifies on Fastow's LJM1 and LJM2 partnerships.	15	12	3	0	0
Nov. 8—Enron has announced a upgraded, formal SEC investigation into its finances, that it is restating its financial results as far back as 1997 and that it is in merger talks with Dynegy.	15	11		3	1
Nov. 28—Enron is downgraded to junk bond status by major credit rating agencies; this triggers a merger agreement clause, causing Dynegy to terminate the deal.	14	3	3	7	1
Nov. 29—Second-last trading day before Enron files for bankruptcy. (Two analysts dropped coverage of Enron.) Enron now trading at \$0.36.	12	2	1	7	2

Exhibit 3 Recommendations from Analysts Following Enron's Stock

Source: Dan Ackman, "Enron Analysts: We Was Duped," Thomson Financial/First Call, <http://www.forbes.com/2002/02/27/0227analystsprint.html>, June 25, 2002, and Matt Krantz, "Why Were Analysts So Slow to Downgrade Enron?," <http://www.usatoday.com/money/energy/2001-11-30-enron.htm>, June 25, 2002.

*As tracked by Thomson Financial/First Call.

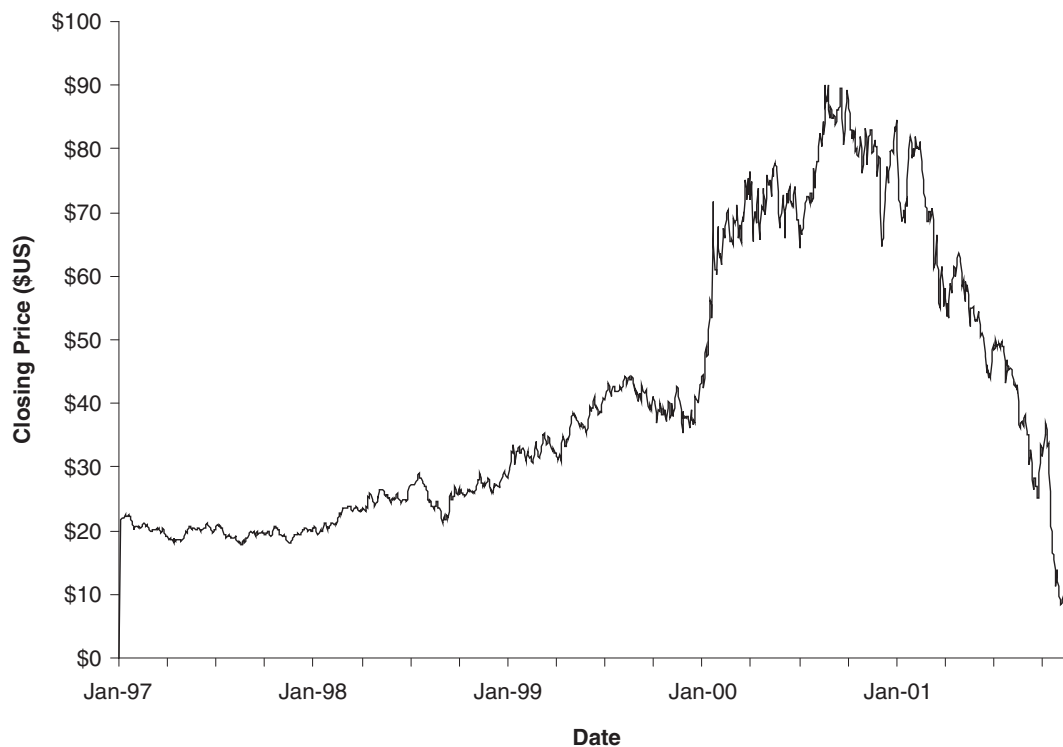


Exhibit 4 Enron's Share Price Performance 1997 to 2001

Source: Stock quotes from www.siliconinvestor.com, July 17, 2002.

Note: Chart shows prices until December 3, 2001, the first day of trading after Enron's chapter 11 bankruptcy filing on December 2, 2001.

Even before Enron became prominent for its leadership position in online energy trading, Chairman and CEO Ken Lay was respected in the business community and connected in political circles. Lay was known to President George W. Bush and Vice-President Dick Cheney, both former Texas oilmen. Enron and its executives were Bush's largest political patrons during his 2000 presidential election (see Exhibit 5). Lay served as formal energy advisor to former President George Bush and as informal advisor to the second Bush administration of George W. Bush.

On February 12, Enron's board approved Jeffery Skilling's promotion to CEO; Ken Lay would remain Enron's chairman. Skilling, long the second-in-command at Enron, had worked as a McKinsey consultant with Lay to craft Enron's vision in the 1980s; he joined Enron in 1990 and had been steadily groomed as Lay's successor.

ENRON'S FINANCING STRATEGY

Beginning with its gas-fired heat and power facility in the United Kingdom, Enron made

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- From 1989 to 2001, Enron Corporation PAC, Enron executives, employees and their family members gave \$5,951,570 in hard and soft money to federal candidates and parties. Republicans received 74 per cent of the donations (\$4,404,162) while Democrats received 26 per cent (\$1,547,408).
- As of 2001, Enron Corporation was the biggest contributor of George W. Bush's political career; from 1993 to 2001, Enron Corporation PAC, Enron executives, employees and their family members donated \$736,800 to Bush. Enron was Bush's biggest patron in his 2000 presidential campaign.
- Ken and Linda Lay gave \$276,500 to Bush from 1993 to 2000, including \$100,000 to Bush's inauguration fund. Jeffrey Skilling and Enron each donated an additional \$100,000 to the inaugural fund.¹

Enron's hard money donations from 1989 to 2001

	<i>Republicans</i>	<i>Democrats</i>	<i>Independent</i>	<i>Total</i>
Senate	\$417,480	\$110,513	\$2,500	\$530,493
House of Representatives	\$346,348	\$257,140	N/A	\$603,488

Ken Lay's hard money political donations from 1989 to 2001

<i>Total Republicans</i>	<i>Total Democrats</i>	<i>Total Donations</i>
\$793,110	\$86,470	\$882,580

Exhibit 5 Enron's Political Donations

Source: data from Center for Responsive Politics/Federal Election Commission; "Enron Timeline", http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/5.stm and http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/7.stm, June 25, 2002.

1. www.thedailyenron.com/enron101/political.asp, June 25, 2002.

many huge investments in power plants and pipelines around the world during its international expansion. EnronOnline was also growing, at its peak trading nearly \$3 billion worth of contracts every day. Energy trading fuelled Enron's rapid growth, but required large amounts of cash. Since EnronOnline was structured so that Enron was the counterparty for every deal, Enron needed to secure its obligations with money to cover the possibility it was unable to find enough buyers to match with sellers, or vice versa. Consequently, more trading required more cash to secure Enron's counterparty obligations.

For the company's trading operations to continue, Enron needed an investment-grade credit rating. Without it, sources of debt to secure its trading obligations would be more expensive and difficult to acquire. If customers lost confidence that Enron could guarantee the liquidity of the market it made for energy commodities, customers would stop trading with Enron.

Enron financed its growth in part with debt; the company's on-balance sheet debt climbed from \$3.5 billion in 1996 to \$13 billion in 2001.⁹ In the first nine months of 2000, Enron issued a net of \$3.9 billion in debt.

The overriding importance of protecting Enron's credit rating meant that the company had to limit the amount of debt it took on. The company's growth required financing beyond what debt alone could provide; additional financing came from Enron's use of special purpose entities (SPEs) (see Appendix).

Enron had hundreds of SPEs. Merrill Lynch, J.P. Morgan Chase, Citigroup, Credit Suisse First Boston, General Electric, the MacArthur Foundation and the Arkansas Teacher Retirement System were among the SPE investors. Enron sold energy contracts and assets to some of the SPEs, sometimes at prices inflated above fair market value.¹⁰ These transactions enabled Enron to move the sold assets off its balance sheet and to show income from the sales on its income statement. While the money Enron received for the sale of its assets was obtained by SPEs borrowing against the transferred assets, the money from these loans were counted as debt on the SPEs' books, but were recorded as income on Enron's books.

Among Enron's SPEs were four partnerships collectively known as the Raptors; the Raptors were created in 2000 and run by Andrew Fastow, Enron's chief financial officer (CFO). These SPEs had been formed to hedge Enron's market risk in its portfolio of volatile technology stocks; the effect was that roughly \$504 million in losses from portfolio investments were kept off Enron's books. To finance the Raptors, Enron issued common stock in exchange for a notes receivable from the Raptor SPEs. Essentially, Enron had sold its own shares to itself and paid for them with an IOU to itself. The Raptors ultimately resulted in the shareholders' equity on Enron's balance sheet being overstated by \$1 billion and Enron's notes receivable being overstated by \$1 billion.

Enron's SPEs had the effect of keeping debt off Enron's balance sheet, thus protecting the company's credit rating. The SPEs also kept losses off Enron's income statement, thus improving reported profit. Fastow's role in running numerous partnerships, including the Raptors, was approved by Enron's board of directors.

MANAGEMENT MOTIVATION

Some people wondered if the actions of Enron's management might have been motivated by the incentive scheme that was in place for managers. Under a four-year program called the Performance Unit Plan, Enron had set a series of stock-price targets in 2000, which, if met, would result in a one-time bonus for the company's executives. For meeting these stock-price targets, \$320 million in bonuses, money that Enron executives said had been anticipated for several years, was paid out during the ten months prior to the company's collapse. In January and February of 2001, top executives received other bonuses whose amounts were determined largely by company earnings. CFO Andrew Fastow received three payments totaling over \$3 million, then-president and chief operating officer (COO) Jeffrey Skilling received two payments totaling \$7.5 million and then-CEO Ken Lay received two payments totaling \$10.6 million.¹¹

ARTHUR ANDERSEN

Enron's auditor since the company's formation in 1985 was Arthur Andersen LLP, the U.S. member firm of Andersen Worldwide and one of the American "Big Five" accounting firms. Andersen Worldwide, the co-ordinating entity for autonomous member firms around the world, had its roots in the accounting firm Andersen, DeLany & Co, established in 1913 in Chicago. In September 2001, Andersen Worldwide's individual member firms collectively employed approximately 85,000 people; Andersen Worldwide's revenues for 2001 were in excess of \$9.3 billion.

Based in Chicago, Arthur Andersen LLP served Enron through its Houston office, with David Duncan as the office's lead partner and chief auditor for Enron.

In addition to auditing services, Andersen also acted as a consultant to Enron, providing advice and helping in the structuring of some of Enron's SPEs and transactions. Enron reported paying Arthur Andersen \$52 million in fees for 2000,

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\$25 million for auditing services and \$27 million for consulting services.

There were some early indications of accounting problems. Several years earlier, while auditing Enron's 1997 financial statements, Andersen proposed \$51 million in adjustments to the statements; these changes would have reduced Enron's income for the year by almost 50 per cent, from \$105 million to \$54 million. When Enron refused to make the changes, Andersen decided the adjustments were not material and certified the company's accounts anyway.¹²

On February 5, 2001, David Duncan, Thomas H. Bauer (the other lead accountant on the Enron account), six colleagues and six Andersen executives connected by speakerphone held a meeting in which the handling of two of Fastow's partnerships—LJM1 and LJM2—was debated at length. The accountants resolved to suggest that a special committee of the Enron board be created to review the fairness of Enron and LJM's transactions; they also decided to confirm with Enron that the LJM partnerships met accounting rules that allowed the partnerships to be treated as separate entities and not as subsidiaries whose financial results would be shown on Enron's books. One week later, when Enron's audit and compliance committee gave the auditors the opportunity to express any concerns they had, Duncan and Bauer raised neither of these points.¹³

UNRAVELLING

It had been suggested that the nature of Enron's business made it difficult to value; the value of its assets shifted continually and Enron utilized many off-balance sheet partnerships based on complicated derivatives transactions. Furthermore, the company was not required to, or did not adequately disclose the details of these partnerships. Since some of the transactions Enron engaged in were difficult to assess, the revenue reported on them was based on the company's own aggressive estimates.¹⁴ Despite bullish endorsements from analysts following Enron's stock, the consensus among those

analysing Enron's businesses and financial results was that the company was very complex and difficult to understand. Enron kept many details about its Wholesale Energy Operations and Services confidential for "competitive reasons." Some analysts were at a loss to explain how the company made money.¹⁵

Even the financial statements and disclosures Enron released did not fully clarify its business activities and their results. "The ability to develop a somewhat predictable model of this business for the future is mostly an exercise in futility," wrote Bears Stearns analyst Robert Winters in a report shortly before Enron began to crumble.¹⁶ Not having a good understanding of Enron's business, analysts admitted they took Enron's word on its numbers.¹⁷

In early 2001, James Chanos, president and founder of Kynikos Associates, a firm specializing in short selling, publicly raised questions about Enron's profitability, the level of risk associated with its trading business, the mysterious related-party transactions, the conflict of interest implied by having these entities run by "a senior officer of Enron," and the company's optimism about its plan to trade broadband capacity and its other investments in telecommunications, a sector that was in sharp decline. These types of concerns, compounded with analysts' existing complaints about the clarity and level of disclosure in Enron's financial statements, coincided with Enron's stock price drop.

Financed with Enron stock, Enron's transactions with the Raptors contained provisions requiring Enron's share price to remain above certain levels. The Raptors and the losses they covered could only be kept off Enron's books if the SPEs remained financially healthy enough to fulfill their obligations. As the value of technology stocks on the NASDAQ continued to drop, the losses that the Raptors were supposed to cover ballooned. At the same time, Enron's stock price was falling, hindering the Raptors' ability to cover these losses. There were provisions should the stock price fall too far; if the price declined too much, Enron would be forced to report a \$504 million loss.

Enron's management tried to bolster the company's credibility to boost the share price; one share price trigger had already been breached near the end of the first quarter of 2001, but at the last minute, Enron found a way to refinance and prop up the Raptor SPEs. Late July, at the beginning of the third quarter, Enron's stock price dropped below \$47, a second price trigger. In spite of management's efforts, the stock never rebounded.

On August 14, Skilling unexpectedly resigned after only six months as CEO. He left Enron citing "personal reasons," assuring investors that "there's nothing to disclose. The company's in great shape."¹⁸

WARNING¹⁹

The same day Skilling resigned, Ken Lay, who resumed the CEO position, tried to reassure employees through an e-mail:

All of you know that our stock price has suffered substantially over the last few months. One of my top priorities will be to restore a significant amount of the stock value we have lost as soon as possible . . . I want to assure you that I have never felt better about prospects for the company . . . Our performance has never been stronger; our business model has never been more robust; our growth has never been more certain. . . . We have the finest organization in American business today.²⁰

Two weeks later, in another e-mail to employees who received a stock options grant, Lay said, "one of my highest priorities is to restore investor confidence in Enron. This should result in a significantly higher stock price."²¹

After Skilling's resignation, Lay began meeting with employees and encouraging them to write about their concerns anonymously.

One unsigned letter he received pointed, with great detail, at problems with Enron's SPEs:

I am incredibly nervous that we will implode in a wave of accounting scandals . . . Skilling is resigning for "personal reasons," but I think he wasn't

having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in two years . . . the business world will consider the past successes as nothing but an elaborate accounting hoax.

The letter writer soon identified herself as Sherron Watkins, an accountant who had worked at Enron for eight years. She was laid off the previous spring and then brought back in June to work for Fastow. Watkins also expressed her concerns to David Duncan and two other accountants at Andersen, one of whom recorded her concerns in a memo in Enron's file.

Lay met with Watkins on August 22 and decided, along with Enron's general counsel, to assign an investigation to the law firm Vinson & Elkins, who had handled some of the legal documents for a number of the SPEs. Enron wanted quick results and instructed Vinson & Elkins not to spend time examining the propriety of the accounting treatment of Enron's SPEs, the heart of Watkins' warnings. The lawyers interviewed Fastow, Duncan and others involved in the SPE transactions and reported to Lay on September 21 that there was no reason for concern—Fastow's operations appeared to be proper and legitimate.

COLLAPSE

In preparing financial reports for Enron's third quarter, the company's auditors discovered that they had made a mistake more than a year earlier in the way they had accounted for the Enron shares used to finance the Raptor partnerships. Correcting the mistake would involve reducing Enron's assets by \$1 billion that had mistakenly been added earlier. The Raptor partnerships were dismantled, necessitating the report of Enron's investment losses to shareholders and further reducing assets by \$200 million. On October 16, an Enron press release announced a \$618 million loss for its third quarter, the company's first quarterly loss in more than four years. Shareholders' equity was written down by \$1.2 billion, and Enron announced it was restating

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earnings through the first half of 2001. The *Wall Street Journal* reported that of Enron's losses, \$35 million alone had come from the two LJM partnerships run by Fastow; Fastow himself had made \$45 million from the management of these two partnerships. The Securities and Exchange Commission (SEC) began an inquiry into some of the Fastow partnership transactions. Ken Lay and Enron's board of directors said they stood by Fastow, but on October 24, Fastow took a leave of absence and did not return to the company.

By the end of October, credit agencies were considering a downgrade on Enron's credit rating. On October 31, the SEC's inquiry was upgraded to a formal investigation into Enron's finances. On that same day, Enron announced its board of directors had formed an investigation committee of its own with the power to take disciplinary action against any Enron employee, officer or director who it determined had improperly participated in the limited partnership transactions.

LAST-DITCH EFFORTS

Ken Lay sought intervention from officials in various government agencies in Washington; on October 26, he phoned Federal Reserve Chairman Alan Greenspan. Later, spokespeople for the Federal Reserve would not disclose what was discussed during the conversation between Lay and Greenspan, but said Greenspan did not follow up the call with any action. "He did nothing in response to the call. It would have been inappropriate," the spokesperson said.²²

On the same day, Lay phoned Donald L. Evans, the Commerce Secretary (reportedly one of President Bush's closest friends). Evans was out of town, and Lay did not reach him that day.

On October 28, Lay contacted Paul H. O'Neill, the Treasury Secretary. Lay described Enron's problems to O'Neill, suggesting that the company's collapse could put the entire financial system at risk. O'Neill consulted Peter R. Fisher, the Under Secretary for Domestic Finance; Fisher advised O'Neill that such aftershocks were unlikely.

Donald L. Evans was back at his office October 29 and returned Lay's call. Evans' spokesperson James Dyke later indicated that during the October 29 phone call, Lay "indicated that he would welcome any support the secretary thought appropriate" in dealing with the credit rating agencies.

Ultimately, both O'Neill and Evans decided against intervening.²³

At around the same time, discussions began with rival company Dynegy over a merger that might save Enron. In the meantime, officials at Enron discovered another accounting mistake: a secret side deal had been drawn up during the formation of an SPE controlled by an Enron employee working under Fastow. The side deal shifted SPE ownership away from independent investors; these SPEs had never been independent entities and therefore did not meet the accounting requirements for off-balance sheet treatment. Accountants from Andersen informed the company that hiding the side deal might have been a criminal act.²⁴

A tentative agreement to merge was reached by Enron and Dynegy's boards of directors on November 7. On November 8, Enron filed a report with the SEC, restating its earnings back to 1997. Enron disclosed \$591 million in losses against previously reported profits and acknowledged that three of the SPEs should have been consolidated into Enron's financial statements all along. Enron's quarterly filing on November 19 revealed its depleted cash situation and a \$690 million debt payment that had been accelerated due to its downgraded credit rating. Dynegy had received little warning about these revelations.

On November 28, Standard and Poor's downgraded Enron's credit rating to below investment grade, triggering the immediate repayment of almost \$4 billion in off-balance sheet debt. Enron's downgrade to junk bond status triggered a clause in the merger agreement with Dynegy; on the same day as the credit downgrade, the merger with Dynegy fell apart. On December 1, Enron's board of directors unanimously supported a motion to declare bankruptcy. The petition was filed December 2.

RESULT

Following the filing of its bankruptcy petition, Enron laid off 4,000 of its 20,000 workers worldwide. Enron employees also suffered through their 401(k)²⁵ retirement plans; Enron contracted out the administration of the fund to an outside company, a process that froze the investment accounts being transferred. The frozen accounts kept Enron employees from dumping their Enron stock in late October as the share price plummeted. A feature of Enron's retirement fund involved matching 50 per cent of any contributions from employees, up to six per cent of their salary, with Enron stock. Employees were prohibited from selling any of the stock Enron gave them until the age of 50; however, they were free to sell any Enron stock they had purchased with their own money.²⁶ Of the assets in Enron's retirement system, approximately 62 per cent of the individual pensions were made up of the company's own stock.²⁷ The combination of frozen 401(k) accounts and Enron's restrictions on selling stock it had contributed forced employees to hold on to the company's stock even as the price collapsed. The 401(k) plan ended up losing more than \$1 billion in October and November of 2001, rendering many of employees' 401(k) accounts worthless.²⁸

Meanwhile, between 1999 to mid-2001, a group of Enron executives and directors sold 17.3 million Enron shares, pocketing approximately \$1.1 billion. Lay's take was the second highest, selling 1.8 million shares for \$101.3 million; Skilling received \$66.9 million for 1.1 million shares; Fastow had a take of around \$30 million for his Enron holdings.²⁹

From its high of \$90.75 on August 23, 2000, Enron shares closed at \$0.26 on November 30, 2001, the last trading day before it declared bankruptcy. From a market capitalization of more than \$60 billion at the beginning of 2001, by the end of the year Enron had destroyed all of its value. Shareholders' lawsuits were filed against Enron and against Arthur Andersen in an attempt to recover some of their losses.

CONCLUSION

The report released on February 2, 2002 by the special investigation committee formed by Enron's board of directors concluded

the partnerships . . . were used by Enron management to enter into transactions that it could not, or would not, do with unrelated commercial entities. . . . Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or transfer risk.

The board of directors, technically elected by the shareholders, was responsible for overseeing management as well as ensuring that proper accounting reports were delivered to the shareholders. In fact, a company's financial statements were usually signed by two members of the board on behalf of all the board members. Enron's board and its audit committee (see Exhibit 6) were also being asked to explain what happened and to justify their actions in light of the consequences to the company and its investors and creditors. Carl Levin, the chairman of a U.S. Senate subcommittee investigating the Enron affair, made the following statement about the board of directors: "[the board] approved an awful lot of what happened. They can't duck their responsibility."³⁰ The question many asked was where were the board of directors and the audit committee when Enron was quickly deteriorating? What were their responsibilities? Did they act in the best interest of the shareholders?

Enron's collapse had damaged investors' faith in the corporate financial reporting system. What and where were all the checks and balances? What were the institutional and other safeguards? Which ones failed? Calvert, after his experience with Enron, wondered if anything could have been done to prevent his losses, and what, if anything could be done in the future to prevent a similar disaster from occurring.

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Kenneth L. Lay
Houston, Texas
Chairman, Enron Corp.

Robert A. Belfer
New York, New York
Chairman, Belco Oil & Gas Corp.

John H. Duncan
Houston, Texas
Former Chairman of the Exec. Committee
of Gulf & Western Industries, Inc.

Charles A. LeMaistre
San Antonio, Texas
President Emeritus, University of Texas
M.D. Anderson Cancer Center

Norman P. Blake, Jr.
Colorado Springs, Colorado
Chairman, President and CEO,
Comdisco, Inc.
Former CEO and Secretary General,
U.S. Olympic Committee

John A. Urquhart
Fairfield, Connecticut
Senior Advisor to the Chairman, Enron Corp.
President, John A. Urquhart Associates
Former Senior Vice President of Industrial and
Power Systems, General Electric Company

The following members of Enron's Board of Directors also formed Enron's Audit Committee.

John Mendelsohn
Houston, Texas
President, University of Texas
M.D. Anderson Cancer Center

Robert K. Jaedicke
Stanford, California
Professor of Accounting (Emeritus) and
Former Dean, Graduate School of
Business, Stanford University

Paulo V. Ferraz Pereira
Rio de Janeiro, Brazil
Executive Vice President of Group Bozano
Former President and COO, Meridional
Financial Group
Former President and CEO, State Bank
of Rio de Janeiro, Brazil

Jeffrey K. Skilling
Houston, Texas
President and CEO, Enron Corp.

Jerome J. Meyer
Wilsonville, Oregon
Chairman, Tektronix, Inc.

Frank Savage
Stamford, Connecticut
Chairman, Alliance Capital
Management International

Ken L. Harrison
Portland, Oregon
Former Chairman and CEO,
Portland General Electric Company

Herbert S. Winokur, Jr.
Greenwich, Connecticut
President, Winokur Holdings, Inc.
Former Senior Executive Vice
President, Penn Central Corporation

Ronnie C. Chan
Hong Kong
Chairman, Hang Lung Group

John Wakeham
London, England
Former U.K. Secretary of State for
Energy and Leader of the Houses of
Lords and Commons

Wendy L. Gramm
Washington, D.C.
Director of the Regulatory Studies
Program of the Mercatus Center at
George Mason University
Former Chairman, U.S. Commodity
Futures Trading Commission

Exhibit 6 Enron's Board of Directors and Audit Committee

Source: Enron Corporation 2000 Annual Report, <http://www.enron.com/corp/investors/annuals/2000/board.html#super>
June 25, 2002.

NOTES

1. This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Enron Corp. or any of its employees.

2. <http://www.ferc.fed.us>, April 8, 2002.

3. Annual Energy Outlook 2002 with Projections to 2020, Energy Information Administration, <http://www.eia.doe.gov>. Accessed April 17, 2002.

4. <http://www.enron.com/corp/pressroom/milestones/frameset.html>, March 27, 2002.

5. All figures in U.S. dollars.

6. William H. Miller, "Vision Vanquisher," May 18, 1998. <http://www.industryweek.com>, April 3, 2002.

7. The Corporate and Other business segment included the operation of water, renewable energy businesses and clean fuel plants, as well as overall corporate activities.

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13. Kurt Eichenwald and Diana B. Henriques, "Web of Details Did Enron In As Warnings Went Unheeded," *New York Times*, February 10, 2002.

14. Mathew Ingram, "How Aggressive Should An Accountant Be?," *The Globe and Mail*, April 3, 2002.

15. Bethany McLean, "Is Enron Overpriced?," *Fortune*, March 5, 2001.

16. Ibid.

17. Bethany McLean, "Why Enron Went Bust," *Fortune*, December 24, 2001, pp. 59 to 60.

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APPENDIX: INTRODUCTION TO SPECIAL PURPOSE ENTITIES

A special purpose entity (SPE) is an organization with a limited purpose or life. Such vehicles are commonly used to manage risk and to access capital. A SPE is created by a sponsoring company that typically sells an asset to the SPE.¹ For an SPE to qualify for off-balance sheet treatment, an independent third party must invest at least three per cent of the fair value of the financial asset to be sold into the SPE as equity; the remaining 97 per cent is often in the form of loans from

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creditors. The third-party investor would control the SPE's activities and bear the substantial risks and rewards of the entity. The sponsoring company receives the money borrowed by the SPE as payment for the asset sold; the asset, now owned by the SPE, is used as collateral for the loans.

The benefits of using such an SPE come from isolating assets in an entity that is prohibited from undertaking any other business activity or from taking on additional debt. This isolation helps manage risk; should the sponsoring company go bankrupt, the transferred asset in the SPE could not be touched by the sponsor's creditors. Conversely, if the SPE became insolvent, the sponsoring company would only be responsible for what it had put into the SPE. Isolating the transferred asset also has the effect of protecting the asset from the risks of the sponsor's other business activities or claims from other creditors; consequently, credit risk is reduced. The SPE can borrow against the asset at a lower cost of capital than the sponsor would have been able to obtain borrowing against the same asset.

The theory behind SPEs is that the value of its assets (the loan collateral) should be equal or greater than the value of the SPE's debt; the debt risk is covered as the assets and liabilities effectively cancel each other out. If the assets have solid value that does not fluctuate dramatically, the SPE would be unlikely to become insolvent as a result of its own activities. Typically, SPE

consolidation does not cause differences in reported income. Since the assets and liabilities in a SPE usually balance out, consolidation of an SPE into the sponsoring company's financial statements usually does not have much effect on the financial statements. This form of off-balance sheet financing might be used because other reasons exist for keeping assets or special projects off the consolidated balance sheet.

Having been created for a specific purpose, the SPE is structured with limitations on liabilities it can incur, with insulation from the liabilities of third parties, protection from dissolution risk and with measures to prohibit it from filing a bankruptcy petition while solvent. These measures ensure the SPE is adequately isolated from any of its related parties and does not engage in any business outside of that which it was created for.

Note

1. SPEs are used in various ways to manage risk or as a financing vehicle: an SPE can be a joint-venture partner in a special project with the sponsoring company co-signing the SPE's debts; a SPE can enter into leasing arrangements for large assets to enable the sponsoring company to avoid capitalizing the lease. Virtually all banks use SPEs to issue debt secured by pools of mortgages. SPEs are widely used for factoring (the generation of cash through selling off receivables). The SPE structure described above is known as an asset securitization.

ACME HARDWARE

Alister K. Mason

Claude Lanfranconi

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INTRODUCTION

John Smith, C.A., was recently assigned the responsibility for the audit of Acme Hardware, a

new client. He was wondering what action, if any, he should take about the way certain stores of Acme Hardware were accounting for inventory and advertising costs. As a result of his pre-audit

review of the previous auditor's files, he had identified a situation where there was a probability that certain store managers, motivated by the company's management and control system, were taking advantage of discretionary accounting alternatives available to them. Any complete investigation would be disruptive and expensive and had to be considered in light of the fact that the impact of their actions on the company's financial statements might be immaterial.

THE COMPANY

Acme Hardware was a rapidly expanding chain of hardware stores which operated in southern Ontario. All stores were company-owned; there were no franchises.

By the beginning of the 1987/1988 fiscal year, Acme had 14 stores, four of which had been opened up in the previous five years. Total sales in 1986/1987 were \$30.7 million (up from \$21.4 million in 1982/1983), resulting in net income—after corporate expenses and income taxes—of \$1.2 million (\$650,000 in 1982/1983). Total assets as at March 31, 1987 were \$17.4 million.

Acme's success was attributed to several factors, but the most important was usually considered to be the generous bonuses (\$15,000), which were payable to the store manager when the budgeted net income for the year was met. Budgets were set by head office, after negotiations with store management. Net income was computed in accordance with accounting policies laid down by head office, and in the event of disagreement, Acme's auditors, who also reviewed each store's records, were to act as arbitrators. The predecessor audit firm had not been required to arbitrate any disagreements about the income computations in the preceding five-year period.

PREPARATION FOR THE AUDIT

Acme had recently engaged a new firm of auditors, AB&Co., and John Smith was the partner assigned to the engagement. In planning

the work to be performed for the first year—the year ended March 31, 1988—he reviewed the predecessor audit firm's working paper files. John found that the above-mentioned bonus arrangement had been identified by that firm as a potential "audit risk"¹ with regard to the pressure on store managers to achieve budgets.

John reviewed the budget and actual net income figures for the previous five years, to see how frequently the budgets had been met, and hence the bonuses paid. He noted that, for 10 stores he examined, because they had been in operation for some time, and therefore had an established pattern of operations, bonuses had been paid on 23 occasions (out of a maximum of 50). He also noted that, when a budget was met, the tendency seemed to be for it to be met by a narrow margin, but, when missed, by a much wider margin.

ANALYSIS OF INCENTIVE SYSTEM

To examine this issue more closely, John prepared a table setting out the budget and actual net income figures for the 10 stores over the five-year period (see Table 1). He separated the 10 stores into two groups:

1. Three stores (North York, Hamilton, and Waterloo) in which:
 - a. budgets were met four times out of a possible 15 (27 per cent);
 - b. the margins by which the budgets were met were \$10,000, \$3,000, \$9,000 and \$6,000 (average \$7,000); and,
 - c. on the 11 occasions when the budgets were not met, the margins ranged from \$5,000 down to \$1,000 (average \$2,800).
2. The other seven stores, for which:
 - a. budgets were met 19 times out of a possible 35 (54 per cent);
 - b. the margins by which the budgets were met ranged from \$2,000 to \$5,000 (average \$3,300); and,
 - c. on the 16 occasions when the budgets were not met, the margins ranged from \$7,000 to \$18,000 (average \$11,200).

	1982/1983 Income		1983/1984 Income		1984/1985 Income		1985/1986 Income		1986/1987 Income	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Oshawa	\$125	\$129*	\$136	\$118	\$132	\$135*	\$140	\$132	\$145	\$147*
Scarborough	180	173	195	198*	212	217*	228	216	236	240*
Markham	76	65	84	88*	102	86	120	125*	138	121
North York	202	198	212	208	220	218	235	245*	250	247
Mississauga	168	171*	175	165	185	189*	197	186	202	205*
Hamilton	136	139*	142	137	148	146	158	167*	168	165
St. Catharines	94	85	98	100*	105	96	110	112*	114	102
Guelph	85	76	88	92*	95	98*	101	92	104	106*
Waterloo	148	146	154	160*	163	160	172	170	185	184
London	189	192*	195	184	198	201*	205	195	209	213*

Table 1 Budget/Actual Net Income Figures for 10 Stores (all figures in \$000)

*Bonus paid to store management.

John concluded that there was a strong probability that the managers of seven stores were manipulating net income computations. Based on his experience, John thought that the most likely way of doing so would be by advancing or deferring—from one period to the next—the recognition of income and/or expenses. For example:

1. By deferring the recognition of income or advancing the recognition of expenses, it would be easier to meet the budget in the next period. Managers would be tempted to do this when it was apparent—say by the 10th or the 11th month of the fiscal year—that (a) the current year's budget could not be met, or (b) the budget had already been met.
2. By advancing the recognition of income or deferring the recognition of expenses, it would be easier to meet the budget in the current period. This would be particularly tempting when, without action of this kind, the budget would probably be missed by a fairly narrow margin.

John reviewed the monthly income statements for the individual stores, all of which followed a standard format (prescribed by head office), based on the income and expense accounts in the general ledger. He concluded that the two most likely areas for manipulation were:

1. Inventories

These were valued at the lower of cost (determined on a FIFO first in first out basis) and net realizable value. The write-down to net realizable value was largely a matter of judgment, particularly in respect of seasonal merchandise, e.g., garden supplies, and products for which expected new models might make the present ones obsolete, e.g., power mowers.

2. Advertising Expenses

Company policy required the costs of local advertising to be expensed in the period the campaign was run. However, store managers had discretion when a campaign should be run, and it would be quite possible to advance a campaign scheduled for the first week of April to the last week of March. (Experience had shown that some advertising campaigns result in increased sales over the next few weeks, rather than only in the period in which the advertisements are run.)

CONCLUSION

John was very familiar with these types of incentive schemes because of their use by many of his other clients. He was also aware that senior management recognized that any management control system had flaws. However, these systems motivated their operating managers to maintain a focus on net income and, in the process, to maximize revenues and minimize costs.

John also recognized that, unless several stores manipulated their results in the same direction in any year, the impact on the corporate financial statements would probably not be material. He now had to decide what, if any, action was necessary.

NOTE

1. "Audit risk" is the risk that the audit firm would fail to express a reservation in its opinion on Acme's financial statements if they were materially misstated. Such material misstatement would not have been prevented or detected by Acme's internal controls, and would not have been detected by the audit firm.

FARDO INDUSTRIES INC.

Jeffrey Gandz

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Ron Bellamy, senior tax partner for a large public accounting firm was preparing for a meeting with John Gardner, president and chief executive officer of Fardo Industries. Fardo was about to conclude an acquisition of Shorter Software, a small software company specializing in developing custom software for several large organizations. The only minor problem was not directly related to the acquisition at all but, rather, how Fardo should amortize the \$1.5 million goodwill payment included in the purchase price.

FARDO INDUSTRIES INC.

Fardo Industries was a privately held company with an estimated market value of \$20 million and 1,000,000 shares outstanding. John Gardner, the founder, held 31 per cent of the shares; two other corporate officers held 20 per cent between them; the remaining shares were held by 30 outside investors, none of whom held more than five per cent.

Since its inception ten years previously, Fardo had specialized in acquiring small firms in the information systems field. It had raised the equity capital for this from small investors, mainly professionals such as doctors and lawyers, and also had substantial lines of credit at two banks.

SHORTER SOFTWARE

Founded by two brothers, Ben and John Shorter, former systems analysts and programmers with large computer firms, Shorter Software had developed a specialized niche in the software market, developing customized software to tie together a number of frequently utilized and commercially available application packages.

THE ACQUISITION

Ron Bellamy had helped the Shorters set up their business six years ago and had acted as their accountant since its start. He had been surprised when, some three months previously, Ben had indicated that they would like to try to sell the business.

It really needs more capital to expand and, quite frankly, John and I are not very good business people . . . we're much happier doing the technical stuff. Maybe if we could sell the business to someone, remain associated with it for a number of years, and then retire, we could see a much better business development and have our own retirement nest eggs.

Ron Bellamy had mentioned this conversation to John Gardner since he thought that Fardo Industries might be interested . . . they were. Bellamy immediately suggested to Ben Shorter that they get some independent financial advice since he could not really act for both the buyer and the seller in this kind of acquisition. Shorter retained George Miller, an old friend who was an accountant with a small firm.

Negotiations proceeded very smoothly and a deal was soon struck. The Shorters were to get ten Fardo shares for each of their shares, with Fardo issuing 100,000 new shares for the acquisition. Furthermore, after five years, the Shorters would have to tender their shares to Fardo for an amount equivalent to ten times the earnings per share in the best of the five years following the acquisition. Ben Shorter called Ron Bellamy after the deal was agreed to.

We're real happy, Ron. This Gardner guy seems pretty good to us and we think the deal's a fair one. Thanks for your help in this.

Ron Bellamy's Concern

Ron Bellamy did not feel quite as excited as Ben Shorter about this deal. Of the acquisition price of \$2 million, \$1.5 million was for goodwill, representing the relationships built up between the Shorters and their customers over

the years. Such goodwill was not deductible for Fardo, however. Furthermore, the conventional accounting practices allowed a very wide range of alternative methods and amounts for writing off such goodwill. It could be written off quickly, over five years, or much more slowly, up to forty years! (See Exhibit 3 for guidelines.)

	<i>Before Acquisition</i>	<i>After Acquisition</i>
Current Assets	5,000	5,500
Fixed Assets	25,000	25,000
Goodwill	0	1,500
Total Assets	<u>30,000</u>	<u>32,000</u>
Current Liabilities	2,500	2,500
Long-Term Debt	17,500	17,500
Total Liabilities	<u>20,000</u>	<u>20,000</u>
Shareholders' Equity	10,000	12,000
Total Liabilities & Shareholders' Equity	<u>30,000</u>	<u>32,000</u>

Exhibit 1 Balance Sheet December 31, 1987 (000's)

FARDO INDUSTRIES INC. (amortization period of 5 years)

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>	<i>Year 6</i>
Revenue ¹	30,000,000	31,500,000	33,075,000	34,728,750	36,465,1888	38,288,447
Oper. Expenses	25,500,000	26,775,000	28,113,750	29,519,438	30,995,409	32,545,180
Amort. Goodwill	300,000	300,000	300,000	300,000	300,000	
Net Income	4,200,000	4,425,000	4,661,250	4,909,313	5,169,778	5,743,267
Tax ²	2,025,000	2,126,250	2,232,563	2,344,191	2,461,400	2,584,470
Earnings A/T	2,175,000	2,298,750	2,428,688	2,565,122	2,708,378	3,158,797
# Shares O/S	1,100,000	1,100,000	1,100,000	1,100,000	1,100,000	1,100,000
E.P.S.	1.98	2.09	2.21	2.23	2.46	2.87
Shorter's Tender @ 10 × earnings	1,977,273	2,089,773	2,207,898	2,331,929	2,462,162	2,871,634

Exhibit 2 Projected Income Statement for Six Years Subsequent to Acquisition of Shorter Software

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GOODWILL

- .54 Goodwill is commonly considered to be a composite of all the factors which cannot be individually identified and valued and which contribute to or accompany earnings capacity of a company. In a business combination, goodwill is represented by the difference between cost and the acquiring company's interest in the identifiable net assets.
- .55 There are various possible approaches that may be considered in accounting for goodwill including the following:
- (a) retain as an asset indefinitely unless a reduction in its value becomes evident;
 - (b) retain as an asset but permit amortization as an operating expense over its estimated limited life or over an arbitrary but specified maximum or minimum period;
 - (c) retain as an asset but require amortization as an operating expense over its estimated limited life or over an arbitrary but specified maximum or minimum period;
 - (d) write off complete amount at time of acquisition;
 - (e) reflect as a deduction from shareholders' equity unless a reduction in its value becomes evident.
- .56 The accounting treatments which do not involve the amortization of goodwill are based on the contention that the value of goodwill is not consumed or used to produce earnings in the same manner as various other assets and therefore net income should not be reduced by mandatory amortization of goodwill. Furthermore, it is contended that net income should not be reduced by both amortization of goodwill and the current expenditures that are incurred to enhance or maintain the value of acquired intangible assets. Amortization of goodwill is also criticized as being arbitrary, since it is contended that the life of goodwill is indefinite and an estimated period of existence is not measurable.
- .57 In the opinion of the Committee, however, goodwill does not have a limitless life, and therefore, amortization of goodwill should have the same theoretical recognition as is presently afforded depreciation of tangible assets. Goodwill existing at the acquisition gradually disappears and may, or may not, be replaced by new goodwill. Furthermore, goodwill is a cost which is incurred in anticipation of future earnings, and should be amortized by systematic charges to income over the periods of those future earnings in order to produce a proper matching of costs against revenue. The straight-line method of amortization should be applied. An analysis of all pertinent factors should normally enable the company to assess a reasonable estimated life of such goodwill. However, the period of amortization should not exceed forty years.
- .58 *The amount reflected as goodwill at the date of acquisition should be amortized to income by the straight-line method over the estimated life of such goodwill; however, such period should not exceed forty years. The period of amortization should be disclosed.*
[April 1, 1974*]
- .59 Because Recommendations are not normally given retroactive effect, the Recommendation in paragraph 1580.58 is not intended to apply to goodwill arising from business combinations where the date of acquisition (see paragraph 1580.39) is prior to the effective date of these Recommendations.
- .60 Since goodwill is an asset (see paragraph 1580.42), it would be accounted for as such both at the date of acquisition and in subsequent periods to the extent that it has not been amortized. It would not be written off in a lump sum at the date of acquisition or shown as a deduction from shareholders' equity. A subsequent permanent impairment in value would result in a writedown of goodwill which would be treated either as a charge against income before extraordinary items, or as an extraordinary item, depending on the circumstances.
- .61 *The amount attributed to goodwill should be shown separately on the balance sheet as an intangible asset, to the extent that it has not been amortized or written down. It should not be shown as a deduction from shareholders' equity.*
[April 1, 1974*]
- .62 *Where there has been a permanent impairment in value of the unamortized portion of goodwill, it should be written down. The write-down should be treated as a charge against income. The charge against income will be shown either in income before extraordinary items or as an extraordinary item, depending on the circumstances which give rise to the impairment in value. (See EXTRAORDINARY ITEMS, Section 3480.)*
[April 1, 1974*]

Clearly, writing this off over five years—as John Gardner wanted to do—would depress the earnings-per-share of Fardo Industries significantly in those five years. This would affect the amount that the Shorters would actually get for their shares at the end of the five-year period. Beyond that, however, it would also affect the earnings-per-share and, presumably, the share price for all investors, including small minority shareholders, several of whom were either clients of Bellamy's firms or personal acquaintances.

Ron Bellamy had to give Gardner some clear advice about what to do in this situation, but he was uncomfortable about the impact on the Shorters and other minority shareholders. Before meeting with Gardner, he decided to discuss the matter with George Clarke, a senior auditing partner with his firm, who was known throughout the accounting profession as an expert in accounting ethics. He wondered what Clarke was likely to say to him and, indeed, what the case was for either a quick or slow write-off.

THE ONTARIO CAPITAL GROUP

Niels Billou

David J. Sharp

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Frederick Jones, branch manager at the London, Ontario branch of the Ontario Capital Group (OCG), was alarmed. It was late October 1997 and Jones had just finished a quarterly review meeting with one of his investment advisers, Dan Cooper. It appeared that since the previous July, Cooper had been injecting his own capital into a client's account that had been losing value, but which had now recovered and had made a profit. As Jones pondered his next move, he thought to himself, "How did this go unnoticed? But no harm has come to anyone—why should I do anything about it?"

THE ONTARIO CAPITAL GROUP—LONDON BRANCH

The Ontario Capital Group was a mid-sized brokerage house with offices throughout Southwestern Ontario. The London, Ontario branch had been a moderately successful operation throughout its 20-year history; however, its

performance had suffered in the past two years as other branches posted higher trading volumes and assets under management.

The branch had been under pressure from the head office in Toronto to improve its results. The employees, many of whom had been at the branch since its opening, felt "under the gun" to improve their performance.

DAN COOPER

Dan Cooper was 50, married with three children and had been with the London branch of OCG for the past 15 years. His performance had been consistently average over the years. His quiet, reserved style attracted mostly elderly retirees. One of his colleagues commented:

Dan is a quiet, conservative person. He's not a high volume trader, and generally recommends established securities that yield a stable return. His clients are mostly pensioners and widowers in fixed incomes with a small nest egg. Many are

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quite elderly, and we joke with him that if doesn't lower his minimum age requirement below 70 he's not going to have any clients left pretty soon. I think he must be getting tired of our ribbing because I've seen him advising some young professional types lately.

THE QUARTERLY REVIEW

All investment advisers had quarterly reviews with the branch manager to discuss performance for the past quarter as well as discuss targets for the upcoming quarter. Trading volumes, assets under management, number of existing and new clients and selling success rates were all examined.

As Jones was reviewing Coopers file prior to the meeting, he noticed an number of trades in one particular account, under the name Gerry Marchisi, that struck him as odd, given Cooper's trading style and clientele.

THE MARCHISI ACCOUNT

Gerry Marchisi was 31 years of age, married, and the president of Marchisi Supermarkets, a family owned firm. He had an annual income of approximately \$75,000 per year and a net worth of approximately \$300,000. He opened a margin account in March of 1990 and listed his investment objectives as 30 per cent growth, 40 per cent growth with risk, and 30 per cent venture situations. The account was not approved as a discretionary or a margin account.

The following is a summary of the trading activity on the file for the period July to September 1997:¹

- On July 3, 1,000 shares of Movie World shares were purchased at a price of \$14.00.
- On July 21, the value of the Movie World shares had declined to a price of \$3.25. Marchisi's account had a negative equity of \$492 and was undermargined by \$4,534. On that day, 1,000 shares were sold for \$3.25, resulting in a loss of approximately \$11,000. Despite the sale, the account still had a negative

equity of \$552, and was still undermargined by \$3,600, resulting in a margin call.

- On July 23, \$4,500 was deposited into the account in order to satisfy the margin call. This resulted in a net equity of \$3,600 and excess margin of \$635.
- In August, the shares lost their option eligibility and the account was once again undermargined. Three more deposits were made between August 15 and August 30, for a total of \$1,200.
- On September 5, Cooper bought 3,000 shares of Cable Communications for \$3.25. At this point, the account was undermargined by \$4,800.
- On September 12, the settlement date for the trade, Cooper sold the 3,000 Cable Communications shares for \$5.50, resulting in a profit of approximately \$6,000 (after commissions and interest). The account now had excess margin of approximately \$4,500.
- On September 15, Cooper bought 5,000 shares of DT Technologies for \$7.875. This resulted in a the account being undermargined by approximately \$14,500.
- On September 20, two days before the settlement date, Cooper sold the 5,000 DT Technologies shares for \$9.875, resulting in a profit of \$8,500. The account now had excess margin of \$14,000.

CURRENT SITUATION

Cooper seemed nervous and apprehensive from the beginning of the review. When Jones further questioned Cooper about these trades, Cooper hesitantly explained the story.

Gerry Marchisi was referred to me by his grandfather, Umberto, one of my long-time clients. He's a pretty aggressive young guy, wants to go for the risky stocks that have the potential for big gains. Not my sort of client, really, but with all the talk lately of getting the numbers up, he seemed like the new type of client that management wants us to go after. At first I bought him some equity mutual funds, but he wanted higher returns and was willing to take more risk. So I recommended Movie World—rumor had it that it was a takeover target and the stock was going to go through the roof. The rumors proved to be wrong, their second quarter results were disastrous, and the company was being

sued for a breach of contract that could bankrupt the company if they lost. Marchisi blamed this all on me and told me he would not put any more money into the account to satisfy margin calls or settle trades. Given that he was undermargined, he was obliged to put in more money. I told him that we could make up the money, and he told me to do as I pleased, but he wasn't going to inject any more cash into the account. I didn't really know what to do, so I put in my own money to satisfy the margin calls.

I then received these tips on these two stocks, so I bought them on the company's account and flipped them before the settlement date. Thankfully, the stocks went up and now Marchisi's original loss has been eliminated, and he's even made a profit.

As Cooper finished his story and left, Jones thought to himself, "How could this go unnoticed? We should have controls to prevent such a situation from occurring. At the same time, to what extent is Cooper to blame? What kind of a message are we sending when an essentially decent guy like Cooper feels compelled to act the way he did?"

NOTE

1. During that period the Marchisi account included other securities that were not traded.

THE JEFFREY VERDE ACCOUNT

Michelle Theobalds

David Sharp

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On December 5, 1997, Sarah Robertson, an investment advisor at Securities Trading Company (STC), looked over Jeffrey Verde's recent transaction history and contemplated her next move. That morning, she had received a call from Verde to enter into six long March Standard and Poor's 500 (S&P 500) Index futures contracts. Mr. Verde had a history of temporarily exceeding his trading limits,¹ and this most recent order would once again put him over the limit.

Verde was actually the client of her colleague, David Simpson. However, Sarah, who had recently passed the Futures Licensing Course, was overseeing his accounts while he was away on sick leave. In response to Verde's request, Sarah informed him that STC's research department had issued a sell recommendation on those contracts in view of the continuing uncertainty in the Asian markets. Verde replied,

Yes I know . . . David already told me. However, I am convinced that your analysts are wrong. The market is heading for further gains and I want to be a part of it.

Sarah knew that Verde was an experienced speculator in the market and had been a client of Simpson's for almost 20 years. She responded, "OK, Mr. Verde, I'll see if I can put through the order."

As soon as she hung up the telephone, Sarah regretted her hasty decision. Although she knew of Mr. Verde's long-standing relationship with David Simpson and the firm, she did not know much else about him. She decided to check Verde's Futures Application Form and also printed his recent transaction history. Sarah also consulted Simpson's sales assistant to find out more details on Verde.

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JEFFREY VERDE

Simpson's sales assistant knew Jeffrey Verde very well. He had met and spoken with Verde on a number of occasions, and, therefore, he was able to fill in the details not included in Verde's application form.

Jeffrey Verde, aged 60, was a lawyer by profession. Over his 30-year career, he had practised with several large law firms, was an in-house counsel for a mutual fund, and then, finally, counsel for a consumer finance organization. Two years ago, Verde's employment was terminated, however, his employer continued to pay his salary until the end of last year. Since then, Verde had attempted to generate an income stream through consulting, writing a book and some highly speculative projects. Up until December, these attempts were largely unsuccessful.

In August 1997, Jeffrey Verde got married. While the marriage did result in Verde moving to a larger apartment, Mrs. Verde was not dependent on him for income. Although she had worked at a variety of jobs, her main vocation was exotic flowers. Shortly after they were married, the Verdes travelled to Florida to explore the possibility of opening a flower shop in a trendy section of Palm Beach. Although the initial plan fell through, it was their intention to look for other business opportunities in the area and to eventually move to Florida.

Jeffrey Verde was in Toronto in November and had since transacted several trades through Simpson. He had mentioned to Simpson that he was worried about his mother, who had been ailing for some time.

Relationship with David Simpson

Verde and Simpson met over 20 years ago when Simpson was an account executive at a rival brokerage. Simpson, who was also trained as a lawyer, inherited Verde's account from another broker. At that time, Verde had a small account, mostly in common shares. Verde was very interested in the markets, and, over time, became a more active trader. Verde and

Simpson's relationship may be described as one of mutual respect. Jeffrey Verde viewed Simpson as a very knowledgeable and reliable broker, while Simpson described Verde as a "keen student of the market, always looking for opportunities for successful trading."

In the early days, Simpson and Verde dabbled in commodity futures contracts (hogs, cattle) on the Chicago Mercantile Exchange. Over time, Verde learned the business from Simpson and increasingly made decisions on his own. He always followed the markets in the daily newspapers and the financial network on television. He also subscribed to market oriented periodicals and believed in the Elliot Wave Theory of market cycles. Like a professional technical analyst, Verde kept charts of market activity and used the charts to make forecasts. He was particularly attracted to "hot equity new issues" and futures trading in order to make significant short-term gains. Clearly, Jeffrey Verde was not a conservative investor.

In 1992, Simpson moved to Securities Trading Company (STC) and Verde's accounts totalling \$85,000² were transferred with him. According to the normal procedure, Verde filled out and signed the following documents: New Client Application Form, Customer Account Agreement, Futures Account Application Form, Risk Disclosure Statement and a Futures Trading Agreement. On the application forms Verde indicated an annual income of \$52,000 and a net worth (and liquid net worth) of \$225,000.

In the same year, Simpson introduced Verde to stock index futures contracts and in particular, S&P 500 Index contracts. Within one year, Verde was trading these contracts confidently, while relying less on the commodity futures and equities. At that time, Verde's trading in the markets increased significantly when his mother chose to distribute a portion of her estate. He received \$120,000, which he put into his accounts at STC. From time to time, Verde would accumulate large cash balances from liquidated positions and realized profit. Simpson recommended an interest-bearing stock account to keep these cash balances until

required. Verde agreed, understanding that the transfers to this account would be temporary until the funds were needed to enter into more futures contracts or to meet margin calls. As long as there were sufficient funds in the stock account, then margin calls would be satisfied without giving notice to Verde.

Verde was a "careful position trader." He would make an informed decision on the near term market prospects and hold that position regardless of daily fluctuations. Over the past three years, Verde had been successful with his trading. In fact, the profits on his accounts in the past two years had exceeded the annual income he had declared on his application form. In 1995, the year-end summary indicated that Verde had made a profit of US\$83,870. While last year, his profits were US\$114,860 for the year.

In January 1997, perhaps in recognition of his changed circumstances, Verde acquired a portfolio of Canadian and United States income-producing stocks. Therefore, the cash reserve in the stock account that was previously used to enter into futures contracts or to meet margin calls was depleted, leaving share assets in the account. By the end of March 1997, the **cash** position had declined from a credit balance of \$233,000 as at December 31, 1996, to a debit balance of \$35,000. However, Verde continued to trade in commodity and index futures on a regular basis.

While Verde had a good relationship with Simpson and STC, the relationship was by no means exclusive. Verde had accounts with several other brokerages in Canada and the United States. Recently, Verde had asked Simpson for a discount on stock trades. When Simpson told him that discounting was against company policy, Verde transferred a part of his portfolio to a local discount brokerage. It was not known exactly how much business Verde conducted with other firms.

RECENT TRANSACTION HISTORY

Now that Sarah knew some of the details of Jeffrey Verde's circumstances, risk profile and

trading experience, she turned to a summary of his recent trading transactions. Exhibit 1 shows Verde's transactions for the period November 1 to December 2.

Trading Limit

The first column Sarah looked at was the trading limit, which was set at \$100,000. She thought this figure was high, given Verde's most recent Futures Account Application Form. In 1994, Verde had submitted financial information indicating net worth of \$550,000, liquid net worth of \$250,000 and an annual income of \$65,000. STC's compliance manual, filed and approved by the Toronto Stock Exchange (TSE), stated that the "10-40 rule" would be applied in order to establish client trading limits. This rule stated:

The trading limit for a client will not exceed a level of 10 per cent of the client's net worth or 40 per cent of liquid net worth **whichever is less**.

In the event that a net worth statement is not provided or can not be verified, the account can only be carried if the client provides excess margin or other collateral to eliminate the credit risk. The trading limit was established to minimize the risk of a loss that might endanger a client's standard of living or ability to meet obligations. According to the 10-40 rule, Sarah calculated that Verde's trading limit should not have exceeded \$55,000. A total net worth of at least a million dollars was required for a trading limit of \$100,000. The trading limit of \$100,000 had been approved in February. Justification for the increase was US\$281,000 held in Verde's Canadian accounts. A note from the credit manager indicated that the accounts should be "monitored regularly."

Even more disturbing was the "Original Margin Req." column. This column was the total margin required by STC based on the futures contracts held by the client. The original margin required should always be less than the trading limit. Over the past month, Verde had exceeded his trading limit every day except November 28,

Client: Jeffrey Verde

Date	(a) Closing Balance	(b) Gain(Loss) Unrealized	(c) Net Equity	(d) Actual Call (Excess)	(e) Funds in (Out)	(f) Trading Limit	(g) Original Margin Req.	(h) Purchase and (Sale)	(i) Gain(Loss) Realized
1-Nov	168,460	(80,115)	88,345	15,440	(18,400)	100,000	141,940	—	—
2-Nov	183,900	(89,095)	94,805	25	15,440	100,000	141,963	—	—
3-Nov	183,900	(103,542)	80,358	61,530	—	100,000	141,910	—	—
4-Nov	245,455	(125,597)	119,858	—	61,555	100,000	141,963	—	—
7-Nov	245,455	(131,876)	113,579	(818)	—	100,000	141,963	—	—
8-Nov	244,637	(141,702)	102,935	(2,725)	(818)	100,000	141,760	—	—
9-Nov	241,912	(148,145)	93,767	3,543	(2,725)	100,000	141,760	—	—
10-Nov	245,455	(125,130)	120,325	3,081	3,543	100,000	141,621	—	—
11-Nov	248,536	(96,722)	151,814	(11,113)	3,081	100,000	140,700	—	—
14-Nov	237,536	(98,162)	139,374	—	(11,000)	100,000	140,700	—	—
15-Nov	202,691	(94,050)	108,641	—	—	100,000	140,700	6(6) T-Bond	(34,845)
16-Nov	202,691	(116,319)	86,372	—	—	100,000	140,700	—	—
17-Nov	104,633	(7,117)	97,516	—	—	100,000	140,700	10(10) S&P	(98,058)
18-Nov	104,633	(562)	104,071	—	—	100,000	140,700	—	—
21-Nov	104,633	(27,902)	76,731	63,975	—	100,000	140,700	—	—
22-Nov	168,608	29,905	198,513	(57,812)	63,975	100,000	140,700	—	—
23-Nov	110,908	29,725	140,633	—	(57,700)	100,000	140,700	—	—
24-Nov	110,908	(14,680)	96,228	—	—	100,000	140,700	—	—

Exhibit 1 Summary of Commodity and Index Futures Trading Data (Continued)

	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Date	Closing Balance	Gain(Loss) Unrealized	Net Equity	Actual Call (Excess)	Funds in (Out)	Trading Limit	Original Margin Req	Purchase and (Sale)	Gain(Loss) Realized
25-Nov	110,908	26,422	137,330	—	—	100,000	140,700	—	—
28-Nov	144,174	12,730	156,904	(76,202)	—	100,000	80,700	(6) S&P	33,265
29-Nov	68,174	1,095	69,269	40,000	(76,000)	100,000	120,700	4 S&P	—
30-Nov	113,857	355	114,212	9,500	40,000	100,000	130,200	2 S&P 7(7) crude oil	5,683
1-Dec	156,122	(1,982)	154,140	(83,941)	9,500	100,000	70,000	(6) S&P	32,765
2-Dec	74,105	537	74,642	(8,041)	(83,700)	100,000	66,600	(4) Cdn. \$	1,683

Exhibit 1 Summary of Commodity and Index Futures Trading Data

Explanation of Columns

- (a) This represents the cash funds in the account.
- (b) Unrealized gain or loss on open positions.
- (c) Net equity is the balance plus or minus the unrealized gain or loss on futures contracts held.
- (d) Variation margin call or excess generated due to market activity for that day. A margin call takes place if net equity falls below the maintenance margin level. If this happens net equity must be replenished back to the original margin level.
- (e) Actual cash funds transferred into or out of the account.
- (f) The trading limit is the maximum total original margin requirement the client is allowed to carry. The limit is set by the client in the Futures Trading Agreement.
- (g) Total original margin required by STC based on the futures contracts held (e.g. \$10,000 for each S&P contract).
- (h) The number and type of contracts purchased or sold on a particular date. For example, 8 (8) indicates that on the same day, eight contracts were opened and then closed; 6 indicates the opening of six new contracts.
- (i) The gain or loss from the offset of contracts.

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December 1, and December 2. At the end of December 2, Verde's required amount stood at \$66,600. Sarah quickly calculated that if she purchased the six S&P 500³ contracts that Verde requested that morning, then the original margin required would rise to \$126,600, once again exceeding his trading limit.

Margin⁴ Calls

Sarah noticed that there had been eight variation margin calls in the past month. Virtually all of the margin calls had been satisfied via a transfer of funds into the futures/commodity account. On further investigation, Sarah realized that the source of the funds was the interest bearing stock account that Verde had opened some years previously. However, since his January stock purchases, the cash balance in that account had been depleted. Therefore, the "funds" that were being transferred from this account were really excess margin or loans from STC using the stock assets in the account as collateral. All of the stocks that Verde had in this account were option eligible securities,⁵ therefore, he could borrow up to 70 per cent of the market value of these stocks from STC. As per the usual arrangement, Verde was not informed of the margin calls on his commodity account as long as there was sufficient margin in the stock account to cover the calls. On December 2, Verde had equity valued at \$117,000 in the stock account.

This use of "margin to cover margin" was alluded to in the STC Customer Account Agreement signed by Verde:

Ten. Any and all securities and any credit balance held or carried by you to the delivery of which you are entitled under this agreement for the account of the undersigned shall stand as security for any and all of the indebtedness or obligations of the undersigned to you, however arising, and in whatever account appearing, as well as for any contingent liability to you by reason of any guarantee by the undersigned of the account of any other person. Whenever the undersigned shall carry more than one account with you, you may at any time, without notice to the undersigned, charge any one or

more of said accounts with any sum upon crediting any other of the said accounts with the same sum.

CONCLUSION

As Sarah looked over the recent transactions and documentation, she pondered her next move. She had already spent over half an hour investigating the Verde account, and she had to make a quick decision. Since Sarah had recently completed the Futures Licensing Course, the regulations (see Exhibit 2 for an excerpt) regarding futures contracts and the standards of practice were fresh in her mind. However, she was reluctant to approach her supervisor. Her colleague who normally managed this account, David Simpson, was a well respected, experienced broker in the firm. He must have been aware of the status of the Verde account, yet he had continued to accept orders from his client. In addition, the credit and compliance staff at STC had not restricted Verde's trading and had even given him more leverage than provided for in the "10-40 rule." As Sarah thought about a suitable course of action, she was very aware that whatever she did may impact her long-term prospects at STC and her career.

NOTES

1. Trading limits refer to the original margin required.
2. All dollar amounts are in Canadian dollars unless otherwise indicated.
3. Each S&P contract required an additional \$10,000 in margin.
4. See Appendix for definitions of margin and related terminology.
5. An option eligible security qualifies as an underlying security for either Canadian or U.S. exchange-traded put and call options. To qualify, common shares must have a market price of five dollars or higher. In addition, the company must meet specific criteria as to the number of shareholders, number of publicly held shares outstanding and market capitalization.

1800.5 The designated futures contract principal or designated futures contract options principal of a Member designated pursuant to Regulation 1800.2 shall ensure that the handling of customer business relating to futures contracts or futures contract options, as the case may be, is in accordance with the By-laws, Regulations, Rulings and Policies of the Association. In this respect the Member shall have written procedures acceptable to the Director of Compliance describing the control, supervisory and delegation procedures used by the Member to ensure compliance with the By-laws, Regulations, Rulings and Policies. In the absence or incapacity of the designated futures contract principal or futures contract options principal or when the trading activity of the Member requires additional qualified persons in connection with the supervision of the Member's business, an alternate, if any, shall assume the authority and responsibility of such designated persons. Without limiting the foregoing, each designated futures contract principal and designated futures contract options principal shall be responsible for the following matters with respect to trading or advising in respect of futures contracts and futures contract options, respectively:

- (a) opening all new contracts accounts pursuant to a new account application form approved by the Director of Compliance and the approval in writing on such form of all accounts prior to the commencement of any trading activity;
- (b) using due diligence to learn and remain informed of the essential facts relative to every customer (including the customer's identity, creditworthiness and reputation) and to every order or account accepted, to ensure that acceptance of any order for any account is within the bounds of good business practice and to ensure that recommendations made for any account are appropriate for the customer and in keeping with the customer's investment objectives;
- (c) obtaining prior to the commencement of any trading activity in any futures account the executed futures contract or futures contract trading agreement referred to in Regulation 1800.9 or the letter of undertaking referred to in Regulation 1800.10;
- (d) imposing any appropriate restriction on futures contracts or futures contract options accounts and the proper designation of such accounts and related orders;
- (e) the continuous supervision of each day's trading in futures contracts and futures contract options and the completion of a review of each day's trading no later than the next following trading day;
- (f) reviewing on a monthly basis the cumulative trading activity of each futures contracts and each futures contract options account no later than the day of mailing of the monthly statement for each month;
- (g) monitoring performance as necessary of any duties that have been delegated by the futures contract principal or futures contract options principal, as the case may be; and
- (h) performing such other responsibilities as the Director of Compliance may prescribe from time to time.

A designated futures contract principal or designated futures contract options principal may delegate by written direction the performance of any of his or her duties under this regulation 1800.5 (except those described in clauses (g) or (h) unless permitted by the Director of Compliance and except those that are expressly stated not to be delegated) to any person whom he or she has reason to believe is capable of performing such duties; provided that futures contract principal or futures contract options principal shall remain fully responsible for the performance of such duties.

1800.9 Each Member shall have and maintain with each customer trading in futures contracts or futures contract options an account agreement in writing defining the rights and obligations between them on such subjects as the Director of Compliance may from time to time determine, and shall include the following:

- (a) the rights of the Member to exercise discretion in accepting orders;
- (b) the obligation of the Member with respect to errors and/or omissions and qualification of the time periods during which orders will be accepted for execution;

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- (c) the obligation of the customer in respect of the payment of his or her indebtedness to the Member and the maintenance of adequate margin and security, including the conditions under which funds, securities or other property held in the account or any other accounts of the customer may be applied to such indebtedness or margin;
- (d) the obligation of the customer in respect of commissions, if any, on futures contracts or futures contract options bought and sold for his or her account;
- (e) the obligation of the customer in respect of the payment of interest, if any, on debit balances in his or her account;
- (f) the extent of the right of the Member to make use of free credit balances in the customer's account either in its own business or to cover debit balances in the same or other accounts, and the consent, if given, of the customer to the Member taking the other side to the customer's transactions from time to time;
- (g) the rights of the Member in respect of raising money on and pledging securities and other assets held in the customer's account;
- (h) the extent of the right of the Member to otherwise deal with securities and other assets in the customer's account and to hold the same as collateral security for the customer's indebtedness;
- (i) the customer's obligation to comply with the rules pertaining to futures contracts or futures contract options with respect to reporting, position limits and exercise limits, as applicable, as established by the commodity futures exchange on which such futures contracts or futures contract options are traded or its clearinghouse;
- (j) the right of the Member, if so required, to provide regulatory authorities with information and/or reports related to reporting limits and position limits;
- (k) the acknowledgement by the customer that he or she has received the current risk disclosure statement provided for in Regulation 1800.2 unless provided for by other approved means;
- (l) the right of the Member to impose trading limits and to close out futures contracts or futures contract options under specified conditions;
- (m) that minimum margin will be required from the customer in such amounts and at such times as the commodity futures exchange on which a contract is entered or its clearing house may prescribe and in such greater amounts at other times as prescribed by the By-laws and Regulations and as determined by the Member, and that such funds or property may be commingled and used by the Member in the conduct of its business;
- (n) in the case of futures contract options accounts, the method of allocation of exercise assignment notices and the customer's obligation to instruct the Member to close out contracts prior to the expiry date; and
- (o) unless provided for in a separate agreement, the authority, if any, of the Member to effect trades for the customer on a discretionary basis, which authority shall be separately acknowledged in a part of the agreement prominently marked off from the remainder and shall not be inconsistent with any By-laws or Regulations pertaining to discretionary accounts.

Exhibit 2 Excerpts from Investment Dealers Association of Canada Regulation 1800, Commodity Futures Contracts and Options, 1994

Source: Materials provided by the Canadian Securities Institute.

APPENDIX: MARGIN ACCOUNTS

Stock Margin Account

A stock margin account is a special brokerage account that allows a client to buy securities

on credit, by borrowing part of the purchase price from the dealer, or to sell securities short. The word margin in this case refers to the amount of funds the investor must personally provide. The margin plus the amount provided by the dealer (the dealer's loan) together make

up the total amount required to complete the transaction.

Interest on the margin loan is calculated daily on that month's debit balance. The exchanges

regulate the amount of credit that a Member may extend to customers on the purchase of securities. Below are the maximum loan values allowed:

<i>On listed securities selling:</i>	<i>Maximum Loan Value</i>
at \$5.00 and over, qualifying as "Option Eligible Securities"	70% of market value
at \$2.00 and over	50% of market value
at \$1.75 to \$1.99	40% of market value
at \$1.50 to \$1.74	20% of market value
under \$1.50	No loan value

A margin call is generated on a stock margin account when the client's margin deposit is less than the gross margin requirement (30 per cent of market value in the case of option eligible securities).

Futures Margin Account

When a futures contract is initiated both the buyer and the seller must post margin with the Member firm through whom the transaction took place. The Member firm in turn submits the margin to the clearinghouse. The future margin represents a good faith deposit or a performance bond. It does not represent a partial payment or a loan from the Member firm as is the case of equity margin.

Futures exchanges set both original (initial) and maintenance (variation) margin levels. Original margin is the amount of capital the client must deposit when a futures position is first established. Maintenance margin, generally

set at a level under the original margin, is essentially a threshold level. Once net equity (funds in the account plus open profit or minus open loss) in the account falls below the maintenance margin level, the client will receive a margin call that requires him/her to replenish the account back to the original margin level.

Minimum margin requirements for futures contracts are generally established by the exchange where the futures contract is traded. The exchange sets both the original and maintenance margin requirements. Member firms are allowed to levy more than the minimum requirements if they so choose. Margin requirements are based on several factors including the size of the contract, the volatility of the underlying security, the type of position, the type of customer (hedger or speculator), and whether the futures contract has entered its spot month.

Source: Materials provided by the Canadian Securities Institute

