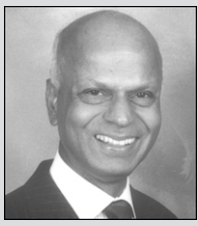


Wall Street and auditing reform



CHAKLADER MAHBOOB-UL ALAM writes from Madrid

CORPORATE America is in a turmoil. Wall Street, the Mecca of American capitalism is suffering a crisis of confidence among the ordinary investors. It has clearly become discredited. The stocks are falling despite favourable economic indicators.

Repercussions of this deepening crisis continue to reverberate all across the stock markets of the world. The cumulative fall in the Madrid stock exchange has been so significant that share prices have fallen to the level of 1997. The Ibx fell 4 per cent in one single day, this week. Other major European stock markets have fallen this year by over 15 per cent. The dollar is gradually losing ground to the Euro. Day by day, investor confidence in the market (the management of the corporations, their auditors, the regulators and the investment analysts) has dropped because there is a growing sense of cynicism among the ordinary investors about the proper functioning of the capital markets. Why?

Hardly a week passes without a new financial scandal hitting the headlines. The ordinary investors have not only lost their faith in the professional integrity of the corporate managers and directors but also in the current and forecasted results reported by their accountants. They are convinced of the existence of a corporate culture of cheating.

Houston based Enron occupies

the pride of place (or should it now go to Worldcom?) in this long list of financial scandals. Enron was a small gas-pipeline business only a few years ago. Its president, Jeffrey Skilling had a vision. First, he wanted to turn it into the largest energy-trader of the world, then to turn it simply into the world's largest energy company. In order to fulfil his dream he was prepared to do everything necessary. If that meant, cooking the books, why not? In the process, he broke every rule of doing good business that came in his way. In order to inflate its revenues, Enron routinely entered into "round-trip" transactions, with other companies in the same sector. (Global Crossing Ltd, one of Enron's partners in these sham deals has also recently filed for bankruptcy-court protection.) These were, in effect bogus operations by which the parties massaged each other's revenues, whenever the actual revenues fell short of the forecasted ones. (Enron's reported revenues grew from under \$20 billion in 1996 to \$100 billion in the year 2000.) In order to show a continuous increase in the EPS (earnings per share), the company set up several off-balance-sheet entities which were managed by company insiders and persuaded Arthur Andersen, its auditors not to consolidate their profit or loss into the company's results. What is extraordinary is that its chief financial officer was allowed to manage some of these entities from which he personally benefited -- over \$40 million between 1999 and the end of 2001. (No wonder, crucial documents related to these hidden liabilities were shredded by Andersen.) When that was not enough, Enron entered into all sorts of ingenious operations, like selling fixed assets and booking the profits as part of operating profits etc. It seems all this was done with the knowledge and connivance of Arthur Andersen, the company auditors. There were other material accounting irregularities of such magnitude that it is hard

to understand how an auditor with an iota of decency and professional ethics could accept them as fair accounting. The ultimate objective of all this "creative accounting" was, of course, to help drive up the stock prices, which in reality meant cheating the ordinary investors. Again, in order to keep the government regulators away from probing too deeply into these fiddles, the company built up a network of lobbyists in places of power through generous financial gratifications.

The Securities and Exchange Commission is currently looking into the accounting practices of a huge Denver-based company called

to buy Enron has recently disclosed that it had regularly entered into "round-trip" trades -- buying and selling energy at the same price with CMS Energy Corporation and other companies in the same sector -- with the clear objective of artificially inflating revenues.

In the wake of the Enron scandal, both the CEOs (of Dynegy and CMS Energy Corp) have felt obliged to resign. Dynegy has now changed its accounting policy to book new long-term contracts, which at best are of uncertain value and will most certainly not generate any cash for years to come, as revenues. After Enron, Global Crossing, Qwest, can

director on charges of misappropriation, falsification of key documents etc. The net result of all this on Tyco stocks has been disastrous -- their market prices have fallen by more than 80 per cent.

At Adelphia, its founder and boss John Rigas transferred billions of dollars of shareholders' money to his family's accounts. He failed to distinguish between company's assets and his private interests.

Last week, Sam Waksal, the founder of the biotech firm Imclone was detained by police on charges of committing massive securities fraud. The SEC has now also filed insider trading charges against him.

touting overpriced shares of some corporations in the hope of earning fat investment banking fees from them. The blue blood stockbroker Merrill Lynch has recently been fined \$100 million by a court for peddling worthless stocks to its clients. (Ken Lay, the Enron CEO is also guilty of this fraud, because he urged his employees to buy Enron stocks, when he was busy dumping them as quickly as possible). But the bulk of the responsibility for this erosion of investor confidence lies with the auditors, those high priests of capitalism, who are entrusted with the job of looking after the integrity of the system. (Here, I

Enron, Samuel Buell, one of the prosecuting lawyers correctly said, "Andersen was working too hard to protect itself and its client Enron, without paying enough attention to the interests of the investing public". He could have added that the primary responsibility of an auditor is to protect the interests of the investing public by giving correct information as opposed to acquiescing in giving misleading information. Much before Enron scandal hit the headlines, Andersen was implicated in fraud with another of its clients called Waste Management.

There is no doubt that the auditing profession is under suspicion. It is difficult to think of a time when the profession was held in such high repute. Why? There are several reasons. I am in complete agreement with Bruce Spacek (son of Leonard Spacek, partner and co-founder of Arthur Andersen in 1913), when he said recently that the principal reason for the failure of the profession is greed, which has been allowed to override all other considerations including ethical values. Instead of returning to their roots (pure auditing), the auditors have kept on branching out into all sorts of non-audit activities, such as consulting, tax work, corporate financing, etc. etc. Some of them have even been accused of entering into joint ventures with their clients. (The SEC has recently brought charges against Ernst & Young for having a seven-year business partnership with one of its clients, PeopleSoft Inc., a software company. KPMG has recently been fined on similar charges of violating professional independence rules. How can an auditor maintain his professional independence when he is in business with one of his clients? There have been many other cases of conflict of interest but they have been ignored. This is why the push for auditing reform has slowly but steadily gained momentum.

Unfortunately, self-regulation has been found to be hopelessly inadequate to uphold the professional integrity of the auditor. The ordinary investors need the protection of the law. There are several proposals to reform the profession. In my opinion, the bill (which may eventually become law) presented by Senator Serbanes is probably the best so far because it will introduce far-reaching reforms. Although it does not place an outright ban on consulting work, it substantially limits the scope of the consulting work the auditors can undertake. It wants to set up a new

regulatory body with statutory powers to control and punish the auditors. The SEC has also proposed something similar (Public Accountability Board). The bill wants to make the Financial Accounting Standards Board (FASB) independent of powerful lobbies by guaranteeing its financial survival.

The essential element of the auditing profession is trust. There is no doubt that this trust has been damaged significantly. How can the auditors recover their lost credibility, and regain investor confidence?

First of all, there must be a change in the auditor's professional attitude. Ethical values are important. Then there is also a clear need for radical improvements in the levels of both audit standards and compliance.

In every case, there is a need for thorough or at least sufficiently comprehensive audit work. This will most certainly increase the costs. Therefore, if need be, the auditors should raise their audit fees instead of charging low audit fees and trying to recoup the difference through hiked-up fees for non-audit services. This will allow them to stand up to pressures from corrupt company executives. The auditors must insist on strict compliance to the corporate disclosure rules. All material information, for example stock options (no matter whether expensed or not), potential conflicts of interest, policies with regard to revenue recognition, depreciation, inventory valuation, possible changes in the market etc. must be disclosed to all investors at the same time. (The company management and investment analysts must ensure that no preference is given to institutional investors.) If during the fiscal year there has been a change in the accounting treatment of a material item, the auditor should see to it that it is fully disclosed. He must also ensure that the financial statements show the restated results under the previous accounting method, so that the investors can clearly understand the impact of the change. The audit report and all related information should be written in plain English, not couched in vague terms and legal jargon, so that the ordinary shareholders can easily understand them.

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LETTER FROM EUROPE

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Qwest Communications International Inc because of dubious swap agreements it entered into with Global Crossing Ltd and Enron. Qwest's chief executive Joseph Nachio has just been forced to resign.

Another Andersen client, Halliburton Corporation, whose chief executive was vice president Cheney, altered its accounting policy and booked approximately \$100 million in disputed costs (unbilled collectibles, which can be best described as claims) as revenues in 1998, when its shares had slumped in the stock market. The company did not disclose this change in the accounting policy until some time later, which in effect meant misrepresentation of Halliburton's results to the ordinary investors. In April, 2002, Halliburton dismissed Andersen as its auditor.

Dynegy Inc., another energy-trading company, which once tried

the investors have any faith in Dynegy's reported results?

The SEC has forced Xerox to restate its financial accounts back to 1997 for booking false revenues, which has led to the firing of its auditor.

Tyco, audited by another large firm of auditors, was a little-known laser research lab until Dennis Kozlowski turned it into a huge conglomerate--a hodgepodge of more than 700 companies operating in sectors as diverse as electronics, valves, security systems, financial services, leasing etc. Kozlowski, although operated out of Exeter, Hampshire, moved the registered offices of Tyco to Bermuda in order to avoid paying taxes. Recently he was forced to resign among charges of tax dodging and corruption (misappropriation of company funds). Now Tyco has also sued Mark Belnick, its former general counsel and Frank Walsh, a former

The latest (at the time of writing this article) in this series of scandals, which has further eroded investor confidence in the stock market is the case of the Mississippi-based giant telecom company WorldCom, which has just disclosed that it overstated its profits by \$3.8 billion. Dealings in Worldcom shares have just been suspended. The company may now face bankruptcy. Again, Andersen were their auditors.

There is no doubt that unscrupulous and over-ambitious CEOs, who have acted more like wheeler-dealers at the local flea market rather than as managers of giant public corporations, bear some of the responsibility for the decline in investor confidence. The financial analysts also bear some of this responsibility for deliberately manipulating the market and misleading ordinary clients by giving incorrect information like knowingly

should highlight the difference between accounting and auditing. Accounting is the art of recording and reporting transactions, while auditing is a matter of trust. An auditor, as an independent professional, tests the legitimacy of the transactions, verifies the existence of the assets and liabilities of a business concern at a certain date and if satisfied, opines that the financial statements give a true and fair view in all material respects.) This is a serious task. According to a recent survey in the US, as many as 993 companies have been forced to restate their misrepresented results in the last five years. This does not speak very highly of the integrity of the auditing profession in America.

After Arthur Andersen was found guilty of obstructing justice for impeding proper investigation by the Securities and Exchange Commission into the collapse of

Rating Bangladesh for gas reserve: The present controversy

DR. BADRUL IMAM

THE failure to come up with a unanimous decision on the status of gas reserve of the country by the government appointed gas reserve committee has exposed the controversies that have been floating around lately. These controversies have confused the press and the people alike and involve at least two major aspects of gas issue. Among the general public a lack of knowledge on the technicality of the subject has contributed to the confusion.

A major point of confusion relates to the use of term reserve and its category. Reserve has three categories: proven, probable and possible and each has specific meaning and implication. If a reserve figure is quoted without specifying whether it is proved or probable or possible reserve, it is bound to bring confusion. For example, one can trade with proven reserve, but can not trade with probable or possible reserve and this makes all the differences in practical terms. A recent point of concern among the petroleum economists of the country is whether or not we are considering only the proven reserve while debating about gas trade or gas export. If probable reserve is on this agenda rather than only the proven reserve, all our economic calculations may tumble one day creating serious crisis.

This was the point why the terms of reference of the job proposed to specifically assess the proven, the probable and the possible gas reserves of the country. Strangely enough the final report of the reserve committee, for unknown reason, apparently violated the terms of reference in the sense that it did not specify the proven reserve. The two members of the reserve committee who tried to persuade the chairman of the committee to separate out the proven reserve as per the terms of reference failed to do so in spite of all the relevant arguments they officially noted and submitted to him. And finally, when the request of the

above two members to, at least, include their observations and comments in the final report was not accepted, the two members declined to sign the report in protest. This has made the report controversial and thus failed to serve the purpose of gas reserve assessment by the national committee.

A second point of controversy arises regarding the "undiscovered gas resource". Undiscovered gas resource is the unknown gas estimated on the basis of hypothetical exercise from imaginative and speculative data base. Because of the highly conjectural nature of undiscovered resource estimate, it has no commercial value, this being the difference between gas reserve (known gas deposit) and gas resource (includes hypothetical gas

understanding on the technicality of reserves and discuss some points of controversies before we enter into any future discussion on our gas issue.

Gas reserve

How is this defined: By internationally accepted practice, reserve is "the quantity of gas that is considered commercially recoverable from known and discovered field by using the present technology." Because of the uncertainty involved in the reserve calculations, reserves cannot be measured but are estimated. Furthermore, depending on the degree of uncertainty, reserves are estimated into three categories i.e. proven, probable and possible. The definitions of the three categories of reserves, as used all over the

mentors? After all, there was no lack in efforts to properly groom up certain committee members by some quarters including dignitaries of foreign oil companies with data base to perform well with reserve estimation. No wonder a single digit figure is too difficult to pass through pipeline perhaps.

Controversies over reserve update by Norwegian-Bangla team: Recent updating of the gas reserve of the country by the Norwegian Petroleum Directorate along with Bangladeshi counterpart is not unanimously accepted by geoscientists and organizations engaged in gas exploration and production in the country. The Norwegian-Bangla team has estimated that the present reserve is about 16 Tcf, about 35 per cent more

Two other members are high government officials and it is apparent that it would be difficult for them to independently opine on a subject matter other than what the government wants them to do. It is ironic that the remaining two members who are university professors had to walk out of the exercise by not signing the report because their arguments were not placed in the report document.

As the government has declared that it will depend on the recommendation of the gas reserve committee to decide on the issue of gas export, it is of paramount importance that unanimous decision from the committee should come out on this issue. The government should not undertake a course of action on a split decision on gas reserve.

ing up of last estimate of Bangladesh's undiscovered gas resource by USGS has been a case of science or a case of manipulation.

A group of technocrats and bureaucrats of certain quarters including some in the government hierarchy seem to be obsessed, either knowingly or unknowingly, with the undiscovered gas resource estimates. This group has on a number of occasion publicly referred to this undiscovered gas resource values as reserve values. They have used the term reserve and resource interchangeably which is misleading. This may be apparently aimed to created an unrealistic impression of inflated gas reserve volume lying beneath the country.

Certain International Oil companies (IOC) are also preaching confusion over the same issue. The 170 years of gas supply in Bangladesh, as fantasized by Unocal, for example, took the undiscovered gas resource along with the present reserve to figure out the length of period of gas supply the country will have. This is an unprofessional attitude purposely made to mislead people about the gas reserve.

Conclusion

The fact that gas reserve committee could not come up with a unanimous decision on the country's gas reserve implies that the report does not reflect the true picture of the gas reserve of the country. As such the government, who have repeatedly declared that it would take a decision on gas export issue on the basis of the gas reserve committee report, should not do so on the basis of the report in its present form which is riddled with controversy.

The gas reserve committee, by not agreeing show the proven reserve of the country has apparently violated the terms of reference of the job they have been asked to do. The apparent insistence of a group of committee members to show proven and probable reserve added together does indicate motivation to avoid showing a single digit figure for the gas reserve of the country. The committee purposefully avoided showing the country's proven reserve which is less than 7 Tcf, although all data were present with the committee for that estimate. The committee's acceptance of USGS undiscovered gas resource estimate has been disputed by some members. The USGS estimate has been criticized by independent petroleum experts for incorporating unrealistic data on several geological parameters, supposedly with a view to showing inflated resource figure.

By not including the comments and observations of two expert members of the committee, the report appears unduly biased towards a particular group or philosophy. The observations and comments of the two members, who did not sign on the report in protest, should be taken into full consideration before the report be judged by any third party. Furthermore, the report should be made public along with the comments and observations of the above two non-signing committee members.

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volume). The gas reserve committee's dispute over the undiscovered gas resource of the country arises from the fact that the previous assessments of the undiscovered gas resource of the country are not beyond controversies and therefore should not be accepted as such. Whether it was assessed by United States' Geological Survey or Norwegian Petroleum Directorate or an international oil company, the undiscovered gas resource assessment has involved, so to say, too much hypothetical gymnastics, sometimes disregarding the well established geological features of the country. So when the reserve committee accepted one of the previous assessment results as it is, this was pointedly rejected by certain members.

Because the issue of gas reserve assessment is of technical nature, it is easy to confuse people on this subject. The time is perhaps right that we should have a degree of

work in petroleum industry, have been formally established jointly by the World Petroleum Congress and Society of Petroleum Engineers and are as follows:

1) Proven reserve is that volume of gas which is estimated with reasonable certainty to be commercially recoverable. By the word, reasonable certainty a confidence level (of the estimation) of 90 per cent is implied. As such, proven reserve is considered bankable asset and can be traded with. Bangladesh has a proven reserve of about 7 Tcf at present.

2) Probable reserve is that volume of gas which is more likely than not (50% confidence level) to be commercially recoverable. Because of high degree of uncertainty, the New York Stock exchange and other financial entities, for example, would not consider probable reserve as bankable asset and thus would not trade with that quantity. The widely publicized estimate of 11.5 Tcf of gas reserve of Bangladesh is not all proven reserve, but is the sum of proven and probable reserves. As such this (proven plus probable) amount should not be considered bankable asset, and hence should not be taken up for trade.

3) Possible reserve is that quantity which is less likely (10% confidence) to be commercially recoverable than probable reserve.

As pointed out earlier, a major point of dispute among the committee members is centered on the reserve category to be considered for the final report. While a group of the committee members, who openly advocate in favour of gas export to India, stressed that the committee should show proven and probable reserves added together, a second group argued that the proven and the probable reserve should be shown separately as per the terms of reference of the job. It is interesting to guess what is the philosophy behind the group which favours 2P (proven plus probable reserve) rather than 1P (proven reserve) to be shown in the report and its executive summary. Is the single digit figure of 7 Tcf of proven reserve of gas too embarrassing to show or too upsetting for their

than the previous estimate which is used by Petrobrangla till date. The Norway-Bangla assessment has shown a 103 per cent increase in the reserve in Habiganj gas field, and 143 per cent increase in reserve in Titas gas field. The Bangladesh Petroleum Exploration Company (BAPEX) geoscientists have pointedly offered explanations why the degree of above reserve growth shown by the Norway-Bangla team should be considered over optimistic and hence is not acceptable.

Major differences of opinion exists between BAPEX and Norway-Bangla team on the gas recovery factors used for individual gas fields and thus the gas reserves of the fields. The Norway-Bangla team has changed the recovery factors of all gas fields to a high of at least 70 per cent without adequate scientific explanations. These values were taken up in earlier estimates differently for different gas fields and ranges mostly from 51 per cent to 65 per cent. In addition to the recovery factor, the local geoscientists have disputed over some points on the aerial extension of gas pools used by the Norway team. Some petroleum observers have suggested that Norway-Bangla team had prior motivation of showing inflated gas reserve of the country. In the above circumstances, the results of the Norway-Bangla assessment should not be taken as a benchmark for assessing the gas reserves of the country. So when results of the Norway-Bangla reserve assessment were emphatically included in the report, this was disputed by certain members of the reserve committee.

According to a committee member, it looks like certain members were purposefully handing the reserve data in order to fix a gas reserve estimate which has been considered inflated by others. As for that matter, the member continues, the composition of the gas reserve committee itself can stir up some curiosities. Three persons who openly advocate in favour of gas export to India have been made members in both the gas reserve committee and gas utilization committee. These three members are so aggressive in their formulae that it is difficult to logically argue with them.

Undiscovered gas resource

Undiscovered resource is the volume of gas that may possibly be discovered in future. The estimation of undiscovered gas resource is based on hypothetical and speculative data and thus is conjectural and imaginative. The estimate, thus, has no commercial value as such, but may form data base to guide future exploration strategies and planning. Nowhere in the world undiscovered gas resource is taken into consideration for trade. United States Geological Survey (USGS) and Norwegian Petroleum Directorate (NPD), in collaboration with Bangladeshi counterparts and several oil companies, have assessed the undiscovered gas resource of Bangladesh during the last few years.

The gas reserve committee has accepted and used the USGS's undiscovered gas resource value for Bangladesh in the final report. This has been disputed by some committee members on the ground that the USGS estimate has used unrealistic data base while assessing certain geological parameters of the country. The members thus argue until these parameters be corrected, a separate committee be formed for the country's undiscovered gas assessment.

USGS estimates a mean value of 32.1 Tcf of undiscovered gas resource of Bangladesh. However it is interesting to note how the USGS changed its view over a short span of time on the undiscovered gas resource estimate for this country. Curiously enough the time of such action coincided with the time US government started advising Bangladesh to export its gas. The USGS's estimate for undiscovered gas resource of Bangladesh has been 18.9 Tcf in the year 1986, 14.7 Tcf in 1993 and then it shot up to 32.1 Tcf in 2000. The USGS's estimate for undiscovered gas resource of India (27.8 Tcf in 1986, 24.8 Tcf in 1993 and 22.2 Tcf in 2000) and Pakistan (34.3 Tcf in 1986, 32.0 Tcf in 1993 and 28.0 Tcf in 2000) did not shoot up lately as in the case of Bangladesh, rather these have been estimated at lower than the previous values. The question remain whether the shoot-