THE ENRON BOMB (Newsletter Winter/Spring 2002)

Fotosearch

"To be efficient, markets need reliable information. Enron shows the extent to which they are not getting it." The Economist, February 9th., 2002.

The fallout from the Enron debacle continues to spread around the globe. The bankruptcy on December 2nd. 2001 of America's seventh largest company and the behaviour before and after the failure, of its auditor Arthur Andersen, the world's fifth largest accountancy, were initially overshadowed by events in Afghanistan. No longer! As the battle against al-Qaeda wanes, the spotlight is increasingly focused on the transparency, honesty and … well accountability, of accounting practices in the United States and worldwide. In part it is fuelled by anger at a system which allowed senior managers at Enron to pocket millions, shortly before the "restated" accounts rendered the pension plans of less enlightened employees virtually worthless. No doubt other Enron shareholders were pretty peeved too.

Whilst the Enron scandal is the largest and therefore the most dramatic evidence of audit failure it is no isolated case. The Economist reports that over 700 American companies have been forced to restate their accounts during the past four years. Indeed there has been a rash of restated accounts globally: Maxwell and Polly Peck in Britain, Metallgesellschaft in Germany, Cendant, Sunbeam and Waste Management in America, being the most visible before Enron exploded on the world stage. More are on the way: on April 1st. Xerox Corp. agreed to pay a $10 million (U.S.) civil fine to the U.S. Securities and Exchange Commission, and restate its results from 1997 through 2001. Little wonder that the Globe and Mail's Report on Business (April issue) pondered whether investing in the stock market was merely gambling. Like the priest who, faced with man's inhumanity to man, continues to believe in God, Report on Business uneasily rejected the gambling argument before tendering as an act of penance, the evidence of Enron, Global Crossing, Bre-X and Nortel. Their logic was less than compelling. Nor was the full page newspaper advertisement by the Chartered Accountants of Canada assuring investors that they were ascertaining if Enron like practices were being perpetrated here, of great comfort. Most Canadians probably believe they already know the answer.

An Excess of Enron

Enron and its siblings are likely to have at least as large an impact economically and geographically as the events of September 11th. The effect will probably be of greater longevity. If one cuts through the wailing, breast beating and gnashing of teeth, there appears to be general agreement that the auditing function failed because of the following weaknesses.

1. *Auditing is self regulated*. The accountancy profession polices itself through a system of peer review: a process which has been granted statutory authority. Self regulation is toothless, self serving and an "old boys network" cloaked in the guise of the public good.

2. *The accounting firms earn considerable revenue for consulting activities from the firms they audit*. This consulting revenue often far exceeds their audit fees so the audit process is viewed as an entré to the more lucrative work. This creates a conflict of interest since the accountancy may be reluctant to place its consulting fees at risk by rendering an unfavourable (to the management) audit.

3. *Five accountancy firms do the bulk of the auditing work*. Little attempt is made to rotate auditors. The management/auditor relationship becomes too "cosy": audit discrepancies are more likely to be discovered when there is a change of auditors.

Parallels With Real Estate Appraisal

There is a clear parallel between the relationship of appraisers undertaking portfolio valuations for asset managers, and accountants auditing companies. Although no real estate body has yet reacted to the crisis of confidence engendered by Enron, by happy coincidence the Royal Institution of Chartered Surveyors had already struck a Working Party to study the very issues which have now surfaced in such spectacular fashion. The RICS is the world's premier real estate body with 110,000 members in 120 countries. The Working Party, chaired by Sir Bryan Carsberg a Chartered Accountant, published its report in February 2002. It drew upon research conducted by the Universities of Reading and Trent in the United Kingdom on real estate appraisals carried out for financial reporting purposes, commissioned by investment fund managers (pension funds, insurance companies, unit trusts) and property companies. The RICS extended that research to the Appraisal Institute, the largest professional body of appraisers in the U.S.A., and to auditor members of the Institute of Chartered Accountants of England and Wales. The RICS noted that many of the issues highlighted were also applicable to appraisals for secured lending purposes for banks and other financial institutions.

The findings of the Carsberg Report have applicability to Canada particularly as they relate to self regulation (an oxymoron!) and client influence on the appraisal. Our Federal and Provincial governments have shied away from dealing with these matters despite the collapse of many prominent Canadian financial institutions based on faulty real estate loans, during the past twenty years (1983-Crown, Greymac and Seaway Trusts: 1985-Northland Bank and Canadian Commercial Bank: 1992-Central Guaranty and Shoppers Trust: 1993-Confederation Life; Prenor, Security and Dominion, Trusts: 1993- Royal Trust saved by Royal Bank: 1994-Monarch Trust).

The RICS Working Party determined that:

1. *Self regulation was ineffective and the use of regulatory powers was largely reactive, i.e. only when things go badly wrong and are reported (usually by the aggrieved party) is action taken*. The Working Party recommended instead that appraisal firms implement a Quality System which focuses on process rather than outcome. Compliance should be monitored by internal and external audits. The latter to be undertaken by an independent body not a peer review group.

2. *Appraisal firms should declare the total fees they earn from the party commissioning the appraisal* and the length of their relationship, so that third party users of the report could

gauge the fiscal influence that had been exerted.

3. Draft reports and meetings with the party commissioning the report *"provide clients with an opportunity to influence the outcome of the appraisal, potentially to the advantage of their organisation, or to their own personal advantage (through, for example, annual bonuses linked to the performance of their property portfolios which in turn is linked to the outcome of the appraisals)"*.

   The Working Party did not condemn draft reports and meetings but advocated that detailed notes be kept of the discussion together with information on any changes in the appraised value.

4. The Working Party recognised that it may not be economically feasible to rotate appraisal firms and suggested instead that the appraisal personnel be changed each time.

Canada: A Status Report

Everybody in Canada has paid dearly for the failure of the financial industry and the appraisal profession to clean up their act. We continue to bear that cost today: it's as if the sorry parade of financial institution failures from 1983 to 1994, never happened. At the time we wrote to the Federal Canada Deposit Insurance Corporation (CDIC) as well as the Federal Office of the Superintendent of Financial Institutions (OSFI) suggesting that "most of the problem of biased and inflated appraisals could be avoided if real estate loan regulations mandate that the appraiser contract directly with the mortgagee rather than the mortgagor. This will remove an obvious conflict of interest". CDIC and OSFI both responded, essentially saying it was the other's responsibility and that neither could govern the conduct of appraisers since this was a Provincial responsibility!

The cost of the bank, trust and life company failures was borne by every taxpayer, bank user, policy holder in Canada, as well as by the creditors of the institutions that failed. The bank and trust companies were, and continue to be back- stopped by the CDIC. The life companies created an industry (i.e. policy holder) financed body, the Canadian Life and Health Insurance Compensation Corporation (CompCorp) in January 1990, to perform a similar role to the CDIC. The biggest cost to Canadians however, lies in the difficulty and cost of financing real estate. Prior to 1990, banks and trust companies were the primary source of finance for commercial mortgages of <= $1.0 million: the life companies performed the same function for larger loans. The commonly stated loan to value ratio was 75% of the property's market value. Today all commercial mortgages are more difficult to obtain even at the current loan to value ratio of 65% and loan sources continue to evaporate, particularly in Atlantic Canada for <= $0.5 million mortgages. Although the credit unions have taken up some of the slack, mortgages are less available and more costly. The life companies have only recently returned as a source for higher value loans (>= $2.0 million), joining a couple of the banks that stayed the course, and conduit financiers such as Merril Lynch, GMAC, et al.

1. *Self regulation has actually been legislated in New Brunswick and Nova Scotia!* The United States responded to their Savings and Loan debacle in the late 1980's by eliminating self regulation and imposing State regulatory controls on appraisal activities including the requirement that all appraisals undertaken within the jurisdiction of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) be undertaken **only** for the mortgagee. The Federal Government also ordered the appraisal industry to initiate appraisal standards: these became the Uniform Standards of Professional Appraisal Practice (USPAP). *No similar action was instigated in Canada: in fact the Appraisal Institute of Canada, the largest trade organisation in the country alarmed at the events in the United States, redoubled its efforts to*

persuade gullible Provincial governments to legislate self regulation! Their gall was breathtaking: "Public Money Private Greed" Terence Corocoran and Laura Reid's book on the 1993 Greymac, Seaway and Crown Trusts affair noted that "AACI", the Appraisal Institute of Canada's designation was "an acronym that was often said to mean Appraised According to Client's Instructions, implying that official appraisal reports were of little real value to serious real estate investors". Ten years later Rod McQueen made a similar observation in his book "Who Killed Confederation Life?". Nevertheless AIC members were successful in promoting private member's bills legislating self regulation for appraisers in New Brunswick (1995) and Nova Scotia (1998). The Nova Scotia bill went through all three readings in ten days … just before the House broke for its Christmas vacation. There was no publicity or consultation with consumer groups or impacted parties: it was sneaked through in virtual secrecy. We found out about it after the event; the MLA who tabled the Bill did not appear to have read it … he thought it was a consumer protection Act! Apparently he was in good company: at least one party caucus didn't know what they had approved.

2. *Conflicts of interest are the rule, rather than the exception*. Commercial appraisals for financing are almost always undertaken for the mortgagor. Our suggestions to the financial institutions that they commission the appraisal, are fiercely resisted. Asset Managers too usually commission appraisals from the same appraiser on the same property each time they require an updated value. It is quite usual for the same appraiser to undertake appraisals of the entire portfolio year after year … and to supply other consulting services such as property tax, financing appraisals, and so on.

3. *Asset managers almost always request Draft Reports, the conclusions of which have to be discussed prior to the issuance of the final figure: most insist on this commitment before they will commission the assignment*. Typical are the following instructions we recently received from a Life Company **"A FULL DRAFT copy of the report's entire net income analysis and valuation sections, as well as all valuation-related material contained in the report's appendix (e.g. DCF—Supporting printouts, detailed comparable information, land valuation, etc.) is to be sent to The Asset Manager and xxx xxx two weeks prior to the appraisal's due date".** These instructions are usually directed to specific appraisers, rather than the firm. In this instance we advised the Life Company that it was against our company policy to undertake "Draft" reports and they decided not to proceed with us. (In fairness we should add that we recently had a similar experience with a regional Life Company and they readily agreed to waive the requirement. They also decided to pursue a policy of commissioning appraisals from different companies).

For the full text of the Carsberg Report visit the RICS web site at www.rics.org/val.