Agincourt Capital Management, LLC

August 2002

INVESTMENT UPDATE

BLOOM: It makes a great deal of difference. That's fraud. If they found out, you could go to prison.

BIALYSTOCK: Why should they find out? It's only two thousand dollars, Bloom, do me a favor, move a few decimal points around. You can do it. You're an accountant. The word 'count' is part of your title.

BLOOM: But that's cheating!

BIALYSTOCK: It's not cheating ... It's charity. Bloom, look at me ... look at me! I'm drowning. Other men sail through life. Bialystock has struck a reef. Bloom, I'm going under. I am being sunk by a society that demands success, when all I can offer is failure.

Even in 1967, when Mel Brooks wrote the screenplay for "The Producers", desperate men were playing fast and loose with their accountants. Is it a coincidence that, more than 30 years after it was written, Brooks' madcap morality tale became a Broadway hit just as the bubble of the New Economy was bursting? The parallels between the producer on the verge of bankruptcy and the embattled CEO's of today desperate to keep shareholders happy are too obvious to ignore. If the slimy producer Bialystock can get the nebbishy accountant Bloom to go along with his scheme, he might find success—at least for a while.

But when the scheme blows up, literally (as in the screenplay) or figuratively (as in the current market), the guilty must be punished. Today there is a loud and clear call from lawmakers, regulators, industry groups and investors that those parties responsible for the recent accounting scandals be brought to justice—*The San Francisco Examiner* now runs a weekly column called "The Outraged Investor". What's more, the collective public wants tougher laws, regulations and penalties to ensure that there will be no future Enrons, Global Crossings or WorldComs. Not an easy job.

The first problem, of course, is deciding just who is to blame in a case of accounting fraud. Do you go after management—after all, they're the ones recording the revenues and expenses; they know better than anyone what businesses they're in and how profitable they are. Should the blame be placed on the auditors, since they are responsible for thoroughly examining the company's operations and signing off on the results? Should a company's board of directors bear the burden? Directors are shareholders' elected representatives and have the ultimate responsibility for hiring and firing both the executives and the auditors. And finally how much blame should be directed at the other players—the investment bankers and lawyers who dream up the elaborate financing schemes, the regulators who fall asleep while the public is being duped, the accounting standards board whose vague guidelines encourage companies to make up their own rules on how to account for certain businesses?

Arrests have been made, and there are straightforward cases of theft, fraud, and securities and tax law violations that should result in guilty verdicts. Recent sightings of executives in handcuffs include Adelphia's Rigas boys, who allegedly hid liabilities and looted the company while it sank, ImClone CEO (and friend of Martha) Samuel Waksal, who is said to have advised family members to sell their stock (and tried to sell more than 79,000 shares of his own) based on non-public information, and Tyco's Dennis Kozlowski, who has been arrested on eleven counts of felony tax evasion stemming from personal transactions. Again, while these executives have only been charged and have yet to have their day in court (where they will likely plead "not guilty"), their prospects appear dim.

On the other hand, it is important to note who has *not* yet been charged with criminal malfeasance. Bernie Ebbers, the mastermind behind WorldCom, has not been charged, although two people from his executive ranks are awaiting trial. Ousted Qwest CEO Joseph Naccio has not been charged, despite his successors' admission of accounting "errors". Perhaps most shocking is that Kenneth Lay and Jeffery Skilling, the Butch Cassidy and Sundance Kid tandem from Enron, continue to walk the streets. In fact, despite the fact that "Enron" has entered the public lexicon to represent the pure definition of corporate wrongdoing, the only person charged from the Enron meltdown has been Arthur Andersen auditor David Duncan, who cut a plea deal with federal prosecutors. Subsequently, a Houston jury found Andersen guilty of obstruction for shredding documents prior to an SEC investigation of Enron.

While we are still learning about all the details about what when wrong with Enron, Qwest, Global Crossing, et al, it's not all that surprising that charges have not been made against some of these individuals, for a number of reasons:

600 East Main Street Suite 2120 Richmond, VA 23219 Tel: 804.648.1111 Fax: 804.648.4475

1) Historically, the Justice department has had difficulty prosecuting executives for willful misconduct in these types of cases. The issues are often highly complex and can be difficult for a jury to understand; the average juror never took intermediate accounting, and wouldn't remember much if he or she did. Jurors end up frustrated and may even blame the prosecution for not making the issues easy to understand.
2) While E-mail has proven to be a prosecutor's dream in recent years, there often is no "smoking gun" tying individual executives, auditors or board members to instances of malfeasance. In companies where responsibilities are widely dispersed, there may be multiple instances of small sins committed by many individuals that add up to a larger problem, but no "mastermind" who can be held accountable.
3) While the actions of an individual may be unethical, and their business practices unconscionable, that doesn't mean that what they did was *illegal*. Some of these companies failed simply because their management made poor business decisions, not because they were corrupt.
4) Accounting rules are very often open to interpretation, making prosecution on the grounds of "cooking the books" difficult. Different methods of revenue recognition, "swaps" agreements, and use of "SPE's" (special purpose entities) are all allowed by the accounting industry. Many of the most severe problems experienced by these bankrupt companies were caused by financing schemes that were acceptable under GAAP (generally accepted accounting principals). Again, "aggressive accounting" may not have been illegal.

Meanwhile, in an effort to prevent a repeat of the corporate scandals that have plagued the market over the past few months, no shortage of new laws and guidelines have sprung from many different sources. The most far-reaching of these is the *Sarbanes-Oxley Act of 2002*, signed on July 30 by President Bush: it establishes an oversight board (under the SEC) to regulate the accounting industry, sets new standards for auditor independence, establishes criminal liability for public company securities fraud, and toughens penalties for obstruction of justice, ERISA violations, fraud, and filing false certifications with the SEC. The Act also sets new standards for directors and (especially) management, including new prohibitions on personal loans and a provision for management to reimburse past bonuses and gains from stock sales in cases of noncompliance with financial reporting. Finally, the Act attempts to improve financial disclosure and gives new enforcement powers to the SEC for those who fail to comply.

Not to be outdone, the New York Stock Exchange (NYSE) formed a committee that has put forth new standards of corporate governance for those companies listed on the NYSE. These proposals differ from those of the Sarbanes-Oxley Act in that they mainly focus on the actions and responsibilities of board members, rather than senior management. The NYSE's proposals greatly expand the responsibilities of a company's board members and demand that directors keep an "arms length" relationship with the company's management. For example, the audit, compensation and nominating/corporate governance committees must be comprised *solely* of independent directors. The NYSE proposals also instruct board members to publish and adhere to formal guidelines of corporate governance and to enforce a code of ethics for member firms.

Finally, the SEC has been fairly quick to respond and has, since April, been issuing proposed rule changes for certain required SEC filings. Their intent is to get more timely and complete disclosure from public companies into the hands of investors. Included are new rules for disclosing critical accounting policies, certification of financial results, disclosure of management transactions, executive compensation and oversight of auditors.

Unfortunately, the weakest response so far has come from the Financial Accounting Standards Board (FASB), the private sector organization responsible for setting the standards of financial accounting and reporting by which all US companies must comply. As we've seen, more stringent accounting rules are needed to eliminate "gray areas" in the accounting profession that have led to the hiding of liabilities and questionable recognition of certain revenues. All of the FASB proposals are in the "comment period"–still being discussed.

As President Bush said recently, "some things aren't exactly black and white when it comes to accounting procedures". True enough. But the one thing the capital markets need today is for public companies to provide an honest and accurate report of their financial condition. Whether companies clean up their act on their own or because of new laws and regulations, there will be accounting reform. Eventually, sentiment will improve, emotions will cool and a sense of trust will return to the stock and bond markets. After one of the uglier chapters in American capitalism, some lasting good may come from these reforms.