



Yale SCHOOL OF MANAGEMENT

FINANCIAL FRAUD THROUGHOUT HISTORY: A FORENSIC APPROACH

MGT 848 01 (SP13)

Mondays, March 23 to May 4, 2014

Time: 2:40 p.m. to 5:40 p.m.

Room: EVANS 4200

Lecturer in Finance James S. Chanos (YC '80)

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OVERVIEW

Financial frauds occur often, leaving investors to suffer huge losses while undermining public trust and confidence in capital markets. As Howard M. Schilit and Jeremy Perler write in their book *Financial Shenanigans*, “dishonest companies continue to find new tricks (and recycle old favorites) to fool investors,” taking advantage of “grey areas” in the accounting rules to exaggerate the positive and downplay the negative. What constitutes “financial fraud?” Is there “legal fraud,” as author Bethany McLean posits? How does “control fraud,” William Black’s concept, work? Are “willful blindness” (intentionally putting yourself in a position where you will be unaware of facts that could render you liable; “What could you have known?”) and “conscious disregard” (intentionally looking the other way) useful doctrines (tools) for the prosecution? The effective counter-arguments from the defense? What types of financial fraud have been most prevalent throughout history? What models can financial detectives use to detect fraud? What financial and nonfinancial red flags should investors

probe to find managed earnings, for example? What lessons can we derive from the study of past financial frauds to inform our use of forensic tools to uncover future ones? Why do investors find the schemes believable for a period of time? How does financial euphoria (and its momentum) undermine caution, staunch skepticism, and foster misperceptions? As John Kenneth Galbraith observed, “The euphoric episode is protected and sustained by the will of those who are involved, in order to justify the circumstances that are making them rich. And it is equally protected by the will to ignore, exercise, or condemn those who express doubts.” Does the tendency of investors to be prone to “myopia” and “mood swings,” as Niall Ferguson suggests, explain why markets are slow in ferreting out and sanctioning frauds? Or, is it the overconfidence that Daniel Kahneman sees as endemic in how we think and/or the self-deception Robert Trivers says “evolves in the service of” fooling others? How are the frauds revealed? What policy responses do governments pursue after major financial frauds are discovered? Effective? Roadblocks easily circumvented?

Learning Objectives:

- Using historical examples and five models (Kindleberger/Minsky; the “fraud triangle;” Black’s “control fraud;” McLean’s “legal fraud;” and Jennings’s “seven signs of ethical collapse”), examine both the environment in which frauds flourish and the factors conspiring to support fraud. (How does a study of historical fraud provide a framework for detecting future financial frauds?)
- Review and analyze the red flags alerting investors to financial deception and fraud, using the Schilit/Perler templates. (What are the earnings, cash flow, and metrics signals?)
- Apply a range of forensic tools to financial reporting documents to determine the tools’ validity and limitations for different frauds. (Why do auditors miss the obvious?)
- Develop an analytical framework to single out relevant data – including what internal whistleblowers and journalists provide – for building a case for fraud well before market regulators uncover wrongdoing. (What data matter most and why?).
- Review and analyze government reactions (i.e., regulatory initiatives, approaches to prosecution) to financial fraud, assessing the responses, the motivations driving the actions, and the impact (any change in incidences of fraud; “lessons learned”). (Why wasn’t one major executive – the “untouchables” as PBS Frontline put it – sent to jail for their role in frauds contributing to the 2007-2008 financial crisis?)

Assignments:

Group Project

Before the first class, enrolled students will select which of the ten groups they would like to participate. There is a signup sheet for this in the Resources Tab in V2 or you can use this link -

<http://community.som.yale.edu/signup/app.php?event=ProjectPresentationGroup.ev>.

(Some changes in groups will occur after the first class as some drop the class while others join. Rhona and Jim will monitor and work with the groups to ensure each has

the same number of students.) Each group is an expert witness for either the prosecution or the defendant for one of five case studies. The case studies are: Ivar Kreuger, Lincoln Savings and Loan/Charles Keating, Enron, AIG, and Lehman Brothers. As an expert witness, you will provide specific facts to support your client in court through a memo. Avoid opining on legal theories; this is not a legal brief.

Final Exam

Take-home written exam requiring you to answer four questions, including applying forensic tools to a case of your choosing. The best responses use strong examples and incorporate both class readings and lectures. Distributed Monday, May 4. Due Friday, May 8, at noon EST.

Please consult the end of this syllabus for more information about the assignments and grading policy.

General Textbooks

****All available on course reserve at CSSI****

Howard Schilit and Jeremy Perler, *Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports*. Third Edition. New York: McGraw-Hill, 2010.

Ed Chancellor, *Devil Take the Hindmost*. New York: Plume, 2000.

Student-Teacher Post-Class Dinners

Students sign up for pizza at Pepe's with Professor Chanos immediately after each class, starting with the first class on March 23. Please use this link to sign up: <http://community.som.yale.edu/signup/app.php?event=Pizza.ev> (the link can also be found in V2 under "Resources" tab).

OVERVIEW: The Models and Cues of Deceits

What is financial fraud? How is it defined legally? What are the difficulties involved in proving whether fraud exists? Is “willful blindness” a strong tool for prosecutors? Where can the line be drawn between “aggressive accounting” and fraud? What are the forces driving the deceptions? Rapid asset growth, erratic increases in revenues dependent on unsustainable growth, discrepancies between financial and nonfinancial performance, and stealth expenses are all red flags. Are there other cues of deceit such as signs of a collapse in ethics? Which ones do investors and auditors typically miss, and why? What roles have whistleblowers, journalists, and investors played in detecting fraud? How accurate is the “madness” or the “wisdom” of the crowds? Today, is fraud harder to uncover given the complexity of accurately valuing and reporting on highly sophisticated financial instruments and intangibles? Do corporations’ multinational Brodingnagian structures make it easy to hide fraud? What forensic tools are effective? (In subsequent lectures, the tools will be applied to various cases.) Are number theories such as Benford’s Law useful? What nonfinancial signs, such as a company’s public persona or examples of ethical collapse, signal deeper problems? (“No one will find me to have knowingly committed fraud,” said Bernard Ebbers, the WorldCom CEO who was eventually convicted in 2005 of fraud and conspiracy as a result of his company’s false financial reporting.)

Five models will be explored:

Kindleberger/Minsky (a macro-model): Seven stages unfold in a speculative bubble: **displacement** (an event that sharply changes expectations); **expansion**; **euphoria**; **distress**; **revulsion**; **crisis**; and **contagion**. One of three patterns typically evolves. Equity prices sharply rise to a peak and then plummet immediately. Or, the pace and scale of the rise in value is matched by the similar pace and scale of the decline. Or, the price hits a peak before gradually declining and then, at some point, abruptly crashes.

Fraud Triangle (a micro-model): Fraud detection requires understanding the psychology and personal character traits of fraudsters and how they react to opportunities. Three key factors are present when an ordinary person commits fraud: **rationalization**, **opportunity**, and **motivation** or **pressure**.

“Control Fraud:” William Black, a former Federal regulator of banks and now a university professor, defines control fraud as using a corporation as both a “weapon” and a “shield” to conduct fraudulent activity. The CEO can eliminate any checks and balances to facilitate the conduct of fraud (“weapon”) and co-opt auditors to sign off on fraudulent accounting (“shield”).

“Legal Fraud:” Bethany McLean, who broke the Enron story for *Fortune* magazine and ended up writing a book, *The Smartest Guys in the Room*, puts forward the concept of “legal fraud.” Every action may have been in accordance with the laws and regulations but, taken together, the actions fit into a pattern of “intent to deceive.”

“Seven Signs of Ethical Collapse:” Marianne Jennings examines why good people at great companies cross “very bright lines” and do dumb, unethical things. Her seven signs: pressure to maintain numbers; fear and silence; young ‘uns and a bigger-than-life CEO; weak board of directors; conflicts of interest overlooked or unaddressed; innovation like no other company; and, goodness in some areas atones for evil in others.

Readings

Note: The required reading for the first class is heavy, but the topics covered provide a framework for subsequent lectures and discussions; we’ll be revisiting the points made by these readings throughout the course in the lectures and group projects.

Required:

Schilit/Perler, *Financial Shenanigans*: entire book (310 pages).

William K. Black, *The Best Way to Rob a Bank is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*. Houston: University of Texas Press, 2005. Chapter One (“Theft by Deception: Control Fraud in the S&L Industry”). Also, “Bill Moyers Journal,” April 3, 2009. Available at: <http://www.pbs.org/moyers/journal/04032009/watch.html>.

Tracy Coenen, “Fooling the Auditors in Seven Easy Steps.” *Minnesota Society of CPAs Footnote Magazine*, February/March 2014. Available at: <http://www.sequenceinc.com/fraudfiles/2014/02/fooling-the-auditors-in-seven-easy-steps/>.

Marianne M. Jennings, *The Seven Signs of Ethical Collapse*. New York: St. Martin’s Press, 2006. Chapter One (“What are the Seven Signs? Where Did They Come From? Why Should Anyone Care?”), [pages 1-16](#). Available on Classes*V2.

Baruch Lev, *Winning Investors Over*. Cambridge, Mass.: Harvard Business Press, 2012. Chapter Seven: “Life Beyond GAAP,” [pages 145 – 171](#). Available on Classes*V2.

Zabihollah Rezaee and Richard Riley, *Financial Statement Fraud. Prevention and Detection. Second Edition*. New York: Wiley, 2010. [Part One, pages 1- 55](#). (Covers similar ground as Schilit/Perler with different examples.) Available on Classes*v2.

Clyde T. Stambaugh, Manuel A. Tipgos, Floyd W. Carpenter, and Murphy Smith, Murphy, “Using Benford Analysis to Detect Fraud.” *Internal Auditing*, Vol. 27, No. 3 (May 2012): 24-29.

Available at: <http://ssrn.com/abstract=2111653> . Irregular patterns of numbers may indicate fraudulent activity or material errors. The Benford Analysis Workbook can be accessed at: <http://goo.gl/EnOIV> .

Video: Interview by Professor Chanos with Bethany McLean. (2014) *Available on Classes*v2*.

Video: Interview by Professor Chanos with Jeremy Perler. (2014). *Available on Classes*v2*.

MARCH 30 (Session 02)

Financial Frauds in the 17th and 18th Centuries – Similarities and Differences Between the English Stock Market Boom (1690s), the Mississippi Bubble (1719-1720), the South Sea Bubble (1720), and Railroad Booms and Busts in the U.K. (1843 – 1845)

Joint stock companies emerged in the latter half of the sixteenth century in England, with trading infrequent between buyers and sellers of shares since stock ownership was not widespread for some time. From the 1600s onward, the English government granted royal charters and government patents to companies, bestowing an imprimatur of authority while creating legal trading monopolies. Sham companies proliferated, many “chimeras to defraud the naive,” from paper manufacturers to excursions for sunken treasures. Key were the government’s need to finance the costs of the Nine Years’ War and the cultural and economic transformations, which supported the equities market boom. The government was deeply involved in promoting the speculation; the ventures operated under royal charters and patents, which imparted legitimacy. Market manipulation by stock brokers (“jobbers”) was rife. There was “a zeitgeist of greed or an eagerness to get rich quick,” Edward Chancellor writes, “so that in the 1690s, which was an era of the so-called ‘moneyed men,’ it was said of the period that ‘it rained gold and silver,’ and the historian Macaulay later described it as ‘an age that showed an impatience to be rich and a contempt for those slow but sure gains which are the proper reward of industry, patience, thrift, had spread through society.’” As one after another fraud unraveled, public outcry reached a level so great that Parliament passed the country’s first securities laws (limits on the number brokers; licenses; commission caps; and, prohibitions against self-dealing). (This event is more relevant to understanding fraud than Tulipomania, an example of investor mania.)

Nearly a century later, John Law used propaganda to pump up investor fervor for shares of Law’s Mississippi Company. He contrived scenes, such as a staged deposit of gold and silver from the Duc d’Orléans, to boost confidence in the ailing bank and its paper notes. He masterminded stories and songs touting the promise of Mississippi’s bounties to tempt potential investors. Law paid out profits with bank notes but lacked the specie (hard money) to cover all the notes issued. He used call options (called “prime”) to support prices. Modeling his “system” along the lines of the Bank of England and the East India Company, Law created “a

giant holding company controlling the tax farms, the national debt, the overseas trading companies, the mint, and the note-issuing bank.” In 1720, some investors demanded specie for their notes; that “prick of reality” burst the bubble.

The South Sea Company, a British joint stock company, also saw speculation in its shares, aided by “the most extravagant of rumors.” (The term bubble was used to refer to the fraud, not the rapid ascent in price.) Directors made false claims about the South Sea riches, alleging the company had a monopoly to trade in Spain's South American colonies as part of a treaty during the War of Spanish Succession. Politicians were offered shares; their involvement gave the business a sense of legitimacy and helped to pump up share prices. Interest in the company intensified in March when the government endorsed the company's proposal to assume more of the national debt in exchange for South Sea Company stock. “Derivatives” in the form of the company's “subscription shares” (compound call options on the firm's own fully-paid shares) facilitated the share price rise. (Meanwhile, investors scrambled to buy shares in other joint-stock companies.) The share price rose from £128 in January to £1,050 in late June, before collapsing to £175 in September.

Less known is the Scotsman Gregor MacGregor, who the *Economist* says, “pulled off the greatest confidence trick of all time” between 1820 and 1823. He invented an entire country, “Poyais,” and persuaded investors to buy the non-existent government's bonds and emigrate there. (Note: this lecture will not cover Tulipomania and MacGregor.)

The mid-19th Century railroad mania has been likened to the “dot.com” boom. The United Kingdom saw a massive wave of investment to build a nationwide railroad network. A new investor class emerged, eager to buy shares with only ten percent down. Share prices rose 62 percent from 1843 to 1845, when investor demand collapsed and share prices fell dramatically over the next four years (until 1849). Fraud was rampant, including “false prospectuses and criminally deceitful accounting practices,” though some argue that the dividends (paid out of capital) justified the high share prices for a time. On the heels of this, a banking panic erupted in 1847, as many banks failed and a severe recession took hold.

Why are investors vulnerable to a “follow the leader process,” as Charles P. Kindleberger puts it? Is there “nothing as disturbing to one's well-being and judgment as to see a friend get rich,” as James Steward suggests? How did the lack of reliable information for outside investors influence their appetite for risk? Do these cases show, as J. K. Galbraith writes, that “individuals were dangerously captured by belief in their own financial acumen and intelligence?” What light can the four models shed on these cases? Can a profile be discerned of con artists and their victims, as Tamar Frankel's research suggests? What role did government policies play in supporting the frauds by expanding money supply and fostering an environment for speculation and misallocation of investors' capital? What mechanisms, such as derivatives, helped to sustain speculation? What caused each bubble to burst, the tipping points or the “prick(s) of reality?” In each case, how did government respond to guard against future bubbles and frauds (e.g., “Bubble Act” outlawing all joint-stock companies not authorized by a royal charter)? Did governments prosecute anyone? Reforms curtail future frauds?

Readings

Required:

Anne L. Murphy, *The Origins of English Financial Markets: Investment and Speculation before the South Sea Bubble*. Cambridge, U.K.: Cambridge University Press, 2012. "Introduction." Chapter 1 ("London's First Stock Market Boom"). *Available on Classes*v2*.

Chancellor, *Devil Take the Hindmost*. Chapter 1 ("This Bubble World"), pages 3-29. Chapter 2 ("Stockjobbing in 'Change Alley: The Projecting Age of the 1690s"), pages 30-57. Chapter 3 ("The South Sea Scheme"), pages 58-95.

Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes*. New York: Wiley, 2005, [pages 58 – 61](#). *Available on Classes*v2*.

Janet Gleeson, [Millionaire: The Philanderer, Gambler, and Duelist Who Invented Modern Finance](#). New York: Simon and Schuster, 2001. [About John Law] Chapters 8 ("The Bank") to 13 ("Descent"). *Available on course reserve at CSSI*.

APRIL 6 (Session 03)

Crédit Mobilier (1870s), Ponzi, and the "Match King"

In the United States in the 1860s, the federal government chartered two companies – Union Pacific (UP) and Central Pacific – to build a transcontinental railroad, providing enormous incentives. UP's biggest shareholders created a dummy construction and holding company, Crédit Mobilier of America, to build a segment. That company charged more than double the work's costs. It was a story of self-dealing, resulting in massive losses for shareholders and the government as bondholder. In this "Gilded Age," scandal was endemic with few investor protections and weak corporate governance structures.

Charles Ponzi founded the Securities and Exchange Company, which guaranteed investors a 50-percent profit in 45 days. Ponzi kept that promise for a while, using new investors' money to repay earlier investors. By summer 1920, Ponzi was taking in \$250,000 daily. Eventually, he couldn't repay investors, and then the *Boston Post* unmasked the scam. "The public deserves exactly what it gets," Ponzi retorted. "No more, no less."

Ivar Kreuger built a global empire, controlling as much as three-quarters of worldwide production of matches, taking advantage of the laissez-faire spirit of cash-strapped European governments to obtain match monopolies. J. K. Galbraith called him the "Leonardo of larcenists." The charismatic and mysterious Kreuger financed his activities by selling both

shares and bonds of his companies as well as borrowing large sums from banks. Jack Morgan despised Kreuger for winning business with France and Germany, former J.P. Morgan & Co. clients. In what biographer Frank Partnoy calls "an ingenious piece of financial engineering," Kreuger created dual classes of stock ownership. Kreuger also designed a new "convertible debenture derivative." His elaborate corporate structures shifted funds from one entity to another to sustain the illusion of growth and profits. A brokerage and accounting firm were willing accomplices.

What made the shameless chicanery of Ponzi and Kreuger so appealing? Use of leverage, other financial engineering – what roles do these techniques play in fraud? Did federal government policies play a role in facilitating these frauds?

Group Project Presentations

Ivar Kreuger

Readings

Required:

James Chanos, "Case Study: George Hudson and the 1840s Railroad Mania." (Yale Case Study 11-042). Available at: <http://nexus.som.yale.edu/hudson/> . The case can be accessed either with Yale NetId or the following: Username: SOMcase. Password: Caseview@SOM10.

Chancellor, *Devil Take the Hindmost*, Chapter 5 (" 'A Ready Communication:' The Railroad Mania of 1845"), pages 122-151.

Frank Partnoy, [*The Match King: Ivar Kreuger*](#). *The Financial Genius behind a Century of Wall Street Scandals*. New York: Public Affairs, 2008. Read the entire book. *Available on course reserve at CSSI*.

Mitchell Zuckoff, [*Ponzi's Scheme: The True Story of a Financial Legend*](#). New York: Random House, 2006. Chapters 11 ("Like Stealing Candy from a Baby") and 12 ("Money Madness"). *Available on Classes*v2*.

Shameless Chicanery and Wall Street's "Hellhound;" The 60s/70s: The "Go-Go-Years;" The 80s: Junk Bonds/Drexel/Milken, Savings and Loan Crisis

The cross-examination by Ferdinand Pecora, chief counsel of the Senate Banking and Currency Committee, in 1933 of National City Bank, surfaced a morass of tawdry scams. The hearings revealed abusive practices, including conflicts of interest, underwriting securities to repay the bank's bank loans, and "pool operations" to support the bank's stock prices. Testimony by the bank's head showed that "the market was not a level playing field," that "only small, unconnected investors [bore] the costs of their imprudent investments; the insiders would simply bail themselves out," as Michael Perino writes. These hearings represented the first time that Wall Street was subjected to public accountability. Congress passed the Securities Act of 1933, the Securities Exchange Act of 1934, and the Bank Act of 1933 (Glass-Steagall) to address the problems Pecora's investigation raised.

New Yorker writer John Brooks coined the phrase "go go years" to capture the story of the meteoric rise of "growth stocks" during the 1960s (the "nifty fifty") and the devastating market crash in the 1970s. "A smooth operator with a streak of the gambler; a company more interested in attracting investors than in making real profits; the resort to tricky accounting; the eager complicity of long-established, supposedly conservative investing institutions; the desperation plunge in a gambling casino at the last minute; the need for massive central-banking action to localize the disaster; and finally, reform measures instituted too late - we will see all of these elements reproduced with uncanny faithfulness in United States financial scandals and mishaps later in the nineteen sixties," Brooks writes. "Adam Smith" sees the era as a story about "image and reality and identity and anxiety and money." By August 1979, *BusinessWeek* was pronouncing "The Death of Equities," with the PE ratio standing at 8 or 9. Brooks examines the emergence of conglomerates using mergers and acquisitions to boost share prices, the shift in Wall Street's leadership to a younger generation with different ethics, the rise of mutual funds and celebrity portfolio managers, and the scrutiny of exchanges' trading practices. "Smith" similarly raises concerns about conglomerates and the ways in which financial statements were manipulated. ("If the profit numbers on income statements are treated with such reverence, it was obviously only a question of time before some smart fellows would start building companies not around the logical progression of a business but around what would beef up the numbers.")

The 80s/90s saw the failure of 747 savings and loan associations ("thrifts"), following the real estate crash that a tax law change triggered. Deregulation in 1982 allowed S&Ls to invest in junk bonds, property, and other speculative ventures. S&Ls became entrapped in a yield gap, having lent funds for long periods at low rates but forced to pay higher rates on short-term deposits to replenish capital. The thrifts sought out high-yield junk bonds to try and close that gap. Thrift insurance premiums encouraged risk-taking since high-risk S&Ls were not charged more for deposit insurance than the prudent ones.

Michael Milken pioneered the widespread use of junk bonds, creating a network of bond buyers in arguably an orchestrated “daisy chain” that allowed S&Ls to circumvent regulation. Deregulation in 1980 and 1982 lifted restrictions on the investments that S&Ls could make. Between 1975 and 1986, more than \$71 billion in junk bonds were issued; roughly a third issued between 1978 and 1983 had defaulted by 1988. As authors Grey, Frieder, and Clark note, “the quality of junk bonds declined progressively as the gap between a leveraged buyout (LBO) company’s earnings and the interest payments on its junk bonds whittled away.” In March 1989, a federal grand jury indicted Milken on 98 counts of racketeering and fraud. On April 24, 1990, Milken pleaded guilty to six counts of securities and tax violations.

Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), which barred S&L’s from further purchases of high-yield bonds and required them to liquidate their high-yield bond portfolios over a five-year period. The bailout cost an estimated \$150 billion, with the capital coming mainly from the sale of government debt by both the Treasury and the Resolution Funding Corporation (RefCorp). Who was prosecuted? Were the federal government responses appropriate and effective?

Group Project Presentations Lincoln Savings and Loan/Charles Keating

Readings

Required:

John Brooks, *Once in Golconda: A True Drama of Wall Street, 1920-1928*. New York: Wiley, 1999. *New Yorker* writer Brooks portrays the character and peccadilloes of financier Richard Whitney, a Morgan broker who headed the New York Stock Exchange, but ended up in Sing Sing Prison for his misdeeds. (Golcondo – source of wealth; derived from diamond mine in India) Read the entire book. *Available on course reserve at CSSI.*

_____. *The Go-Go Years. The Drama and Crushing Finale of Wall Street’s Bullish ‘60s*. New York: Wiley, 1973. Read the entire book. *Available on course reserve at CSSI.*

Chancellor, *Devil Take the Hindmost*, Chapter 7 (“The End of a New Era: The Crash of 1929 and Its Aftermath”), pages 191-232. Chapter 8 (“Cowboy Capitalism: From Bretton Woods to Michael Milken”), pages 233-282.

Kindleberger, *Manias, Panics, and Crashes*. “Instability of Credit and the Great Depression,” [pages 83-89](#); “International Ramifications,” [pages 138-40](#); and, Chapter 11 (“Domestic Lender of Last Resort”), [pages 225-242](#). *Available on Classes*v2.*

Michael Perino, [*The Hellhound of Wall Street*](#). New York: Penguin Press, 2010. "Part Two," pages 129-279; "Epilogue," pages 280-304. Available on course reserve at CSSL.

William K. Black, [*The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*](#). Austin, Texas: University of Texas Press, 2005. Chapter 2 ("Competition Laxity") and Chapter 10 ("It's the Things You Do Know, But Aren't So, That Cause Disasters"). Available on Classes*v2.

Business Week, "The Death of Equities. How Inflation is Destroying the Stock Market." August 13, 1979. Available at: http://www.businessweek.com/investor/content/mar2009/pi20090310_263462.htm .

APRIL 20 (Session 05) _____

90s "Boiler Rooms;" Lessons from Enron, WorldCom, Tyco, etc.: Finding the "Dogs" behind Financial Statements' "Ducks"

In the 1990s, Stratton Oakmont and other "boiler rooms" aggressively marketed penny stocks in "pump and dump" schemes. Federal prosecutors succeeded in pressing charges that Stratton manipulated the stocks of at least 34 companies, which cost investors hundreds of millions of dollars. Jordan R. Belfort, 37, and Daniel M. Porush, 42, who served as chairman and president (the shares sold to the public by Stratton became worthless). The memoirs of Stratton's founder, Belfort, formed the basis of "The Wolf of Wall Street," a film directed by Martin Scorsese and released in December 2013. "They were drunk on youth, fueled by greed, and higher than kites," he wrote. "The name of the game, moving the money from the client's pocket to your pocket." *The Boiler Room* is an earlier film (2000) inspired by Stratton and Belfort.

Bethany McLean, then a *Fortune* writer, broke the Enron scandal in 2001. She quotes one employee explaining how the accounting and auditing process worked at Enron: "Say you have a dog, but you need to create a duck on the financial statements. Fortunately there are specific accounting rules for what constitutes a duck: yellow feet, white covering, orange beak. So you take the dog and paint its feet yellow and its fur white and you paste an orange plastic beak on its nose, and then you say to your accountants, 'This is a duck! Don't you agree that it's a duck?' And the accountants say, 'Yes, according to the rules, this is a duck.' Everybody knows that it's a dog, not a duck, but that doesn't matter, because you've met the rules for calling it a duck."

Companies used accounting flexibility to project artificial growth but dug a hole deeper and deeper with each quarter. That is because the "number" (the consensus estimate that Wall Street analysts predict for companies' quarterly and annual earnings), Alex Berenson writes, mattered most.

Are there parallels with John Law’s Mississippi Company, Enron, WorldCom, Tyco, others? Was the Federal Reserve’s accommodative policy in the late 1990s a factor fueling investor euphoria? In response to the corporate scandals, Congress enacted the Sarbanes Oxley Act in August 2002; its 11 titles range from additional corporate board responsibilities to tougher regulations for auditors to executive certification of financial statements to more severe criminal penalties for committing investor frauds.

Despite those reforms, are accounting rules still poorly crafted such that the financial statements are insufficiently transparent and clear? What is the line between “aggressive accounting” and “fraud?” How do you find the “dogs” the financial statement says are “ducks”? Fair value accounting – how best to determine values for securities with no current market? Do these scandals show a correlation between economic growth and the propensity for a culture of corporate greed? Has SarBox proven to be an effective response? Why or why not?

Guest Speaker:

U.S. District Court Judge Jed S. Rakoff, Southern District of New York

Group Project Presentations Enron
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Readings

Required:

Jed S. Rakoff, “The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?” *New York Review of Books*, January 9, 2013. Available at: <http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/?page=1> .

Adam Liptak, “Stern Words for Wall Street’s Watchdogs, From a Judge.” *New York Times*, December 16, 2013. Available at: www.nytimes.com.

_____, “Justice Deferred is Justice Denied.” *New York Review of Books*, February 19, 2015. <http://www.nybooks.com/articles/archives/2015/feb/19/justice-deferred-justice-denied/>

Alex Berenson, *The Number*. New York: Random House, 2003. Part Two: “This is Now...” Available on course reserve at CSSI. (A new rationale set the foundation for each new wave of frauds using accounting machinations.)

Jim Chanos, "[Short-Lived Lessons — From an Enron Short](#)," *Wall Street Journal*, May 30, 2006. Available on *Classes**v2.

_____, "[Short Sellers Keep the Market Honest](#)," *Wall Street Journal*, September 22, 2008. Available on *Classes**v2.

_____, "[We Need Honest Accounting](#)," *Wall Street Journal*, March 24, 2009. Available on *Classes**v2.

Herb Greenberg and Lisa Munoz, "Does Tyco Play Accounting Games?," *Fortune*, April 1, 2002. Available at:

http://money.cnn.com/magazines/fortune/fortune_archive/2002/04/01/320643/index.htm .

Jennings, *The Seven Signs of Ethical Collapse*, select pages: [23-29](#); [61-73](#); [103-111](#); [152-160](#); [187-193](#); [205-207](#); [238-244](#). Chapter Nine ("Applying the Signs for the Future"), pages 258-269. Chapter Ten ("The Road Ahead"), pages 270-286. Available on *Classes**v2.

Charles Layton, "Continuation of Ignoring the Alarm." *American Journalism Review*. March 2003. Available at: <http://www.ajr.org/article.asp?id=2793> .

Bethany McLean, "Is Enron Overpriced?" *Fortune*, March 5, 2001. Available at:

http://money.cnn.com/2006/01/13/news/companies/enronoriginal_fortune/index.htm .

(This article was seminal in drawing attention to Enron's problems. "The company remains largely impenetrable to outsiders, as even some of its admirers are quick to admit. Start with a pretty straightforward question: How exactly does Enron make its money? Details are hard to come by because Enron keeps many of the specifics confidential for what it terms 'competitive reasons.' And the numbers that Enron does present are often extremely complicated. Even quantitatively minded Wall Streeters who scrutinize the company for a living think so.")

Bethany McLean, "Why Enron Went Bust." *Fortune*, December 24, 2001.

Available at:

http://money.cnn.com/magazines/fortune/fortune_archive/2001/12/24/315319/index.htm .

Bethany McLean and Peter Elkind, *The Smartest Guys in the Room. The Amazing Rise and Scandalous Fall of Enron*. New York: Portfolio Trade, 2004. Read the entire book. Available on course reserve at CSSI.

Video: Interview by Professor Chanos with Bethany McLean. (2014) Available on *Classes**v2.

Floyd Norris wrote a series of articles in the *New York Times* between 1999 and 2002. These include:

- "At Tyco, Accounting 'Baths' Begin Before the Deals Close." October 29, 1999. Available at: <http://query.nytimes.com/gst/fullpage.html?res=9401E7DE1E38F93AA15753C1A96F958260&scp=11&sq=Floyd%20Norris%20Tyco&st=cse> .

- “Market Place; Tyco Took Profit on Bad Deal, Then Paid Bonuses.” September 25, 2002. Available at: <http://www.nytimes.com/2002/09/25/business/market-place-tyco-took-profit-on-bad-deal-then-paid-bonuses-to-executives.html?scp=14&sq=Floyd%20Norris%20Tyco&st=cse> .
- “Is a Looted Tyco Really Worth \$36 Billion?” September 13, 2002. Available at: <http://query.nytimes.com/gst/fullpage.html?res=9C0CE0DF1131F930A2575AC0A9649C8B63&scp=17&sq=Floyd%20Norris%20Tyco&st=cse> .

Frank Partnoy, *Infectious Greed*. New York: Public Affairs, 2009. Chapter 6 (“Morals of the Marketplace”), pages 141-186. Chapter 10 (“World’s Greatest Company” [Enron]), pages 298-349. “Epilogue”, pages 393-412. *Available on Classes*v2*.

Schilit/Perler. Tyco: 3, 14-17, 32, 142, 228-229, 231-237, 300; Enron: 3, 4-8; 34-35, 37, 59-61, 88, 91, 108-109, 141-142, 164, 166, 201-202, 259; WorldCom: 3, 8-14; 32, 34, 37, 113-115, 155, 166, 218-220, 228-229, 231-232. *Available on course reserve at CSSI*.

APRIL 27 (Session 06)

The Dot.com Implosion;

The Great Collapse 2007-2009: Financial Detectives’ Epic Battles for the Truth (PART ONE)

The “Dot Com” bubble began in April 1997 and ended in June 2003. Economists theorized the stock market valuations reflected the “New Economy.” Companies went public and raised hundreds of millions of dollars. In 1999, of the 457 IPOs, 117 had doubled in price on the first day of trading. “Crazy ideas that had no business model and no realistic chance of success were viewed as the next big thing,” said Steve Case, the former head of AOL. Financial (a surge in money and credit) and psychological dynamics (suspension of belief in traditional valuation measures) fueled the speculation. By 2000, within months, the NASDAQ stock index crashed from 5,000 to 2,000.

A few years later (2007-2008), an unprecedented collapse of the global financial system occurred. Its origins were in macroeconomic trends. The rise of sophisticated financial instruments, the “misplaced reliance” on mathematical models, high levels of leverage, and “hard-wired pro-cyclicality (ratings, triggers, margins, and haircuts)” – these were the macro trends behind the global story, as Lord Turner outlined in his report. At the firm-level, we saw examples of fraud that the global financial crisis made impossible to sustain.

Investment strategist William Ackman devoured 140,000 pages of financial information about MBIA to find “an extremely highly levered, yet AAA-rated financial institution, which we believe has inadequate reserves, undisclosed credit- quality problems, aggressive accounting and substantial unconsolidated indebtedness contained in off-balance-sheet special-purpose

vehicles.” According to his analysis, MBIA held just \$1 of capital for every \$140 of debt it guaranteed.

Investor David Einhorn probed Allied Capital, questioning the valuation of illiquid securities. The SEC followed with an investigation, concluding in June 2007 that Allied broke securities laws relating to the accounting and valuation of illiquid securities.

AIG provided an illusion of safety through its credit default swaps to “insure” mortgage-backed securities should defaults occur. But AIG’s bet was grossly lop-sided bet, and it lacked the financial resources to make good on those contracts should housing market collapse and counterparties make collateral calls. Federal Reserve Chair Ben Bernanke blamed the regulatory system: “There was no oversight of the Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets– took huge losses. There was no regulatory oversight because there was a gap in the system.” Was there a moral hazard? Did counterparties believe that Washington would bail them out if AIG ever failed? Former AIG chairman and CEO, Maurice “Hank” Greenberg, recently challenged the White House’s illegally harsh terms (in his view) to lend the insurance megalith \$85 billion (*Starr International Co. v. U.S.*, 11-cv-00779, U.S. Court of Federal Claims/Washington). (Closing arguments were due in early February 2015.)

U.S. District Judge Jed S. Rakoff wrote a stirring piece in the *New York Review of Books* questioning the federal government’s failure to prosecute individuals involved in the financial crisis. “In striking contrast with these past prosecutions,” he writes, “not a single high level executive has been successfully prosecuted in connection with the recent financial crisis, and given the fact that most of the relevant criminal provisions are governed by a five-year statute of limitations, it appears very likely that none will be. It may not be too soon, therefore, to ask why.” He assigns three reasons for the federal prosecutors’ inaction: other priorities including terrorism and the Madoff scandal, diverted the Justice Department’s (DOJ) attention; the government’s own role in the financial crisis complicated matters (could a CEO be indicted he believed the government wanted them to do what they were doing?); and, a shift within DOJ to prosecuting individuals rather than companies. Rakoff points to the conclusions of the Financial Crisis Inquiry Committee, which views the crisis as a “result of human action and inaction.” “The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public.”

(The second part will focus on the collapse of investment banks and the Federal government’s response.)

Guest Speaker:

Roddy Boyd, author, *Fatal Risk: A Cautionary Tale of AIG’s Corporate Suicide*.

Group Project Presentations AIG
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Readings

Required:

Roddy Boyd, *Fatal Risk: A Cautionary Tale of AIG's Corporate Suicide*. New York: Wiley, 2011. Available at Course reserves at CSSI.

David Faber, *And then the Roof Caved In*. New York: Wiley, 2010. [Chapter 10 \("A House of Cards"\), pages 135-154](#). [Chapter 11 \("And Then the Roof Caved in"\), pages 155-170](#). ["Epilogue," pages 171-180](#). Available on Classes*v2. (Note: Video available: <http://www.cnbc.com/id/28892719> .)

Bethany McLean and Joseph Nocero, *All the Devils Are Here*. New York: Portfolio, 2010. [Chapter 18 \("The Smart Guys"\), pages 267-284](#). [Chapter 19 \("The Gathering Storm"\), pages 285-307](#). [Chapter 22 \("The Volcano Erupts\), pages 342-357](#). Available on Classes*v2.

William Ackman, "Is MBIA Triple-A?". Available on Classes*v2.

Brandon L. Garrett, *Too Big to Jail: How Prosecutors Compromise with Corporations*. Cambridge, Mass.: Belknap Press, 2014. Chapter 3 ("What Happens to a Prosecution Deferred?"), pages 45 – 80. Chapter 10 ("The Future of Corporate Prosecutions"), pages 250 – 290. Available on Classes*v2.

Andrew Zajac and Christie Smythe, "Starr Gets Boost From U.S. Documents in AIG Bailout Case." Bloomberg, November 25, 2014. <http://www.bloomberg.com/news/articles/2014-11-25/starr-gets-boost-from-u-s-documents-in-aig-bailout-case>

Filings in: *Starr International Co. v. U.S.*, 11-cv-00779, U.S. Court of Federal Claims/Washington.

Interview with Roddy Boyd available on Classes*v2.

MAY 4 (Session 07)

The Great Collapse, 2007-2009: Were We All to Blame but No One Was at Fault? Too Big to Fail and Jail? (PART TWO)

This lecture will look at the roles of financial institutions in the crisis, such as Goldman, Sachs and Lehman Brothers. Lehman Brothers used "materially misleading" accounting gimmicks to

mask the perilous state of its finances, according to the 2,200-page Examiner's Report. "Unbeknownst to the investing public, rating agencies, government regulators, and Lehman's board of directors, Lehman reverse engineered the firm's net leverage ratio for public consumption." A close reading of the financial statements of the largest financial institutions revealed the contrivances masquerading enormous problems that jeopardized the firms' survival. What processes were used to comb through the mountain of financial statements? Why did it take so long before investors believed the dissenting voices?

A recent paper by the Bank for International Settlement looks at the role played by fair value accounting, "through an increased volatility of profit and loss figures," in influencing "investment and risk management decisions in banks." Anecdotal evidence suggests that "the combination of an opaque balance sheet with funding constraints... led to the demise of systemically important banks." Evidence remains inconclusive, however, BIS finds, in understanding if fair value accounting principles resulted in disclosures that disguised banks' financial weaknesses or led senior managers to make poor decisions.

Also assessed will be the government's response. Did Dodd-Frank address the problems the financial crisis revealed? Were the anti-fraud provisions of Sarbanes-Oxley sufficiently strong, as Einhorn suggests, but "the problem was that the laws were not enforced"? Were the financial institutions "too big to fail and jail"? Why were no heads of these institutions prosecuted for the wrongdoing set out in the Financial Crisis Inquiry Commission? Was Justice's approach to prosecution (deferred prosecution to compel changes in corporate culture) "justice denied," as one writer put?

Meanwhile fiscal accounting shenanigans became the norm for governments worldwide and in the United States, for Federal, state, and local governments. "China's overall debt-to-GDP ratio has sprung to over 200% from about 120% in five years. Most of this is from local governments and state-supported companies," reports the *Wall Street Journal* March 5, 2014).

What are the implications? Greece's government engaged in a decade-long series of maneuvers to mask debt (for example, using a "currency trade" to raise funds) and skirt EU borrowing limits. Mary Meeker analyzed the Federal budget as she would a corporation and found in 2012 that U.S. expenses outstripped revenue by 56 percent. Tax breaks exceeded \$1 trillion last year, which she argues accounted for 83 percent of the deficit in cash flow. Shift in industry, wealth, and population all point to diverging outlooks for two groups of states, Meredith Whitney's view. Does a doomsday scenario await failing states and municipalities?

And, the "work ahead," as Alan Blinder outlined in his book. Erik Gerding explains how financial regulation plays into the dynamics of asset price bubbles. "[A]sset price bubbles weaken financial regulation just as financial markets begin to overheat and the risk of crisis spikes." "[T]he failure of financial regulations adds further fuel to a bubble." He sees five dynamics: regulatory stimulus cycle; compliance rot; regulatory arbitrage frenzies; procyclical regulation; and, promoting of investment herding. "These five dynamics become most dangerous when they undermine financial regulations that govern financial institution leverage and the supply of credit."

Lord Adair Turner, former head of the U.K. securities regulator, concluded that “the financial crisis of 2007/08 occurred because we failed to constrain the private financial system’s creation of private credit and money.” Banks, he said that can create credit and private money with weak oversight, they will likely “create sub-optimally large or sub-optimally unstable quantities of both credit and private money.... Banks which can create credit and money to finance asset price booms are thus inherently dangerous institutions.”

U.S. District Judge Jed S. Rakoff wrote a stirring piece in the *New York Review of Books* questioning the federal government’s failure to prosecute individuals involved in the financial crisis. “In striking contrast with these past prosecutions,” he writes, “not a single high level executive has been successfully prosecuted in connection with the recent financial crisis, and given the fact that most of the relevant criminal provisions are governed by a five-year statute of limitations, it appears very likely that none will be. It may not be too soon, therefore, to ask why.” He assigns three reasons for the federal prosecutors’ inaction: other priorities including terrorism and the Madoff scandal, diverted the Justice Department’s (DOJ) attention; the government’s own role in the financial crisis complicated matters (could a CEO be indicted ho believed the government wanted them to do what they were doing?); and, a shift within DOJ to prosecuting individuals rather than companies. Rakoff points to the conclusions of the Financial Crisis Inquiry Committee, which views the crisis as a “result of human action and inaction.” “The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public.”

The shift in Justice’s prosecution strategy for corporate fraud, University of Virginia Law Professor Brandon L. Garrett shows in his book (*Too Big to Jail: How Prosecutors Compromise with Corporations*) has not had an impact in reducing incidences of fraud. In striking deals with companies to withhold prosecution if the company commits to changing its corporate culture, Garrett finds the approach removing the accountability of the company’s leaders and fraud continuing. “The punishment and deterrence of corporate crime has, for all the government’s rhetoric, effectively been reduced,” Rakoff writes in reviewing Garrett’s book.

Guest Speaker:

Alex Berenson, author, *The Number*.

Group Project Presentations Lehman Brothers
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Readings

Required:

William K. Black, "Wall Street's Broken Windows." *New Economic Perspectives*, March 4, 2012. Available at: <http://www.neweconomicperspectives.org/2012/03/wall-streets-broken-windows.html> .

Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response and the Work Ahead*. New York: Penguin, 2013. Available on course reserve at CSSI.

Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report. Volume 1 ("Introduction and Executive Summary"), pages 2-26. (The report is divided into nine volumes and features hyperlinks to all of the documents cited in the report's 8,000-plus footnotes.) Available at: <http://lehmanreport.jenner.com/> .

Mary Meeker, "USA Inc. - A Basic Summary of America's Financial Statements." February 2011. Available at: <http://www.scribd.com/doc/49434520/USA-Inc-A-Basic-Summary-of-America-s-Financial-Statements> .

Report of the Financial Crisis Inquiry Committee. "Conclusion," pages xv – xxviii. Available at: <http://www.fcic.gov/> .

Final take-home exam distributed.

Friday, May 8

Final exam due at noon (New Haven, CT time).

ASSIGNMENTS

Group Project

Starting April 6, each week two groups will make 20-minute presentations, assuming the role of expert witness for either the prosecution or the defense. Apply the four models to organize your inquiry into the facts: Kindleberger Minsky; "fraud triangle;" McLean ("legal fraud"); and Black ("control fraud"). Each group will prepare a 20-page paper and a PowerPoint presentation. The paper and PowerPoint are due at 5 p.m. Sunday prior to the presentation date. Both will be posted on Classes*v2 for students to review before class. Each group will

present its analysis within a 20-minute time period and field questions from students for another 10 minutes

All members of the group will receive the same grade. The grade will reflect performance for the written materials and the oral presentation.

A two-page outline for each group's assignment is due Monday, March 30, at noon to the teacher's assistant via email.

GROUP PROJECT DEADLINES

Presentation Date	Website Posting Deadline
April 6	April 5 5 p.m.
April 13	April 12 5 p.m.
April 20	April 19 5 p.m.
April 27	April 26 5 p.m.
May 4	May 3 5 p.m.

Final Exam

A take-home written exam covering key concepts and their application will be **distributed Monday, May 4 and due Friday, May 8 at noon (Yale time).**

GRADING

Group Project	30 percent
Final Written Exam	40 percent
Class Participation	30 percent

Grading Policy

Yale's grading system is: Distinction, Proficient, Pass, and Fail. The faculty guideline for awarding a grade of Distinction is that it should be given to no more than 10 percent of the SOM students enrolled.

All assignments will be graded in terms of the quality of the analysis, research/content (the level of original thinking), and writing.

Deadlines

If an assignment is late, it will be accepted but your grade will be affected. Please be conscious of this.

Attendance Policy

Students are expected to attend all classes unless excused. A sign-in sheet will be provided before each class begins. It is your responsibility to sign in and record your attendance. Attendance will be reflected in the final grade's "participation" component. Please contact the teaching assistant should you need to miss a class so that we can discuss any need for a review of lectures missed. Consult the university's policy on religious holidays.

Academic Integrity

Please review the university's policy available at:
<http://yalecollege.yale.edu/content/academic-dishonesty> .

Please refer to Yale's official warning about plagiarism:
<http://yalecollege.yale.edu/content/cheating-plagiarism-and-documentation> .

SUGGESTED READINGS

MARCH 23: LECTURE ONE

Dan Amiram, Zahn Bozanic, and Ethan Rouen, "Financial Statement Irregularities: Evidence from the Distributional Properties of Financial Statement Numbers." January 2, 2014. *Columbia Business School Research Paper No. 14-9*. Available at: <http://ssrn.com/abstract=2374093> or <http://dx.doi.org/10.2139/ssrn.2374093>. Researchers find that companies whose financial statements deviate from Benford's Law are likely to be engaging in earnings manipulation. Companies with a higher deviation from Benford's Law in the three years prior to fraud detection by the SEC suggest that "fraudulent firms are able to hide their activities using techniques that violate Benford's Law, but only get caught if those techniques become unsustainable."

ANZ Research, "[Do Chinese Activity Data Conform to Benford's Law?](#)". January 8, 2013. Available on Classes*v2. ("Our preliminary tests on some selected Chinese activity data suggest that while all satisfy Benford's first digit law, all of them fail to satisfy the second digit law when these data are published in percentage terms. Our application of Benford's Law seems to have confirmed that most data published in percentage terms could have been subject to data manipulation, appearing to confirm long-rooted suspicions on the quality of Chinese data.")

Ray Ball, "Accounting Informs Investors and Earnings Management is Rife: Two Questionable Beliefs." May 15, 2013. *Accounting Horizons*, forthcoming. Available at: <http://ssrn.com/abstract=2211288> . Ball argues that financial statements do not provide a "relatively large proportion of the new information used by the equity market." He also questions research methodologies used to prove the frequency of accounting manipulation.

Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, "Using Nonfinancial Measures to Assess Fraud Risk." July 20, 2009.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=886545.

("If auditors or other interested parties [e.g., directors, lenders, investors, or regulators] can identify nonfinancial measures [e.g., facilities growth] that are correlated with financial measures [e.g., revenue growth], inconsistent patterns between the nonfinancial and financial measures can be used to detect firms with high fraud risk. We find that the difference between financial and nonfinancial performance is significantly greater for firms that committed fraud than for their non-fraud competitors. ... Manipulating . . . NFM's can be difficult to conceal because NFM verification is often straightforward. ... Overall, our results provide empirical evidence suggesting that nonfinancial measures can be effectively used to assess the likelihood of fraud.")

Markus K. Brunnermeier and Martin Oehmke, "Bubbles, Financial Crises, and Systemic Risk." Available at:

<http://www0.gsb.columbia.edu/faculty/moehmke/papers/BrunnermeierOehmkeHandbookSystemicRisk.pdf> . Brief historical account of bubbles, financial crises, and systemic risks.

Jeffrey R. Cohen, Yuan Ding, Cédric Lesage, and Hervé Stolowy. "Corporate Fraud and Managers' Behavior: Evidence from the Press." October 06, 2010. Available at: <http://ssrn.com/abstract=1160076> .

("Based on evidence from press articles covering 39 corporate fraud cases that went public during the period 1998-2005, the objective of this paper is to examine the role of managers' behavior in the commitment of the fraud." From this paper's detailed list of frauds, choose a case for your group's project. It's also possible to choose a more recent case.)

P. M. Dechow, W. Ge, C. R. Larson, and R. G. Sloan, "Predicting Material Accounting Misstatements." [*Contemporary Accounting Research* 28 \(2011\) \(1\): 17-82](#). (Reviews 2,190 SEC *Accounting and Auditing Enforcement Reports* between 1982 and 2005 to identify firms with misstated quarterly or annual earnings. "We find that the overstatement of revenues, misstatement of expenses, and capitalizing costs are the most frequent types of misstatements. We find that at the time of misstatements, accrual quality is low and both financial and nonfinancial measures of performance are deteriorating. We also find that financing activities and related off-balance-sheet activities are much more likely during misstatement periods. Finally, we find that managers of misstating firms appear to be sensitive to their firm's stock price. These firms have experienced strong recent earnings and price performance and trade at high valuations relative to fundamentals. The misstatements appear to be made with the objective of covering up a slowdown in financial performance in order to maintain high stock market valuations.")

Ilija D. Dichev, John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "Earnings Quality: Evidence from the Field." September 9, 2012. Available at: <http://ssrn.com/abstract=2103384> or <http://dx.doi.org/10.2139/ssrn.2103384>. (Researchers' survey of CFOs finds: "[A]bout 50%

of earnings quality is driven by non-discretionary factors; (iii) about 20% of firms manage earnings to misrepresent economic performance, and for such firms 10% of EPS is typically managed; (iv) CFOs believe that earnings manipulation is hard to unravel from the outside but suggest a number of red flags to identify managed earnings....”)

Roman Frydman and Michael Goldberg, *Beyond Mechanical Markets: Asset Price Swings, Risk and the Role of the State*. Princeton, New Jersey: Princeton University Press, 2011.

(The authors suggest an approach that lies in-between efficient market theory and behavioral investing. They posit the “contingent-market hypothesis.” “The causal process underpinning price movements depends on available information, which includes observations concerning fundamental factors specific to each market. This process cannot be adequately characterized by an overarching model, defined as a rule that exactly relates market outcomes to available information up to a fully predetermined random error at all time periods, past, present and future.”)

Robin Greenwood and Stefan Nagel, “[Inexperienced Investors and Bubbles.](#)” *NBER Working Paper #14111*. 2008. Available at: <http://www.nber.org/papers/w14111.pdf>.

(“Young managers, but not old managers, exhibit trend-chasing behavior in their technology stock investments” during the technology bubble of the late 1990s “The economic significance of young managers' actions is amplified by large inflows into their funds prior to the peak in technology stock prices.”)

Jessen L. Hobson, William J. Mayew, and Mohan Venkatachalam, “Analyzing Speech to Detect Financial Misreporting.” October 9, 2011. Available: <http://ssrn.com/abstract=1531871>.

(Paper examines the role of vocal cues in detecting financial misreporting, using vocal emotion analysis software. The researchers focus on cognitive dissonance, “a state of psychological arousal and discomfort occurring when an individual takes actions that contrast with a belief, such as cheating while believing oneself to be honest.” “We find that cognitive dissonance in CEO speech can predict whether a firm’s quarterly financial reports will be adversely restated at better than chance levels. . . . [I]mportant nonverbal clues to detect financial misreporting are present in earnings conference calls.” Researchers caution about the limits, given the early stages of Layered Voice Analysis technologies and research methodologies.)

Bradley E. Lail, Wayne B. Thomas, and Glyn J. Winterbotham, “Classification Shifting Using the 'Corporate/Other' Segment.” April 26, 2013. Available at: <http://ssrn.com/abstract=2257120>.

(This paper examines management’s use of the “corporate/other” segment of financial statements to “mask the true performance of operating (or core) segments. We find that managers take advantage of vague cost allocation requirements to shift expenses between the corporate/other segment and core segments. ...This shifting increases the reported performance of underperforming core segments. In addition, when proprietary concerns are high (i.e., operations in less competitive industries), we find evidence consistent with corporate/other expenses being shifted to core segments. By shifting expenses to core segments, core profits are concealed when proprietary motives are present.”)

Andrew W. Lo, "Fear, Greed, and Financial Crises: A Cognitive Neurosciences Perspective." October 13, 2011. Available at: <http://ssrn.com/abstract=1943325>. ("One of the most significant consequences of the Financial Crisis of 2007–2009 is the realization that the intellectual framework of economics and finance is incomplete in several respects.")

Mark J. Nigrini, "I've Got Your Number." *Journal of Accountancy*. May 1999. Available at: <http://www.journalofaccountancy.com/Issues/1999/May/nigrini>. (Nigrini: "Benford's law is used to determine the normal level of number duplication in data sets, which in turn makes it possible to identify abnormal digit and number occurrence. Accountants and auditors have begun to apply Benford's law to corporate data to discover number-pattern anomalies.") For more information on Benford's law, see: Robert Matthews, "The Power of One." *New Scientist*. July 10, 1999. [Pages 26-30.](#))

Prabin Kumar Panigrahy and Anuj Sharma, "A Review of Financial Accounting Fraud Detection Based on Data Mining Techniques." *International Journal of Computer Applications* Vol. 39, No. 1 (February 2012). Data mining techniques are providing great aid in financial accounting fraud detection, since dealing with the large data volumes and complexities of financial data are big challenges for forensic accounting. This paper presents a comprehensive review of the literature on the application of data mining techniques for the detection of financial accounting fraud and proposes a framework for data mining techniques based accounting fraud detection." Available at: <http://arxiv.org/abs/1309.3944> .

Steven Pressman, "On Financial Frauds and Their Causes: Investor Overconfidence." *American Journal of Economics and Sociology*. Vol. 57, No. 4 (October 1998), pages 405-421. Available at: <http://www.jstor.org/stable/3487115> .

(Pressman rebuts the classical economic view that investors are rational and the neoclassical view that investors are at a disadvantage with their asymmetric information. Instead, he argues that investors focus on certain facts, such as the massive early gains of the first investors, to make their decisions. "Empirical psychology provides a good deal of evidence that people are psychologically constituted to make the very sorts of errors that lead to cases of massive financial fraud. "One result from the empirical psychology literature is that judgments about potential risk are frequently mistaken, and human fallibility tends to be greatest when people hold their faulty judgments with great confidence [Slovic, Fischhoff, and Lichtenstein, 1982]. Moreover, people are psychologically predisposed to be optimistic whenever they are individually involved and have had no bad personal experiences from their past to counter this innate optimism. For example, a large majority of people think that they will live past 80 [Weinstein, 1980] and that they, personally, are unlikely to be harmed by products they buy and use [Rethans, 1979]. Psychologically, people tend to live in the world of Lake Wobegon, where all children are smarter than average and better behaved than average.")

Nate Silver, *The Signal and the Noise: Why So Many Predictions Fail — but Some Don't*. Penguin Press, 2012. "Introduction," Chapter One: "A Catastrophic Failure of Prediction," [pages 1 – 46](#); and Chapter 11: "If You Can't Beat 'Em...", [pages 329 – 369](#). (Failing to predict the financial

crisis demonstrates common failures of prediction, one key one being that models are “simplifications of the world.” Further, “To the extent that markets are reflections of our collective judgment, they are fallible too. In fact, a market that makes perfect predictions is a logical impossibility.”) Available on Classes v*2.

Christopher J. Skousen, Kevin R. Smith, and Charlotte J. Wright, “Detecting and Predicting Financial Statement Fraud: The Effectiveness of the Fraud Triangle and SAS No. 99.” October 28, 2008. Available at: <http://ssrn.com/abstract=1295494> .

(“We find that rapid asset growth, increased cash needs and external financing are positively related to the likelihood of fraud. Internal versus external ownership of shares and control of the board of directors are also linked to increased incidence of financial statement fraud. Expansion in the number of independent members on the audit committee, on the other hand, is negatively related to the occurrence of fraud.”)

Victor Zarnowitz. *Business Cycles: Theory, History, Indicators and Forecasting*. Chicago: University of Chicago Press, 1992. Chapter One, “Macroeconomics and Business Cycles: An Overview,” [pages 1 – 19](#). Available on Classes*v2.

(Does fraud most likely occur during the period up to and including a boom? A chapter from this book looks at the dynamics of business cycles and their influence on corporate and investor behavior.)

MARCH 30: LECTURE TWO

Tamar Frankel, *The Ponzi Scheme Puzzle: A History and Analysis of Con Artists and Victims*. New York: Oxford University Press, 2012. Chapter 4 (“A Profile of Con Artists and Their Victims”), [pages 110 – 159](#). Available on Classes*v2.

1690s Stock Frauds in England

Murphy, *The Origins of English Financial Markets: Investment and Speculation before the South Sea Bubble*. Entire book.

Matthew David Mitchell, “The Extravagant Humour of the English Body Politic, 1690-1720.” *Essays in Economic and Business History*. Vol. XXX (2012). Available at: <http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCQQFjAA&url=http%3A%2F%2Fwww.ebhsoc.org%2Fjournal%2Findex.php%2Fjournal%2Farticle%2Fdownload%2F49%2F195&ei=16AXU5HKCeni0wGd2lCICg&usq=AFQjCNESynHOppiS8b7RziF6QFcDtbgQ>. (Insights into the political debate over the merits of “stockjobbing”)

Carl Wennerlind, *Casualties of Credit: The English Financial Revolution, 1620-1720*. Cambridge, Mass.: Harvard University Press, 2011. (The need to expand credit dominated much of the thinking about the economy in England from the 1620s onward.)

John Law

Niall Ferguson, "The Ascent of Money." Episode Two: Bonds of War. Available at: <http://www.pbs.org/wnet/ascentofmoney/featured/the-ascent-of-money-episode-2-bonds-of-war/90/> .

Rik G. P. Frehen, William N. Goetzmann, and K. Geert Rouwenhorst, "New Evidence on the First Financial Bubble." July 1, 2009. *Yale ICF Working Paper No. 09-04*. Available at: <http://ssrn.com/abstract=1371007> .

("We find evidence against indiscriminate irrational exuberance and evidence in favor of speculation about two factors: the Atlantic trade and the incorporation of insurance companies. We study the role of innovation in the insurance market by examining market betas and volatilities of new insurance company shares, like [Pastor and Veronesi, *Technological Revolutions and Stock Prices*, 2009]. We find strong evidence for a revolution in the insurance business in 1720. Our findings are consistent with the hypothesis that financial bubbles require a plausible story to justify investor optimism.")

Antoin E. Murphy, "[The Evolution of John Law's Theories and Policies 1707 – 1715](#),". *European Economic Review* 34 (1991): 1109-1125. Available on Classes*v2. (The writer surveys Law's views supporting paper money, rather than precious metals, broadening the definition of money to include financial instruments, and linking monetary and fiscal policies.)

_____, *Economic Theorist and Policy-Maker*. Oxford: Clarendon Press, 1997.
Available on course reserve at CSSI.

Jon Moen, "[John Law and the Mississippi Bubble: 1718-1720](#)." Available at: <http://mshistory.k12.ms.us/articles/70/john-law-and-the-mississippi-bubble-1718-1720>.

Larry Neal, "*I Am Not Master of Events*": *The Speculations of John Law and Lord Londonderry in the Mississippi and South Sea Bubbles*. (Yale Series in Economic and Financial History). New Haven, CT: Yale University Press, 2012.

Dave Smart, "[Famous First Bubbles? Mississippi Bubble](#)." Erasmus School of Economics .

François R. Velde, "Was John Law's System a Bubble? The Mississippi Bubble Revisited." In: *The Origin and Development of Financial Markets and Institutions: From the Seventeenth Century to the Present*, Jeremy Atack and Larry Neal, ed. Cambridge, U.K.: Cambridge University Press, 2009, [pages 99-120](#).

Gregor MacGregor

"The King of Con-men," *Economist*. December 22, 2012.

David Sinclair, *The Land That Never Was: Sir Gregor MacGregor and the Land that Never Was: The Most Audacious Fraud in History*. New York: Da Capo Press, 2003.

South Sea Company

John Carswell, *The South Sea Bubble*. London: Cresset Press, 1960.

Virginia Cowles, *The Great Swindle: The Story of the South Sea Bubble*. New York: Harper & Brothers, 1960.

Julian Hoppitt, "The Myths of the South Sea Bubble." *Transactions of the Royal Historical Society*. 2002: 12.

Ralph M. Dillon, "Complete Histories – The South Seas Company – The Forgotten ETF." September 5, 2013. Available at: <http://www.ritholtz.com/blog/2013/09/complete-histories-the-south-seas-company-the-forgotten-etf/> . The South Sea Company was one of the first exchange-traded funds and a debt-equity swap.

Richard Kleer, " 'The Folly of Particulars': the Political Economy of the South Sea Bubble." [*Financial History Review* 19-2 \(2012\): 175-197](#). (The author argues that South Sea Company's agreeing in 1720 to convert a large part of the public debt into shares was seen as "an opportunity to establish dominance in the British banking industry.")

Gary S. Shea, "Financial Market Analysis Can Go Mad (in the Search for Irrational Behavior During the South Sea Bubble." February 2006. *Centre for Dynamic Macroeconomic Analysis Working Paper No. 0508*. Available: <http://ssrn.com/abstract=779025> . ("An investigation into the legal and political history of South Sea Company subscription finance shows that the **subscription contracts had default options** built into them, as was typically the case in eighteenth-century subscription financing. **Company records and contemporary pamphlet literature show that people understood the subscription finance mechanics that were stated in law**. A fair presentation of South Sea share value data also supports this view. We thus conclude that the analyses published in this review by Dale, Johnson, and Tang were irretrievably flawed and present a substantially incorrect history of the markets for South Sea shares.")

_____, "Understanding Financial Derivatives during the South Sea Bubble: The Case of the South Sea Subscription Shares." 2007. *Oxford Economic Papers* 59 (Supplement 1): 73-104. Available at: <http://ssrn.com/abstract=870282> .

("South Sea Company subscription shares were compound call options on the firm's own original shares. From the description of shares found in 6 Geo. 1, c.4, a theory of their pricing is developed. A method for computing subscription share values is also developed. Calculated theoretical values for subscription shares are compared to the shares' historical values and a close correspondence between the two is demonstrated. **The pricing of the subscriptions**

appears to have been quite rational and explainable using simple financial economic theory.”)

John G. Sperling, *The South Sea Company: An Historical Essay and Bibliographical Finding List*. Available at: <http://pds.lib.harvard.edu/pds/view/2573630?n=9&s=4&printThumbnaills=no> .

Resource: “Sunk in Lucre’s Sordid Charms.” South Sea Bubble resources in the Kress Collection of Baker Library, Harvard University. Available at: <http://www.library.hbs.edu/hc/ssb/> .

APRIL 6: THIRD LECTURE

U.K. Railroads

Gareth Campbell, “The Railway Mania: Not So Great Expectations?.” May 23, 2009. Available at: <http://www.voxeu.eu/index.php?q=node/3598> .

Gareth Campbell, “Bubbling Dividends.” MPRA Paper No. 29840. June 30, 2010. Available at: http://scholar.googleusercontent.com/scholar?q=cache:xlp62Re6Z24J:scholar.google.com/&hl=en&as_sdt=0,9 . (He argues: “Although this period was a bubble in the popular sense of the word, in that there was a substantial asset price reversal, it was not a bubble in the economic sense, as railway shares were not obviously mispriced at the market peak. Prices of railway shares rose by an average of 106% between 1843 and 1845, but the market then crashed, and during a prolonged decline, railway shares fell back below their original value. However, a similar rise and fall also occurred in the dividends paid by the railways. There is evidence that the railways were priced consistently with non-railways throughout the period, given the short-term dividend growth which they were experiencing, and it would have been difficult for anyone to have predicted the extent of the asset price falls that eventually transpired.”)

Gareth Campbell, John D. Turner, and Clive B. Walker. “The Media in a Mania: Newspaper Coverage of the British Railway Mania.” Available at: [Explorations in Economic History](#). Volume: 49 (2012) Issue: 4 (Pages: 461-481.)

(Paper examines the “news media during one of the largest asset price reversals in history, namely the British Railway Mania. Using textual analysis, we find that the nature of news media commentary on the railway market and industry did not affect the market for railway stock. We also find that the negative editorials of the *Times* and *Economist* had little impact on the market. Finally, the amount of coverage received by individual railway companies did not affect the performance of their stocks. Overall, our findings suggest that the news media did not contribute to the asset price reversal.”)

Gareth Campbell and John D. Turner, “The Greatest Bubble in History. Stock Prices during the British Railway Mania.” *Queen’s University Management School Working Paper Series MS_WPS_FIN_10_1*, April 2010. Available at: <http://www.qub.ac.uk/schools/media/Media,260350,en.pdf> .

("The rapid decline in the dividends paid by railway firms during the downturn suggests that changes in cash flows may have been influential in the price falls.")

David Morier Evans, [*Facts, Failures and Frauds: Revelations, Financial Mercantile, Criminal*](#). Originally published in 1859. Nabu Press reprint 2010. Chapter 1 (" 'High Art' Crime – Its Inauguration, Development, and Rapid Progress") and Chapter 2 ("The Rise and Fall of Mr. George Hudson, M.P.").

Dionysius Lardner, *Railway Economy: A Treatise on the New Art of Transport, its Management, Prospects, and Relations, Commercial, Financial, and Social*. London: Harper & Brothers, 1850. ("A contemporary writer on railways, Dionysius Lardner, observed that for the new projects to have been profitable the number of passengers carried on the railways would have had to increase five-fold. Mr. Lardner's observation was both fairly obvious and accurate. But no one listened to him. Instead, the mania ran its course. Railway stocks shed two-thirds of their value after 1845, with the index of shares ending up below where it had been before the first mania commenced in 1835. Railway shareholders, including the Brontë sisters and Charles Darwin, suffered painfully.")

Ed Chancellor, "[Bubbles: A Victorian Lesson in Mania](#)," *Financial Times*, April 11, 2010. Available at: <http://www.ft.com/cms/s/0/b3573436-440b-11df-9235-00144feab49a.html#ixzz18neAQkP2>.)

Andrew Odlyzko, "This Time is Different: An Example of a Giant, Wildly Speculative, and Successful Investment Mania." June 21, 2010. Available at: <http://www.dtc.umn.edu/~odlyzko/doc/mania01.pdf> . ("The railway mania of the 1830s serves as useful antidote to claims that bubbles are easy to detect or that all large and quick jumps in asset valuations are irrational.")

_____. "Collective Hallucinations and Inefficient Markets: The British Railway Mania of the 1840s." January 15, 2010. Available at: <http://www.dtc.umn.edu/~odlyzko/doc/hallucinations.pdf> . ("There were trustworthy quantitative measures to show investors [who included Charles Darwin, John Stuart Mill, and the Brontë sisters] that there would not be enough demand for railway transport to provide the expected revenues and profits. But the power of the revolutionary new technology, assisted by artful manipulation of public perception by interested parties, induced a collective hallucination that made investors ignore such considerations. They persisted in ignoring them for several years, until the lines were placed in service and the inevitable disaster struck.")

For readings on the accounting debate involving John Hudson's railroads:

S. McCartney and A.J. Arnold, "Financial Reporting in the Context of Crisis: Reconsidering the Impact of the 'Mania' on Early Railway Accounting." [*European Accounting Review*, Vol. 11 \(2002\), pp. 401-417](#).

_____. (2003) "The Railway Mania of 1845-1847: Market Irrationality or Collusive Swindle Based on Accounting Distortions?". [*Accounting, Auditing and Accountability Journal*](#), Vol. 16 (2003): 5, pp. 821 – 852.

Crédit Mobilier

Edward Winslow Martin, *Behind the Scenes in Washington: A Complete and Graphic Account of the Crédit Mobilier Investigation*. New York: The Continental Publishing Company and National Publishing Co., 1873. Available at: http://cpr.org/Museum/Credit_Mobilier_1873.html . On reserve at library.

James Surowiecki, "Durant's Big Scam." *New Yorker*, January 2003. Available at: <http://www.pbs.org/wgbh/americanexperience/features/general-article/tcrr-scam/?flavour=mobile> .

Mark Twain. *The Gilded Age*. (1873 novel that satirizes greed and political corruption in post-Civil War America)

U.S. Congress. *Crédit Mobilier. Reports of Committees*. Hard Press, May 2008.

U.S. House of Representatives, "Crédit Mobilier: Report of the Selection Committee of the House of Representatives Appointed under the Resolution of January 6, 1873, to Make Inquiry in Relation to the Affairs of the Union Pacific Railroad Company, the Crédit Mobilier of America, and other Matters Specified in Said Resolution and in Other Resolutions Referred to Said Committee." Washington, D.C.: Government Printing Office, 1873. Available at: <https://archive.org/details/reportofselectco06unit> .

U.S. Senate, "The Expulsion Case of James W. Patterson of New Hampshire (1873) (Crédit Mobilier Scandal)." Available at: http://www.senate.gov/artandhistory/history/common/expulsion_cases/064JamesPatterson_expulsion.htm .

Tamar Frankel, *The Ponzi Scheme Puzzle: A History and Analysis of Con Artists and Victims*. New York: Oxford University Press, 2012.

Robert Shaplen, *Kreuger, Genius and Swindler*. New York: Knopf, 1960.

William H. Stoneman, *The Life And Death Of Ivar Kreuger*. Indianapolis: The Bobbs-Merrill Company, 1932. Available at: <https://archive.org/stream/lifedeathofivark00stonrich#page/n9/mode/2up> .

APRIL 13: FOURTH LECTURE

Robert Sobel, *The Great Bull Market: Wall Street in the 1920s*. New York: Norton, 1968.

John Kenneth Galbraith, *The Great Crash 1929*. New York: Houghton Mifflin, 1954.

Charles M. Jones, "[Shorting Restrictions: Revisiting the 1930's](#)." *The Financial Review* 47 (2012): 1–35.

("Market participants must have driven up prices thinking that restrictions on short sellers would make it more difficult for prices to impound their pessimistic beliefs.... Regulation can improve liquidity by constraining a certain class of market participants. However, this comes at some cost to the constrained parties.... One of the main problems is that it is hard to quantify the costs and benefits.... As events have unfolded, the economic justifications seem less and less likely.")

The Pecora Report. [The 1934 Report on the Practices of Stock Exchanges from the "Pecora Commission."](#) Chapter 2 ("Investment Banking Practices"), pages 83-153, and Chapter 3 ("Commercial Banking Practices"), pages 155-229. Download the full Pecora Report from the PBS Nightly Business Report blog post by Washington Bureau Chief Darren Gersh. Available at: http://www.pbs.org/nbr/blog/2009/01/wall_street_misdeeds_could_mea.html.

Pecora Investigation Hearings (also known as *Stock Exchange Practices. Hearings before the Committee on Banking and Currency Pursuant to S.Res. 84, S.Res. 56, and S.Res. 97*). The full-text of these hearings is posted on the FRASER Website of the Federal Reserve Bank of St. Louis in searchable PDF format. Available at: <http://fraser.stlouisfed.org/publications/sensep/>.

Frank R. Rayburn and Ollie S. Powers, "A History of Pooling of Interests Accounting for Business Combinations in the United States." *Accounting Historians Journal*, Vol. 18, No. 2. Available at: <http://www.accountingin.com/accounting-historians-journal/volume-18-number-2/a-history-of-pooling-of-interests-accounting-for-business-combinations-in-the-united-states/>. (Traces accounting reforms Accounting Principles Board Opinion Nos. 16 and 17)

Richard C. Sauer, *Selling America Short. The SEC and Market Contrarians in the Age of Absurdity*. New York: John Wiley & Sons, 2010. [Chapter 1 \("Theft by Deception: Control Fraud in S&L"\)](#); [Chapter 2 \("Competition in Laxity"\)](#); and, [Chapter 11 \("It's The Things You Do Know, But Aren't So, That Cause Disasters"\)](#). Available on Classes*v2.

APRIL 20: FIFTH LECTURE

"Adam Smith" (aka George J. W. Goodman). *The Money Game*. New York: Vintage, 1976.
Read the entire book.

Maggie Mahar, *Bull: A History of the Boom and Bust, 1982-2004*. New York: Harper, 2004. [Chapter 3 \("The Stage Is Set, 1961-81"\)](#), pages 35-47; [Chapter 4 \("The Curtain Rises, 1982-87"\)](#), pages 48-60; and [Chapter 5 \("Black Monday, 1987-89"\)](#), pages 61-77. Available on Classes*v2.

Abraham J. Briloff. *The Truth about Corporate Accounting*. New York: Harper Collins, 1981. (Available on course reserve at CSSI.)

_____. *Unaccountable Accounting*. New York: Harper & Row, 1972. (Available on course reserve at CSSI.)

FDIC, The S&L Crisis: A Chrono-Bibliography. Available at: <http://www.fdic.gov/bank/historical/s%26l/index.html> .

Economist, "Drexel Burnham Lambert's legacy: Stars of the Junkyard." October 21, 2010. Available at: <http://www.economist.com/node/17306419> . ("Twenty years after Michael Milken's junk-bond firm came crashing down, the financial revolution that it fostered lives on.")

James Grant, *Minding Mister Market: Ten Years on Wall Street with Grant's Interest Rate Observer*. New York: Three Rivers Press, 1994. ["A Thrift for Our Time", pages 128-134](#); ["Part Six: Adventures in Leverage," pages 237 – 287](#). Available on Classes*v2.

Stephen R. Moehrle and Jennifer A. Reynolds-Moehrle, "Say Good-Bye to Pooling and Goodwill Amortization. Will FASB's new standards for business combinations cause big changes?" *Journal of Accountancy*, September 2001. Available at: <http://www.journalofaccountancy.com/Issues/2001/Sep/SayGoodByeToPoolingAndGoodwillAmortization.htm> .

Glenn Yago, *Junk Bonds: How High Yield Securities Restructured Corporate America*. New York: Oxford University Press, 1991. ("Far from being the scourge of the capital markets or a 'betrayal of capitalism,' junk bonds have been associated with rapid growth in sales, productivity, employment, and capital spending. High yield firms have consistently outpaced their industries in these and other key performance areas.")

Film: Oliver Stone, "Wall Street." 1987. A young and impatient stockbroker is willing to do anything to get to the top, including trading on illegal inside information taken through a ruthless and greedy corporate raider who takes the youth under his wing. (Gordon Gekko: "greed is good.") Available on reserve at the Yale Film Study Center, 53 Wall Street, Room B17.

Film: "The Boiler Room." 2000. Based on interviews of those working for Stratton Oakmont and other "pump and dump" securities firms, the film shows how brokers created artificial demand in stocks of fake or bankrupt companies. Available on reserve at the Yale Film Study Center, 53 Wall Street, Room B17.

Film: Martin Scorsese, "The Wolf of Wall Street." 2013. Based on the memoirs of Jordan Belfort, the founder of the boiler room Stratton Oakmont. Available on reserve at the Yale Film Study Center, 53 Wall Street, Room B17.

Business Week, "Why Dow 36,000 is Probably a Fantasy." September 17, 1999. Available at: www.businessweek.com.

John Cassidy, *Dot.Con: The Greatest Story Ever Sold*. New York: HarperCollins, 2002. [Chapter 1 \("Popular Capitalism"\), pages 25-36](#). [Chapter 2 \("New Economy"\), pages 150-165](#). [Chapter 20 \("Crash"\), pages 279-294](#). [Chapter 21 \("Dead Dotcom"\), pages 295-312](#). Available on *Classes*v2*.

John C. Coffee, "What Caused Enron?: A Capsule Social and Economic History of the 1990's." *Columbia Law and Economics Working Paper No. 214*. Available at: <http://ssrn.com/abstract=373581> or doi:10.2139/ssrn.373581 . ("Between January 1997 and June 2002, approximately 10% of all listed companies in the United States announced at least one financial statement restatement. The stock prices of restating companies declined 10% on average on the announcement of these restatements, with restating firms losing over \$100 billion in market capitalization over a short three day trading window surrounding these restatements." Coffee outlines several plausible explanatory narratives: the "gatekeeper story" in which the auditors, analysts, debt-rating agencies, and regulators failed, failures which Sarbanes-Oxley was intended to address; the "misaligned incentives story" that shows how a shift to equity-based compensation incited management to inflate earnings and create short-term price spikes; and, the "herding story," in which incentives force investors to focus on quarterly performance and "ride the bubble.")

Economist, "[Bubble Trouble: And What Policymakers Should Do about It](#)." May 16, 2002.

James Glassman and Kevin A. Hassett, "Dow 36,000." *The Atlantic*. September 1999. Available at: <http://www.theatlantic.com/past/docs/issues/99sep/9909dow.htm> . ("Stocks were undervalued in the 1980s and early 1990s, and they are undervalued now. Stock prices could double, triple, or even quadruple tomorrow and still not be too high.")

Roger Lowenstein, *Origins of the Crash*. New York: Penguin, 2004. Chapter 1 ("Origins of a Culture"), [pages 1 – 14](#). [Chapter 10 \("Epilogue"\), pages 217-227](#). Available on *Classes*v2*.

Mark Maremont, "[How is Tyco Accounting for Its Cash Flow?](#)" *Wall Street Journal*, March 5, 2002.

Catherine S. Neal, *Taking Down the Lion*. New York: Palgrave Macmillan, 2013. "Kozlowski is a better person than the guy portrayed in the media for the past eleven years. We must remember that not everything we read is accurate. Sometimes, things are written simply to sell more newspapers or to get more online hits. Perhaps it's time to give Dennis Kozlowski a break — allow him to rebuild his life without any further public castigation, name-calling, and

mischaracterizations.” A group of "hunters," led by veteran Manhattan district attorney Robert Morgenthau, set out to take down Kozlowski — "the lion," she writes. “Throughout,” writes FT Management Editor Andrew Hill in a review, “she points the finger at almost everyone other than Kozlowski.” *On reserve at CSSI.*

Roberta Romano, “Does the Sarbanes-Oxley Act Have a Future?” May 14, 2009. *Yale Law and Economics Research Paper No. 385*. Available at: <http://ssrn.com/abstract=1404967>. (“Although the enactment of the Sarbanes-Oxley Act (SOX) received nearly unanimous congressional support, only a few years thereafter its wisdom was increasingly questioned and its supporters had to stave off attempts to redraft the legislation. The financial crisis of 2008 has sidelined efforts to alter the legislation’s most costly provision, as Congress’s attention has turned to overhauling the regulatory regime for financial institutions. **There is, nonetheless, much to be learned about financial regulation and SOX’s future, from an in-depth examination of the interplay of the government and private commissions created with an eye to revising the legislation, media coverage of those entities, and congressional responses. That interaction provides a map of political fault lines and assists in forecasting the prospects for redrafting SOX’s most costly provision. It also serves as a cautionary tale regarding significant regulation enacted in the midst of a financial market crisis.** The ongoing financial crisis has sidelined SOX, but its burdensome costs suggest that it might well, in due course, reemerge on the legislative agenda.”)

Razaee/Riley- 2010. [Enron: 3, 9, 11, 12, 13, 14, 18, 25, 27, 28, 30; WorldCom: 3, 6, 9, 13, 14, 28, 29, 33, 51, 68.](#)

M. Useem, “[What Tyco Tells Us.](#)” *Wall Street Journal*, June 5, 2002.

Film: “The Smartest Guys in the Room.” 2005 documentary based on the book of the same name. *Available on reserve at the Yale Film Study Center, 53 Wall Street, Room B17.*

APRIL 27: SIXTH LECTURE

Clive R. Boddy, “Corporate Psychopaths Theory of the Global Financial Crisis.” *Journal of Business Ethics* (2011) 102:255–259 (“This short theoretical paper elucidates a plausible theory about the Global Financial Crisis and the role of senior financial corporate directors in that crisis. The paper presents a theory of the Global Financial Crisis which argues that psychopaths working in corporations and in financial corporations, in particular, have had a major part in causing the crisis.” Column by: William D. Cohan, “Did Psychopaths Take Over Wall Street Asylum?” Bloomberg, January 3, 2012. <http://www.bloomberg.com/news/2012-01-03/did-psychopaths-take-over-wall-street-asylum-commentary-by-william-cohan.html> .)

Emanuel Derman, *Models Behaving Badly: Why Confusing Illusion with Reality Can Lead to Disaster on Wall Street and in Life*. New York: Free Press, 2011.

David Einhorn, *Fooling Some of the People All of the Time*. New York: John Wiley & Sons, 2011. [Chapters 5 \(“Dissecting Allied Capital”\), 6 \(“Allied Talks Back”\), 8 \(“You Have to Be Kidding Me Method of Accounting”\), and 35 \(“Looking Back As the Story Continued”\).](#)

Michael Lewis, *The Big Short*. New York: Norton, 2010. *Available on course reserve at CSSSI.*

Michael Lewis and David Einhorn, “The End of the Financial World as We Know It,” *New York Times*, January 3, 2009. Available at: http://www.nytimes.com/2009/01/04/opinion/04lewiseinhorn.html?_r=1&pagewanted=all.

Andrew Palmer, “Playing with Fire: Special Report: Financial Innovation.” *The Economist*, February 25, 2012. Available at: www.economist.com/node/21547999 .

Frank Partnoy and Jesse Eisenger, “What’s Inside America’s Banks?”, *The Atlantic*, January-February 2013. Available at: http://www.theatlantic.com/magazine/archive/2013/01/whats-inside-americas-banks/309196/?single_page=true . (“Sophisticated investors describe big banks as ‘black boxes’ that may still be concealing enormous risks—the sort that could again take down the economy. A close investigation of a supposedly conservative bank’s financial records uncovers the reason for these fears—and points the way toward urgent reforms.”)

Carmen M. Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*. Princeton: Princeton University Press, 2011. [Part One \(“Financial Crises: An Operational Primer”\).](#)

Christine S. Richard, *The Confidence Game. How Hedge Fund Manager Bill Ackman Called Wall Street’s Bluff*. New York: Bloomberg Press, 2011. [Chapter 2 \(“The Short Seller”\), pages 9-24. Chapter 24 \(“Judgment Day”\), pages 271-280. Chapter 25 \(“Nuclear Threat”\), pages 281-291. “Epilogue”, pages 293-300.](#) Available on Classes*v2.

Hussein Tarraf, “Literature Review on Corporate Governance and the Recent Financial Crisis.” December 27, 2010. Available at: <http://ssrn.com/abstract=1731044> .

Gillian Tett, *Fool’s Gold*. New York: Free Press, 2010. [Chapter 10 \(“Tremors”\), pages 143-164.](#) Available on Classes*v2.

Amir Amel-Zadeh and G. Meeks, “Bank Failure, ‘Mark-to-Market and the Financial Crisis.’ ” November 1, 2011. Available at: <http://ssrn.com/abstract=1494452> . (“Two of the most prominent bank failures cannot, at first sight, be attributed to fair value accounting: we show that Northern Rock was balance sheet solvent, even on a fair value basis, as was Lehman Brothers. The anecdotal evidence is augmented by empirical tests that suggest that daily mark-to-market risk does not increase the perceived bankruptcy risk of banks which is rather explained by constraints in the interbank lending market. Moreover, we do not find evidence that fair value accounting introduced pro-cyclical bank balance sheets or market externalities.”)

Roger Lowenstein, *The End of Wall Street*. New York: Penguin Press, 2010. Available on course reserve at CSSI

Gretchen Morgenson and Joshua Rosner, *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to the Economic Armageddon*. New York: Times Books, 2011. Available on course reserve at CSSI

Lord Adair Turner. *The Turner Review: A Regulatory Response to the Global Banking Crisis*. London: Financial Services Authority, March 2009. Read: "1. What Went Wrong?", pages 11-28; "1.4. Fundamental theoretical issues," pages 39-49. Available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf .

_____. Speech to the South African Reserve Bank, November 2, 2012. Available at: <http://www.fsa.gov.uk/static/pubs/speeches/1102-at.pdf> . "...the existence of banks as we know them today – fractional reserve banks – exacerbates these risks because banks can create credit and private money, and unless controlled, will tend to create sub-optimally large or sub-optimally unstable quantities of both credit and private money."

Film: "Inside Job" won an Oscar for best documentary movie. Written and directed by Charles Ferguson and narrated by Matt Damon, the film exposes the problems leading to the financial meltdown and the roots of the causes in the incestuous relationships among investors, journalists, academics, and politicians. Available on reserve at the Yale Film Study Center, 53 Wall Street, Room B17.

MAY 4: SEVENTH LECTURE

Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*. Princeton: Princeton University Press, 2013. (Argues that banks operate with vastly insufficient levels of equity capital relative to their assets.) Available on course reserve at CSSI.

Basel Committee on Banking Supervision, "The interplay of accounting and regulation and its impact on bank behaviour: Literature review." *Working Paper 28*. January 2015. Available at: <http://www.bis.org> .

Claudio Borio, "The Financial Cycle and Macroeconomics: What Have We Learnt?" *BIS Working Paper No. 395*. December 2012. Available at: <http://www.bis.org/publ/work395.htm> .

John Cassidy, "The Volcker Rule: Obama's Economic Adviser and His Battles over the Financial-Reform Bill." *New Yorker*, July 26, 2010. Available at: http://www.newyorker.com/reporting/2010/07/26/100726fa_fact_cassidy .

William D. Cohan, *Money and Power. How Goldman Sachs Came to Rule the World*. New York: Doubleday, 2011. Available on course reserve at CSSI.

Economist, “Special report: Europe and its currency. Staring into the abyss.” November 12, 2011.

Jesse Eisinger, “For One Whistle-Blower, No Good Deed Goes Unpunished.” *ProPublica*, June 1, 2011. Available at:

<http://www.propublica.org/thetrade/item/for-one-whistle-blower-no-good-deed-goes-unpunished> .

Niall Ferguson, “Fiscal Crises and Imperial Collapses: Historical Perspective on Current Predicaments.” May 13, 2010. Available at:

<http://www.piie.com/publications/papers/niarchos-ferguson-2010.pdf> .

Erik F. Gerding, *Law, Bubbles, and Financial Regulation*. New York: Routledge, 2014.

Chapter One (“The Regulatory Instability Hypothesis”). Available at:

<http://ssrn.com/abstract=2359729> . He “outlines how financial regulation can fail when it is needed the most. The dynamics of asset price bubbles weaken financial regulation just as financial markets begin to overheat and the risk of crisis spikes. At the same time, the failure of financial regulations adds further fuel to a bubble.”

Gary B. Gorton, *Misunderstanding Financial Crises: Why We Don't See Them Coming*. New York: Oxford University Press, 2012.

Christian Laux and Christian Leuz, “Did Fair-Value Accounting Contribute to the Financial Crisis?” October 12, 2009. *Chicago Booth Research Paper 09-38; ECGI - Finance Working Paper No. 266/2009; Journal of Economic Perspectives*, Forthcoming. Available at:

<http://ssrn.com/abstract=1487905> .

(“Many critics have argued that fair-value accounting, often also called mark-to-market accounting, has significantly contributed to the financial crisis or, at least, exacerbated its severity. In this paper, we assess these arguments and examine the role of fair-value accounting in the financial crisis using descriptive data and empirical evidence. Based on our analysis, it is unlikely that fair-value accounting added to the severity of the 2008 financial crisis in a major way. While there may have been downward spirals or asset-fire sales in certain markets, we find little evidence that these effects are the result of fair-value accounting. We also find little support for claims that fair-value accounting leads to excessive write-downs of banks’ assets. If anything, empirical evidence to date points in the opposite direction, that is, towards overvaluation of bank assets.”)

Ross Levine, “The Governance of Financial regulation: Reform Lessons from the Recent Crisis.”

Bank for International Settlement Working Paper No. 329. November 2010. Available at:

<http://www.bis.org/publ/work329.htm> .

(“There was a systemic failure of financial regulation: senior policymakers repeatedly enacted and implemented policies that destabilized the global financial system. . . . The crisis does not primarily reflect an absence of regulatory power, unclear lines of regulatory authority, capital account imbalances, or a lack of information by regulators. Rather, it represents the unwillingness of the policy apparatus to adapt to a dynamic, innovating financial system.”)

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