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Economic & Business Focus

The High Cost Of Corporate Crime

Financial scandals have cost investors more than the events of September 11, the war on terrorism and Middle East crises combined.

As India and Pakistan stood on the brink of nuclear war last spring, the Bombay benchmark market fell 9 percent and the Karachi stock exchange fell 14 percent — perilous drops, but less precipitous than the 20 percent decline in U.S. markets caused by this year's corporate scandals. In fact, the combined effects of the World Trade Center attacks, the war on terrorism, and the crises raging in Southern Asia and the Middle East have done less damage to the U.S. economy than the spate of corporate accounting and reporting scandals that began with Enron and climaxed in the WorldCom collapse in July.

U.S. companies have been whipsawed by the double blow of increased political and financial risks worldwide. But in the final analysis, the economic damage caused by the enemy within far exceeds damage from external sources. The "terrorists in the boardroom," as some commentators call them, pose a greater threat to

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U.S. Risks Grow

100 = LEAST RISKY

	JULY 2002	MAY 2001
UNITED ARAB EMIRATES	77.0	80.0
CZECH REPUBLIC	78.5	79.0
UNITED STATES	78.5	90.0
HONG KONG	80.0	79.5
ITALY	80.0	83.0
FRANCE	80.5	80.0
SLOVENIA	80.5	81.5
SPAIN	83.0	82.0
JAPAN	85.5	88.0
CANADA	86.5	91.0
GERMANY	86.5	88.0
UNITED KINGDOM	88.0	92.5
SINGAPORE	89.0	89.5
NETHERLANDS	91.0	96.5
SWEDEN	92.0	93.0
IRELAND	92.5	90.5
SWITZERLAND	92.5	93.0
LUXEMBOURG	95.0	94.5

SOURCE: INTERNATIONAL COUNTRY RISK GUIDE

corporate success than the terrorists who destabilize governments. With this grim equation in hand, CFOs are taking a new look at risk management.

Impact of the Scandals

Michael Burt, senior economist at research firm Economy.com Inc. in West Chester, Pa., says the corporate scandals have directly damaged the U.S. economy through three primary channels:

1. Loss of investor wealth. The Wilshire 5000 index, a good proxy for the value of all publicly traded stocks, dropped in July to levels below those reached in the darkest days just after the World Trade Center attacks.

"This represents a loss of more than $2 trillion in wealth since the beginning of this year and a decline of approximately $6 trillion in wealth since the market's peak in early 2000," Burt says. "Now that equity prices are expected to grow at a much more subdued pace going forward, growth in consumer spending will weaken as well."

2. Decline of the dollar. "Although the dollar was generally perceived to be overvalued, and the massive current account deficit (more than 4 percent of GDP) indicated that a decline was inevitable, the accounting scandals triggered the dollar's decline," Burt notes. The trade-weighted dollar has fallen by more than 5 percent since its peak and by even more against some major currencies as foreign investors have lost confidence in the U.S. market. This may be beneficial to export-dependent industries, he says, but a weaker dollar can also lead to higher inflation, which reduces consumers' spending power.

3. Capital allocation. Accounting scandals have reduced the attractiveness of corporate bonds and equities, while current interest rates have lowered real returns on money market accounts to almost zero. As a result, Burt reports, mortgage rates have dropped to near-record lows, feeding a frenzy of home buying and building and leading to unstable home price appreciation. "Median home prices remain in line with median incomes, but continued home price appreciation above the rate of income growth will lead to a housing bubble forming," he says.

Another casualty of the accounting scandals, foreign direct investment (FDI) in the United States fell from its peak of $301 billion in 2000 to $124 billion in 2001 and is dropping even more rapidly this year. Economists estimate that 2002 may close with less than $50 billion in total FDI.

Impact of Terrorism

The terrorist attacks and the resulting political risks have had a more muted effect, although the federal government and the travel and insurance industries have been hit hard. Over the past 18 months, the federal budget has swung by more than $300 billion, from a sizable surplus to a large deficit. "The terrorist attacks and their impact on the economy directly account for approximately one-third of this change," Burt says. Economy.com estimates that travel-related industries lost more than $10 billion in output as a result of the attacks. And insurance companies were forced to pay approximately $40 billion in claims. "While reinsurance spread this risk sufficiently to prevent any one company from going bankrupt, the attacks have led to significant changes within the industry," Burt reports.

"Terrorism is a real and present danger to American society," says Lloyd Jeff Dumas, professor of economics at the University of Texas at Dallas, "but as long as there is no extended series of devastating terrorist attacks, terrorism will be read by business in general as adding some costs — including shipping delays, increased security and insurance costs — to the normal costs of doing business. These costs will be absorbed accordingly. That is how businesses in other parts of the world have reacted to 'low intensity' terrorism in the past — for example, in Great Britain."

The threat of terrorism has already created, and will continue to create, profitable opportunities for some industries and companies at the same time it hurts profits in other industries, Dumas says.

Risk Factors

Finance professors John Graham and Campbell Harvey at Duke University's Fuqua School of Business analyze the relationship between the risk of doing business in a particular country and return on equity within that nation. The U.S.'s risk rating fell from 90 to 80 (100 represents the lowest level of risk) after September 11. Graham and Harvey found that this change corresponded to a 200 basis point increase in the risk premium on equity here.

By late spring 2002, the U.S. risk rating was recovering and approaching 90 again. Then the accounting scandals multiplied, and it dropped to 78.5 — the same level as the Czech Republic and

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Taiwan. "In our estimation, the risk premium [for equity investments] has increased approximately 200 basis points due to increased accounting risk," Graham reports. (See *U.S. Risks Grow* on page 8.)

"Market volatility coupled with high-profile corporate defaults have caused firms of all sizes to reevaluate how they achieve consistent results," says Jane Hiscock, vice president at Barra Inc., a Berkeley, Calif.-based investment risk management firm. "Stung by poor returns, investors are more cautious, and risk is on everyone's mind. Risk management is no longer optional; it is essential.

"Today's chief investment officers are looking for ways to avoid surprises," Hiscock adds. "By making risk the critical component of the risk/reward equation, investors can better understand where their risks reside and make informed investment decisions."

Risk Management

For the past five years, CFOs have engaged in discussions of enterprise risk management. "There has been a lot of talk," says Thomas Conway, consulting actuary and partner in the North American actuarial services group of Ernst & Young LLP in Chicago, "but not a lot of traction. The ongoing concerns raised by September 11, combined with the new concerns raised by the corporate scandals, tie in to the new enterprise risk management approach, as CFOs attempt to get a clear picture of the universe of risks they face." Conway reports that a number of major companies have created a new chief risk officer (CRO) position to manage risk across the enterprise.

"Now CFOs see the value of managing risk to reputation and brand name, especially in the wake of Arthur Andersen, where a company was destroyed almost overnight," he notes. "They are also looking at risks related to 401(k) investments and how companies are directing their employees with respect to allocations. They are looking closely at D&O insurance. Prices are hardening, but there is more attention to adequate coverage in this area."

In the past, companies managed insurable risk by buying as much insurance as they could, Conway says. "Now they are more willing to accept risk where they have control over the processes. They are taking more of an investor's perspective and looking at what they are paying for coverage in each area. This new perspective is driven by higher insurance costs and by the fact that more midsize companies are evaluating their coverage." As companies take on more insurance in areas such as D&O, they are shifting to lower levels of coverage in areas such as workers' compensation and general liability, Conway reports.

– Fay Hansen

Expense Management

Putting Computers on Snooze

Computers and monitors — companies' biggest devourers of energy in terms of office equipment — need to be put to sleep when they're not in use. The EPA estimates that 45 percent of the nation's monitors are not taking advantage of power management technologies, costing U.S. businesses and organizations about $900 million a year.

Energy Star, a program managed by the EPA, is helping companies eliminate energy waste by providing software that switches monitors into a low-power sleep mode during periods of inactivity. Businesses benefit because they pay utilities only for the time that the computers are in use. According to the EPA, for every 1,000 monitors that are enabled with a power management tool, a company can save about 200,000 kilowatt hours (kWh) and about $17,000 in energy bills per year.

To simplify power management, Energy Star created two pieces of software. EZ Save watches the activity level of every computer on a network from a central location and puts those not in use to sleep. And EZ Wizard helps individuals equip their own desktops with power management software. Both can be downloaded at no cost from www.energystar.gov/powermanagement.

Cisco Systems, Agere Systems and Pitney Bowes are among the business leaders supporting the power management initiative. When Cisco's California office installed an Energy Star application that manages the energy consumption of 20,000 monitors, the implementation required only 16 hours of staff time. The software is now saving Cisco 3.4 million kWh of electricity, and about $528,000, annually.

Based on this initial success, Cisco is expanding the program to 30,000 additional monitors in other offices. The combined savings from the "sleeping" monitors will be 8.5 million kWh — enough energy to power about 10,000 U.S. households for one month — and about $1 million per year.

– Laurie Brannen