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Corporate Accounting Crises in the USA 2002

A Study of Possible Effects on Swedish Companies

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ABSTRACT

During the past year there have been several companies in the USA that have used different doubtful accounting methods. These cases have caused a heated debate in the USA and have led to changes in accounting and corporate governance regulation.

The purpose of this thesis is to find out if and how the accounting cases in the USA will affect Swedish companies through changes in accounting and corporate rules and regulations in Sweden.

In this thesis, Enron and WorldCom are used as representatives for the recent accounting cases in the USA, and four areas that have been discussed in relation to these companies are studied. The areas are: consolidation, financial derivatives, expenditures and corporate governance. In order to find out the possible changes in Swedish regulation of the four areas selected, we have conducted interviews with auditors.

The study shows that there will probably not be many changes in the Swedish regulation of accounting and corporate governance, following the recent accounting cases in the USA. The conclusion is, therefore, that the recent accounting cases in the USA will not affect Swedish companies to a great extent. However, in some areas there could be consequences for Swedish companies, primarily due to changes in the regulation of corporate governance.

Keywords: US Accounting Cases, Consolidation, Financial Derivatives, Expenditures, Corporate Governance, Swedish Regulation

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Göteborg, December 2002

Anna Blomberg Johanna Larsson

LIST OF ACRONYMS AND ABBREVIATIONS

ABL	The Companies Act (Aktiebolagslagen)
ARB	Accounting Research Bulletin
BFL	The Book-keeping Act (Bokföringslagen)
BFN	Swedish Accounting Standards Board (Bokföringsnämnden)
CEO	Chief Executive Officer
CFO	Chief Financial Officer
EU	European Union
FAR	Swedish Institute of Authorised Public Accountants (Föreningen Auktoriserade Revisorer)
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FI	Swedish Financial Supervisory Authority (Finansinspektionen)
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
NYSE	New York Stock Exchange
PRV	Patent and Registration Office (Patent- och Registreringsverket)

RR	Swedish Financial Accounting Standards Council (Redovisningsrådet)
SEC	Securities and Exchange Commission
SIC	Standing Interpretations Committee
SPE	Special Purpose Entity
ÅRL	The Annual Accounts Act (Årsredovisningslagen)

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APPENDICES

1. INTRODUCTION

In this chapter we present the subject of the thesis. First, there is a discussion of the problem, followed by a presentation of the purpose of the thesis. We also present the delimitations and the perspective of the thesis. Finally, there is a thesis outline in order for the reader to see the structure and follow the main thread of the thesis.

1.1 Problem

In an increasingly competitive environment it is important for companies to present a good picture of themselves. Naturally, companies look for ways to improve their figures. During the past year there have been several cases in the USA where companies have used different doubtful methods in their accounting in order to present the company in a more favourable way. Some of the cases have revealed that large multinational companies, which seemed very prosperous, had circumvented and even broken the accounting rules. The market lost its trust in the companies, which eventually led to big losses and, in some cases, even bankruptcy. Many people were affected by these cases, for example, many lost their jobs and pensions and shareholders lost their investments.

The recent accounting cases have caused a heated debate regarding the credibility of companies' accounting and the need for stricter regulation to make sure that companies present themselves correctly. The cases have also caused discussions regarding corporate governance and whether the existing regulation in this area is sufficient. Several organisations in the USA have already taken precautions, such as incentives for changing accounting rules and improving corporate governance, to try to prevent similar things from happening again.

The recent accounting cases in the USA, and the discussion that followed, attracted our attention and we thought it would be interesting to study the problem further. Since there have been changes made in the USA, due to these cases, we would like to find out if there will be changes in Sweden as well, and

how this will affect Swedish companies. Based on this we have formulated the research problem, which is stated below:

- Will the recent accounting cases in the USA affect Swedish companies, through changes in accounting and corporate rules and regulations in Sweden?

In order to clarify the research problem, we have formulated some more specific questions.

- What are the changes in the accounting and corporate rules and regulations in the USA due to the recent accounting cases?

- Will any changes take place in Sweden due to these cases?

- If so, will the changes in Sweden be similar to those in the USA?

1.2 Purpose

The purpose of the thesis is to find out if and how the accounting cases in the USA will affect Swedish companies through changes in accounting and corporate rules and regulations in Sweden.

1.3 Delimitation

The accounting cases that serve as a starting point for the thesis are Enron and WorldCom. We have chosen these two companies since they, in our opinion, are the cases that have been most discussed and subsequently are major reasons for the changes in accounting and corporate rules and regulations in the USA.

As it is not possible for us to study all areas related to the two accounting cases, we have selected certain issues that we believe the debate has mostly been focused on. These areas are: consolidation, financial derivatives, expenditures and corporate governance.

We have chosen to study a time period of one year. The period starts in October 2001, when the first accounting case, Enron, was revealed, and ends in October 2002, at the start of the thesis writing. We have not included any information that has been issued after this time.

We have limited our study to only be applicable to Swedish public limited companies. This is due to the fact that we believe that it is mostly these companies that would be affected by changes in the Swedish regulation, since most of the accounting regulation and corporate governance rules apply to this kind of company. Therefore, when referring to Swedish companies in the thesis, this means public limited companies.

In order to find out possible consequences for Swedish companies, we have chosen to interview five auditors, as representatives for the audit profession.

1.4 Perspective

The perspective of the thesis is that of Swedish public limited companies. Since it is the companies that will be mostly affected by possible changes in accounting and corporate rules and regulations in Sweden, we want to study the changes from their point of view.

1.5 Thesis Outline

The thesis is structured as follows:

Introduction – this chapter provides a brief discussion of the research problem of the thesis. Also, it includes the purpose, delimitation, perspective and thesis outline.

Methodology – this chapter describes the methods used in the research. In connection with the different methods, it is outlined why we have chosen these methods.

Background – in this chapter we provide a background to the research problem. It gives a description of the two companies, Enron and WorldCom, which we have used as a starting point in our thesis work. It also describes the accounting and corporate governance issues that have been discussed in relation to these companies.

Theoretical Framework – this chapter outlines the theory that serves as a base throughout the thesis. It provides the theory connected to the Swedish regulation of four areas of accounting and corporate governance relating to the two companies described in the background. The areas that are studied are consolidation, financial derivatives, expenditures and corporate governance.

Empirical Research – this chapter contains a description of the changes that have been made in the USA, due to the recent accounting cases, in the areas of consolidation, financial derivatives, expenditures and corporate governance. It also contains the results of the interviews, which were conducted to find out possible changes in Swedish regulation in these areas.

Analysis – in this chapter we tie together our empirical findings with the theory outlined in the thesis in order to make an analysis of possible consequences for Swedish companies due to the recent accounting cases in the USA. This part serves as a basis for our conclusions.

Concluding Discussion – this chapter contains the conclusions that we have drawn from the analysis. The conclusions will try to give an answer to the research problem. In the chapter there are also suggestions for further research in areas related to the thesis subject.

List of References – this chapter contains a list of the literature, articles and reports, accounting regulation, Internet sites, interviews and other sources that are used in the thesis.

2. METHODOLOGY

This chapter contains the concepts of methodology that are applied in the thesis. It provides a brief description of the concepts and in relation to this an explanation is given as to why these concepts are used.

2.1 Scientific Approach

According to Wiedersheim-Paul and Eriksson (1997), there are two main ways of approaching a scientific problem: positivism and hermeneutics.

The concept of positivism is built upon formal logic and facts, which are the results of measurements. From this a theory is formed which in turn is used to test different hypotheses. By using the hermeneutic approach the researcher aims to get a holistic picture of the scientific problem. This approach is very much connected to the researcher's own interpretations (Wiedersheim-Paul and Eriksson 1997).

The thesis is written using a hermeneutic approach, as the purpose of the study is to interpret and understand a situation rather than describe it. We aim to gain a holistic picture of the consequences for Swedish companies following the recent accounting cases in the USA. The study will not form a theory based on facts and therefore the positivistic approach is not suitable.

2.2 Research Approach

When conducting research there are different research approaches. Two of these are the descriptive approach and the explanatory approach.

The descriptive approach is useful when a problem is clearly defined but there is no intention of examining the cause and effects. The researcher who uses this approach tries to get an exact answer to a problem (Wiedersheim-Paul and Eriksson 1997).

The explanatory approach is suitable when the purpose of a research is to study relations between cause and effect. Using this research approach, the problem structure should be clearly defined and there should also be hypotheses and assumptions that a certain factor affects another (Wiedersheim-Paul and Eriksson 1997).

The thesis is written using a descriptive approach as well as an explanatory approach. The theoretical part of the thesis has a descriptive approach since we give a description of accounting and corporate governance rules and regulations in Sweden. This is a necessity, as it serves as a basis for the empirical study. The first part of the empirical research is also carried out using a descriptive approach. This approach is suitable since we want to describe the changes that have been made in the USA. In the second part of the empirical research we use an explanatory approach. This is the necessary approach, as it is a study of the relation between cause and effect; we want to explain if and how Swedish companies will be affected by the changes in accounting and corporate governance rules and regulations.

2.3 Research Method

There are two methods to use when conducting a scientific research: the qualitative method and the quantitative method (Holme and Solvang 1991).

The qualitative method is used when the researcher wants to achieve a deeper understanding of a research problem. When using this method a large amount of information is gathered using just a few research units. The researcher's aim is to obtain a holistic picture of the context of the problem (Holme and Solvang 1997). This method is useful when a description of a problem is needed rather than the frequency of its occurrence (Repstad 1988).

The quantitative method is more formalised and structured than the qualitative method (Holme and Solvang 1991). When using a quantitative method, information is gathered from several research units to obtain a general understanding of a research problem. Statistic measurement and hence the figures are of importance in using this method (Holme and Solvang 1997). The

researcher is measuring the scope of an occurrence rather than describing it (Merriam 1994).

The research method for this study is the qualitative method. This method is used as the study aims to gain a profound and holistic picture of the research problem. We want to see the consequences for Swedish companies in four main areas, consolidation, financial derivatives, expenditures and corporate governance, rather than study general effects. Also, in-depth interviews are carried out with a few respondents to obtain more profound information.

2.4 Data Collection

Data that is collected for a study can be of two kinds. Primary data is data that the researcher collects from original sources for the specific study. Secondary data is data that already exists since someone else has collected it for another purpose. It is easier and more cost efficient to use secondary data, which is the reason why this data often is used first (Wiedersheim-Paul and Eriksson 1997).

An example of primary data is the result of interviews. Interviews are carried out to find out what cannot be observed directly. The purpose of interviews is to make it possible to hold the perspective of another person (Patton 1984 see Merriam 1994). Interviews can be structured, partly structured or unstructured. In the structured interview the questions are predetermined and the order of the questions is decided in advance. This type of interview can be useful when the researcher aims to obtain quantitative results, for example in a survey. From partly structured interviews the researcher wants to obtain certain information from all respondents. This kind of interview makes it possible for the researcher to be flexible and adjust the interview to the situation as it develops. Unstructured interviews are suitable when the researcher does not have enough knowledge about a specific issue to be able to ask relevant questions. This kind of interview is very exploratory as there are no formulated questions (Merriam 1994).

This study is carried out using both primary and secondary data. The theoretical part of the thesis is based on secondary data, collected through literature, accounting standards, etc. The first part of the empirical research is also based

on secondary data collected through written regulation and different Internet sources.

The second part of the empirical research is based on primary data, as this part contains the results of interviews with auditors. Since the objective of the interviews is to obtain the respondents' views on certain issues, the interviews are partly structured. They are based on a questionnaire with rather open questions, which enables the respondents to discuss the issues and also add what they consider of importance. A structured interview would not be suitable since this is a qualitative study and the aim is not to quantify the result. Also, an unstructured interview would be unsuitable as there are certain specific issues that need to be covered by all respondents. Prior to the interviews the respondents received a letter and a questionnaire in Swedish, which served as the base for the interviews[1].

2.5 Sample

To gather information for the background, we have searched in the library databases and on the Internet, using the search words "Enron" and "WorldCom". We found an enormous amount of material relating to these two companies. As it would be impossible to study all this material, we have made a selection to study the articles that we consider are most relevant.

The sources used in the theoretical framework were selected through searches in the library databases. We have searched for material relating to the four different areas covered in the chapter: consolidation, financial derivatives, expenditures and corporate governance. We have selected the literature and the written regulation that we find are of importance to the thesis.

To gather information for the first part of the empirical research we studied articles to find out if there were any changes made in the accounting and corporate governance rules and regulations in the USA and what these changes were. We also received suggestions regarding this from our tutor. We then

[1] See Appendix I.

selected relevant information regarding the changes in the four areas outlined in the theoretical framework.

The second part of the empirical research is based on interviews with auditors. The auditors have been selected by different criteria. Mikael Winkvist was selected as he is an accounting expert and works with questions relating to US Generally Accepted Accounting Principles (GAAP). Hamish Mabon, Peter Markborn and Carl-Eric Bohlin were selected since they are all members of the Accounting Committee of the Swedish Institute of Authorised Public Accountants (FAR)[2]. Björn Grundvall was recommended to us by our contact, Staffan Landén, at Ernst & Young.

2.6 Research Evaluation

2.6.1 Validity

The concept of validity can be defined as the ability for an instrument to measure what it is intended to measure. There are two different kinds of validity: internal and external. Internal validity expresses to what extent the result of a scientific research is reflecting the reality (Merriam 1994). External validity indicates to what extent the result of a scientific research is applicable in other situations than the situation in which the research is conducted (Guba and Lincoln 1981 see Merriam 1994).

In our opinion, the thesis has a high level of internal validity. We base this upon the fact that we consider the auditors that we have interviewed to have much knowledge in the areas of accounting and corporate governance. All respondents are members of different expert groups in the area of accounting, which increases the internal validity of the thesis. However, the fact that the auditors could be subjective is an issue that needs to be taken into consideration, since this could affect the internal validity of the results of the thesis.

[2] In the autumn of 2002, Peter Markborn left the Accounting Committee of FAR. This was after the interview had been carried out.

We think that the result of the study could be applicable in other similar situations and explain how similar accounting cases can affect Swedish companies, which gives external validity to the study. However, the result of the study cannot be applicable in all similar situations. In order to achieve external validity there is also a need for the circumstances surrounding the cases to be similar. For example, the result of the study can probably be applicable to similar accounting cases in the USA, but not to similar accounting cases in a European country.

2.6.2 Reliability

The concept of reliability is to what extent the result from a study can be replicated. Reliability exists if the same result is achieved if the study is carried out again (Merriam 1994).

The thesis has a high level of reliability, as we believe that the respondents in the interviews will provide the same information if the study were to be carried out again. The respondents have all proofread their parts of the interviews, which is something that increases the reliability of the thesis. If the study was to be carried out again, the result would most likely be the same. However, as a part of the thesis will be carried out through our own interpretation of literature and different documents, this could have a negative impact on the reliability of the thesis. Other researchers may interpret the literature and documents differently, which therefore has an influence on the reliability.

2.6.3 Relevance

A study has relevance if the result of the study is meaningful to others (Wiedersheim-Paul and Eriksson 1997). The study should contribute to new theories and knowledge in the research area[3].

In our opinion the thesis has a high level of relevance. This is due to the fact that it can be useful for companies to know if and how they will be affected by

[3] Javefors, Håkan, Tutorial 2001-04-19.

the recent accounting cases in the USA. We also hope that our study will contribute to new and valuable knowledge in the accounting and corporate governance area.

2.7 Criticism of Sources

It is important to be critical towards the sources used in a research, as the result of a study depends on whether the sources provide reliable and correct information.

In our opinion, the sources used in the thesis are reliable. In the theoretical chapter, as well as in the empirical chapter, we have used laws and recommendations, which we consider to be very reliable as they are stating the existing law. Regarding the other sources used in the theoretical chapter, for example, the literature, it is possible that they sometimes reflect the authors' own opinions, and this can affect the reliability negatively. However, through a comparison among the different sources we have tried to eliminate this subjectivity and obtain the correct information. The result from the interviews, in the empirical chapter, we consider reliable, since the respondents are very competent and have much knowledge in the areas that were covered in the interviews.

As some of the sources used in the thesis have been translated from Swedish into English, there could be mistranslations, which can affect the reliability of the thesis negatively. However, as we consider ourselves to have good knowledge of both languages, we think that this minimises the risk of mistranslations.

3. BACKGROUND

This chapter provides a description of the two companies, Enron and WorldCom, which we have chosen to represent the recent accounting cases in the USA. The chapter gives a brief description of the companies as well as the events that led to their bankruptcy. In the section about Enron, there is also a part explaining Special Purpose Entities (SPEs), in order for the reader to better understand the case.

3.1 Enron

Enron was formed in 1985 in a merger between two natural gas pipeline companies, Houston Natural Gas and Internorth (www.enron.com). In time the company transformed itself into an entrepreneurial trader of energy, mostly electricity and natural gas. According to Fortune Magazine, Enron's sales ranked it the seventh-largest company in the USA in 2000, with reported earnings of nearly $1 billion. Its total market value was $70 billion. Fortune labelled it the most innovative company in America (Madrick 2002). However, time has shown that the company was not as prosperous as it appeared to be.

In the beginning of 2001, the Enron stock price began to decline. As Enron had liberally used its stock to guarantee loans and other liabilities to outside lenders and investors, this put increasing financial pressure on the company. In August 2001, rumours of financial trouble began to circulate, and in October 2001 Enron announced it was taking a $618 million loss (Madrick 2002). $544 million of this amount was related to hedging transactions with an SPE (for a description of SPE see section 3.1.1) called LJM2 Co-Investment, L.P. (LJM2). Enron also announced the reduction of shareholders' equity of $1.2 billion due to accounting errors related to that same SPE (Powers, Troubh and Winokur 2002).

In November 2001, Enron declared that it was restating its financial statements for the period 1997 to 2001, due to accounting errors relating to transactions with two other SPEs, called LJM Cayman, L.P. (LJM1) and Chewco Investments, L.P. (Chewco) (Powers et al. 2002). This reduced Enron's earnings by $600 million for the years 1997 to 2001 and added $2.5 billion to

the debt on the company's books (Madrick 2002). Chewco, LJM1 and LJM2 were used by Enron to enter into transactions that it could not have done with unrelated commercial entities. Many of the most significant transactions were designed to improve the financial statements, not to achieve economic objectives or transfer risk. For example, some transactions were implemented to offset losses, by allowing Enron to conceal very large losses resulting from merchant investments by creating an appearance that those investments were hedged. The hedging involved a third party that was obligated to pay Enron for the amount of those losses, but in fact this third party was an entity in which only Enron had a substantial economic stake (Powers et al. 2002).

In December 2001, Enron filed for bankruptcy protection in accordance with Chapter 11 of the US bankruptcy laws[4]. After this, several thousand Enron employees lost their jobs and many of them have lost most of their retirement savings. Enron employees were encouraged by the company to buy Enron stock for their pension plans, while many Enron executives sold their shares in the company (Madrick 2002).

In February 2002, a Special Investigative Committee of the Board Directors of Enron Corp. issued the Report of Investigation explaining the specific transactions that led to the third-quarter 2001 earnings charge and the restatement of the financial statements. The report highlights the accounting, corporate governance, management oversight and public disclosure issues related to these transactions (Powers et al. 2002).

The report states that some of the employees and parts of the management and board of directors of Enron had personally been involved in the doubtful transactions and enriched themselves at Enron's expense. The main characters involved were Andrew Fastow, Chief Financial Officer (CFO), Jeffrey Skilling, Chief Executive Officer (CEO) until August 2001, Kenneth Lay, CEO from August 2001 and Michael J. Kopper, an employee working for Fastow in the finance area (Powers et al. 2002). A criminal investigation regarding several individuals at Enron is presently being carried out by the US Department of Justice (www.bbc.co.uk, a).

[4] Under this law the company is protected from its creditors and can continue its business while the company is restructured ("WorldCom's Bankruptcy Mess" 2002).

Fastow was fired in October 2001, when the company reported losses of more than $600 million (www.bbc.co.uk, b). He was involved in transactions with the SPEs on both sides that allowed him to hide Enron's losses, and also appeared to use his position to enrich himself. Kopper was also closely involved in the partnerships and enriched himself considerably from them (Powers et al. 2002). Kopper has now pleaded guilty to the allegations and has promised to cooperate with federal prosecutors in the case (www.bbc.co.uk, c). Skilling and Lay had, as CEOs, the responsibility to make sure that the officers reporting to them performed their duties properly. However, it seems as though neither Skilling nor Lay fulfilled their responsibilities correctly (Powers et al. 2002).

3.1.1 Special Purpose Entities[5]

Enron used many doubtful accounting procedures. The most important had to do with the off-balance-sheet partnerships, technically known as SPEs (Powers et al. 2002). According to Lynn Turner, a former Chief Accountant at the Securities and Exchange Commission (SEC)[6] and a witness at a hearing regarding the fall of Enron, SPEs are typically designed for a specific transaction. They come in various forms and are used for many purposes such as financing buildings and equipment and raising capital by transferring receivables into an SPE that in turn raises capital. SPEs usually involve at least four parties when they are set up. The company who sets it up is called the sponsor and is establishing the SPE. The SPE itself acquires or builds an asset with funding provided by a lender. An investor will own the SPE and put up, in the form of equity, at least 3% of the amount of capital needed to acquire the asset (www.senate.gov, a).

According to general accounting rules, a sponsoring company that owns 50% or less of another company does not have to consolidate this second company into its own financial statements. The main advantage with SPEs is that a sponsoring company may own more than 50% of the SPE and still not have to

[5] This section gives an overview of the US regulation of SPEs prior to the recent accounting cases in the USA.
[6] The SEC is a US governmental organisation established by the Congress to protect investors and maintain the integrity of the securities markets (www.sec.gov).

consolidate it (Madrick 2002). However, in order for a company to be treated as an SPE, two conditions must be fulfilled; first, an owner independent of the sponsoring company must make substantive equity investment of at least 3% of the SPE's assets, and second, the independent owner must exercise control of the SPE. In those circumstances the sponsoring company does not need to include the assets and liabilities of the SPE in its balance sheet (Powers et al. 2002).

According to Frank Partnoy, a Professor of Law at the University of San Diego School of Law and a witness in the hearing regarding the fall of Enron, the possibility of using this structure of setting up an SPE is based on guidance from a letter from the Acting Chief Accountant of the SEC in 1991. The letter states that:

> *The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar [leasing] transactions with similar risks and rewards. The SEC staff understands…that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property* (www.senate.gov, b).

Turner (www.senate.gov, a) states that while SPEs are sometimes used for legitimate business purposes, they are often used to hide liabilities from the unwary investor. Partnoy (www.senate.gov, b) states that as more companies have used SPEs in this way, more debt has moved off the balance sheets, to the point that, today, it is difficult for investors to know if they have an accurate picture of a company's debts.

In many ways, Enron circumvented the accounting rules regarding SPEs. For example, many of Enron's SPEs failed to meet the requirement of 3% outside equity investment as well as the condition for outside control. In reality, Enron and the partnerships were usually, in fact, one and the same. Some of the most important partnerships were run by Enron's executives themselves, which clearly was a conflict of interest (Madrick 2002). Enron employees involved in the partnerships received, in total, tens of millions of dollars they were not

really entitled to (Powers et al. 2002). Truly independent partnerships would not have made business so favourable to Enron (Madrick 2002).

According to the Report of Investigation (Powers et al. 2002), the main transactions leading to the bankruptcy of Enron involved the SPEs of LJM1, LJM2 and Chewco. These transactions were very complex and below are brief summaries of the most important transactions with these SPEs.

3.1.1.1 LJM1 and LJM2

From June 1999 to June 2001 Enron completed at least 20 distinct transactions with the LJM partnerships. These were of two general types: assets sales and purported hedging transactions. Close to the end of financial reporting periods, Enron sold assets to the LJM partnerships that it wanted to remove from its books. There is some doubt as to whether these transactions should have been treated as sales since the risk and rewards of ownerships were not actually transferred to the SPE. For example, Enron bought back some of the assets after the end of the financial reporting period. Also, in every transaction the LJM partnerships made a profit, even when the assets had declined in market value (Powers et al. 2002). The sales created intercompany gains. According to US GAAP these intercompany gains have to be eliminated in the consolidated accounts (Griffin, Williams and Larson 1971). If the SPEs had been consolidated, the gains would have been eliminated.

The normal idea of a hedge is to contract with a creditworthy outside party that is prepared, for a price, to take on the economic risk of the investment. However, in Enron's case the hedging was done by setting a contract with an SPE, which could not be seen as an outside party. One example is the hedging of an investment Enron made in Rhythms NetConnections Inc. (Rhythms). In this case Enron transferred its own stock to an SPE in exchange for a note receivable. The SPE took on the risk that Enron's investment in Rhythms would decline. The idea was to hedge Enron's investment in Rhythms stock, allowing Enron to offset losses on Rhythms if the price declined. If the SPE was required to pay Enron due to the hedging contract, the transferred Enron stock would be the principal source of payment. The hedging transactions may have appeared to be like economic hedges, but they actually functioned as

accounting hedges. They seem to have been designed to circumvent accounting rules by recording hedging gains to offset losses in the value of investments on Enron's income statements (Powers et al. 2002).

The problem with this kind of hedge was that if the value of the investment fell at the same time as the value of Enron stock, the SPE would be unable to meet its obligations and the hedges would fail. This is exactly what happened in late 2000 and early 2001. The fact that Enron hedged its investments, not with a creditworthy outside party, but with itself, resulted in the announcement in October 2001 of a $544 million after-tax charge against earnings (Powers et al. 2002).

3.1.1.2 Chewco

During the years 1993 to 1996, Enron and the California Public Employees' Retirement System (CalPERS) were partners in a joint venture partnership called Joint Energy Development Investment Limited Partnership (JEDI). Because of the joint control, Enron did not have to consolidate JEDI into its financial statements. In November 1997, Enron wanted to buy back CalPERS' interest in JEDI so that CalPERS could invest in another larger partnership. As Enron did not want to consolidate JEDI into its financial statements, it needed to find a new partner. Therefore, Enron assisted Kopper in forming Chewco to purchase CalPERS' interest in JEDI. The requirement for not having to consolidate JEDI would be that Chewco needed to have independent ownership of at least 3% of equity capital. As an investor for this 3% interest was not found, Enron financed Chewco's purchase almost entirely with debt. Even though this situation required consolidation of JEDI and Chewco, the partnerships were not consolidated in the Enron statements. In March 2001, Enron purchased Chewco's interest in JEDI. Kopper had invested $125,000 in Chewco in 1997 and the repurchase by Enron resulted in that Kopper received more than $10 million from Enron. When Enron and its auditor, Arthur Andersen LLP, reviewed the transaction in 2001, they concluded that Chewco did not fulfil the requirements for SPEs and neither did JEDI. Therefore, Enron had to consolidate Chewco and JEDI retroactively to 1997. This restatement resulted in a large reduction in Enron's reported net income and a substantial increase in its reported debt (Powers et al. 2002).

3.2 WorldCom

WorldCom was founded as Long Distance Discount Service in 1983 and it was not until 1995 that the company was renamed WorldCom. One of the founders was Bernie Ebbers, who later became CEO of the company (Haddad, Foust and Rosenbush 2002). WorldCom is a global communications company, which offers Internet, voice- and datasolutions (www.worldcom.com). WorldCom has grown through mergers with other companies in the same business into one of the world's largest telecom companies (Haddad et al. 2002: Sandberg, Blumenstein and Young 2002). At its peak, in 1999, WorldCom was worth around $180 billion (www.ft.com: "World Con? WorldCom; Another Casualty; Another Scandal" 2002).

In June 2002, it was revealed that WorldCom might have committed one of the biggest accounting frauds ever, involving $3.8 billion. At that time WorldCom confirmed that it was investigating how this amount of money had been used and that the last five quarterly accounting periods would have to be restated. It turned out that during 2001 and the first quarter of 2002, the company had accounted for $3.8 billion in operating expenses as capital investments ("World Con? WorldCom; Another Casualty; Another Scandal" 2002).

This accounting procedure made no difference in WorldCom's cash situation, but it allowed the company to show profits for 2001 and for the first quarter of 2002, rather than the losses that it would have shown otherwise (Sloan 2002). The misclassification of the expenses also made WorldCom's cash from operations, on the statement of cash flows, look much better than it actually was[7]. The accounting procedure affected the net income since expenses were spread out over years, instead of charged against earnings immediately (Elstrom 2002). WorldCom's reported profits of $1.4 billion for 2001 and $130 million in the first quarter of 2002, should, in fact, have been big losses ("World Con? WorldCom; Another Casualty; Another Scandal" 2002).

This discovery of the accounting discrepancies led to a further investigation by the company and notification of the SEC ("WorldCom Looking for Account Errors" 2002). Eventually, the SEC sued WorldCom for accounting fraud

[7] Halvorsen, Marcia, Tutorial 2002-09-18.

(Sloan 2002). In July 2002, WorldCom decided to file for bankruptcy protection in accordance with Chapter 11 of the US bankruptcy laws ("WorldCom's Bankruptcy Mess" 2002).

In August 2002, WorldCom revealed another $3.3 billion in accounting deception, which brought the book-keeping discrepancies to an amount of approximately $7 billion. The discovery of the new $3.3 billion accounting fraud was made as the company reviewed its books for 1999 and 2000 (Brister 2002). A part of this amount was, again, due to the fact that WorldCom accounted for what should have been expenses as investments. Other improprieties included reserve reversals, which are funds companies typically set aside to cover the estimated cost of a future event. Once the cost is incurred, any additional funds can be reversed back into earnings (Pulliam and Sandberg 2002). The reserves can allow management to manipulate the earnings, moving profits from one year to another[8]. According to US GAAP, companies are permitted to estimate and set aside reserves for future events. However, these reserves should not be overstated, which could have been the case regarding WorldCom (Pulliam and Sandberg 2002).

At the same time, in August 2002, two former WorldCom executives, former CFO, Scott Sullivan, and former Controller, David Myers, were arrested and charged by federal prosecutors for hiding billions of dollars in expenses and lying to investors and regulators. The former CEO, Ebbers, who borrowed $400 million from the company that has not yet been repaid, has not yet been charged with any crime (www.bbc.co.uk, d).

[8] Halvorsen, Marcia, Tutorial 2002-09-18.

4. THEORETICAL FRAMEWORK

This chapter discusses the present Swedish rules and regulations, as regards accounting and corporate governance, relating to the problem areas described in the background. The chapter starts with an introduction to the Swedish accounting theory, followed by a description of more specific regulation regarding consolidation, financial derivatives and expenditures. This is followed by a section that treats corporate governance issues, reflected through Swedish legislation and the regulation of the Stockholm Stock Exchange.

The chapter aims to provide an understanding of the areas mentioned above. This is necessary as it serves as a basis for the empirical research and is also useful in the analysis of whether Swedish companies will be affected by the recent accounting cases in the USA.

4.1 Fundamentals of Swedish Accounting Theory

There are several laws in the accounting area that are applicable to Swedish companies. However, since this thesis is only focusing on public limited companies, we have chosen to study the laws that are applicable to this type of company. These are the Book-keeping Act (BFL) and the Annual Accounts Act (ÅRL), which are set by the government. The rules for the companies' book-keeping and annual accounts are established in BFL. ÅRL states the rules for the reporting of public information, such as the annual financial statements and accounting for consolidation (Svensson and Edenhammar 2000).

In the accounting area there are several Swedish standard setting bodies that give recommendations as complements to the law. Swedish accounting is also to a large extent influenced by the accounting standards issued by the International Accounting Standards Board (IASB). These standards are applicable when there is not enough Swedish regulation. The next section of this chapter gives short descriptions of the organisations that we find are relevant for the thesis.

4.1.1 Accounting Standard Setting Bodies

The Swedish Accounting Standards Board (BFN) is a governmental authority, with its own instructions and grants. The BFN is an expert in the accounting area and has the main responsibility for the development of GAAP as regards the book-keeping and public accounting of the companies. The BFN provides general advice regarding the application of BFL and ÅRL (Svensson and Edenhammar 2000). The recommendations set by the BFN are not legally binding (Westermark 1998).

The Swedish Financial Accounting Standards Council (RR) was founded by the BFN, the FAR and the Federation of Swedish Industries[9] (Westermark 1998). The standard setting of the RR focuses on public limited companies, or companies, which, due to their size, are of public interest. Its recommendations are, like the standards set by the BFN, not legally binding. However, they have significant importance in defining GAAP. The RR recommendations are founded on international standards set by the IASB (Svensson and Edenhammar 2000).

The FAR is an organisation for authorised public accountants, approved public accountants and other highly qualified professionals in the accountancy sector. The organisation has an important role in the development of professional standards, education and information for the audit profession in Sweden (www.far.se).

The IASB is an international, independent, privately funded standard setting body, which cooperates with national accounting standard setters. Its objective is to harmonise the accounting standards worldwide (www.iasb.org.uk, a). The IASB sets accounting standards that are aimed primarily at international public limited companies (Westermark 1998).

[9] Sveriges Industriförbund.

4.1.2 Generally Accepted Accounting Principles

Accounting practice is something that evolves over time, and this is something that Swedish legislators have considered. To avoid very detailed regulations, they have allowed for GAAP to govern the preparation of the annual accounts (KPMG 1997).

GAAP could be described as the standards that are based on, apart from laws and regulations, accounting practice and recommendations and statements from certain governments and organisations, primarily the BFN, the RR and the Swedish Financial Supervisory Authority (FI)[10]. According to ÅRL ch. 2 par. 2, the annual reports should be established in a well-arranged way and in accordance with GAAP. The different parts of the annual report should be understandable together without difficulty. BFL also expresses the importance, for a company that is required to maintain accounting records, of following GAAP (Svensson and Edenhammar 2000).

The concept of GAAP reflects a producer perspective when assembling the information (Eriksson 1998). However, it can sometimes have an unclear meaning. The concept is a mixture of the practice that actually exists, and the statements from the standard setting bodies. What is considered to be GAAP should be decided through a traditional interpretation of laws and other rules in the area, an interpretation that mainly should be based on the wordings of the regulations according to their purposes and the general principles that the rules express. When a traditional law interpretation is not sufficient, an additional interpretation must be made, which is appropriately rooted in common practice. In many cases though, a clear statement will be needed. This is where the standard setting bodies are needed to identify the standards that should be used (Svensson and Edenhammar 2000).

[10] The FI is an authority that supervises companies in the financial market. The supervision should benefit the public's interest and contribute to maintain the trust in the financial sector.

4.1.3 True and Fair View

Another important concept in accounting is true and fair view. This concept is stated in ÅRL ch. 2 par. 3. The correct meaning of the concept is, however, somewhat unclear. It can be seen as a superior requirement that the financial statements should contain such financial information that the reader will obtain a picture, which is as correct as possible, of the company's financial situation. The concept's major importance is to act as an instrument to interpret accounting regulations in specific cases and to correct misleading results, which may occur through a too strict application of general standards (Svensson and Edenhammar 2000).

The determination as to what is a true and fair view should be based on different users' needs for a relevant and reliable basis for decisions. The responsible accountant in the company should try, as much as possible, to apply a user perspective in assembling the information (Eriksson 1998).

4.2 Consolidation

The objective of consolidation of entities is to report the affairs of a group of affiliated companies as if they were a single economic entity (Huefner, Largay and Hamlen 2001).

The rules and regulations of consolidation that are studied in the thesis are ÅRL and the recommendations RR1:00, Consolidated Accounts, and RR13, Associated Companies, from the RR. According to the foreword of the RR's recommendations (FAR 2000), if there are not enough guidelines in the Swedish regulation, the international accounting standards of the IASB are applicable. Therefore, as there are no specific Swedish accounting regulations regarding related parties or SPEs, we have also studied IAS24, Related Party Disclosures and SIC12, Consolidation – Special Purpose Entities.

There are several methods for including other entities in the consolidated financial statements. As this study does not require a thorough description of these consolidation methods, we have only mentioned the methods briefly in the following sections.

4.2.1 Consolidated Accounts

Chapter 7 of ÅRL treats consolidated accounts. It is often difficult to achieve a clear picture of the group's position and results from the separate companies' financial statements alone. In essence, the consolidated accounts aim to give a composite economic picture of the companies included in the group and also give the interested parties, of the parent company and the other companies in the group, possibilities for judging the group as a whole (Svensson and Edenhammar 2000).

According to ÅRL ch. 7 par. 6, the consolidated accounts should be established in a well-arranged way and in accordance with GAAP. Furthermore, the consolidated statements should be established as a whole, and the statements should provide a true and fair view of the position and results for the companies that are included in the consolidated accounts. The requirement of a true and fair view does not refer to the individual companies in the group, but rather to the group as a whole (Svensson and Edenhammar 2000).

4.2.2 Subsidiaries: Definition and Accounting

4.2.2.1 Definitions

According to ÅRL ch. 1 par. 4, a legal entity is considered a subsidiary to a company, if this company owns more than half of its voting stock. Another alternative is that the company owns some shares, but through an agreement with other shareholders disposes of more than half of the total voting stock. It is also sufficient to have ownership in the legal entity as well as the right to appoint or dismiss more than half of the members of the board for the legal entity to be considered a subsidiary. This right could also be based on an agreement between the subsidiary and the owning company. The paragraph also states that it is sufficient to have indirect influence or ownership of the legal entity, for example through ownership in a subsidiary that in turn owns the majority of the stock in the legal entity (Svensson and Edenhammar 2000).

4.2.2.2 Determination of Inclusion of Subsidiaries

According to ÅRL ch. 7 par. 5, the main rule is that all subsidiaries are to be included in the consolidated accounts. There are, however, some cases where a subsidiary does not need to be included in the consolidated accounts. If a subsidiary has insignificant importance according to the requirement of a true and fair view, it can be excluded from the consolidation. This judgement should be based on the importance for the group as a whole. The exclusion can also be applied to inactive companies. Even if a specific subsidiary is of insignificant importance it cannot be excluded if it, together with other similar companies, is of significant importance for the group as a whole. Other cases where the subsidiary can be excluded are if there is a hindrance for the parent company to exercise influence over the subsidiary, if necessary information cannot be received with reasonable cost or within reasonable time, or if the shares in the company are a temporary possession and will be sold later (Svensson and Edenhammar 2000). According to Eriksson (1998), Swedish public limited companies only exclude subsidiaries from the consolidation in exceptional cases.

The RR seems, compared to ÅRL, to have a stricter attitude towards the exclusion of subsidiaries from the consolidated accounts. According to RR1:00, subsidiaries will only be excluded if one of two conditions is met (Eriksson 1998):

- The parent has only a temporary possession of the shares in the subsidiary, a normal time span of a year.

- There exist significant and lasting hindrances for the parent company to exercise influence over the subsidiary.

According to ÅRL ch. 7 par. 16, the consolidated accounts are required to present details regarding the subsidiaries' names, residences and corporate identity numbers. There is also a requirement to provide information about the share of equity that the parent company, or other companies in the group, owns in the subsidiary. Also, it must be disclosed as to why a certain company has been classified as a subsidiary. This applies to companies excluded in the consolidated accounts as well. However, the information can be left out if the

parent company owns more than 50% of the voting stock of the subsidiary and the share of equity is the same size as the voting stock. Details, as required in ÅRL ch. 7 par. 16, may be excluded if the information could harm the parent company or the subsidiaries. However, according to ÅRL ch. 7 par. 17, this has to be approved by the Patent and Registration Office (PRV) (Svensson and Edenhammar 2000).

4.2.2.3 Accounting for Subsidiaries

There are certain criteria in accounting standards and company law that, if met, require a business combination to be accounted for as a merger. In all other cases the business combination should be accounted for as a purchase (KPMG 1997).

The methods of consolidation are stated in ÅRL ch. 7 par. 19-24 and RR1:00. When companies are consolidated due to a purchase, the purchase method should be used. However, if the business of the subsidiary is very different from the business of the rest of the group, using the purchase method might not provide a true and fair view. In these cases the equity method should be used (RR1:00 2000, par. 29). When using the purchase method the acquisition is considered to be a transaction through which the parent indirectly purchases the subsidiary's assets and takes over its liabilities. An acquisition analysis is used to identify and value the assets and liabilities (RR1:00 2000, par. 30-31).

In the case of a merger the pooling of interests method should be used (RR1:00 2000, par. 84). When using the pooling of interests method assets and liabilities are accounted for at the same amount that they are accounted for in the separate companies' balance sheets. Corrections are only made concerning coordination of applied accounting standards (RR1:00 2000, par. 85).

4.2.3 Associated Companies: Definition and Accounting

The definition of an associated company is based on a situation where a company owns stock in a legal entity and has influence over this entity without an existing parent-subsidiary relationship (ÅRL ch. 1 par. 5). For this kind of

situation to exist, the owner must exercise significant influence over the legal entity's operational and financial activities. The ownership must also be of a lasting relation between the companies. In ÅRL ch. 1 par. 5 there is also a presumptive rule that describes when an associated relationship exists. The criteria of significant influence and lasting relations are presumed to exist when a company owns at least 20% of the voting stock in a legal entity. If the voting stock does not involve any influence, the presumptive rule is of course not fulfilled. Also, there is no requirement of direct ownership, indirect ownership is qualifying as well (Svensson and Edenhammar 2000).

As mentioned in section 4.2.2.2, ÅRL ch. 7 par. 16 states that the consolidated accounts are required to present details regarding subsidiaries. This information is also required regarding associated companies, unless this disclosure is of insignificant importance as regards the concept of true and fair view.

Associated companies are also treated in RR13. According to this recommendation, the definition of an associated company is a company in which the owning company has significant influence without the associated company being a subsidiary. The ownership should be a link in a lasting relation. Significant influence means that the owning company can participate in the decisions that involve a company's strategies, but does not involve a controlling influence over these strategies. Controlling influence means a right to shape a company's strategies for the purpose of gaining financial benefits (RR13 2000, par. 2).

The definition in RR13 of what is considered to be significant influence is the same as in ÅRL; ownership of 20% of the voting stock in a legal entity should qualify the entity as an associated company. There are several ways that indicate whether a company has significant influence over another entity. The owning company might be represented on the entity's board or a similar management body, the owning company participates in the work of the entity's strategic and policy questions, significant transactions take place between the owning company and the entity, there is an exchange of personnel in principal positions between the owning company and the entity, and/or the owning company and the entity exchange essential technical information (RR13 2000, par. 3-4).

Shares in associated companies should be accounted for in the consolidated balance sheet and income statement using the equity method. An exception to this rule is if there are significant and lasting hindrances, which essentially limit the possibility to transfer gains from the associated company to the owner. In this case the acquisition value method should be used (RR13 2000, par. 7-9).

By using the equity method an investment is initially accounted for at its acquisition value. Thereafter, the value is increased or decreased to reflect the owner's share of the associated company's gains or losses after the acquisition. According to the acquisition value method, the owner accounts for its share in the associated company at acquisition value (RR13 2000, par. 5-6).

4.2.4 Related Parties: Definition and Disclosure

Related parties are not treated to a great extent in Swedish regulation, but there is an international standard from the IASB called IAS24, Related Party Disclosures, that covers this area. It states that parties are considered related if one party has the ability to control the other party or to exercise significant influence over the other party in making financial and operating decisions (IAS24 1984, par. 5).

The standard deals with certain related party relationships such as parent-subsidiary, entities under common control, associates, individuals who have significant influence and key management personnel. The standard also treats the relationship between enterprises in which individuals or key management have a substantial interest in the voting power (IAS24 1984, par. 3).

Information regarding a related party relationship, where control exists, should be disclosed whether there have been transactions between the parties or not (IAS24 1984, par. 20).

Transactions between related parties should be disclosed by the reporting enterprise. The disclosure should include the nature of the relationship and the types and elements of the transactions that are necessary for understanding the financial statements (IAS24 1984, par. 22).

4.2.5 Special Purpose Entities: Consolidation

The International Financial Reporting Interpretations Committee (IFRIC) is a part of the IASB that reviews accounting issues of widespread importance that are lacking in guidance. The objective is to reach appropriate accounting treatment, which is done within the context of IAS and the IASB framework (www.iasb.org.uk, b). One of the interpretations issued by IFRIC is SIC12, Consolidation – Special Purpose Entities, which addresses the question of when an SPE should be consolidated into the financial statements. According to the interpretation, the SPE should be consolidated when the reporting enterprise controls the SPE. Control is presumed to exist when the reporting enterprise has the ability to direct or dominate decision making with the objective of obtaining benefits from the SPE. Examples of this are when the SPE performs activities on behalf of the reporting enterprise, the reporting enterprise has decision-making powers over the SPE, and the reporting enterprise has rights to the majority of benefits of the SPE and therefore is exposed to significant risks of the SPE (www.iasb.org.uk, c).

4.3 Financial Derivatives

Financial derivatives are financial instruments whose prices are derived from the prices of other financial instruments. The instruments to which they relate include stocks, bonds, interest rates and currencies (Redhead 1997).

According to KPMG (2001), there are different reasons for a company to use financial derivatives:

- Hedging: to use financial derivatives in order to protect the business against undesirable effects in the market development. The purpose is to protect the business from various kinds of losses.

- Arbitrage: to use financial derivatives for temporary incorrect pricing in the market. Incorrect pricing means that the financial derivative has a return that diverges from what the risk actually motivated in respect to the risk exposure.

- Speculation: to use financial derivatives in order to achieve a higher return, by taking a risk in the market development. A company may speculate in, for example, the market development, in order to accomplish larger gains through purchases of forward contracts. The purpose is to affect the result through these gains of increase in value.

4.3.1 Types of Financial Derivatives

Financial derivatives include forwards, futures, options and swaps (Redhead 1997).

Forward Contract
A forward contract always involves a contract initiated at one time and performance in accordance with the terms of the contract occurs at a subsequent time. Further, forward contracting involves an exchange of one asset for another. The price at which the exchange occurs is set at the time of the initial contracting. Actual payment and delivery of the goods occur later (Kolb 1997).

Futures Contract
A futures contract is a type of forward contract with highly standardised and closely specified contract terms. As in all forward contracts, a futures contract calls for the exchange of some goods at a future date for cash, with the payment for the goods to occur at that future date. The purchaser of a futures contract undertakes to receive delivery of the goods and pay for it, while the seller of a futures contract promises to deliver the goods and receive payment. The price of the goods is determined at the initial time of contracting. The user of a futures contract seeks to reduce an already existing risk. This is done by taking a futures position that would tend to show a profit in the event of a loss on the underlying position (and a loss in the event of a profit on the underlying position). There are several differences between the futures contracts and other types of forward contracts, for example, futures contracts always trade on an organised exchange (Kolb 1997). Another characteristic of the futures contract is that there is a recognition every day of the profit or loss on the contract. This variation margin is received or paid every day (KPMG 2001).

Option

An option is a financial derivative that may relate to individual stocks, stock indices, bonds, interest rates, currencies or futures. Options provide protection against adverse market movements while preserving the ability to gain from beneficial price or rate movements (Redhead 1997). To acquire the rights of an option, the owner of the option buys it from other traders by paying a price, or premium to a seller. In these arrangements, all rights lie with the owner of the option. The seller of an option has all the obligations, because the seller undertakes obligation in exchange for payment (Kolb 1997). The seller is often referred to as the writer (Redhead 1997).

An option is either a call option or a put option (Kolb 1997). A call option provides the right, but not the obligation, to buy at a specified price, the strike price, during a period of time or at a point of time. It thus provides a maximum buying price and protects the user from price increases above this maximum. It could be profitable to exercise the call option, i.e. exercising the right to buy shares at the strike price, if the market price of the stock is higher than the strike price. If the owner decides not to exercise the option the premium paid is lost but there will be no further loss, since the premium is the maximum loss that can be incurred (Redhead 1997).

A put option provides the right, but not the obligation, to sell at a specified price, the strike price, during a period of time or at a point in time. It provides a minimum selling price, and hence protects the user against share price declines. The holder of this option can exercise it, sell it, or allow it to expire. It is worthwhile exercising a put option, that is, exercising the right to sell shares at the strike price, only if the market price of the stock turns out to be lower than the strike price (Redhead 1997).

Swap

Another type of financial derivatives is swaps (Redhead 1997). A swap is an agreement between two or more parties to exchange sets of cash flows over a period in the future. The parties that agree to the swap are known as counter parties (Kolb 1997). The cash flow exchanged can be of different types. Examples of swaps are interest swaps, currency swaps and equity swaps (Redhead 1997).

4.3.2 Legislation

The legislation for financial instruments in Sweden only considers instruments in the spot market, which is the market for immediate delivery (Öhrlings Coopers & Lybrand 1996: Larsson and Rydell 1998). Derivatives, such as futures, forwards options and swaps, are not explicitly regulated.

Accounting practice in this area is based upon analogisms of BFL's valuation rules and fundamental accounting principles stated in ÅRL. Further guidelines can be found in a draft published by the FAR, Accounting for Standardised Options, Futures and Foreign Exchange and Interest Swaps (Öhrlings Coopers & Lybrand 1996). International accounting standards have had a significant influence on the accounting area for financial instruments in Sweden (Ernst & Young 1996). One international standard relating to financial derivatives is IAS39, Financial Instruments: Recognition and Measurement.

4.3.2.1 The Book-keeping Act

According to BFL, a business transaction occurs when a contract is settled to purchase or sell a financial instrument. Strict interpretation of BFL implies that a business transaction shall be recorded on the transaction day. However, the derivatives are off-balance-sheet items until the day when the transaction is concluded. When preparing the annual report an evaluation of the derivatives is required. A possible write-down shall be reserved as a liability in the balance sheet. Furthermore, derivatives should be disclosed in the notes (KPMG 2001).

4.3.2.2 The Annual Accounts Act

ÅRL has no specific rules for futures, forwards, options and swaps (FAR 2000). However, there are some concepts of major importance in ÅRL as regards derivative instruments. These are GAAP, the concept of true and fair view, prudence and realisation (for a description of the first two concepts see sections 4.1.2 and 4.1.3). The concepts of prudence and realisation are expressed in ÅRL ch. 2 par. 4. The prudence concept means that the evaluation of different items should be made with reasonable prudence. This means that in

an uncertain situation one should choose a lower evaluation of assets and a higher evaluation of liabilities (Svensson and Edenhammar 2000). The realisation concept means that revenues and expenses, which are attributable to the financial year, should be included in that year, regardless of the time of payment (ÅRL ch. 2 par. 4).

Accounting problems may arise when trying to combine a hedging activity with the accounting concepts of prudence and realisation (Svensson and Edenhammar 2000). The accounting information provided will not give a true and fair view of the hedging activity if these concepts are followed strictly. Therefore an exception has been made and the traditional accounting rules have been set aside (Öhrlings Coopers & Lybrand 1996). It is important to notice, as stated in ÅRL ch. 2 par. 4, that exceptions can be made as long as the concepts of GAAP and true and fair view are not disregarded (Svensson and Edenhammar 2000). The approach that has been accepted is what has been called hedge accounting (Öhrlings Coopers & Lybrand 1996).

The purpose of hedge accounting is to accomplish allocation by allowing the profit/loss in one position to be offset by the loss/profit in another position. This can be done in two different ways (Öhrlings Coopers & Lybrand 1996):

- Deferral hedge accounting: the off-balance-sheet items are not affected by changes in currency and interest, while the effects on the result are matched and taken into consideration at the same time.

- Mark to market hedge accounting: this means that both the hedged item and the underlying asset are marked to market continuously and this valuation procedure affects profit and loss immediately through the income statement.

4.3.2.3 FAR Draft: Accounting for Standardised Options, Futures and Foreign Exchange and Interest Swaps

This draft applies to legal entities other than the estate of a deceased person and partnerships (FAR 2000). It provides specific guidelines of how to report financial derivatives in the annual report.

When accounting for options there are some aspects that need to be taken into consideration. The draft offers detailed procedures of how to account for the option premium until the transaction is concluded. The draft also provides guidelines of how to account for the result of the option contract. The draft also gives some guidelines regarding disclosure of an option (FAR 2000).

The draft states how to account for a forward or futures contract in bonds, treasury bills or stocks. The forward and futures contracts are normally not accounted for until they are transferred or exercised. However, the effect of forward and futures contracts that are outstanding at the balance sheet date must be recorded and a possible loss has to be reserved (FAR 2000).

The draft gives information regarding currency and interest rate swaps. One purpose of currency swaps can be that the counter parties wish to eliminate or minimise the currency risk connected to a loan in foreign currency. The interest swap can be used when a company wants to swap a fixed rate in exchange for a floating rate and vice versa (FAR 2000).

4.3.2.4 IAS39: Financial Instruments: Recognition and Measurement

The IASB standard IAS39, Financial Instruments: Recognition and Measurement, provides rules for how to recognise and measure financial assets and liabilities.

The IASB defines a financial instrument as follows:

> *A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise* (IAS39 2000, par. 24).

According to the IASB, a derivative is a financial instrument whose value changes according to the changes in the underlying. The underlying can be interest rates or different indices. The derivative requires little, or no, initial net investment relative to similar contracts. The derivative is settled at a future date (IAS39 2000, par. 25).

Typical derivatives are futures, forward, swap and option contracts (IAS39 2000, par. 29). According to IAS39, all financial assets and liabilities, including financial derivatives, should be recognised on the balance sheet (IAS39 2000, par. 15). They should initially be measured at cost, and after this all financial assets should be remeasured to fair value. However, there are some exceptions, for example financial assets whose fair value cannot be reliably measured. The financial liabilities should, after the initial recognition, be measured at original cost less repayments and amortisations. Derivatives and liabilities held for trading should be remeasured to fair value (IAS39 2000, par. 18).

The IASB defines hedging as follows:

> *Hedging for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item* (IAS39 2000, par. 27).

A hedging instrument, for accounting purposes, is a designated derivative whose fair value or cash flow is expected to offset changes in the fair value or cash flow of a designated hedged item (IAS39 2000, par. 28).

The hedged item can be an asset, liability, firm commitment or forecasted future that is exposed to a risk of change in value or changes in future cash flows. Hedge accounting recognises the offsetting effects on net profit or loss symmetrically. Hedge accounting is allowed in special cases under the condition that the hedging relationship is clearly defined, measurable and actually effective (IAS39 2000, par. 16).

4.4 Expenditures

Expenditures are the economic compensation that a company gives for the production resources that it acquires. Another definition is that expenditures are transactions that decrease the equity capital (Gröjer 1997).

The RR has a prepared a framework, which is a direct interpretation of the IASB's Framework for the Preparation and Presentation of Financial Statements. The RR framework treats fundamental concepts and principles for preparation and presentation of financial statements. It includes, among other things, definitions of assets, liabilities, equity, revenues and expenses. It states when these items should be included in the balance sheet or income statement and how the evaluation of the items should be made (RR framework 1995, par. 1, 5).

According to the RR framework, there is a close relationship between an expenditure and an asset. When a company incurs expenditures, it may seem obvious that the company's objective is to achieve future economic benefits. However, it is not necessarily the case that the company has gained something that fulfils the definition of an asset (RR framework 1995, par. 59).

ÅRL ch. 4 par. 2 allows the possibility of capitalising some intangible assets whose value is determined as the company's expenses for the specific project. The objective is to enable the company to divide the expenses over several years. A requirement for all of the expenses mentioned in the paragraph is that they have to be of significant value to the company during coming years (Westermark 1998). Examples of these expenses are costs due to research and development, patents, licenses and goodwill (ÅRL ch. 4 par. 2).

An expenditure shall not be recorded as an asset in the balance sheet if it is unlikely that the economic benefits due to the expenditure will be provided to the company during the subsequent accounting periods. The expenditure should, in that case, be expensed in the current income statement (RR framework 1995, par. 90).

4.4.1 The Nature of an Asset

Hendriksen (see Gröjer 1997) mentions that there are three characteristics of an asset. First, the asset has to have future value for the company. Second, the rights must belong to a specific individual or organisation. Third, there must exist a legal sustainable claim on the production resources.

The RR framework states that:

> *An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise* (RR framework 1995, par. 49a).

Future economic benefits are the possibility that the benefits, directly or indirectly, contribute to the cash flow (RR framework 1995, par. 53).

Once it is decided that the definition of an asset is fulfilled, the asset also needs to be classified by type of asset. The definition of an asset in ÅRL states that it is the intention of the possession that decides whether the asset is a fixed or a current asset (Westermark 1998). A fixed asset is an asset that is for continuous use or possession in the business. A current asset is an asset that does not meet the requirement of a fixed asset (ÅRL ch. 4 par. 1).

An asset should be recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the value of the asset can be measured reliably (RR framework 1995, par. 89).

4.4.2 The Nature of Expenses

According to the RR framework expenses are defined as follows:

> *Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants* (RR framework 1995, par. 70b).

The RR framework states that the definition of expenses includes losses as well as expenses incurred in the ordinary activities (RR framework 1995, par. 78).

An expense should be recognised in the income statement when there is a decrease in future economic benefits that can be measured reliably. The decrease is due to a decrease in the value of an asset or an increase in the value of a liability (RR framework 1995, par. 94).

4.5 Corporate Governance

According to Monks and Minow (2001) corporate governance can be defined as the relationship among various participants in determining the performance and direction of a corporation. The participants are primarily the shareholders, the management and the board of directors. Other participants are employees, creditors and the community.

4.5.1 Legislation

4.5.1.1 The Companies Act

The Companies Act (ABL) is a law that manages limited companies. Chapter 8 of ABL treats the management of a company. According to ABL, the general meeting of shareholders is a company's highest decision-making body. This body has an exclusive decision-making right in many important questions. The board of directors is responsible for the organisation of the company and the administration of the company's affairs (ABL ch. 8 par. 3).

The board chooses a CEO (ABL ch. 8 par. 23). This person is often a member of the board, but does not have to be. As regards the CEO, he/she cannot be the chairman of the board in public limited companies (ABL ch. 8 par. 14). There must be someone else on the board with a position to be a counterpart to the CEO (Rodhe 2002).

The CEO manages the continuous administration according to the guidelines set up by the board of directors. He/she may also take other measures, if the board's decisions cannot be obtained without essential inconvenience (ABL ch. 8 par. 25). The board should make sure that the organisation of the book-keeping and the management of assets include satisfactory control (ABL ch. 8 par. 3). The CEO should determine that the company's book-keeping is completed according to law and that the management of assets is managed in a secure way (ABL ch. 8 par. 25). There is an overall requirement that the board and the CEO are responsible, by their actions, for promoting the interests of the company (Kedner 1995).

The board is chosen at the general meeting of shareholders (ABL ch. 8 par. 6). The only requirements to become a member of the board are that the person is not underage, in bankruptcy or has a trustee. Furthermore, to become a board member, the person cannot be banned from carrying on business (ABL ch. 8 par. 9). Also, on January 1, 2002, a new section was included in ABL, stating that a person who is not intending to take on the responsibilities of a board member, cannot, without acceptable reasons, become a member of the board (ABL ch. 8 par. 9). This rule was written to prevent the shareholders from appointing persons who do not have the intention to participate in the business, i.e. people who just lend out their names (Rodhe 2002).

According to ABL ch. 13 par. 12, the board is responsible for preparing a balance sheet for liquidation purposes when there is reason to believe that the equity of the company is less than half of the registered share capital or the company is shown to have no assets available for seizure (Rodhe 2002).

According to ABL ch. 8 par. 37, the board of directors and the CEO should, at the time of their appointment, report their ownership of shares in the company and in companies within the same group. Changes in ownership should be reported within a month. It is of great importance that members of the company management do not buy or sell shares in the company without this being known to the company. The objective of this rule is to satisfy the interests of the company. Another law that states this is the Swedish Insider Act, which applies to companies listed on the Stockholm Stock Exchange. According to this law, there is a prohibition that says that an employee, who has become aware of a non-official influencing circumstance, is prohibited from using this information for trading purposes. This prohibition also applies to shareholders regarding information about the company in which they hold shares (Kedner 1995).

A member of the board or a CEO is not allowed to handle matters concerning agreements between himself/herself and the company. Further, he/she is not allowed to handle matters concerning agreements between the company and a third party, if he/she has a substantial interest in the matter that can go against the interest of the company, for example, if the third party is a company owned by himself/herself. Additionally, he/she is not allowed to handle matters between the company and a legal person, which he/she, alone or together with someone else, has the right to represent (ABL ch. 8 par. 28) (Kedner 1995).

4.5.1.2 The Annual Accounts Act

In accordance with ÅRL ch. 2 par. 1, an annual report should consist of a balance sheet, an income statement, notes on the accounts and a director's report. In some cases a cash flow analysis should be included as well. All the members of the board, as well as the CEO, should sign the annual report. If a divergent opinion regarding the annual report has been noted in the records of the board, this statement should be added to the accounts (ÅRL ch. 2 par. 7) (Westermark 1998).

Chapter 5 of ÅRL states a requirement of additional disclosure in the annual report. Apart from the disclosure of evaluation methods, fixed assets and other requirements concerning the accounting, information should be given regarding the subsidiaries and the associated companies of the enterprise (Westermark 1998). Furthermore, if a company has granted a loan to a member of the board, a CEO or similar person, this loan should be disclosed. Information should be given regarding the size of the loan, loan conditions, reimbursed amounts, etc. (ÅRL ch. 5 par. 12). Also, ÅRL ch. 5 par. 19-20 contain disclosure requirements regarding salaries and compensations to the management and other employees.

Chapter 6 of ÅRL contains rules for the director's report and the cash flow analysis. According to ÅRL ch. 6 par. 1, the director's report should contain a fair review of the development of the company's business, position and results. The director's report should be designed to complement the information given in the other parts of the annual report. Some information is required to be disclosed, but there is no hindrance from disclosing other information as well. The report should reflect the company's real situation and give as comprehensive a picture as possible. The cash flow analysis should present the company's financing and capital investments during the financial year (ÅRL ch. 6 par. 5) (Westermark 1998).

4.5.1.3 Personal Responsibility

The main rule regarding the shareholders' responsibilities is found in ABL ch. 1 par. 1. This paragraph states that the shareholders do not have personal

responsibility for the company's obligations. There are, however, certain exceptions to this rule, including, for example, law firms, where the shareholders have personal liability towards their clients (Löfgren and Kornfeld 2002).

ÅRL ch. 8 par. 12 states the personal responsibility for the members of the board and the CEO. If copies of the company's annual report and audit report have not been handed in to the PRV within 15 months after the financial year-end, the members of the board and the CEO have equitable responsibility for the obligations that apply to the company. This responsibility can, however, be avoided if the board member or the CEO can provide evidence that the failure to hand in the documents was not due to neglect on his or her behalf (Löfgren and Kornfeld 2002).

Furthermore, a shareholder can be personally responsible for paying back unlawful dividends (ABL ch. 12 par. 5). Personal responsibility can also be the case, according to ABL ch. 13 par. 17-18, for liabilities that the company has incurred after the obligation to go into liquidation has occurred (Löfgren and Kornfeld 2002).

A board member or a CEO can be liable for damages towards the company, if they, intentionally or by serious negligence, harm the company (ABL ch. 15 par. 1-6). However, at the general meeting of shareholders, decisions can be made as to whether there should be a discharge from liability for the members of the board and the CEO (ABL ch. 9 par. 7) (Rodhe 2002).

4.5.2 Stockholm Stock Exchange's Listing Agreement

This section gives a description of the Stockholm Stock Exchange's Listing Agreement. This is an agreement that is obligatory for all companies that are listed on the Stockholm Stock Exchange. The source for this section of the thesis is Guide to the Exchange Rules 2001, which is available on the Stockholm Stock Exchange's web page (www.stockholmsborsen.se).

According to the Listing Agreement, it is of great importance that all participants in the stock market are enabled to act on equal terms. Due to this,

companies must provide information in accordance with the Listing Agreement. The fundamental concept of this agreement is that all new price-sensitive information must be immediately published in a press release. In rare cases, situations arise in which the publication of certain information will seriously damage the company. In such a situation, the company may obtain permission, from the Stockholm Stock Exchange, not to publish the information. The reasons for the obligation to provide the stock market with information are stated below:

- Through information, the investors on the stock market should be able to understand a specific company's financial situation and thereby be able to make an accurate evaluation of the company's shares.

- The fair setting of prices and efficient trading provide listed companies with greater possibilities to acquire new venture capital.

- The Stockholm Stock Exchange needs information in order to ensure that trading and price setting take place in a proper manner.

4.5.2.1 The Listing Agreement

The Listing Agreement consists of several sections and below is a brief description of the most relevant sections.

The first section, the General Clause, states that a company is required to publish all new price-sensitive information immediately. This means that information which may have material effect on the valuation of the company's shares or information, which may change the previous impression of the company, should be reported directly. What is meant by the term material effect may be determined on a case-by-case basis. Examples of agreements, decisions, or events, which may give rise to the obligation to provide information in accordance with the General Clause, are major acquisitions or sales of companies, agreements of major importance and unexpected changes in results.

The section Mandatory Information Updates, states that certain information is considered to be so significant to the stock market that its release is obligatory. Examples of this type of information are stated below:

- Unaudited annual earnings figures and interim reports: reports must be given on a quarterly basis not later than two months after the end of the accounting period.

- Stock issue resolutions: the company must immediately publish a resolution regarding a planned stock issue.

- Resolutions adopted by shareholders' meetings: notices of shareholders' meetings must be published in a press release in connection with their issuance.

- Forecast adjustments: if the company has published a forecast, it has a responsibility towards the stock market. In the event that the company discovers that the forecast is inaccurate, either upwards or downwards, it must be adjusted in a press release.

- Changes in management: the departure or appointment of a CEO or member of the board of directors appointed by a shareholders' meeting must be published immediately.

- Annual reports: the annual report must be prepared in accordance with applicable law or other regulations, as well as in accordance with GAAP applicable to stock market companies.

In the section Selective Information, it is stated that in very special situations, a company may release information to certain parties without publishing the same. An example of this could be to inform advisers or major shareholders prior to planned stock issues or other major transactions. The opportunity to utilise this exemption must be used very restrictively and applies only to the release of information that is of major significance to the company.

Transactions with Affiliated Parties is a section that states that specific information is required when a listed company decides to carry out a business

transaction with a senior executive of the company. Senior executives possess special knowledge regarding the company and its business, and thus there is a risk that this advantage may be used at the shareholders' expense.

The Listing Agreement also contains five recommendations from the Industry and Commerce Stock Exchange Committee. These recommendations are compulsory for companies listed on the Stockholm Stock Exchange. The recommendation, Benefits to Senior Management, states that in the annual report, Swedish listed companies must provide information with respect to benefits to senior management. This applies to both the CEO and chairman of the board of directors, as well as to any other member of the board of directors who receives separate compensation.[11]

[11] There are also recommendations that treat the following areas: Public Tender Offers, Acquisitions and Transfers of Securities; Disclosures, Information Prior to Elections of the Board of Directors and Purchase by a Company of its Own Shares. However, as these are outside the scope of the thesis they are not discussed further.

5. EMPIRICAL RESEARCH

The empirical research is based on the different areas described in the theoretical framework: consolidation, financial derivatives, expenditures and corporate governance. The chapter consists of two parts. The first part of the chapter outlines the changes in the regulation of accounting and corporate governance in the USA, following the recent accounting cases. The second part of the empirical research presents the results of the interviews that we have carried out with auditors in order to find out if and how Swedish regulation will be affected by the recent accounting cases in the USA.

5.1 US Changes in Accounting and Corporate Governance Rules

After the cases of Enron and WorldCom there have been discussions in the USA that the framework of regulation, of both accounting and corporate governance, is not enough and needs to be improved. Due to this, several changes have been proposed or enacted to prevent similar cases from occurring again. In this part of the chapter we give a brief overview of the changes made in the USA, as regards the areas of consolidation, financial derivatives and corporate governance. In the area of expenditures there have not been any changes so far, which is why this area is not discussed in this section of the chapter.

5.1.1 Consolidation

According to current US accounting standards, a company is required to consolidate a subsidiary in which it has controlling financial interest. This requirement is usually based on whether the company has a majority voting interest in the subsidiary, or not. However, in many cases where a company has similar relations with an SPE, the SPE is not included in the consolidated financial statements. The reason for this is that in ARB51, Accounting Research Bulletin - Consolidated Financial Statements, it is stated that consolidation should be based on voting interest. However, the relationship between a company and an SPE is established in other ways. The Financial

Accounting Standards Board (FASB)[12] states that, if a company has a controlling financial interest in an SPE, the assets, liabilities and the result of the SPE should be consolidated in the financial statements (FASB 2002).

In June 2002, the FASB issued an exposure draft regarding consolidation of SPEs, Proposed Interpretation – Consolidation of Certain Special-Purpose Entities – an Interpretation of ARB No.51. The exposure draft aims to achieve more consistent application of consolidation policies to SPEs and thereby improve the comparability among companies that are engaged in the same activities, even if some of those activities are conducted through SPEs. Another objective is to provide more complete information about the consolidated companies, by including the assets, liabilities and results of the SPEs in the consolidated financial statements (FASB 2002).

The rules of the exposure draft explain how to identify an SPE that is *not* subject to control through voting interests. They require each company involved with such an SPE to determine whether it provides financial support to the SPE through a variable interest. This variable interest may stem from financial instruments, service contracts, nonvoting ownership interests, or other arrangements. If a company holds either a majority of the variable interest in the SPE, or a significant variable interest that is significantly more than any other party's variable interest, that company would be the primary beneficiary. The primary beneficiary is required to consolidate the SPE's assets, liabilities and result in the financial statements. It will also need to disclose information about the assets, liabilities and the activities of the consolidated SPEs (FASB 2002).

The exposure draft shall not be applied when one or more parties hold equity investments in an SPE that meet all of the following criteria. In that case the evaluation should be based on majority voting interest.

- The nominal owners of the SPE have control of the SPE through voting interest.

[12] The FASB is the accounting standard setter in the USA. The objective of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public (www.fasb.org, a).

- The equity investment in the SPE is sufficient to allow the SPE to conduct and finance its own activities without additional financial support.

- The equity investment is subordinate to all other equity investments of the SPE. This means that the equity investment is the first interest subject to any possible loss and the return of the investment is not limited or guaranteed.

- The assets exchanged for the equity interest are not subordinated beneficial interest in another SPE.

- The equity investment was not provided directly or indirectly by the SPE or other parties involved with the SPE.

If one or more of these conditions are not met, the party making the investment shall consider the investment as a variable interest, and the rules of the exposure draft shall be applicable (FASB 2002).

5.1.2 Financial Derivatives

FAS133, Accounting for Derivative Instruments and Hedging Activities, issued by the FASB, establishes accounting and reporting standards for derivative instruments and hedging activities. In May 2002, the FASB issued an exposure draft, Proposed Statement of Financial Accounting Standards – Amendment of Statement 133 on Derivative Instruments and Hedging Activities, which would amend FAS133 in four key areas (www.fei.org, a):

- Application of scope to commodity contracts
- Interest rate hedging
- Hedging foreign currency receivables/payables
- Hedging foreign currency risk with intercompany derivatives

As the exposure draft treats areas that are not covered in the thesis, a further description of the exposure draft will not be given.

The FASB has also issued a draft, Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE), relating to FAS140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This draft was issued due to certain inquiries received, as an aid to understanding and implementing FAS140 (www.fasb.org, b). The draft contains detailed information regarding certain issues that are not clearly defined in FAS140 and also gives practical examples of how the rules should be applied.

5.1.3 Corporate Governance

5.1.3.1 The Sarbanes-Oxley Act

In July 2002, the US government enacted the Sarbanes-Oxley Act of 2002[13]. The Act is applicable to all companies, both foreign and domestic, that are listed on a stock exchange in the USA.

The objectives of the Act are to restore investors' confidence and to ensure that the market receives correct financial information (Greene 2002). The first section of the Act deals with the establishment of a Public Company Accounting Oversight Board. This board will be a non-government, independent organisation to oversee the audit of public companies. It will establish quality control standards and ethics standards to be used by the public accounting firms in the preparation of audit reports. Additionally, the board will inspect the accounting firms regularly and any deficiencies will be reported to the SEC and be made publicly available. The SEC will conduct the oversight of the board (www.fei.org, b).

According to Greene (2002), there are four means stated in the Act by which the objectives of improving corporate governance will be achieved.

First, financial disclosure has to be improved, for example as regards off-balance-sheet transactions. The management must also ascertain the accuracy

[13]When enacted the name of the Act was changed to the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (Dobie 2002). However, throughout the thesis it is referred to as the Sarbanes-Oxley Act.

of the company's disclosures and internal controls (Greene 2002). The SEC should issue rules that will require companies to disclose off-balance-sheet transactions of material importance for the financial condition of the company. Management and principal stockholders of a company should inform the SEC regarding sales and purchases of that company's shares. Furthermore, the SEC should issue regulations requiring that the annual report should state the management's responsibility for establishing and maintaining internal control structures and financial reporting. The SEC should also issue rules that require companies to disclose information regarding whether senior financial officers have signed a code of ethics or not. Each company that issues financial statements shall timely disclose material changes in the financial condition or operation of the company (www.fei.org, b).

Second, independence of the auditor has to be assured. It is also important that the professionalism of the audit is maintained. This should be achieved by prohibiting the auditor from performing non-audit services to the client at the same time as audit services. Also, the scrutiny of the accounting firms and the standard-setting process has to be reformed (Greene 2002). The audit committee of a company shall approve all audit and non-audit services provided by the accounting firm, and the accounting firm shall report to the audit committee the methods, practices and policies underlying the audit work (www.fei.org, b).

Third, there should be a corporate structure to oversee the audit and management's financial disclosure. All listed companies should establish an audit committee. This committee should consist of independent directors responsible for the appointment, compensation and scrutiny of the work of the accounting firm, as well as other mandated tasks (Greene 2002). The management of a company is responsible for certifying the annual and quarterly reports to the SEC and the company is prohibited from providing the accounting firm with inaccurate information. The management of a company is also prohibited from selling, purchasing and transferring shares of the company during pension fund blackout periods (www.fei.org, b).

Fourth, improper conduct must be punished (Greene 2002). The Act amends the US Code to provide new penalties for destruction, alteration and falsification of documents relating to a federal investigation or bankruptcy. Any

audit review paperwork shall be retained for a period of five years. Penalties for violations will be fines or imprisonment. There shall be protection for employees of publicly traded companies who provide evidence of fraud. Furthermore, any person who purposely defrauds shareholders shall be fined or imprisoned, or both. The Act also contains penalty enhancements for mail and wire fraud. Furthermore, the US Sentencing Commission is given authorisation to tighten sentencing guidelines for certain white-collar crimes. Each periodic report to the SEC shall be certified in writing, by the CEO and the CFO, stating that the financial statements are in compliance with securities laws. The penalties for breaking these rules will be fines or imprisonment (www.fei.org, b).

5.1.3.2 New York Stock Exchange's Corporate Governance Rule Proposals

In February 2002, the New York Stock Exchange (NYSE) was asked by the SEC to review its corporate governance listing standards to enhance the accountability, integrity and transparency of the companies listed on the NYSE. Therefore, the NYSE appointed a Corporate Accountability and Listing Standards Committee to review its current standards. This project resulted in a report, Corporate Governance Rule Proposals. Below is a brief summary of the parts that we find are relevant for the thesis. The source in this section of the thesis is the Corporate Governance Rule Proposals, which is available on the NYSE's web page (www.nyse.com).

Independent Directors
All listed companies must have a majority of independent directors. This is required as it will increase the quality of the board oversight and minimise the problems regarding conflicts of interest. The independence requirement means that the director should have no material relationship with the listed company. Furthermore, the independence requirement is not fulfilled if:

- The director is a former employee of the company and five years have not passed since the employment ended.
- The director is or has been an affiliate or employee of the company's accounting firm and five years have not passed since the affiliation or the auditing relationship ended

Nominating/Corporate Governance Committee
Each listed company must have a Nominating/Corporate Governance Committee that consists of independent board directors. One objective of the committee is to identify qualifying board members and to select, or recommend, these as board members. Another objective is to develop corporate governance principles applicable to the company.

Compensation Committee
Each listed company must have a Compensation Committee composed entirely of independent directors. The purpose of the committee should be to have the responsibility for issues relating to compensation of the company's management. The committee should also produce an annual report on executive compensation for inclusion in the company's proxy statement. The duties and responsibilities of the committee should be to review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation.

Audit Committee
The Audit Committee shall have increased authority and responsibility including the right to hire and fire independent auditors as well as approve non-audit relations with the auditors. The purpose of the Audit Committee is to assist the board in the oversight of, for example, the integrity of the financial statements and the company's compliance with legal and regulatory requirements.

Shareholders' Control over Equity-Compensation Plans
Shareholders should have the opportunity to vote on certain equity-compensation plans to increase their control over the plans.

Corporate Governance Guidelines
All listed companies must adopt and disclose corporate governance guidelines. There are no rules that are suitable to all companies, but there are areas of great importance that must be covered. These are:

- Director qualification standards
- Director responsibilities

- Director access to management and independent advisors
- Director compensation
- Director orientation and continuing education
- Management succession
- Annual performance evaluation of the board

Code of Business Conduct and Ethics

Listed companies must adopt and disclose a code of business conduct and ethics for management and employees. This code aims to provide guidance in order to help the management and employees recognise and deal with ethical issues. It should also provide mechanisms to report unethical conduct and maintain and develop a culture of honesty and accountability. Each company can set its own code of business conduct and ethics, but there are several important topics that have to be covered. Some examples are stated below:

- Conflicts of interest: these occur when an individual's personal interest interferes with the interest of a company as a whole. The company should have a policy prohibiting this situation from occurring as well as providing a means for the management and employees to address the issue in a communicative way.

- Corporate opportunities: management and employees should be prohibited from using the company's property, information or position for personal gain or to compete with the company.

- Protection and proper use of company assets: all company assets should be used legitimately by management and employees.

- Compliance with laws, rules and regulations.

- Encouraging the reporting of any illegal or unethical behaviour: the company should encourage the employees to talk to the appropriate personnel when they are in doubt regarding a certain situation or if they have discovered violations of laws, rules, regulations and the code of business conduct.

Certification by the CEO
The CEO of a listed company must every year certify that he/she is unaware of any violation by the company as regards the NYSE corporate governance rules.

5.2 Swedish Changes in Accounting and Corporate Governance Rules

Since there have been changes in the regulations of accounting and corporate governance in the USA, due to the recent accounting cases, there is a possibility that this situation will affect Swedish regulation as well. In order to find out if and how the accounting cases in the USA will affect Swedish companies, we have conducted interviews with auditors. The respondents are all authorised public accountants working for different accounting firms in Sweden[14].

The interviews have been carried out through discussions of the different areas of consolidation, financial derivatives, expenditures and corporate governance[15]. We use the same structure when presenting the results of the interviews below.

5.2.1 Consolidation

5.2.1.1 Regulation

The respondents are all of the opinion that there is enough Swedish regulation in the area of consolidation. The area is regulated in the RR's recommendation, RR1:00, Consolidated Accounts. There is also an interpretation from the IASB's emergency group, IFRIC, called SIC12, which addresses the issue of consolidation of SPEs. According to Winkvist, RR1:00 is based on IAS22 and IAS27 and therefore it is assumed that the interpretation of these standards, SIC12, is also applicable in Sweden. Mabon thinks that companies have avoided using SIC12, but in a couple of months the RR will issue a

[14] For details of the respondents, see Appendix III.
[15] The Swedish questionnaire, which was used at the interviews, is found in Appendix I. A translation into English is found in Appendix II.

pronouncement, which is a direct translation of the interpretation SIC12, that needs to be followed. Winkvist and Bohlin both say that despite the existing regulation, there are questions regarding interpretation and guidance in the area. Grundvall is of the same opinion and says that the application of the rules varies. He gives as an example that many companies focus on the owning interest, that is, an associated company should be consolidated if you own 20% or more of the shares. However, there are other criteria. For example, even if you only have 10% of the shares you may have a significant influence in the company and therefore that company is to be consolidated as an associated company.

5.2.1.2 Disclosure Requirements

Most respondents seem to be in agreement that there are enough requirements regarding disclosure of which companies to consolidate in the annual report. However, Winkvist discusses the disclosure of so called off-balance-sheet companies and says that there are no specific disclosure requirements for these in Sweden. He makes a comparison to the regulation in the USA, which requires companies to provide information regarding off-balance sheet arrangements. Grundvall means that Swedish companies are generally not following requirements for disclosure. Therefore, he does not think that a supplement as regards the requirements is needed, but the application needs to be more strictly followed.

5.2.1.3 SPEs in Sweden

Winkvist believes that there are Swedish public limited companies that have SPEs, for example, a trust on Jersey or perhaps in the Caribbean. However, this is not a Swedish SPE in the sense that it is not a Swedish legal entity, but it is a Swedish SPE in the sense that it is a Swedish company that owns the SPE. Some accountants believe that an example of a Swedish legal entity similar to an SPE is a limited partnership in which a real estate company has placed its property holdings, with the objective of then leasing them back. According to Winkvist, this kind of arrangement has existed for a long time, mainly to avoid stamp tax and to facilitate transactions. Mabon is also of the opinion that the

reasons for many of these arrangements in Sweden are practical and says that he has never seen or been in contact with Swedish companies using the SPE arrangements the way Enron did. He thinks that the reason for this is that Swedish management compensation is not based on the result to the same extent as in the USA and therefore there might not be the same motive to manipulate the result. Even though certain Swedish management compensation schemes are linked to earnings, the rewards are still a fraction of those in the USA.

Markborn says that there are no specific regulations for SPEs in Sweden. However, he can imagine that they exist since companies use structured finance in order to create benefits to the company. Grundvall says that the regulation of SPEs is typical for the USA. However, the problem exists in Sweden as well. As an example, he mentions the case of the Swedish company Prosolvia, where there was a discussion regarding certain subsidiaries that were not consolidated.

Regarding what consolidation rules to apply to these kinds of companies in Sweden, Bohlin states that SIC12 is applicable. In addition, Mabon believes that when using the IAS rules it is almost impossible not to consolidate an SPE.

5.2.1.4 Possible Changes in the Regulation

Most respondents are of the opinion that the regulation of consolidation in Sweden will not be changed as a direct result of the recent accounting cases in the USA. However, as Sweden is heading towards adoption of international accounting standards[16], there could be changes in Sweden due to changes made by the IASB.

According to Mabon, the most common reason for non-consolidation is to reduce the balance-sheet total in order to achieve better key ratios and one way to achieve this is through securitisation[17]. Mabon says that the implementation

[16] In June 2002, the Council of the EU approved the so called IAS 2005-enactment. The enactment requires that all listed companies in 2005 shall prepare the consolidated accounts in accordance with IAS (www.pwcglobal.com).
[17] Securitisation: to consolidate and sell to other investors for resale to the public in the form of securities (www.m-w.com).

of SIC12 erases a small area of uncertainty, since there have probably been transactions made in the area of securitisation that will not be allowed in the future by using SIC12, or rather that de-consolidation and initial profit recognition will not be allowed. Winkvist states the importance of applying the existing rules in a correct way. Personally, he wishes for more guidance on how to apply SIC12.

Grundvall says it is possible that there will be a supplement with clearer guidelines regarding how to determine whether significant influence exists in a company, even though there is no majority of ownership.

Markborn thinks that it is important to pay attention to new innovative instruments in the market, and how these should be handled. He thinks that today's companies want to report on values and since not all companies are able to obtain resources to do this, companies have to find new finance possibilities. He thinks that there will be more innovations where companies want to enhance and improve their portfolio.

Some respondents also discuss the possibility of a joint project between the IASB and the FASB. According to Markborn, these organisations have the resources to investigate and see what the future accounting standards will be. But he stresses the importance of a Swedish emergency group and states that there is a need for people who understand IAS and how this regulation should be handled from a Swedish perspective.

5.2.2 Financial Derivatives

5.2.2.1 Regulation

All respondents have the same opinion regarding financial derivatives; there is not enough regulation in Sweden. Grundvall says that this is a difficult area with little guidance for companies. This lack of guidance opens up the possibilities of different ways for how to account for financial derivatives. If someone wants to manipulate the accounting, it is of course easier if there is no clear regulation. Winkvist says that the FAR has issued a draft regarding recommendation on accounting for forward and futures contracts and

standardised options, but the draft is old and does not address all instruments and may not be in line with the current thinking of how financial instruments should be accounted for. Grundvall mentions a new recommendation coming next year treating disclosure and classification of financial derivatives. According to Markborn, the regulation in the area of financial derivatives consists mainly of what the FI is prescribing in the bank sector, how to account for derivatives among other assets and liabilities.

The main reason that Sweden does not have the same regulation as FAS133 or IAS39, treating financial derivatives, is, according to Mabon, that these recommendations use market valuation, which is not in compliance with ÅRL and therefore cannot be used in Sweden today. He thinks that this requires a change in legislation prior to implementing the IAS regulation in Sweden in 2005.

5.2.2.2 Disclosure Requirements

All respondents agree that there are not enough requirements for disclosure of financial derivatives in Sweden. Grundvall says that today the derivatives often are off the balance sheet, which might limit the disclosure requirements and it is easy to see that the companies do not fulfil today's requirements regarding, for example, currency and forward contracts.

Winkvist says that there is a recommendation from the RR, RR27, Financial Instruments: Disclosure and Classification, which will require much disclosure. However, the recommendation does not apply to contracts that give delivery of raw material and these contracts may also need disclosure requirements.

Markborn says that it is only in the bank sector, which is under the supervision of the FI, that there are disclosure requirements for financial derivatives. He thinks that all companies should provide disclosure that states the present value of future contracts. However, both he and Bohlin believe that this issue will be regulated in Sweden through the implementation of IAS. Bohlin stresses the importance of considering what is happening in the international field of accounting. Markborn thinks it is important to start thinking more "mark to market", which is one of the main features of both the FASB and the IASB.

5.2.2.3 Possible Changes in the Regulation

All respondents are of the opinion that there will be changes in the regulations in the area of financial derivatives. However, these changes will not be a consequence of the recent accounting cases in the USA, but are due to the fact that there is not enough regulation at present. Winkvist says that through the introduction of RR27 there will be rules regarding the disclosure of financial derivatives.

The respondents are in agreement that there will be changes due to the implementation of IAS in 2005, as financial derivatives are regulated in the IASB standards to a greater extent than they are currently under Swedish regulation. The respondents mention IAS39 as a standard that is applicable in this area. However, Winkvist mentions that to use this standard there is a need for a change of ÅRL, since IAS use actual valuation and this is not permitted in the present ÅRL. He says that there is a memorandum from the Ministry of Justice regarding this issue that proposes to change ÅRL and to permit fair value accounting for financial instruments. Bohlin says that due to this memorandum, there will be changes to ÅRL in 2004.

Mabon discusses the consequences of the implementation of the IAS regulation in 2005. He says that first of all, it will result in a market evaluation, which is not currently used in Swedish accounting. Secondly, transactions that Swedish accounting permits to be off-balance sheet today will be included in the balance sheet with the new regulation. Thirdly, transactions that are considered hedged today will not be considered hedged, since the new regulation has very strict criteria that have to be fulfilled in order for a transaction to be considered hedged.

5.2.3 Expenditures

5.2.3.1 Regulation

All respondents agree that there is regulation in Sweden that treats whether expenditures should be capitalised or expensed. However, they hold different views as to whether the regulation is clear enough. Markborn thinks that clearer

regulation cannot be achieved. He says that the legislation in itself is not so clear, but there are recommendations from the RR, and also from the BFN. In his view, this together is enough regulation regarding what should be capitalised and what should be expensed. Each business is unique and the test of whether to capitalise an expenditure should be based on the ability to generate improved future earnings or cash flow. Mabon also thinks that the regulation clearly defines whether expenditures should be expensed or capitalised. However, he gives as an example that maintenance expenditure is one area of uncertainty, but says that a translation of an IFRIC statement in this area will soon be issued, which will provide guidance. Winkvist also discusses the problem area of maintenance expenditures. He says that it is difficult to decide which expenditures are value-added and which expenditures are maintenance. This is to a great extent a question of judgement and that is what makes it so difficult. Furthermore, he thinks that the fundamental rules are very clearly defined, but their application is not always easy.

Grundvall thinks that the new recommendation RR15, Intangible Assets, defines quite clearly what expenditures to capitalise or not. He says that the recommendation will affect many companies, since it states that under certain circumstances capitalisation should be made. Many companies want to expense expenditures due to prudence and are concerned that they will have to capitalise such expenditures using the new recommendation. Grundvall also states that it might be the application of the rules that is difficult and not the regulation that is unclear. For example, if a company is not doing so well, it might have an interest in capitalising the expenditures. Sometimes, Grundvall says, it is very difficult for the auditor to judge whether the company has applied the rules correctly.

5.2.3.2 Possible Changes in the Regulation

Most respondents do not believe that there will be any immediate changes, due to the recent accounting cases in the USA, in the regulation in the area of expenditures. However, Bohlin thinks that there might be changes in the future. Winkvist is of the opinion that there is enough regulation and the rules should not be changed only because someone decides to break them. Markborn states that it is difficult to change the regulation since realisation of assets is

determined by assessment of the future. Grundvall says that the principles have always been quite the same. It is the judgement of the future value of the expenditures, which is difficult and always will be. Grundvall and Mabon say that the only changes will be through the implementation of rules prescribed by the IASB.

5.2.4 Corporate Governance – Legislation

5.2.4.1 Definition of Corporate Governance

Winkvist says that, in his opinion, corporate governance is how a company is supervised and controlled on a board level. He thinks it is difficult to express the term in Swedish, but he interprets it as the regulation of the board's work. Corporate governance is not a new concept, according to Winkvist, but everyone is using it today and seems to know what it means.

In Markborn's opinion corporate governance is "checks and balances". This is a US term that means that the board should be balanced, so that the management does not have superior control in decision-making. Companies need to work in a way so that people have confidence in them.

To Grundvall corporate governance is all the rules and customs that govern how the general meeting of shareholders, the board, the CEO and the auditors should act together and how the company should be managed.

According to Mabon, corporate governance means that you run a company in a moral and ethical way. This means that the focus is to run the company for the benefit of the shareholders and not to run the company for your own personal benefit.

Bohlin says that corporate governance means governance, control and follow up, in other words, how the board and the CEO do their work.

5.2.4.2 Responsibilities of the Management and the Board

Bohlin's opinion is that if the board and the management act with the right level of integrity and ethics, there should be no problems. If someone wants to cheat, no regulation is sufficient.

Mabon thinks that there is enough regulation in Sweden to prevent the management and the board from favouring themselves. Most boards have compensation committees to ensure that the compensation is reasonable. Through compulsory disclosures in the annual reports, the owners and media receive information regarding compensation, for example salaries, bonuses, pensions or redundancy payments.

Winkvist is also of the opinion that there is enough regulation in this area. He refers to ABL, where, for example, there are rules stating that certain decisions should be made at the general meeting of shareholders. There is also a law treating certain share issues in public limited companies[18]. Furthermore, Winkvist says that the Stock Market Panel[19] has issued a draft, 2002:1 Incentive program, which, for example, treats the board members' participation in share issues. However, the fact that the board favours itself cannot be prevented completely.

Grundvall says that as regards the conflict between the management's private interest and the company's best interest, he does not think that further regulation can prevent the risk of improper conduct. However, he thinks that it is important that the market and the owners receive additional and clearer information. This will give the owners the opportunity to decide whether there has been improper conduct.

Markborn is of the opinion that there should be additional disclosures regarding the management's compensation. Today, it is only required to disclose compensation of the CEO and pensions for the group, the board and the CEO. He refers to the US system, where a SEC registrant is required to disclose all

18 Lag (1987:464) om vissa riktade emissioner i aktiemarknadsbolag m.m.
19 The Stock Market Panel (Aktiemarknadsnämnden) provides statements, guidance and information in order to achieve good practice in the Swedish stock market (www.aktiemarknadsnamnden.se).

compensation to the five highest paid persons in the company and their benefits for the last three years. Markborn thinks it is important with transparency and clarity in this area to earn the confidence of the market.

Grundvall and Mabon think there is enough regulation in Sweden as regards the management's and the board's responsibility towards the company. Grundvall says that perhaps the owners should, to a greater extent, state instructions regarding certain questions relating to the owners. The owners could also be represented in, for example, audit committees and compensation committees. Mabon and Winkvist think that the existing legislation, i.e. mainly ABL, is enough.

Markborn thinks that there should be strict policies regarding the board's and the CEO's responsibilities. He discusses to what extent the CEO should be a member of different boards. In his opinion, the CEO should not be on more than two boards. The primary task of the CEO is to manage the company he works for, and to work on a board is very demanding in the current environment. He does not think that it is possible to regulate this by law, but says that it should be regulated by each board of directors so that the CEO can manage his or her tasks the right way.

5.2.4.3 Requirements of Supervision

The general opinion of the respondents is that the FI is the supervising authority in Sweden, although it does not have the same role as the SEC in the USA. According to Winkvist, the FI reviews a company's prospectus, but there is no organisation that reviews the annual reports apart from the auditors. In the USA, the SEC has the authority to review the annual reports and ask questions of the companies. Winkvist and Grundvall say that in Great Britain there is an independent organisation called the Review Panel, which is to take on the role of studying annual reports of companies listed on the London Stock Exchange and judging whether they have acted in the right way. They say that this is also something that does not exist in Sweden. However, there is a discussion whether Sweden should create a similar panel. In Grundvall's opinion, it is not certain if this Review Panel will be the FI, the Stockholm Stock Exchange or any other independent organisation. Bohlin mentions the Review Panel as well

and says that this area is under investigation by the FI, which plans to present a report regarding this in February 2003.

Grundvall thinks that there is generally enough supervision of Swedish companies. However, he thinks that supervision will be made stricter in the accounting area and with the compliance with IAS, and that the FI probably will take a stronger position regarding the supervision.

Grundvall says that Sweden has a tradition of self-regulation, compared to the USA that have a detailed external regulation. The advantage with the Swedish system is that there are requirements, which are easily adjusted to what the market demands. The disadvantage is that non-compliance with the regulation is not as heavily sanctioned as in the USA.

Grundvall says that the US system could be misinterpreted in the way that all that is not regulated is allowed, even though it might not show a true and fair view. In his opinion the Swedish system, which is based more on true and fair view, is more comprehensive and therefore better. Also, the system in Sweden refers to GAAP and interprets what GAAP is for the market. Grundvall thinks that due to this, there is no need for stricter supervision in Sweden.

Most respondents also refer to the Stockholm Stock Exchange as a supervising authority. Grundvall says that the Stockholm Stock Exchange does not supervise to the same extent as the SEC, but there has not been the same need for such supervision. However, the Stockholm Stock Exchange has, through its Listing Agreement, requirements for listed companies to follow GAAP and the recommendations of the RR, allowing for the possibility of sanctions if companies do not follow these requirements. As there are so many new recommendations coming, Grundvall thinks that the compliance is not what it should be and in that way, the enforcement is not strong enough.
Mabon thinks that a strength in the Swedish legislation is that all companies have to be audited. Also, there is an administration responsibility stated in ABL, which describes the management's responsibility for the accounting and for paying taxes and fees. Together with the supervision by the FI and the Stockholm Stock Exchange, he considers this to be enough.

Grundvall states that there is a discussion regarding whether there should be a European equivalent to the SEC, i.e. an authority or organisation that can take responsibility for the supervision of listed companies in Sweden and within the European Union (EU). The objective should be to gain uniformity or a more similar application of different rules in Europe.

Winkvist discusses the problem of the enforcement of IAS rules when implemented in Sweden in 2005. He says that there is a debate on how to ensure that the rules are used consistently in the whole of Europe and if there should be a European version of the SEC. However, he is not sure that he is personally in favour of such an organisation.

5.2.4.4 Possible Changes in the Regulation

The respondents are of different opinions regarding whether there will be any changes in the regulation of corporate governance in Sweden due to the recent accounting cases in the USA. Markborn believes that there will be many changes in the area of corporate governance, the discussion has accelerated because of the recent debate of what has happened in the USA. He thinks that the general discussion regarding option-programs and unreasonable bonuses is also contributing to this debate. Markborn says that there will be nominating committees, audit committees and compensation committees. He also thinks that there will be distinct changes in the work of the boards. In some audit committees both the CEO and the chairman of the board are members. Markborn thinks that these two cannot be members of the same committee since the auditor cannot have an opinion of the person whose work is to be audited, as well as of the person who gave him the task. In his opinion there should always be a majority of non-employees in the committees. Markborn adds that the stock market, the investors and the community as a whole must trust that there will be no cases similar to those that happened in the USA.

Grundvall is of the opinion that there might be possible changes. For example, there is an ongoing discussion about audit committees. This is an issue that Winkvist also addresses. He is not certain that he favours a requirement of audit committees, even though he thinks it might be suitable for companies to have one. In some cases where the board is quite small there might be a

problem to put together an audit committee. He adds that Sweden already has the custom of independent board members, so he is not sure if audit committees are of the same importance in Sweden. However, the definition of independent in Sweden is not the same as used in the Sarbanes-Oxley Act. Another question, which Winkvist thinks is of great importance, is how much the regulation should be based on the law and how much self-regulation there should be. In his opinion the Swedish system of self-regulation usually works.

Winkvist is not certain that the recent accounting cases in the USA will lead to new regulation, but perhaps there will be changes through the EU. He thinks it is important to study these questions from a European perspective, as Sweden will not do anything on its own or diverge from a possible action by the EU.

Bohlin is also of the opinion that some changes will be made, but not to the same extent as in the USA. However, he thinks that there will be audit committees in listed companies, which he favours. He is also in favour of self-regulation and does not think that anything like the SEC is needed in Sweden, partly due to the fact that Sweden is such a small country. Furthermore, Bohlin says that there is a governmental Commission of Ethics & Reliance[20], led by the former minister of finance, Erik Åsbrink, which will deal with the issues that have been discussed in the aftermath of the events in the USA. He says that the future will tell what the committee will come up with.

Bohlin does not think that all the detailed changes, like the ones in the Sarbanes-Oxley Act, will be implemented in Sweden. According to Winkvist, the Sarbanes-Oxley Act is not suitable in Europe. As an example, he says that in Sweden it is the board that is responsible for signing the annual report according to ÅRL. He does not think that the US system, where the CEO and the CFO sign the annual report, suits the Swedish legislation.

Mabon says that with the current legislation, the audit obligation and the supervising organisations that exist in Sweden today, he cannot see that Swedish regulation is in the need of a change. He does not think that Sweden has the same problems as in the USA. One reason for this is that there is not the

[20] Etik & Förtroendekommission.

same level of compensation in Sweden. Cases where people take advantage of shareholders or the company are unusual in Sweden, even though they do exist.

5.2.5 Corporate Governance – Stockholm Stock Exchange

5.2.5.1 Regulation in the Stockholm Stock Exchange Listing Agreement

Winkvist thinks that there is no need for more regulation regarding the companies' organisation in the Listing Agreement. He says that the Swedish system is different from the US system. For example, in Sweden a custom of independent board members already exists. However, he thinks that there might be a requirement for audit committees.

Grundvall says that the Stockholm Stock Exchange has for a long time had similar requirements to those now introduced in the USA. There is a requirement that two members of the board should be independent in relation to the principal owners, and one of those should have experience of the stock exchange. The majority of the members should be independent in relation to the management. These requirements mainly exist to consider the interests of the minority owners and to ensure that the process of providing information is handled in a correct way. Grundvall says that this is an area where there might be changes.

Bohlin is of the opinion that the Stockholm Stock Exchange will definitely not change the rules regarding the company's organisation in the same way as the NYSE.

5.2.5.2 Possible Changes in the Stockholm Stock Exchange Listing Agreement

Markborn believes that the rules for listing on the Stockholm Stock Exchange will be changed. However, he thinks that the Stockholm Stock Exchange has a difficult task, since it is a marketplace that should be profitable as well as being a "watchdog". Markborn says that if there will be changes in the regulation they will probably be similar to the changes made in the USA. If the Stockholm Stock Exchange is to be responsible for the quality of the companies, the size

of the FI must increase, even though it will not be of similar size as the SEC. He also believes that the FI needs many more resources.

Winkvist does not think that the rules will be changed, but there is a possibility that this could occur in case there are changes in this area in the EU regulation. Grundvall and Mabon are of the opinion that there will be no changes in the rules due to the recent accounting cases in the USA. Grundvall says that this is because Sweden and the Stockholm Stock Exchange have been one step ahead of other markets. The Stockholm Stock Exchange regularly reviews the listing requirements. However, Mabon says that one consequence might be a stricter application of the Listing Agreement.

Bohlin does not think that the listing requirements need to be changed extensively, but he believes that there is a possibility that there will be changes that make the requirements stricter.

5.2.6 Other Issues

5.2.6.1 Possible Changes in Other Areas

Winkvist thinks that generally there is enough regulation today. In many cases it is the morals and ethics of each individual that are the issue, not the lack of regulation.

Markborn says that what has happened in the USA will undoubtedly affect Europe. He discusses whether there should be self-regulation in Sweden or not. He thinks that the market and the politicians, as well as the EU, will not accept total self-regulation. It is possible that there can be a limited form of self-regulation, but with the condition that it must work. If it does not work, more regulation will be needed. Markborn is of the opinion that self-regulation alone will not work. He says that if Europe is to be regulated, there must be a similarity in the systems. Furthermore, he thinks that the FI of the future will be twice the size of today. He thinks that the Stockholm Stock Exchange will become more like a marketplace. It is possible that the Stockholm Stock Exchange will still approve the companies to be listed, but on delegation from the FI. Markborn thinks that a natural reaction, after the accounting cases in the

USA, is that the roles and structures of these different organisations will change.

Grundvall would like to see differentiations in the requirements between small and large companies in ABL. He also thinks that there could be requirements for corporate governance rules in ABL.

Mabon discusses the frequency in the issuance of new accounting regulations. He mentions as an example the recommendations from the RR, which are increasing rapidly. Mabon thinks that there are enough changes at the moment and that there is no specific area where he wants to see new regulations. However, he is not eliminating the possibility that the Sarbanes-Oxley Act will have future consequences in Sweden.

Bohlin thinks that the implementation of IAS in 2005 is good. He does not believe that there are any other areas that need to be changed.

5.2.6.2 Prevention of Illegal Manipulation and Fraud

There is a joint opinion, among the respondents, that accounting rules cannot be written in a way that prevents illegal manipulation and fraud. They all say that if people have the wrong intentions, it does not matter what regulation there is, people will circumvent or break the rules anyway. Winkvist thinks that sometimes there could be incentives to do this, and mentions, as an example, that if a person benefits from the market value of the stock, there might be an interest to achieve a higher market value in different ways.

However, Mabon says that the risk can be reduced by, for instance, implementing different control systems in the company. Grundvall thinks that through clear regulation and stronger follow-up and better possibilities for sanctioning there will be a better compliance with the rules. But to have efficient sanctions, the rules must be clear and he thinks this is something that can be improved. Also, the knowledge of the management and the board as regards accounting issues is important.

Markborn makes a comparison to the US system and states that in his opinion the capital market and the reporting system in the USA are superior. On the other hand, he adds that it is a country where the risks are remarkably bigger, since people may have other motives as well as a different culture. He says that the US system is not perfect in any way, but adds that if the recent accounting cases could happen in the US environment, with that regulation, the only explanation is that people have malicious intent or want to cheat people.

Grundvall mentions WorldCom, as an example, where the manipulation did not seem to be due to unclear rules or lack of regulation. He says that in this case it seems as if expenditures were capitalised instead of expensed, which was due to inaccurate application of accounting rules. The rules were not unclear, and it was how the accounting rules were applied that was incorrect. Winkvist also discusses WorldCom and says that even though WorldCom's accounting was incorrect, there was nothing wrong with the rules of US GAAP. Mabon says that the case of WorldCom is not about accounting issues, instead it is undoubtedly about fraud.

5.2.6.3 Other Consequences for Sweden

Winkvist is hoping for a better enforcement of the regulation that is already existing, and that maybe there will be rules to ensure that the purpose of the regulation will not be circumvented. He thinks that there will be an increased focus on accounting issues. This is something that also Grundvall mentions. He thinks that many boards are now focusing more on the accounting, which could be a consequence of the recent accounting cases in the USA. However, he does not think that Swedish companies will be affected so much by these cases. A possibility, though, is that the FASB may influence the IASB to change its rules, which indirectly will affect Sweden. He says that the best solution would be to have uniform regulation in the USA and Europe, and this could also be a result of what has happened.

Winkvist, Bohlin and Grundvall think that there might be consequences for the audit profession. Winkvist says that there is likely to be a rotation of auditors and Bohlin thinks that there might be requirements regarding the independence of the auditors. According to Grundvall, the FI has suggested that the auditors

should review the quarterly reports. The market is focusing more and more on the quarterly report and less on the annual report and therefore wants more reliable information in the quarterly reports.

Mabon says that the most important change is that people will be more restrictive regarding using their auditors for other services than auditing. He says that another possible change is the introduction of audit committees, but there is a discussion whether they will be mandatory or not. This has been under discussion for several years, but it has received more impetus as a result of the events in the USA. Grundvall is certain that there will be discussions regarding, for example, corporate governance, audit committees and compensation committees. He also thinks that one effect of the recent accounting cases in the USA is that there will be a demand from the shareholders that the annual reports should be clearer regarding decisions on fees, option programs and similar matters.

Bohlin does not think that Sweden will make changes to the same extent as the USA, but things will be improved, as people are affected by the recent events.

6. ANALYSIS

In this chapter we bring together the theory and the empirical research of the study in order to analyse the consequences for Swedish companies, following the recent accounting cases. We have also included issues that are not covered in the theoretical framework, but which have arisen through the empirical research and are of interest and relevance for the thesis. The objective of the analysis is to gain an understanding of if and how the recent accounting cases will affect Swedish companies through changes in the Swedish regulation.

The chapter is divided into the four areas that are discussed throughout the thesis: consolidation, financial derivatives, expenditures and corporate governance. We have chosen this structure in order to clearly identify the possible effects on Swedish companies in the different areas.

6.1 Consolidation

6.1.1 Effects on Swedish Regulation

The rules and regulations for consolidation are stated in ÅRL and in the recommendations RR1:00, Consolidated Accounts, and RR13, Associated Companies, from the RR. When there is no Swedish regulation, the international accounting standards from the IASB are applicable. An example of this is the regulation of SPEs, which is regulated in an interpretation from the IASB, SIC12, Consolidation – Special Purpose Entities. We have found that the existing Swedish regulation together with the international accounting standards are considered to be enough regulation in the area of consolidation. The research has shown that there is no need for any changes in the regulation as a direct result of the recent accounting cases in the USA. A possibility, though, is that there will be changes in Swedish regulation due to changes in the international accounting standards from the IASB, as these regulations will be applicable in Sweden from 2005. As there is a discussion regarding a joint project between the FASB and the IASB, Swedish regulation might also indirectly be affected through changes made by the FASB.

Even though the regulation in Sweden appears to be sufficient, there seems to be a need for clearer guidelines as how to apply the standards. One area where there is uncertainty of the application concerns associated companies. It is stated in RR13 and ÅRL that in order for a company to be qualified as an associated company, and be consolidated in the owner's accounts, the owner must have significant influence in the company. According to the regulation, 20% of the voting stock is considered to give significant influence (Svensson and Edenhammar 2000). However, an owner might own less than 20% and still have significant influence in the company. In this case the company might not be consolidated since the owner owns less than 20%, but according to the requirements of significant influence it should be consolidated. This example illustrates one problem of the application of accounting standards.

Although the regulation of consolidation in Sweden is considered to be enough, there are areas that are not specifically regulated. One respondent mentions the disclosure of so called off-balance-sheet companies as an area where there is no regulation in Sweden. One example of an off-balance-sheet company is the SPE (Powers et al. 2002). An example of a Swedish legal entity similar to an SPE is a limited partnership in which a real estate company has placed its property holdings. The reasons for many of the SPE arrangements in Sweden are practical and one respondent says that he has never seen or been in contact with Swedish companies using the SPE arrangements the way Enron did. Sweden does not have any specific regulation regarding SPEs, which is probably due to the fact that SPEs are not used to the same extent in Sweden as in the USA. However, as mentioned above, SIC12 is applicable.

The regulation in the USA in the area is much more comprehensive. Following the accounting cases in the USA, there have also been some proposed changes of the regulation in the USA. The FASB has issued an exposure draft regarding consolidation of SPEs, Proposed Interpretation - Consolidation of Certain Special-Purpose Entities – an Interpretation of ARB No.51, with the objective to achieve more consistent application regarding consolidation of SPEs (FASB 2002). As companies in Sweden do not use SPEs the same way as in the USA, it seems that further regulation will not be needed. Also, through the implementation of IAS in 2005, Swedish companies will have to follow the international accounting standards and, according to the respondents, these are much stricter than the FASB standards in this area. As the IASB standards are

already very strict, changes in the FASB standards, due to the accounting cases, will probably not affect the IASB regulation. It seems more likely that the IASB will influence the FASB, than vice versa. As a result of the accounting cases, the USA might realise that the FASB standards do not always provide the best solution to different accounting issues.

6.1.2 Consequences for Swedish Companies

In the area of consolidation, we do not believe that there will be any consequences for Swedish companies as a direct result of the recent accounting cases in the USA. This is due to the fact that there will probably not be any changes in the regulation of consolidation accounting. Since the FASB will probably not cause or influence the IASB to change its regulation, there will probably not be any consequences for Swedish companies as regards the international regulation.

6.2 Financial Derivatives

6.2.1 Effects on Swedish Regulation

The study has shown that there is not enough regulation in Sweden in the area of financial derivatives. There is some regulation, for example, in the draft Accounting for Standardised Options, Futures and Foreign Exchange- and Interest Swaps, issued by the FAR, but the area is mostly covered through analogisms of other regulations (Öhrlings Coopers & Lybrand 1996). It is a very difficult area with little guidance for companies and this leads to a situation where companies might use different ways of accounting for the financial derivatives. In the regulation of financial derivatives there will be some changes; for example, the RR has already issued RR27, Financial Instruments: Disclosure and Classification. However, these changes are not a consequence of the recent accounting cases in the USA, but are due to the fact that there is not enough regulation at present.

International accounting standards have had a significant influence on the accounting area for financial instruments in Sweden (Ernst & Young 1996) and

through the implementation of IAS in 2005, the area of financial derivatives will be much more regulated than it is at present. This will bring about changes in the Swedish regulation in the area, as financial derivatives are regulated in the IASB standards to a greater extent. These changes are not due, however, to the recent accounting cases in the USA.

Following the recent accounting cases in the USA, the FASB has issued a draft, Questions and Answers Related to Derivative Financial Instruments Held or Entered into by a Qualifying Special-Purpose Entity (SPE). There will probably not be anything similar to this in Sweden, as Swedish companies do not use SPEs to the same extent as US companies.

6.2.2 Consequences for Swedish Companies

In our opinion, there will be no consequences for Swedish companies in this area as a result of the recent accounting cases in the USA. Even though there is not sufficient regulation in this area in Sweden at present, the implementation of IAS in 2005 will provide all the necessary regulation regarding financial derivatives. Supplementary changes, like the ones made in the USA, will therefore probably not be needed.

6.3 Expenditures

6.3.1 Effects on Swedish Regulation

The area of expenditures is regulated in ÅRL, recommendations issued by the RR and in the framework by the RR, Framework for the Preparation and Presentation of Financial Statements. We have found that the existing regulation in Sweden in the area of expenditures is enough. The problem seems to be whether the regulation is clear enough, which might make the application of the rules more difficult. An example of where it might be difficult to apply the rules is regarding expenditures for maintenance. It is a matter of judgement which expenditures are value-added and which expenditures are maintenance. One respondent mentions that the IASB will soon issue an interpretation in the area of maintenance, which will provide guidance.

We have not found that there have been any changes made in this area in the USA. This is probably due to the fact that the regulation is already considered to be sufficient, and in the case of WorldCom, it was the application of the rules that was incorrect. The general opinion of the respondents is that accounting rules cannot be written in a way that prevents illegal manipulation and fraud. If people have the wrong intentions, it does not matter what regulation there is, because such people will circumvent or break the rules anyway.

The research has shown that there is already enough regulation in this area in Sweden, and no supplementary regulation is needed. The empirical research has shown that Swedish regulation will probably not be affected by the recent accounting cases. Any changes that occur will be a result of the implementation of IAS in 2005 and not due to the recent accounting cases in the USA.

6.3.2 Consequences for Swedish Companies

In the area of expenditures we have found that there will probably be no changes in the regulation due to the recent accounting cases in the USA. As a result there will be no consequences for Swedish companies.

6.4 Corporate Governance

6.4.1 Effects on Swedish Regulation

6.4.1.1 Legislation

The legislation in Sweden that is applicable in the area of corporate governance is ABL and ÅRL. Together with the supervision by the FI and the Stockholm Stock Exchange, the respondents consider this to be enough regulation.

The general opinion seems to be that the FI is the supervising authority in Sweden, but it does not have the same role as the SEC in the USA. However, there is a discussion as to whether there should be a European equivalent to the SEC, through the EU, with the objective to gain uniformity or a more similar

application of different rules in Europe, or a Review Panel, similar to the one in Great Britain. The question is if anything like the SEC is needed in Sweden. Swedish regulation is to a great extent based on GAAP and a true and fair view (Svensson and Edenhammar 2000). We believe that this will require and ensure that companies show a correct picture of themselves. Therefore, there might not be a need in Sweden for a supervising authority like the SEC. The need is probably greater in a country like the USA. According to one respondent, the US system is very detailed and it could be misinterpreted so that all that is not prohibited through regulation seems to be allowed. This could create possibilities for companies to find a way to circumvent the regulation, and in that way present a "better", although inaccurate, picture of the company. Furthermore, Sweden may not have the same problem as the USA where there is a higher level of compensation to the management, which can be an incentive to misuse the regulation and, for example, manipulate the figures. Even though Swedish companies do not have the same compensation levels as the US companies, it is still an issue of discussion. For example, there was a discussion in Sweden earlier this year regarding the pension agreements in the Swedish company ABB, in which the amounts were considered too high.

We have found that as a result of the accounting cases in the USA, there is a possibility that the FI could be assigned more responsibility for supervision of Swedish companies. However, if this is the case, the FI will not have exactly the same role as the SEC, but will probably have a similar function.

As a result of the recent accounting cases in the USA, the US government has enacted the Sarbanes-Oxley Act of 2002 to improve the regulation in the area of corporate governance. We have found that there will probably not be changes in the Swedish regulation to the same extent as in the US regulation. This is due to the fact that the Swedish system is very different from the US system. The regulation in Sweden is not as detailed as in the USA and therefore a detailed regulation like the Sarbanes-Oxley Act would not suit the Swedish system. Furthermore, there is probably not the same need for this kind of regulation in Sweden. Sweden is a small country with few large companies compared to the USA, and, as stated above, Sweden does not have the same level of compensation to the management that could lead to the situation where the management favour themselves at the expense of the company. However, a

possible effect on the Swedish regulation is if the governmental Commission of Ethics & Reliance in Sweden influences new regulation in the area.

As regards regulation of the responsibility of the management and the board towards the company, it seems that the general opinion is that there is enough regulation in Sweden. This is regulated in ABL. In ABL there is an overall requirement that the board and the CEO are responsible, by their action, for promoting the interests of the company (Kedner 1995). There is also a new draft, 2002:1 Incentive program, issued by the Stock Market Panel, which, for example, treats the board members' participation in share issues. Requirements of disclosure regarding salaries, redundancy payments, pensions, etc. are stated in chapter 5 of ÅRL. However, the research has shown that there could be a need for more disclosure regarding, for example, compensation to the management, to make information more available and transparent to the market. Disclosures regarding these issues are very important for the market, and therefore there is a need for more regulation in this area to ensure that the market receives the right information.

The discussion regarding corporate governance regulation has accelerated as a result of the recent accounting cases in the USA. This might lead to consequences for Swedish regulation in certain areas. For example, there might be formations of different committees, such as audit committees and compensation committees, to improve the oversight of the company. However, the general opinion of the respondents is that if there is malicious intent, no regulation can prevent immoral behaviour.

6.4.1.2 Stockholm Stock Exchange

The Stockholm Stock Exchange is considered to be a supervising authority in Sweden. It has issued a Listing Agreement that is obligatory for all companies that are listed on the Stockholm Stock Exchange, which regulates how and when information should be released from the companies to the market (www.stockholmsborsen.se).

From our empirical research we have found that there are different opinions whether the rules of the Stockholm Stock Exchange are sufficient. Most

respondents are of the opinion that there is probably no need for something similar to the Corporate Governance Rule Proposals, which was issued by the NYSE after the recent accounting cases. However, one respondent says that if there will be any changes in Sweden, they might be similar to the changes made in the USA. The Corporate Governance Rule Proposals states requirements of, for example, different committees, corporate governance guidelines and codes of business conduct and ethics (www.nyse.com). This should all aim to enhance the corporate governance of companies and is something that could be suitable for Swedish regulation as well. The areas are important for companies to consider in order to gain the trust of the market. However, the question is whether this should be regulated in the Listing Agreement or in the Swedish legislation. In our opinion, this should probably be regulated in the legislation, as it will then be applicable to companies that are not listed on the Stockholm Stock Exchange as well.

We have found that there will probably be no changes in the regulation of the Stockholm Stock Exchange. However, a consequence following the recent accounting cases in the USA could be the introduction of audit committees. This is something that could be regulated through the Listing Agreement. Another possible consequence might be that the existing requirements in the Listing Agreement will be stricter and also that the application of these requirements will be stricter.

6.4.2 Consequences for Swedish Companies

6.4.2.1 Legislation

Corporate Governance is an area that is very much discussed and the recent accounting cases in the USA have increased focus on these issues. In the area of corporate governance there will probably be consequences for Swedish companies, following the accounting cases in the USA.

The possibility that the FI will have increased responsibility, regarding the supervision of Swedish companies, will, undoubtedly, affect companies. The consequences could be that companies become more cautious and apply the regulations more strictly. Also, there might be more sanctions on companies if

they do not follow the regulations. This can lead to a situation where the market will increase its trust in a company, since the market knows that it can rely on what the company is presenting. This is an advantage for the company, as people might be more interested in investing in it. However, disadvantages for companies, if there is stricter regulation and more supervision, are that it might be time and cost consuming and it might be more difficult for companies to present themselves the way they find is the most favourable. There is also a possibility that companies are affected negatively through different sanctions. For example, if a company is found to have broken the rules, this might result in fines or banishment from carrying on its business.

Another consequence for Swedish companies is a possible implementation of audit committees, which will increase the control of a company as regards the audit. An advantage of an audit committee, which is appointed for a specific purpose, is that it will increase focus on the audit. As a result, decisions regarding the audit might be more carefully considered, for example, decisions relating to the purchase of non-audit services from the firm carrying out the audit services. There is also a possibility that there will be requirements for compensation committees in companies. This is an advantage for companies, since it can reduce the risk that the management and the board benefit themselves at the expense of the company through too much compensation. However, some companies might not have the financial resources or the knowledge to be able to establish audit and compensation committees. This would be a disadvantage for some companies in Sweden, in the case of a requirement regarding such committees.

The work of the governmental Commission of Ethics & Reliance, which was established after the accounting cases in the USA, might also affect Swedish companies. However, as the work of the commission is not yet completed, the future will tell what the result will be and if and how Swedish companies will be affected.

6.4.2.2 Stockholm Stock Exchange

The research has shown that Swedish companies will not be affected to such a great extent in this area, since there will not be many changes made to the

Listing Agreement. However, if there are stricter application requirements of the Listing Agreement, one effect for Swedish companies could be that it might be more difficult for companies to stay listed on the Stockholm Stock Exchange. Companies that are not listed do not have the possibility of raising capital through stock issuance, which could be a negative consequence following the recent accounting cases in the USA.

6.5 Other Issues

One issue that might affect Swedish companies, as a result of the recent accounting cases, is that there might be an increased focus on accounting. Companies might realise the importance of accurate accounting. An advantage of this is that the management and the board will probably need to be more involved in the company's accounting. Subsequently, they will gain a better understanding of the accounting, which might help them to manage the company in the best way. A disadvantage, though, is that in order for the management and the board to have better knowledge of the company's accounting, it is required that more resources are assigned to this area.

There will also be an increased focus on accounting by the market. This could be an incentive for companies to follow the accounting regulations in a correct way, which will lead to more accurate presentations of the companies' results and financial positions. This will be an advantage for companies since they will gain the trust of the market and thereby increase the possibility of raising capital.

7. CONCLUDING DISCUSSION

In this chapter we draw our conclusions, based upon the discussion in the analysis. The conclusions will answer the research problem and thereby fulfil the purpose of the thesis. We also give suggestions for further research in areas related to the thesis subject.

7.1 Conclusions

We have drawn the conclusion that the recent accounting cases in the USA will not affect Swedish companies to a great extent.

Throughout the thesis, issues relating to the areas of accounting and corporate governance have been discussed. These two areas seem to be affected differently by the recent accounting cases in the USA. There will probably not be any changes in the Swedish regulation of the different accounting areas, due to the recent accounting cases, which implies that companies will only be affected through changes in the Swedish corporate rules and regulations. The changes in the Swedish corporate regulation will, to some degree, probably be similar to the changes in the USA.

We have studied three accounting areas that are related to the recent accounting cases in the USA: consolidation, financial derivatives and expenditures. As regards these areas, we have found that there will probably not be any changes in the regulation following the recent accounting cases. This is based on the conclusion that there is already enough regulation in the areas of consolidation and expenditures in Sweden. In the area of financial derivatives there is not enough regulation at present in Sweden; however, the area will be regulated through the implementation of IAS in 2005. Furthermore, the regulations in Sweden and in the USA are very different. As Swedish regulation of accounting is based on GAAP and a true and fair view, detailed regulation, as in the USA, is not suitable and probably not needed. There will probably be no changes in the accounting regulation in Sweden, following the recent accounting cases in the USA, and the effect on Swedish companies will be minimal, if any.

Even though there will probably be no changes in the regulation of the accounting, it is possible that there will be an increased focus, by the market as well as by the company, on the accounting area. The result of an increased focus by the market is that Swedish companies may have to increase the quality of their accounting, by applying the existing accounting regulation more strictly. One result of an increased focus by the company is that the management may become more involved in questions relating to the accounting, which will lead to decisions relating to accounting will be better considered.

We have also studied corporate rules and regulations that are related to the recent accounting cases in the USA. In this area we have found that there might be changes in the regulation as a result of the recent accounting cases, and subsequently this will affect Swedish companies. However, the changes in Sweden will not result in such detailed regulation as in the USA, even if the changes will be of similar kind.

One consequence for Swedish companies is the possible implementation of audit and compensation committees. Such committees will increase the company's control over decisions regarding audit and compensation, which will benefit the company. However, it can be costly for the company to establish these committees and to ensure that their tasks are carried out correctly.

Regarding the Listing Agreement, issued by the Stockholm Stock Exchange, and the responsibilities of the management and the board, there appears to be sufficient regulation in Sweden. Consequently, there will be no changes in the regulation as a result of the recent accounting cases in the USA, and therefore there will be no effects on Swedish companies. However, the application of the Listing Agreement might become stricter. The effect for Swedish companies is that it might be more difficult to stay listed on the Stockholm Stock Exchange, which could lead to difficulties in raising capital.

Another consequence of the recent accounting cases is that the FI will probably have increased responsibility regarding supervision of companies. Stricter supervision by the FI requires companies to make sure that they are fulfilling all necessary requirements. This stricter supervision will increase the market's

trust in the companies, which affects the companies positively. A negative consequence of stricter supervision could be that it will be time and cost consuming to implement new procedures in order to fulfil the requirements. Furthermore, it might be more difficult for companies to present themselves the way they find is the most favourable. If companies do not fulfil the requirements, there might be sanctions that can affect them negatively.

To summarise, following the recent accounting cases in the USA, there have been many discussions, both in the USA and in Sweden, regarding the regulation of accounting and corporate governance and questions of whether the existing regulation is enough. In the USA this has led to major changes, primarily in the corporate governance area. The study has shown that there will probably not be many changes made in Sweden, due to these recent accounting cases in the USA. From this we have drawn the conclusion that the recent accounting cases in the USA will not affect Swedish companies to a great extent. However, in some areas there could be consequences for Swedish companies. These consequences will primarily be a result of changes in the regulation in the area of corporate governance.

> *"Out of the evident crisis, there is opportunity for constructive change...Rebuilding faith in financial reporting will take time. It's an intellectual challenge, as well as business and political challenge."* (Volcker 2002 see www.fei.org, c).

7.2 Further Research

We have the following suggestions for further research:

- Research to follow up the subject of this thesis. When time has shown the actual effects on Swedish companies, following the recent accounting cases in the USA, were the consequences the same as concluded in this thesis?

- Research regarding the result of the changes made in the USA due to the recent accounting cases. A study of whether the changes made in the USA fulfilled their purposes and improved the regulation of companies.

- Research to follow the co-operation between the FASB and the IASB, which is now increasing. This is an important step towards harmonisation and an interesting issue to study is whether there will be one system of international accounting standards applicable throughout the world.

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APPENDIX I
QUESTIONNAIRE IN SWEDISH

Magisteruppsats i Redovisning
Handelshögskolan vid Göteborgs Universitet
Höstterminen 2002

Under 2001/2002 uppmärksammades ett flertal företag i USA där redovisningen inte ansågs vara helt riktig. Detta ledde till utredningar av vad som egentligen hade skett i företagens redovisning. Då det uppdagades att redovisningen i många fall var felaktig, förlorade företagen marknadens förtroende och flertalet gick så småningom i konkurs. Vi blev intresserade av dessa händelser och började fundera över om detta skulle påverka Sverige på något sätt. Då det visade sig att det amerikanska regelsystemet krävde förändringar för att öka tillsynen av företagen och förhindra liknande situationer från att uppstå igen, frågade vi oss om detta skulle medföra förändringar även i det svenska regelsystemet. Vi ville se om, och i så fall hur, svenska företag skulle påverkas av händelserna i USA. Detta blev starten för vår uppsats och syftet har formulerats enligt följande:

The purpose of the thesis is to find out if and how the accounting cases in the USA will affect Swedish companies through changes in accounting and corporate rules and regulations in Sweden.

För att kunna uppnå vårt syfte har vi valt att intervjua revisorer och redovisningsexperter då vi tror att ni är kunniga inom området och på så sätt kan bidra med värdefull information.

Vi har fokuserat på fyra områden som har uppmärksammats i samband med Enron och WorldCom: konsolidering av SPE, finansiella derivat, utgifter samt corporate governance.

Frågeformuläret är uppdelat med frågor på ovannämnda områden. Det finns även utrymme för övriga kommentarer. Innan frågorna har vi gett en kort förklaring till varför området studeras.

Frågeformulär

Allmänt

- Vilken är din nuvarande yrkesroll?
- Hur länge har du arbetat inom ditt yrkesområde?
- Har du haft andra yrkesroller än din nuvarande inom detta område? I så fall, vad innebar den rollen?
- Är du medlem i någon organisation inom redovisning och i så fall vilken är din roll i organisationen?
- I vilken utsträckning har du följt händelserna i USA under det senaste året (Enron, WorldCom, etc.)?

Konsolidering/SPE

Enron använde sig av flertalet Special Purpose Entities (SPE) i sin verksamhet. Enligt god redovisningssed i USA behöver dessa inte konsolideras om vissa kriterier är uppfyllda. Enrons SPEs uppfyllde dock inte dessa kriterier och de borde därför ha konsoliderats. Efter att detta uppmärksammades har Financial Accounting Standards Board (FASB) gett ut ett exposure draft som behandlar konsolidering av SPEs. Våra frågor på detta område är:

- Anser du att det finns tillräcklig reglering i Sverige på området för vilka företag som skall konsolideras i årsredovisningen?
- Finns det, enligt din åsikt, tillräckliga krav på upplysning om de företag som skall konsolideras i årsredovisningen?
- Anser du att det finns något som kan liknas SPE i Sverige? Vilka konsolideringsregler skall i så fall tillämpas?
- Anser du att reglerna för konsolidering i Sverige bör förändras efter de uppmärksammade redovisningsfallen i USA och i så fall hur? Om inte, varför inte?
- Tror du att regleringen i Sverige på området om konsolidering kommer att förändras och i så fall hur? Om inte, varför inte?

Finansiella Derivat

Enron använde sig av finansiella derivat för att hedga sig mot förluster i investeringar. Problemet var att flertalet av dessa transaktioner skedde med en SPE som inte var en oberoende part. Detta medförde i stora drag att Enron hedgade med sig själva. På detta område har det ännu inte skett några större förändringar i de amerikanska redovisningsreglerna. FASB har dock gett ut ett utkast med frågor och svar angående finansiella derivat som innehas av en SPE. Våra frågor på detta område är:

- Anser du att det finns tillräcklig reglering i Sverige på området för finansiella derivat?
- Finns det, enligt din åsikt, tillräckliga krav på upplysning om finansiella derivat?
- Anser du att reglerna för finansiella derivat i Sverige bör förändras efter de uppmärksammade redovisningsfallen i USA och i så fall hur? Om inte, varför inte?
- Tror du att regleringen i Sverige på området om finansiella derivat kommer att förändras och i så fall hur? Om inte, varför inte?

Utgifter

I fallet WorldCom har det uppmärksammats att företaget har aktiverat utgifter som tillgångar när dessa istället skulle ha kostnadsförts. Våra frågor på detta område är:

- Anser du att det finns regler i Sverige som tydligt klargör om utgifter skall aktiveras eller kostnadsföras?
- Tror du att regleringen i Sverige inom detta område kommer att förändras och i så fall hur? Om inte, varför inte?

Corporate Governance - Lagstiftning

I samband med de redovisningsfall som har uppmärksammats, t.ex. de i Enron och WorldCom, uppkom frågor huruvida tillsynen av företag var tillräcklig. Detta tillsammans med övriga frågor, t.ex. diskussionen kring vikten av en

oberoende ledning, medförde att den amerikanska kongressen vidtog åtgärder för att förbättra reglerna för corporate governance och förhindra att liknande situationer skulle uppstå i framtiden. Detta resulterade i utformandet av Sarbanes-Oxley Act of 2002. Våra frågor på detta område är:

- Vad innebär uttrycket ”corporate governance” för dig?
- Anser du att det finns tillräckligt med reglering i Sverige för att förhindra att ledningen och styrelsen gynnar sig själva personligen på företagets bekostnad?
- Anser du att det finns tillräckligt med reglering i Sverige vad gäller ledningens och styrelsens ansvar gentemot företaget, dvs. att sköta företaget för företagets bästa?
- Anser du att det svenska regelsystemet är tillräckligt vad gäller tillsyn över företag?
- Anser du att reglerna för corporate governance i Sverige bör förändras efter de uppmärksammade redovisningsfallen i USA och i så fall hur? Om inte, varför inte?
- Tror du att regleringen i Sverige på området corporate governance kommer att förändras och i så fall hur? Om inte, varför inte?

Corporate Governance - Stockholmsbörsen

Under det senaste året har flertalet fall, såsom Enron och WorldCom, uppmärksammats, där företagens etik, kontroll och laglydighet har ifrågasatts. Med anledning av detta har New York Stock Exchange (NYSE) gett ut Corporate Governance Rule Proposals som syftar till att öka företagets ansvar och insynen för intressenterna, för företag noterade på NYSE. Våra frågor på detta område är:

- Stockholms Börsens Noteringsavtal reglerar i huvudsak hur informationen från de noterade företagen skall förmedlas till intressenterna. Anser du att det behövs mer regler angående företagets organisation?
- Anser du att reglerna för notering på börsen i Sverige bör förändras efter de uppmärksammade redovisningsfallen i USA och i så fall hur? Om inte, varför inte?

- Tror du att börsnoteringsreglerna i Sverige kommer att förändras och i så fall hur? Om inte, varför inte?

Övrigt

- Finns det övriga områden där du vill se förändringar i regleringen av svenska företag?
- Finns det övriga områden där du tror förändringar kommer att ske vad gäller regleringen av svenska företag?
- Anser du att redovisningsregler kan utformas på ett sådant sätt att de kan förhindra olagliga manipuleringar och bedrägeri?
- Övriga kommentarer.

APPENDIX II

QUESTIONNAIRE IN ENGLISH

Master Thesis in Accounting
School of Economics and Commercial Law, Göteborg University
Autumn 2002

During 2001/2002 it was discovered that the accounting in several companies in the USA appeared to be doubtful. This led to investigations regarding what really had happened in the companies' accounting. When it was revealed that the accounting in many cases was inaccurate, the companies lost the trust of the market and several companies eventually filed for bankruptcy. These cases attracted our attention and we wondered if this would affect Sweden in any way. When it appeared that the US regulation required changes to increase the supervision of companies and prevent similar situations from occurring again, we asked ourselves if this would lead to changes in the Swedish regulation as well. We wanted to find out if and, in that case, how Swedish companies would be affected by the recent cases in the USA. This was the starting point for our thesis and the purpose is formulated as follows:

The purpose of the thesis is to find out if and how the accounting cases in the USA will affect Swedish companies through changes in accounting and corporate rules and regulations in Sweden.

In order to fulfil the purpose, we have chosen to interview auditors and accounting experts as we believe that you have much knowledge in the area and in that way are able to contribute with valuable information.

We have focused on four areas that have been observed in connection with the cases of Enron and WorldCom: consolidation of SPE, financial derivatives, expenditures and corporate governance.

The questionnaire is divided into sections with questions in the areas mentioned above. There is also room for other comments. Before the questions we have given a short explanation as to why the area is studied.

Questionnaire

General

- What is your profession at present?
- How long have you been working in your area of profession?
- Have you had any other profession role, in this area, than you have at present? In that case, what did that role involve?
- Are you a member in any accounting organisation, and in that case what is your role within the organisation?
- To what extent have you followed the events in the USA of the past year (Enron, WorldCom, etc.)?

Consolidation/SPE

Enron used several Special Purpose Entities (SPEs) in its business activities. This is permitted according to US GAAP. However, the SPEs did not fulfil the criteria defining an SPE and thus should have been consolidated. After this the Financial Accounting Standards Board has issued an Exposure Draft, which treats the consolidation of SPEs. Our questions in this area are:

- Do you think there is enough regulation in Sweden in the area regarding which entities should be consolidated in the annual report?
- In your opinion, are there enough requirements regarding disclosures of the companies that should be consolidated in the annual report?
- Do you think there are entities similar to an SPE in Sweden? In that case, what consolidation rules should be applied?
- Do you think the regulation of consolidation in Sweden should be changed after the recent accounting cases in the USA, and in that case how? If not, why not?
- Do you believe that the regulation in Sweden in the area of consolidation will be changed, and in that case how? If not, why not?

Financial Derivatives

Enron used financial derivatives in order to hedge against losses in investments. The problem was that many of these transactions involved an SPE that was not an independent party. This led to that Enron in fact hedged with itself. So far there have not been any major changes in the US accounting rules in this area. However, the FASB has issued a draft with questions and answers related to derivative financial instruments held or entered into by an SPE. Our questions in this area are:

- Do you think there is enough regulation in Sweden in the area regarding financial derivatives?
- In your opinion, are there enough requirements regarding disclosures of financial derivatives?
- Do you think the regulation of financial derivatives in Sweden should be changed after the recent accounting cases in the USA, and in that case how? If not, why not?
- Do you believe that the regulation in Sweden in the area of financial derivatives will be changed, and in that case how? If not, why not?

Expenditures

In the WorldCom case it has been revealed that the company has capitalised expenditures that should have been expensed. Our questions in this area are:

- Do you think there is regulation in Sweden that clearly defines whether expenditures should be capitalised or expensed?
- Do you believe that the regulation in Sweden in this area will be changed, and in that case how? If not, why not?

Corporate Governance – Legislation

The recent accounting cases, such as Enron and WorldCom, have raised several questions regarding whether the supervision of companies was sufficient. This, in combination with other questions, for example the discussion about the importance of an independent management, led to that the US Congress took

action to improve the regulation of corporate governance and prevent similar situations from occurring in the future. This resulted in the formulation of the Sarbanes-Oxley Act of 2002. Our questions in this area are:

- What do you generally think of, when you hear the term "Corporate Governance"?
- Do you think that there is enough regulation in Sweden to prevent the management and the board from favouring themselves at the expense of the company?
- Do you think that there is enough regulation in Sweden as regards the management's and the board's responsibilities towards the company, i.e. to manage the company for its own good?
- Do you think that Sweden has enough rules regarding supervision?
- Do you think the regulation of corporate governance in Sweden should be changed after the recent accounting cases in the USA, and in that case how? If not, why not?
- Do you believe that the regulation in Sweden in the area of corporate governance will be changed, and in that case how? If not, why not?

Corporate Governance – Stockholm Stock Exchange

During the past year we have seen several cases, for example Enron and WorldCom, where the companies' ethics, control and diligence have been questioned. Due to this the New York Stock Exchange (NYSE) has issued "Corporate Governance Rule Proposals", with the objective to enhance the accountability and the transparency of companies listed on the NYSE. Our questions in this area are:

- The Stockholm Stock Exchange Listing Agreement mainly regulates how information from the listed companies should be provided to the interested parties. Do you think more regulation is needed regarding the companies' organisation?
- Do you think the listing requirements at the stock exchange in Sweden should be changed after the recent accounting cases in the USA, and in that case how? If not, why not?
- Do you believe that the listing requirements in Sweden will be changed, and in that case how? If not, why not?

Other Issues

- Are there other areas where you would like to see changes regarding the regulation of Swedish companies?
- Are there other areas where you believe changes will take place regarding the regulation of Swedish companies?
- Do you think that accounting rules can be written which can prevent illegal manipulations and fraud?
- Other Comments.

APPENDIX III
PRESENTATION OF RESPONDENTS

Personal Interviews

Mikael Winkvist, Öhrlings PricewaterhouseCoopers, Stockholm, October 21, 2002

Mikael Winkvist is an authorised public accountant at Öhrlings PricewaterhouseCoopers in Stockholm, and has been working in this area for 14 years. However, most of the time Winkvist is working as an accounting expert. He has also worked with different valuation problems, for example, due diligence. He is also a member of the organisation FAR. Winkvist has tried to follow the cases, Enron and WorldCom, in the USA, as much as possible, as he works a lot with US accounting principles. He is working in a group within Öhrlings PricewaterhouseCoopers, called US Capital Markets Group of Sweden. This group works mostly with questions relating to US GAAP.

Hamish Mabon, Ernst & Young, Stockholm, October 22, 2002

Hamish Mabon is an authorised public accountant and a partner with Ernst & Young in Stockholm. He works in the business area of Assurance and Advisory Business Services, AABS. He has worked in this field for 15 years. He started at Andersen in 1987 and worked there until 1999, when he moved to Ernst & Young. Mabon is a member of the Accounting Committee of FAR. Since he works with insurance clients, he deals extensively with questions and problems related to the insurance business. He has followed the events in the USA, both Enron and WorldCom, in detail. He says that this is mostly due to the fact that it has been hard not to follow, but also because it has affected his former employer.

Peter Markborn, Senior Advisor for Deloitte & Touche, Stockholm, October 23, 2002

Peter Markborn is an authorised public accountant. He was hired by Andersen in 1969 and became worldwide partner and CEO for Andersen accounting firm in 1979. He was Country Managing Partner for Arthur Andersen (including Andersen Consulting) in Sweden between 1984-1990. Since the middle of the 1980s, he has been working mostly within the financial sector. He was responsible for Andersen's Financial Services Industry Program in the Nordics between 1997 through 2000. He has had most positions within the company, but is specialised in the financial sector. Currently he has his own firm, PMAC AB, and is working as a senior advisor to Deloitte & Touche. He has been a member of the Accounting Committee of FAR since 1990[21] and has worked in many different countries, for example England, Germany, Finland and the USA. Markborn, as a former partner in Andersen, has followed the Enron case to a greater extent than has been published in the press, and as relates to WorldCom, he has followed this case more peripherally.

Björn Grundvall, Ernst & Young, Göteborg, October 30, 2002

Björn Grundvall is an authorised public accountant at Ernst & Young in Göteborg. He has worked with auditing for over 20 years. Since the end of the 1980s, he also has a special task at Ernst & Young, which involves studying companies applying to be listed on the Stockholm Stock Exchange. This is an investigation task from the Stockholm Stock Exchange, with the purpose of making a judgement of the candidates applying to the Stockholm Stock Exchange. He is also a member of a jury that chooses the best annual report for listed companies. Furthermore, he is a member of the Consultation Group of Accounting Issues within the FAR, and is also in an expert group, tied to the Council of Municipal Accounting. He has followed the recent events in the USA, but not studied the cases of Enron and WorldCom in detail.

[21] In the autumn of 2002, Peter Markborn left the Accounting Committee of FAR. This was after the interview was carried out.

Telephone Interview

Carl-Eric Bohlin, Öhrlings PricewaterhouseCoopers, Stockholm, October 24, 2002

Carl-Eric Bohlin is an authorised public accountant at Öhrlings PricewaterhouseCoopers in Stockholm and has been working in the auditing area for 31 years. He is the Chairman of the Accounting Committee of FAR, which means that he is responsible for managing and controlling the work of the committee. He is also the Chairman of the Consultation Group of Accounting Issues within the FAR. Furthermore, Bohlin is a deputy member in the RR Board and has worked for the IASB. He has followed the recent events in the USA to quite a large extent.