

December 23, 2002

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As the Bubble Neared Its End, Bogus Swaps Padded the Books

By DENNIS K. BERMAN, JULIA ANGWIN and CHIP CUMMINS
 Staff Reporters of THE WALL STREET JOURNAL

It was 10 p.m. on a Friday, 50 hours before **Qwest Communications International Inc.** was due to close the books on its third quarter of 2001. Chief Operating Officer Afshin Mohebbi sat down in his 52nd floor office at the telephone giant's Denver headquarters and tapped out a desperate e-mail to his top salesmen.

The subject line: "Help!!!!!!!!!!!"

What's WRONG?



Mr. Mohebbi was alarmed because a series of sweet deals he urgently needed weren't working out. The plan was for Qwest to swap connections to its phone network for connections to other companies' networks. Phone companies had been making trades like that for years, but lately there was a twist: Both companies would book revenue from these transactions -- inflating their financial results even though they were actually swapping assets of equal value.

But Qwest couldn't quite make these latest swaps work. It had agreed to buy \$231 million in access to telecom networks. But the companies on the other side of the table had committed to spend less than \$100 million with Qwest. The company was going to have to squeeze more money out of the deals if it was going to meet the projections it had given Wall Street.

"What happened to the creativity of this company and its employees?" Mr. Mohebbi wrote in his e-mail. "Let's not have a disaster now."

SPECIAL PAGE

For continuing coverage of corporate-accounting issues go to [Called to Account](#)⁸.

DOWN THE LINE

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COMPANIES

Dow Jones, [Reuters](#)

[Qwest Communications International Inc. \(Q\)](#)

PRICE	5.30
CHANGE	0.23
U.S. dollars	12/20

WHAT'S WRONG

A Wall Street Journal series examining the roots and the inner workings of this year's business scandals.

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Uneasy Money: [What happens when companies lend their CEOs more money than they can repay](#)³ (August 1, 2002)

Venal Sins: [Why the bad guys of the boardroom emerged en masse](#)⁴ (June 20, 2002)

In the end, disaster did strike. Ten months later, Qwest's new chief executive, Richard Notebaert, soberly read a script during a Monday morning conference call with press and stock analysts. He announced that the company's swaps had violated accounting rules. The company later said it would restate \$950 million in revenue, erasing the deals in a stroke from the company's prior results.

When the business history of the past

decade is written,

perhaps nothing will sum up the outrageous financial scheming of the era as well as the frenzied swapping that marked its final years.

Internet companies such as **Homestore** Inc. milked revenue from complex advertising exchanges with other dot-coms in ultimately worthless deals. In Houston, equal amounts of energy were pushed back and forth between companies. The beauty of the deals, from the perspective of the participants, was that everyone walked away with roughly the same amount of revenue to put on their books.

But the swaps rage turned out to be no bargain for investors. The bad deals contributed to an epidemic of artificially inflated revenue. In many cases, swaps slipped through legal loopholes left in place by regulators who had failed to keep pace with the ever-changing dealmaking of ever-changing industries. The unraveling of those back-scratching arrangements helped usher in the market collapse and led to the realization by investors that the highest-flying industries of the boom era -- telecom, energy, the Internet -- were built in part on a combustible mix of wishful thinking and deceit.

Bogus swaps added up to a far bigger piece of American commerce than is widely recognized. The amount of restated revenue from bad swaps totals more than \$15 billion since 1999, according to an analysis by The Wall Street Journal. That number is especially significant since investors focused on revenue in new industries that often had little earnings to show for themselves. Investigators are still

[Homestore Inc. \(HOMS\)](#)

PRICE	0.98
CHANGE	-0.01
U.S. dollars	12/20

[AOL Time Warner Inc. \(AOL\)](#)

PRICE	13.39
CHANGE	0.08
U.S. dollars	12/20

[CMS Energy Corp. \(CMS\)](#)

PRICE	8.61
CHANGE	-0.04
U.S. dollars	12/20

[Telefonica S.A. ADS \(TEF\)](#)

PRICE	27.85
CHANGE	0.55
U.S. dollars	12/20

[Yahoo! Inc. \(YHOO\)](#)

PRICE	17.08
CHANGE	0.37
U.S. dollars	12/20

[Reliant Resources Inc. \(RRI\)](#)

PRICE	2.49
CHANGE	-0.16
U.S. dollars	12/20

* At Market Close

trying to figure out whether Enron Corp. conducted illegal reciprocal energy trades, dubbed wash trades by regulators.

Swaps were used by at least 20 public companies. Some, including **AOL Time Warner Inc.**, **CMS Energy Corp.** and **Global Crossing Ltd.**, the onetime telecom highflier now in bankruptcy proceedings, are under federal investigation.

'A Normal Part of Operations'

It's no accident that the swaps frenzy sprung up in industries with newfangled, intangible products. After all, putting a price tag on online ads, energy or telecom-transmission contracts, and moving them back and forth, is a lot trickier than dealing with a fleet of trucks or a cement plant. Swaps essentially involved "manipulating an abstraction," says Andrew Lipman, a telecom attorney in Washington. "These swaps morphed into devices to satisfy the God of quarterly performance."

WHEN SWAP DEALS GO BAD

Telecom, Internet and energy companies have had to restate or amend revenues from improper swap deals.

COMPANY	RESTATED OR AMENDED REVENUES (In millions)	PERIOD	% OF PERIOD'S REVENUE
CMS Energy	\$5,200 ¹	2000 and 2001	20%
EnCana	724 ²	2001	11%
Global Crossing	1,200 ²	2000 and 2001	11% ³
Homestore	46	First 9 months in 2001	13%
Qwest	950	2000 and 2001	3%
Reliant Resources	6,390	1999 to 2001	10%
Versatel Telecom	23 ⁴	2001	9%

¹Has restated some of this total, intends to restate remainder.

²Have amended revenue numbers, but haven't restated past results.

³Based on "cash revenues," a nonstandard accounting measure.

⁴Hasn't restated, but said it may.

Sources: the companies

Along the way, the reciprocal deals became an accepted part of a business culture obsessed with revenue growth. "If we're one of their big customers, we expect them to be one of our big customers," Robert Pittman, then co-chief operating officer of AOL's America Online unit, said in an interview last year. One AOL executive even approached the operator of subsidiary Time Inc.'s cafeteria about buying online ads in return for AOL's continued business. The company, Compass Group North America, declined.

And while Wall Street types are now griping that they were deceived by these arrangements, until

recently they were applauding swap deals and the companies that favored them. In a research report in 2001, a Goldman Sachs telecom analyst downplayed Global Crossing's collapsing stock price. He wrote that the company's swaps "make sense, they are a normal part of operations the accounting is correct." The company filed for Chapter 11 protection in January.

Swaps have been around since Old Testament days, when Joseph traded food for the horses and donkeys of hungry Egyptians. When it comes to business history, the practice has been less noble. In the 1980s, corrupt savings and loans traded real estate back and forth at increasingly overblown prices. This was known as trading "a dead horse for a dead cow."

The telecom industry for decades got around the expense of building fiber-optic lines by exchanging access to each other's networks, known in telecom lingo as trading capacity. Each year starting in 1975 at the Global Traffic Meeting in Washington, a club of about 200 telecom officials made deals to exchange millions of minutes of voice traffic. Those deals were legal and companies usually didn't record revenue from the trades.

Everything changed when the industry was deregulated, starting in the mid-1990s. Telecom companies bloomed, laying miles of new fiber. By late 2000 it became obvious that there was nowhere near enough customer demand to use up all the capacity.

Stoking the Telecom Fires

"Everyone was scratching their heads about how to make the numbers," recalls Derek Gill, a former vice president at 360networks, which filed for bankruptcy in June 2001. A Canadian telecom builder, 360networks held what salespeople dubbed "stoke the fire" meetings, another former 360networks employee says. They stood up before top executives and listed closed deals and sales prospects. People who didn't deliver their quotas "were considered failures," adds Mr. Gill. "I talked to my friends across the industry and no one was selling."

That's when swaps began to take on an entirely new motive: adding revenue onto quarterly financial results. Facing mounting pressure in late 2000 and early 2001, telecoms turned each other into their best customers. It was an industry in which competing executives were already close. They had worked and played together at events such as the annual meeting of the Pacific Telecommunications Council in Honolulu, which featured fireworks and a bare-chested, drum-banging Hawaiian dance troupe.

GREAT MOMENTS IN THE HISTORY OF SWAPS

Old Testament, Genesis 47

As adviser to Pharaoh, Joseph trades food for horses, donkeys and land of famished Egyptians. He later lets them use the land in exchange for 20% tax.

1626

According to legend, Peter Minuit, an agent for the Dutch West India Company, swaps wampum beads, metal knives and wool blankets for island of Manhattan.

1980s

During savings and loan scandals, land speculators swap property back and forth at increasingly inflated values. They call it "swapping a dead horse for a dead cow."

1992

A trader at commodities firm Mitsubishi creates false profits by repeatedly buying and selling mispriced wheat contracts at Minneapolis Grain Exchange.

1998

In a \$1 billion deal, Williams Communications and Winstar Communications trade long-distance and local telecom access. This is widely regarded as the deal that starts the telecom swapping craze.

Global Crossing had a cozy relationship with Qwest. In 1999 and 2000, they bought assets from one another that their engineers had requested to meet specific needs. By 2001, Global Crossing began doing deals to acquire what it might need in the future. It started booking revenue from the deals in 2000.

2001

CMS Energy and Dynegy simultaneously execute two sets of massive electricity trades worth \$1.7 billion on Dynegy's online trading platform. They cancel each other out, but boost trading volumes on the platform.

Qwest began booking revenue from swaps in 1999. A spokesman says that the company is cooperating with various federal investigations. An attorney for Mr. Mohebbi, who is leaving his chief operating officer post at Qwest this month, says his client didn't encourage employees to break any rules.

Global Crossing sales executives reviewed lists of the company's purchases of access from other telecoms and then pressed those companies to reciprocate by buying access from Global Crossing, a former official says. The company's dealmaking moved at such a furious pace that an internal memo in July 2001 noted that "unfortunately, little is known about what we actually acquired in past deals."

"The buzz was that when we saw an announcement for \$300 million or \$500 million, we thought it was b---s---," says John Shaban, an executive director at Emergia USA, a subsidiary of Spain's **Telefonica S.A.** "The first question was, is it a swap? If it was, who cares?"

Working Backward

At companies such as Global Crossing and 360networks, a lot of folks cared. In March 2001, 14 officials from the two companies convened at the offices of Simpson, Thacher & Bartlett, Global Crossing's New York law firm, to try to make an unwieldy deal work.

The idea was for Global Crossing to exchange \$150 million of its capacity between Asia and San Francisco for \$200 million of 360networks' capacity linking the U.S. and Europe. Both sides would book revenue. But because Global Crossing was getting less revenue, 360networks tentatively agreed that on a subsequent deal it would spend more with Global Crossing, according to an e-mail written by a Global Crossing executive.

Less than a year before, the companies had signed a \$180 million swaps agreement over late-night pizza. This time around, the dealmaking was not so relaxed. "There was a subtext of desperation," says a person who attended the two-day session. The rationale for the deal, he says was "to make sure you met your numbers." The companies, he says, were essentially working backward -- with a revenue figure in mind first.

Global Crossing worried that 360networks soon would file for bankruptcy-court protection. Simpson Thacher told Global Crossing, its client, that if that happened, a judge might deny the company its ownership rights to the capacity it was trying to secure.

Over the phone from the West Coast, 360 CEO Greg Maffei encouraged his New York team to close the

deal, despite Global Crossing's concerns, people familiar with the matter said. A spokesperson for 360 declined to comment. The company recently emerged from bankruptcy-court protection.

But Global Crossing also had an incentive to go forward. If the deal didn't close, the company would not be able to meet the projections it made to Wall Street. In a conference call the day before the quarter ended, the executive committee of Global Crossing's board approved the deal.

In an e-mail exchange about a month later, Global Crossing executives discussed whether the company and 360 should swap back the same capacity they had just sold each other. That never happened. And neither company ever used any of the capacity, according to filings in Global Crossing's bankruptcy. The company declined to comment but has said in the past that all its swaps had clear business purposes.

Accounting Follies

Back in the old days, say seven years ago, the asset exchanges Global Crossing was pursuing would have produced nary a blip on the company's financials. The exchanges of assets would have essentially canceled each other out.

But by 2000, Global Crossing had embraced a new accounting treatment for swaps that allowed it to book what it sold as revenue. Moreover, it booked what it bought as a capital expense, which doesn't show up in the operating results scrutinized by telecom analysts. The trick was to make sure that the two companies exchanged separate cash payments for each transaction.

The arrangement was the brainchild of Arthur Andersen's Professional Standards Group, developed in response to a flood of questions from telecoms. "They were much more operations- and marketing-focused than accounting-focused," recalls an Andersen official. "They needed help."

Arthur Andersen accountants began advising clients to employ the new treatment by late 2000. Several months later it was included in an update of an Andersen white paper on telecom issues that was written in such dense accounting jargon that a member of Qwest's audit committee wrote in an e-mail, "I highly recommend it as a sedative."

Nevertheless, it became a must-read in the telecom world. Eager to attract new clients, Andersen began making presentations explaining its accounting interpretation to telecoms. "They had this product. It almost was a cookbook recipe," says an attorney who sat in on Andersen's hourlong Powerpoint presentation. Andersen spokesman Patrick Dorton calls that characterization incorrect and says it reflects a "lack of understanding about subjective accounting standards."

Some Andersen officials were wary about the white paper. The Andersen team auditing Qwest wrote eight reports to the company's chief financial officer and audit committee between 2000 and 2002 that among other things detailed the team members' worries about the accounting treatment of swaps. In a presentation to Qwest's audit committee on Oct. 24, 2001, the Andersen auditors described Qwest's swap accounting as "maximum risk," according to minutes of the meeting. Still, the auditors and the company's management signed off on Qwest's financial statements for 2000 and 2001.

Mr. Dorton, the Andersen spokesman, says the auditors' advice was "entirely consistent with the white paper." He added that because Qwest was founded as a construction company specializing in laying fiber, and not strictly a telecom, only portions of the paper were relevant.

Andersen officials say their firm was issuing opinions at a time when there was no real guidance from accounting-standards groups or the SEC on telecom accounting. In August the SEC finally barred telecom swaps that create revenue.

Feeding the Dot-Com Frenzy

For revenue-hungry dot-coms, boosting financials through round-trip deals was common. For a while it was even legal. The commodity most often traded back and forth was online advertisements. Many companies swapped the ads and booked revenue on the deals even though not a penny changed hands.

When iVillage Inc., a Web site aimed at women, went public in 1999, it disclosed that 20% of its revenue came from round-trip trades of advertising. That year, 8% of **Yahoo** Inc.'s revenue came from advertising trades.

But by year's end, it became harder for Internet start-ups to use round-trip deals to generate revenue. That's because the Financial Accounting Standards Board got wind of the practice and issued tough guidelines. It warned that booking advertising-swap deals as revenue "may lead to overstated revenues and artificially inflated market capitalization." Henceforth it had to be disclosed as "barter revenues."

That didn't deter Homestore Inc. executive vice president Peter Tafeen from searching for ways to make round-trips work. Known within the company as "the Piranha," Mr. Tafeen began hunting for solutions with Eric Keller, an America Online executive, says a person familiar with the federal criminal investigation of Homestore, an online real-estate company. The California State Teachers' Retirement System has sued Homestore, AOL and Mr. Tafeen in federal court in Los Angeles.

According to that civil suit, Mr. Tafeen in March 2001 outlined his plans to Homestore's chief financial officer, who has since pleaded guilty to criminal charges. Mr. Tafeen told the official that he and Mr. Keller had plans for triangular deals that would help make up for a projected \$15 million shortfall in the company's quarterly revenue goal, according to the suit. Mr. Tafeen allegedly said that the deals would be structured so that auditors would not discover their true nature.

Lawyers familiar with the criminal probe say that the two men used tiny software companies as cash conduits between the two larger companies. Typically in these deals, Homestore would buy products from a third company, which would then buy ads on America Online, according to those lawyers. America Online would share the revenue with Homestore. Prosecutors are scrutinizing 16 transactions involving America Online and Homestore, the lawyers say.

Mr. Keller has been fired from America Online and did not return phone calls. Robert Charles Friese, a lawyer for Mr. Tafeen, said transactions his client worked on had legitimate business purposes.

Homestore and AOL declined to comment.

FinanCenter Inc., a small firm in Tucson, Ariz., had pitched its software to Homestore in late 1999 without success. Two years later, it got a call from Homestore vice president Bruce Cornelius.

At first, Homestore expressed interest in licensing FinanCenter's Web-based financial planning software. But in June, Mr. Cornelius, who has left Homestore, began pushing the smaller company to enter into an unusual arrangement, according to former FinanCenter executives.

Homestore wanted to pay \$3.75 million for software valued at only \$750,000. Then it wanted FinanCenter to spend \$3 million buying ads on AOL, according to the former FinanCenter executives. Mr. Cornelius declined to comment.

Darryl Reed, then a FinanCenter vice president, says he wasn't completely against the America Online twist, but he wanted it in the contract and the money placed in escrow. Homestore balked.

"It was odd that the money was passing through us," says Andria Poe, a former FinanCenter manager, who at one point opened the company's office for a 3 a.m. meeting during a week of frenzied negotiations.

The FinanCenter team worried that the company might be on the hook for a \$3.75 million refund, so Homestore promised to put liability limits into the contract. But Ms. Poe rejected that, fearing that the clauses wouldn't stand up in court. She was also put off by Homestore's desire to backdate the contract.

Finally, FinanCenter president e-mailed Homestore. "The truth be known we'd prefer to just license you the tools for the \$750k that we had originally planned," he wrote. Homestore didn't respond and FinanCenter walked away from the deal.

Other small companies accepted similar proposals from Homestore, including PurchasePro.com Inc. and Classmates Online Inc., according to the civil suit. A Classmates spokesman says his company's transactions with Homestore were valid from its perspective. PurchasePro.com declined to comment.

Round-trip deals allowed Homestore to inflate revenue by \$46 million in 2001, according to prosecutors. Homestore has restated a total of \$164.4 million of revenue for 2000 and 2001. In September, three former executives pleaded guilty to accounting fraud and agreed to cooperate with prosecutors.

Keeping Up With Enron

With Enron so far ahead of the pack, many of its energy-trading competitors were eager to find ways to catch up. For some, round-trip trades were the answer. They simply traded equal amounts of natural gas or electricity at the same time, for the same price. Then they cited the artificially boosted trading volumes and revenue in press releases and prospectuses touting their trading businesses.

For CMS Energy, a relatively small trader, increasing volume was central to its goal of building the reputation of its trading floor. At the end of 2001, Power Markets Week, a trade publication, ranked CMS Energy 21st in terms of power sales in North America, still way behind top-ranked Enron.

But most of CMS Energy's trades of 148.2 million megawatt hours of power during 2000 and 2001 weren't real. The company made \$5.2 billion of meaningless swap transactions.

Wash trades proliferated in the energy business because the new wholesale energy markets are largely unregulated. Commodity exchanges have rules barring the deals, but they don't apply on off-exchange or over-the-counter energy markets. After lobbying by energy companies such as Enron, legislation passed in 2000 exempted from oversight most trading in over-the-counter energy markets. Federal energy and financial regulators have jurisdiction in some cases of wrongdoing and are probing wash trades.

In May, **Reliant Resources Inc.** disclosed that about \$6.4 billion in trades executed between 1999 and 2001 were wash transactions. **Duke Energy Corp.** in August disclosed that it had conducted 89 wash trades, amounting to \$217 million in revenue, in 2001 and 2002.

It turned out that 28 of those trades were executed on a little watched online energy market, the IntercontinentalExchange. ICE, as it is known, was founded in 2000, but it suddenly became more popular with energy traders after the collapse of Enron and its online exchange last year. Based in Atlanta, ICE is owned by 13 primary shareholders that include Duke, **Goldman Sachs Group Inc.**, **Morgan Stanley**, and **BP PLC**.

For owners, there was an incentive to boost volumes on the exchange. People familiar with ICE agreements say that companies could earn equity by pledging to conduct a set volume of trades on the exchange, and that energy-trading owners could boost their stake by increasing volume. Volume statistics also were heavily used in ICE's marketing efforts.

Duke last summer fired two employees after an internal review of its wash trades and has reorganized its trading operations. A spokeswoman said Duke encouraged traders to use ICE but didn't condone wash trades. She said that Duke's equity stake wasn't affected by the wash trades.

A shareholders suit filed last month in Houston against **El Paso Corp.**, another ICE owner, alleges that executives offered a monthly bonus of \$10,000 to the trader who executed the most deals on ICE. The suit, citing El Paso trading logs, lists six wash trades that El Paso allegedly conducted on ICE. A spokesman says El Paso didn't make wash trades.

An ICE spokesman said that ICE has implemented procedures to weed out wash trades and believes they made up a small percentage of volume.

Still, some of those trades have gotten through. On Sept. 21, 2001, ICE sponsored a fund-raiser, in which a day's commissions would go to victims of the Sept. 11 attacks. About \$1 million was raised.

But some of the volume was phony. Traders for **American Electric Power Co.**, an ICE co-owner,

executed three sets of wash trades with El Paso and Aquila Inc. on ICE that day, according to filings the company made with regulators. An AEP spokesman said the trades were made without top managers' approval.

Write to Dennis K. Berman at dennis.berman@wsj.com⁵, Julia Angwin at julia.angwin@wsj.com⁶ and Chip Cummins at chip.cummins@wsj.com⁷

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Updated December 23, 2002

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