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Eroding Empires

Electronics Giants Of Japan Undergo Wrenching Change

Beset by Nimbler Asian Rivals, Former Technology Leaders Are Driven to Slim Down

Toshiba, Fujitsu Lay Chip Plans

By Robert A. Guth

TOKYO—Remember Digital Equipment Corp.? How about ITT Corp.? Once powerhouses of the U.S. economy, their technology empires crumbled years ago and are nearly forgotten. Their fate haunts Japanese electronics executives such as Tadashi Okamura.

Mr. Okamura, president of Toshiba Corp., has watched his conglomerate decline for a decade. First, the South Koreans made off with its memory-chip markets. Then Taiwanese rivals trounced it in flat-panel displays. Last year, Dell Computer Corp. of the U.S. replaced it as the world's top maker of notebook computers.

Toshiba's troubles came to a head last month when it reported its largest-ever

Chips in a Crunch

- Federal antitrust authorities are investigating whether memory-chip makers colluded to prop up prices. A2.
- Toshiba and Fujitsu said they are in talks that could lead to a merger of large portions of their semiconductor operations. A9.

net loss, of $2 billion, for the fiscal year ended March 31. The fresh red ink brought combined losses for the year at Japan's Big Five industrial-electronics makers to $12 billion.

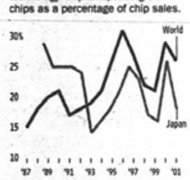
Company executives knew Toshiba was sinking, says the 63-year-old Mr. Okamura, but the loss showed that things were "much worse than we imagined."

Like Toshiba, Japan's other industrial-electronics giants are withering away. Though they once threatened to obliterate the U.S. technology sector, years of passive management have left the Big Five—NEC Corp., Toshiba, Hitachi Ltd., Fujitsu Ltd. and Mitsubishi Electric Corp.—bloated, deep in the red and rapidly losing business to Asian rivals.

Fighting to stem Japan's technological decline, Mr. Okamura and his counterparts are leading one of the most far-reaching industry reorganizations in Japanese history, dismantling their high-tech domains by laying off workers, closing plants and splitting off divisions.

Japanese Retreat

Japan's electronics firms have slashed investments in chip technology. Capital spending on chips as a percentage of chip sales.



Source: IC Insights

Over time, the executives hope to turn their ungainly employers into smaller, healthier companies nimble enough to prosper in selected niches of the electronics market. Indeed, *sentaku to shuchu*, or "selection and focus," has become the buzz phrase in Tokyo boardrooms.

Just yesterday, Toshiba and Fujitsu said they may merge parts of their semiconductor businesses that together would have annual sales of about $4.5 billion. The plan follows a similar deal in March between Hitachi and Mitsubishi and last month's announcement by NEC that it will split off its chip division, which employs 25,000 and has annual sales of about $5 billion, and take it public as

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What's News—

Business and Finance

THE IRS IS BRINGING BACK its controversial practice of randomly auditing individual tax returns in an effort to crack down on what it says is a growing wave of tax scams. IRS officials said the agency plans to conduct about 50,000 random audits related to the 2001 tax year.

(Article in Column 4)

■ **Microsoft's antitrust trial** drew to a close, with the judge pushing both the software firm and states to narrow their demands, a call Microsoft rejected.

(Article on Page A3)

■ **The Justice Department** launched a criminal inquiry into whether the top memory-chip makers colluded to prop up prices.

(Article on Page A2)

■ **Tech shares crumbled,** pushing the Nasdaq down 3% to 1496.83, a low for the year. Bonds rallied as money moved out of stocks.

(Article on Page C1)

■ **ImClone said the SEC told the firm** it could face civil action for its handling of disclosures about its Erbitux cancer drug.

(Article on Page A3)

■ **Dynegy replaced** its finance chief, seeking to boost investor confidence amid allegations of accounting and trading irregularities.

(Article on Page C1)

■ **TRW agreed to sell its aeronautical-systems unit** to Goodrich for $1.5 billion, a deal aimed at thwarting Northrop's bid for TRW.

(Article on Page B4)

■ **ChevronTexaco said** that by April it expects to have saved as much as $2.2 billion from its merger, 22% more than expected.

(Article on Page B4)

■ **Mexico's Pemex said** it expects up to 30 foreign firms to bid on new drilling and production contracts for natural gas.

(Article on Page A10)

■ **Vodafone slashed its CEO's pay** and outlined a new compensation policy amid protests by European investors over rich pay packages.

(Article on Page A10)

■ **Versatel filed** for bankruptcy-court protection, another sign of the European telecom slump.

(Article on Page B5)

■ **Morgan Stanley's net fell** 14% on a steep drop in securities businesses. Bear Stearns's net doubled, helped by an IPO gain.

(Article on Page C5)

■ **Leaders of United's pilots union** approved a wage-concession deal that, if ratified, would save the airline $560 million over three years.

(Article on Page B2)

■ **An ex-DLJ compliance official** said he was fired after calling attention to alleged improprieties at the firm's Miami office.

(Article on Page C13)

■ **Wells Fargo will process** all credit-card transactions on behalf of PayPal under an agreement between the two firms.

(Article on Page A8)

■ **Toshiba and Fujitsu said** they are in talks that could lead to a merger of large portions of their semiconductor operations.

(Article on Page A9)

■ **Mobilcom's creditor banks** are expected to sign off this week on a plan to refinance $4.5 billion of the wireless firm's debt.

(Article on Page B8)

—Markets—

Stocks: NYSE vol. 1,278,420,850 shares, Nasdaq vol. 1,691,438,700. DJ industrials 9561.57, ▼ -144.55; Nasdaq composite 1496.83, ▼ -46.13; S&P 500 index 1019.99, ▼ -17.15.

Bonds (4 p.m.): 10-yr Treasury ▲ +25/32, yld 4.731%; 30-yr Treasury ▲ +30/32, yld 5.391%.

Dollar: 123.81 yen, -0.52; euro 95.74 cents, +0.57 against the dollar.

Commodities: Oil futures $25.31 a barrel, ▼ -$0.12; Dow Jones-AIG futures 97.264, ▼ -0.077; DJ-AIG spot 124.494, ▼ -0.099.

World-Wide

■ **ISRAEL HIT BACK after the second Jerusalem bombing in two days.** A suicide bomber from a group linked to Arafat's PLO faction sprang from a car near a bus stop at a busy intersection, killing at least six people and wounding 35 with his explosives. Israeli helicopters rocketed a Gaza metal workshop said to be used to manufacture weapons, and tanks entered a section of Ramallah. But it wasn't clear if such actions marked the beginning of Israel's implementation of its threat to gradually retake territory controlled by the Palestinian Authority. (Page A10)

Bush put off a speech to lay out Mideast peace proposals, including steps toward a Palestinian state. The White House said the president won't change the speech, but will wait for a better time to deliver it.

■ **Congressional investigators were** told the NSA intercepted Arabic conversations Sept. 10 that spoke of a big event set for the next day, but they weren't translated until Sept. 12. An official said the intercepts lacked details that might have helped authorities to avert the attacks. (Page A3)

■ **The White House was evacuated** briefly when a small plane flew into restricted airspace. Two F-16s were scrambled. Bush was never in danger. In a further sign Washington's nerves are on edge, the Federal Reserve was evacuated while a suspicious item was examined. (Page A2)

■ **A House panel voted** to let some airline pilots carry guns despite administration opposition. A second panel voted to reinstate a ban on "virtual" child pornography despite three court losses on the issue. Action to raise the debt ceiling is stymied despite a looming deadline. (Page A2)

■ **The Pentagon said** the F-16 pilot who mistakenly killed four Canadian troops in Afghanistan April 16 didn't follow procedures and may face punishment. Meanwhile, the Defense Department will let U.S. troops patrol with Filipino allies fighting al Qaeda-linked rebels on a southern island.

■ **Afghanistan's Karzai was sworn in** as interim president as the grand council adjourned. Some delegates complained the new cabinet leaves warlords in place, but Karzai had no post for Uzbek warlord Dostum.

■ **Anthrax experts are growing** pessimistic that genetic fingerprinting will lead to a break in the investigation of the fall attacks. Hospitals are resisting federal pressure to serve as smallpox centers. (Page B1)

■ **A Forest Service worker was** indicted for deliberately setting the big Colorado wildfire. The woman, who says it began accidentally when she burned a letter from her estranged husband, may face 65 years.

■ **Space shuttle Endeavour landed** in California carrying a space station crew whose 196 days aloft set a NASA record. Sergei Krikalov, stranded on the Mir for 10 months by the 1991 Soviet collapse, holds the world record.

■ **The administration is to unveil its** Amtrak plan today. It rejects boosting federal subsidies, gives states a bigger role and calls for looking at splitting Northeast Corridor operations from infrastructure. (Page A2)

■ **Tuition will rise** as much as 25% at some state colleges and universities this coming school year as more than 40 states grapple with budget shortfalls. Enrollment, teachers and courses may be cut back. (Page D1)

■ **The Kursk commission is set** to conclude the Russian nuclear submarine was sunk in 2000 by a torpedo explosion. Western experts have long pointed to volatile hydrogen peroxide propellant as the likely cause.

■ **Bush proposed** spending $500 million over five years to fight mother-child AIDS infections in Africa and the Caribbean. One critic described the plan as "grossly underfinanced."

■ **Gunmen in Nigeria killed** 15 University of Nigeria engineering students while they were taking a test. Police blame a feud between rival secret societies at the Nsukka campus.

—Online Today—

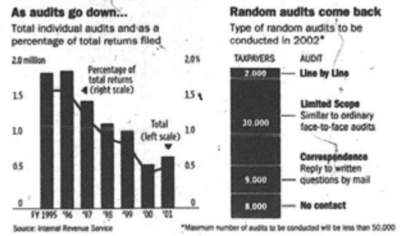
Fiscally Fit: Buying a home at the peak of a real-estate bubble is a risky proposition, warns Terri Cullen.

■ **Work & Family Mailbox:** Finding the time to make a career switch is hard, but Sue Shellenbarger has some helpful hints.

■ **WSJ.com/Microsoft:** See continuing coverage of the Microsoft antitrust trial, and readers' reactions to the latest news.

The IRS Might Want You

The number of people being audited has been dropping for several years. But now the IRS is getting ready to do random audits on 50,000 taxpayers.



Source: Internal Revenue Service

*Maximum number of audits to be conducted will be less than 50,000

Unhappy Returns: IRS Moves To Bring Back Random Audits

By Tom Herman

The Internal Revenue Service is bringing back its controversial practice of randomly auditing individual tax returns in an effort to crack down on what it says is a growing wave of tax scams.

The move is an about-face for the IRS, which did its last batch of random audits in 1988 and was slapped down by Congress when it tried to resume them in the mid-1990s. Legislators pilloried the agency for its aggressive tactics in conducting such audits, in which thousands of Americans were forced to defend every line in their tax returns.

Now the IRS is taking advantage of the post-Enron environment to flex its muscles again. Following the collapse of Enron Corp. late last year, and a slew of subsequent corporate scandals, the mood in Congress has been to lean harder on companies and individuals who scheme to avoid paying taxes.

The IRS says it needs the random audits to collect fresh information about tax cheating—and thus improve the process by which it determines who gets audited each year. It promises its audits will be less invasive this time around. Still, an estimated 2,000 of those picked this time will get intensive line-by-line audits. That means taxpayers probably will have to hire a tax lawyer or certified public accountant to represent them—even if they have done nothing wrong.

Senior IRS officials said the agency plans to conduct about 50,000 random audits related to the 2001 tax year. Those getting audited will be selected from various income groups and types of returns, ranging from average wage earners to small-business owners. The program is intended only for one year, but the agency hopes to conduct random audits every few years.

More recently, even regular IRS audits have plummeted, thanks largely to budget pressures and more employees concentrating on taxpayer service. The IRS said it audited 731,756 individual income-tax returns in the fiscal year ended Sept. 30, down from 1.92 million in fiscal 1995.

Congressional reaction to the IRS plans thus far has been very different from the mid- to late-1990s, when lawmakers focused on reining in what were perceived to be IRS abuses of taxpayer rights. Senate Finance Committee hearings led to enactment of new taxpayer rights in 1998, including creation of an IRS oversight board, and the agency also has launched a massive internal reorganization. Now, the pendulum is swinging the other way, with growing concern that the IRS is letting too many tax cheats escape.

Sen. Charles Grassley, the Iowa Republican and ranking GOP member of the Finance Committee, has been a sharp critic of the IRS in the past. But now he says random audits are needed. "The information from these audits will allow the IRS to target its limited resources on examining those taxpayers who are most likely to be up to no good, while leaving honest taxpayers alone," he said.

Enormous Powers

Given its enormous powers to obtain bank and credit-card records, not everyone believes the IRS needs intensive random audits anymore. Early indications are that as many as two million Americans might be snared in its investigation of credit-card use linked to bank accounts in offshore tax havens, for example.

The IRS also has devised other ways to target tax cheats. It is demanding names of wealthy people who use tax shelters by issuing summonses to their accounting firms, investment banks and other advisers. And it is cracking down on all sorts of schemes and cons being promoted on the Internet.

IRS Commissioner Charles Rossotti said the agency needs better data on the level of compliance with tax laws to update the secret formula it uses to pick many of its audit targets. The IRS scores each return using its "Discriminant Function System" that assigns a "DIF score" to each return based on the return's likelihood of having questionable items. It isn't the IRS's only way of selecting audit

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If Andersen's Books Were Unconventional, Look at Its School

* * *

California Learning Center Drops Classes, 'Teachers'; Accounting for a Twinkie

By Ianthe Jeanne Dugan

ALAMEDA, Calif.—In a small annex of an old high school, next to a defunct Navy base, Arthur Andersen is struggling to thrive.

No, not that Arthur Andersen.

This is the Arthur Andersen Community Learning Center, which the accounting firm launched in 1996, answering former President Bush's call for businesses to get involved in education.

After six years of plotting, it unveiled a school that would lump 12- to 18-year-old "learners" in one big room, writing their own rules and curriculum, with the help of "facilitators"—the new term for teachers. "I felt I was the keeper of the soul of Arthur Andersen," says Morton Egol, the retired Andersen partner who led the project to get the school off the ground. "And I felt the school of the future would do that. It was intended to portray a firm committed to the public interest."

Though educators visited from around the world to study what many academics heralded as a model school, nobody has since tried to emulate the Andersen school. Though the school continues to attract more students than it can accommodate, its wind tunnel and can-crushing machine are in storage. The dry-erase board is out of pens. The videoconferencing equipment is unplugged. And now its name is tarnished. "I think we should rename ourselves Batman High School," suggests Victor Vazquez, a senior.

The school offers a poignant footnote to the saga of the collapsed giant. It was designed to demonstrate that Arthur Andersen's competence and conscience stretched far deeper than corporate books. Now, as the accounting firm rapidly dissolves, this tiny high school may well wind up being the last holder of the Arthur Andersen corporate name.

The firm dreamed up the school in the late 1980s, as it set up groups to gain credibility in far-flung fields. Mr. Egol, who was put in charge of government and education, began holding education conferences each year at Andersen's

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Venal Sins

Why the Bad Guys Of the Boardroom Emerged en Masse

The Stock Bubble Magnified Shifts in Business Mores While Watchdogs Napped

Galbraith Explains the 'Bezzle'

By David Wessel

Every decade has king-size corporate villains. In the 1970s, Robert Vesco was indicted for looting the Investors Overseas Services mutual funds. In the 1980s, arbitrageur Ivan Boesky and junk-bond inventor Michael Milken went to jail.

But the scope and scale of the corporate transgressions of the late 1990s, now coming to light, exceed anything the U.S. has witnessed since the years preceding the Great Depression.

WHAT'S WRONG?
First in a Series

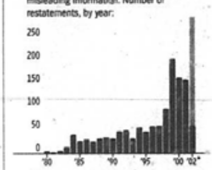
Enron Corp.'s top executives reaped hundreds of millions as the company collapsed. Arthur Andersen LLP, Enron's auditor, was convicted last week of obstructing justice. Tyco International Ltd.'s lionized chief executive is charged with tax evasion and accused of secret pay deals with underlings. Cable giant Adelphia Communications Corp. admitted inflating numbers and making undisclosed loans to its major shareholders. Xerox Corp. paid a $10 million fine for overstating revenues. Dynegy and CMS Energy Corp. simultaneously bought and sold electricity in transactions with no point other than pumping up trading volumes. Merrill Lynch & Co. paid $100 million to settle New York state charges that analysts misled investors, and other Wall Street firms are now under scrutiny.

"I've never seen anything of this magnitude with companies this large," says Henry McKinnell, 59, chief executive of pharmaceutical maker Pfizer Inc.

Why is so much corporate venality surfacing now? Is there more of it, or is more attention being paid? Did a few executives lose their ethical moorings in the exuberance of the 1990s? Or did a few notorious offenders break rules that many others merely bent? Is the entire system of corporate governance and regulation flawed? Or was the system abused by a few cleverly diabolical executives

Double Take

A growing number of companies have restated their earnings, acknowledging that they had given investors incorrect or misleading information. Number of restatements, by year:



*Dark bar represents total for first quarter; light bar represents the year's total if first-quarter pace is sustained all year

Source: Min Wu, New York University

who deserve, as Treasury Secretary Paul O'Neill puts it, "to hang ... from the very highest branches?"

The answer, put simply: A stock-market bubble magnified changes in business mores and brought trends that had been building for years to a climax. The victims: the very shareholders the executives were supposed to be serving.

One culprit was stock options, which gave executives huge incentives to boost near-term share prices regardless of long-term consequences. No CEO pay package seemed to strike any board of directors as too big.

These incentives helped turn the widely practiced art of earnings management—making sure profits meet or barely exceed Wall Street expectations—into a gross distortion of reality at

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INSIDE TODAY'S JOURNAL

Spot the Sponsor

The World Cup has become an irresistible target for companies seeking to sneak into the games with their own marketing campaigns. Advertising, Page B1

Apple of His Eye

In 1997, 'I was so disillusioned with Apple and its products that I wrote a column advising consumers to shun the Mac. Today, Apple and the Mac are far better,' writes Walt Mossberg. Personal Technology, B1

Hide-and-Seek

Some well-respected car dealers have allegedly been sneaking hidden fees into auto loans, and charging customers for unrequested add-ons. The victims aren't who you'd think. D1

Sleeping Beauty

Hotels are expanding their amenities, hoping some unusual new services will help you rest, and help them recover from the post-Sept. 11 travel slump. D1

Millstein in the Middle

Ira Millstein is one of Wall Street's top lawyers, but now he may have met his biggest challenge yet—right in his own backyard, where he's caught up in an unusually nasty feud among his own neighbors. C1

Out of the Ring

Minnesota Gov. Jesse Ventura is retiring, claiming to be just a dad angry over media coverage of his family. The truth is more complicated, writes John Fund. Opinion, A16

Why the Bad Guys of the Boardroom Have Emerged en Masse

Continued From First Page

some companies.

And the institutions that were created to check such abuses failed. The remnants of a professional ethos in accounting, law and securities analysis gave way to getting the maximum revenue per partner. The auditor's signature on a corporate report didn't testify that the report was an accurate snapshot, says Mr. O'Neill. He says it too often meant only that a company had "cooked the books to generally accepted standards."

The current sordid chapter in the history of American business opened on Aug. 14 last year when Jeffrey Skilling quit as chief executive of Enron Corp., an unmistakable sign that all was not well inside one of the country's most-admired corporations.

Enron is "the private sector's Watergate," says John Coffee, a Columbia University securities-law professor. Although not all politicians were crooks, Watergate bred a virulent cynicism about

◆ CAPITAL ◆

government among the public, the press and even some politicians. That cynicism persists 30 years after the White House-blessed burglary of the Democratic National Committee's office.

Enron and all that followed threaten to do the same to American business. "I have had a lot of e-mail from shareholders who seem to have gone off the deep end and think all corporate executives are crooks and all accountants are sheep, just as some think all Catholic priests are pedophiles," says mutual-fund manager James Gipson of Clipper Fund. "None of those statements are true."

Measuring the volume of corporate skullduggery precisely is difficult. The SEC opened 570 investigations last year. That's more than in any of the previous 10 years—but just 10 more than in 1994. More than 150 companies restated their earnings in each of the past three years, an acknowledgment that they had misinformed investors. That's more than triple the levels of the early 1990s, but represents only one of every 100 publicly traded companies.

'A Few Bad Apples' Analysis

One view, a staple of speeches by chief executives and government officials, underscores that only a small fraction of companies and executives stand accused of wrongdoing. It's the "a few bad apples" analysis. Treasury Secretary O'Neill, former chief executive of Alcoa Inc., talks of "a very small number compared to all the enterprises out there."

Pfizer's Mr. McKinnell, who serves as vice chairman of the Business Roundtable's corporate-governance task force, cautions against generalizing from "eight or 10 companies who allegedly behaved in ways that are incomprehensible ... and deserve what they're getting." Securities and Exchange Commission Chairman Harvey Pitt, who has been practicing securities law in and out of government for 35 years, chides business reporters by recalling how the reporting of muckraking journalist Lincoln Steffens created a "crime wave" in the 1890s at a time when the actual number of crimes was falling.

For this camp, the smart response is to punish the miscreants severely and tinker with the parts of the system that are broken, taking care to avoid hasty changes with unintended consequences. "Things aren't as broken as they appear to be," says Mr. McKinnell.

But there's another view: The headline-making cases are symptoms of a broader disease, not exceptions, and a regulatory apparatus that isn't up to the challenge. "A few bad apples? Looks like we've got the whole peck here," says retired federal judge Stanley Sporkin, the SEC's enforcement chief in the 1970s.

"Everybody did this," says economic historian Peter Temin of the Massachusetts Institute of Technology. "The people who got in trouble are those who are most at the edge. Enron didn't get caught. Enron got so far out on the edge that it fell off."

To this camp, the reasonable response is broader legislation and tougher regulation on the scale of the 1930s laws that created the SEC and the modern regulatory regime.

The "irrational exuberance" so famously flagged in 1996 is an essential part of explaining the 1990s. When the man who coined the term, Federal Reserve Chairman Alan Greenspan, talks informally with business and other groups, he says the greediness of human beings didn't increase in the 1990s. What increased, he says, were the number of opportunities to satisfy that greed. The run-up in stock prices meant there was more to grab.

Corporate Accountability

A parade of big companies face serious questions about their business practices.

COMPANY	ISSUE	PERCENT CHANGE IN SHARE PRICE SINCE 1/14/00*
Adelphia	Whether it failed to properly disclose $3.1 billion in loans and guarantees to its founder's family.	▼ -99.75%
CMS Energy	Disclosed it overstated revenue in 2000 and 2001 by including artificial 'round trip' energy trades.	▼ -56.78
Computer Associates	Whether it artificially inflated revenue and improperly rewarded top executives.	▼ -73.58
Dynegy	Whether its 'Project Alpha' transactions served primarily to cut taxes and artificially increase cash flow.	▼ -84.97
Enron	Admitted it improperly inflated earnings and hid debt through business partnerships.	▼ -99.80
Global Crossing	Whether it sold its telecom capacity in a way that artificially boosted its 2001 cash revenue.	▼ -99.87
Halliburton	Whether it improperly recorded revenue from cost overruns on big construction jobs.	▼ -56.51
ImClone Systems	Former CEO Samuel Waksal charged with insider trading.	▼ -52.34
Kmart	Says the SEC is investigating its accounting and other practices. The company investigated whether it improperly accounted for vendor allowances, and since changed its practice.	▼ -91.02
Lucent Technologies	Adjusted fiscal 2000 revenues by $679 million, spurring SEC investigation. Agency also investigating whether vendor-financing played an improper role in its sales.	▼ -93.39
MicroStrategy	Settled without admitting wrongdoing an SEC suit accusing it of backdating sales contracts to meet quarterly financial estimates, among other improper revenue-recognition practices.	▼ -99.07
Network Associates	Whether it hid expenses and overstated revenue from 1998 to 2000.	▼ -28.25
PNC Financial Services	Restated its 2001 results by $155 million after regulators raised concerns about how PNC accounted for a transfer of loans.	▲ +15.61
Qwest Communications	Whether it inflated revenue for 2000 and 2001 through capacity swaps and equipment sales.	▼ -88.35
Reliant Resources	Admitted it inflated revenue by counting artificial 'round trip' energy trades.	N.A.
Tyco International	Whether it improperly created 'cookie jar' reserves that were supposed to cover merger costs but instead were drawn on to boost profits; and whether it improperly 'spring-loaded' earnings from acquisitions by accelerating their pre-merger outlays.	▼ -55.15
WorldCom	Whether it used questionable methods to book sales, classify assets and account for debts it couldn't collect.	▼ -96.60
Xerox	Fined $10 million without admitting or denying wrongdoing for inflating revenue and profits from 1997 to 2000 by including future payments on existing contracts.	▼ -67.53

Sources: WSJ research; WSJ Market Data Group

*Date the Dow Jones Industrial Average hit its all-time high

Revelation and outrage always follow the bursting of a bubble. The cycle is immutable. "At any given time there exists an inventory of undiscovered embezzlement," economist John Kenneth Galbraith wrote in "The Great Crash of 1929." "This inventory—it should perhaps be called the bezzle—amounts at any moment to many millions of dollars. ... In good times people are relaxed, trusting and money is plentiful. But even though money is plentiful, there are always many people who need more."

Mr. Galbraith continues: "Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks."

Mr. Gipson, the mutual-fund manager, says, "There is a tendency during boom times for even honest people to shift their moral compasses, and there is a belief that everyone else is doing it. It's when the music stops, if you will and the scrutiny goes up that the over-the-top cases become apparent."

Stock options were supposed to solve a problem of the past: entrenched corporate management that wasn't serving shareholders—the indictment that corporate raiders made with such ferocity in the 1980s.

Gordon Gekko Speaks

"Today, management has no stake in the company," raider Gordon Gekko says in his speech to shareholders in the 1987 movie "Wall Street." "Where does Mr. Cromwell [the CEO] put his million-dollar salary? Not in Teldar stock. He owns less than 1%. You own the company. That's right, you, the stockholders. You are being royally screwed over by these bureaucrats with their steak luncheons, hunting and fishing trips, their corporate jets and golden parachutes."

The solution, widely embraced in American business, was to use stock options to link executives' and shareholders' interests. It sounded reasonable: Executives would benefit if they managed companies in a way that lifted share prices.

It didn't work as intended. A soaring stock market rewarded executives not for good strategic management, but for riding the roller coaster. And when the stock price dipped below the exercise price—essentially making the options worthless—some companies simply revised the terms or, in Wall Street jargon, "reloaded" them.

Even worse, the incentives to do almost anything to increase the stock price were huge. And the incentives weren't to increase profits and share prices over a decade or two, but rather to increase profits—never mind if they have to be restated later—just long enough for executives to cash out, often without ever risking any of their own money to buy shares in the first place.

Stock options, Mr. Pitt says, were "a device that was supposed to align shareholder and manager interests—and actually 'disaligned' them." Not all executives were swayed, of course, but an ill-designed compensation system pushed them in the wrong direction.

Of course, corporate executives aren't supposed to be monarchs. All sorts of checks and balances have been established during the past century: accountants, lawyers, securities analysts, investment bankers, audit committees, regulators, even the press.

None of the abuses that have been exposed in the past 10 months were committed by chief executives who worked alone to steal shareholders' money. "In every one of these cases," says Mr. Sporkin, the former SEC chief, "you have professional assistance."

This exposes one of the problems that have plagued corporate capitalism since its inception. "When the laws or regulations fail to protect investors, corporate insiders—whether managers or owners—tend to expropriate," economists Gene D'Avolio, Efi Gildor and Andrei Shleifer asserted in a paper they presented at a Federal Reserve Bank of Kansas City conference last summer.

Perhaps the rules were inadequate; that's still being debated. But there is little debate about the failure of the professionals who are supposed to see that rules are obeyed and executives are honest.

The decay of professionalism—and codes of ethics that distinguished a profession from a job—intensified in the 1990s, but it didn't begin then. Reflecting on his 23 years in corporate management, Mr. O'Neill recalls a parade of Wall Street professionals who came to his office with plans for "new and exotic" financial maneuvers to reduce his company's tax bill or report debt levels in ways "not clearly prohibited by the tax code or law," but not designed to illuminate corporate operations, either.

"They get," he says, "into an ethical vacuum space."

The shortcomings of accounting firms are now well exposed. The duplicity of some highly paid Wall Street analysts is documented in internal e-mails that are now public. The acquiescence of the lawyers inside Enron and Tyco, as well as the readiness of lawyers to clear increasingly aggressive corporate tax shelters for other companies, is readily apparent.

This disturbing pattern is the biggest reason why the abuses of the 1990s can't easily be dismissed as the fault of a few flawed human beings. "The professional gatekeepers were greatly compromised by finding they could make tremendous profits by deferring to management," says Columbia's Mr. Coffee.

But not one of the instances of egregious abuse of shareholder interest could have occurred if the CEO had simply said, "No!"

The climate made it commonplace. The incentives were perverse. The watchdogs were sleeping. But not every company did it. What distinguishes those that did from those that didn't?

Mr. Gipson, the mutual-fund manager, divides offenders into two classes: the "confirmed crooks" who deliberately and willfully ripped off shareholders, and the "morally marginal who went right up to the line of acceptable behavior" and then "when the line was moved found themselves on the other side."

Treasury Secretary O'Neill makes a similar point: "A little lie leads to ever bigger ones in lots of cases without a recognition on the part of the perpetrator that they ever told a lie, even when it gets grotesque. They say, 'If only I had another 12 months ... ' "

Case Studies

At Harvard Business School, the citadel of corporate management, the faculty uses case studies of heroes and villains in an effort to inoculate students against the temptations they will inevitably confront.

"Maybe," says a member of that faculty, Richard Tedlow, "we ought to think about CEOs and other managers as fully formed human beings, not as people who focus on one variable and who check their personalities at the coat rack. Some of what was going on was people doing exactly what the incentives suggest that they do: Give me a lot of stock options, and I'll make the stock go up.

"But something is missing," he adds. "Life is lived on a slippery slope. It takes a person of character to know what lines you don't cross. That part of the equation of corporate management hasn't had the emphasis it should have had in the last decade or two."

The excesses of the 1920s and the spectacular crash of the stock market in 1929 led to the creation of modern financial regulation, from bank-deposit insurance to the ban on insider trades, in 1933 and 1934. Despite the obvious parallels, this is a different time. The U.S. is not in an economic depression, nor does George W. Bush see himself as Franklin Delano Roosevelt's heir. The debate over how to repair the system is just beginning to take form; this week saw competing legislative and SEC proposals to tighten oversight of accountants.

The nature and dimensions of the reforms depend on factors that aren't knowable. How many more Enrons and Tycos remain unreported? How swiftly will corporations, boards of directors, the New York Stock Exchange, the National Association of Securities Dealers and other self-regulatory organizations move to reassure investors? And, most important of all, how much longer will the stock market languish?

Question of the Day: *What's most to blame for the spate of scandals surrounding U.S. corporations? Visit* **WSJ.com/Question** *to vote. And e-mail me at* **capital@wsj.com**. *See questions and answers Sunday at* **WSJ.com/CapitalExchange**

Lennar Corp.

Fiscal Second-Quarter Income Rose 9.3% Due to Solid Market

Lennar Corp. said fiscal second-quarter net income rose 9.3% due to the strong housing market nationwide. The home builder reported net income of $106 million, or $1.51 a share, for the period ended May 31, compared with $97 million, or $1.40 a share, a year earlier. Revenue rose 13% to $1.57 billion. Lennar, based in Miami, attributed the improvement primarily to a 10% increase in the number of homes delivered and a 1% increase in the average sales price. Sales of land and other revenue rose 76% to $9.2 million. Based on the second-quarter performance and a backlog of $3.1 billion, Lennar expects to report fiscal 2002 earnings of $6.50 a share—the high end of its previously estimated range of $6.10 to $6.50 a share. For the fiscal year ended Nov. 30, 2001, Lennar earned $417.8 million, or $6.01 a share, on revenue of $6.03 billion. In 4 p.m. New York Stock Exchange composite trading, Lennar shares rose $1.73, or 3%, to $59.03.

—Dow Jones Newswires

Sycamore Networks Inc.

Work Force Will Be Cut by 235; Loss Is Expected for Quarter

Sycamore Networks Inc. said it expects to cut 235 jobs, or about 35% of its work force, and consolidate facilities under a restructuring plan that will result in fiscal fourth-quarter charges of about $45 million to $55 million. The fiber-optic equipment company based in Chelmsford, Mass., said that for the quarter that ends July 31, it expects to post a loss of $19.5 million to $26 million, or eight cents to 10 cents a share, excluding amortization of stock compensation, payroll tax on stock options and other charges. The projection doesn't comply with generally accepted accounting principles due to the exclusions. The company expects revenue for the quarter to be between $5 million and $10 million. For the year-earlier quarter, Sycamore reported a loss of $42.2 million, or 17 cents a share, on revenue of $50.9 million. Sycamore announced its plans after regular trading ended. At 4 p.m. in Nasdaq Stock Market trading, Sycamore shares were down 13 cents, or 3.9%, to $3.25.