Ponzi schemes and California pyramids Ponzi schemes and Home-Stake

Tony Tinker

Baruch College,
City University of New York,
55 Lexington Avenue,
New York, NY 10010, USA
Email: anthony.tinker@baruch.cuny.edu

Adeoye Afolabi

Department of Economic and Management Studies,
College of Social and Management Sciences,
Afe Babalola University,
PMB 5454 Ado-Ekiti, Nigeria
Email: adeoye.afolabi@yahoo.co.uk

Abdelkader Derbali

Department of Finance,
Higher Institute of Management of Sousse,
Sousse, Tunisia
Email: derbaliabdelkader@outlook.fr

Aida Sy*

Department of Business Management,
Farmingdale State College,
State University of New York,
Room BUSC 307, New York 11735, USA
Email: sya@farmingdale.edu
Email: aida.sy1776@gmail.com
*Corresponding author

Abstract: In this paper, we investigate the cases of accounting and business fraud known as Ponzi schemes. These cases studies have been done several decades ago by Professor Tony Tinker. But, notwithstanding Tinker's warning, some corporations and some corporate executives still believe, they are above the law and are using accounting to mislead shareholders and mismanage the corporate finances. The case of Bernard Madoff, a CPA, is an example.

Keywords: Ponzi schemes; critical analysis of accounting; fraud; audits of corporations; California; US economies.

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Biographical notes: Tony Tinker is a Professor of Accountancy at Baruch College, CUNY. He is/has been a Visiting Professor at St. Andrews, Scotland and UNISA, Australia. He is a founder member of the AIA, and CUNY On-Line Programs. He is a Fellow of the ACCA and twice past-council member of the AAA, and past-chair of the AAA Public Interest Section. He has (co)authored *Social Accounting for Corporations*; *Paper Prophets*, and *Policing Accounting Knowledge*, and published numerous articles. He is a co-editor of *IJCA*, the Editor-in-Chief of *IJEA* and holds numerous editorial board memberships. He has appeared on/in CNN, BBC, CBC, Pacifica Public Radio, New York Public Radio, Newsweek and WSJ.

Adeoye Afolabi is a member of Association of National Accountant of Nigeria (ANAN). Previously, he was an Assistant Chief Academic Standard Officer (ACSO) at National Universities Commission Abuja Nigeria. Currently, he is a Senior Lecturer in Accounting and Finance at Afe Babalola University Ado-Ekiti, Nigeria and Facilitator at National Open University of Nigeria.

Abdelkader Derbali is an Assistant Professor in Finance at the Higher Institute of Management of Sousse in University of Sousse, Tunisia. His research interests include capital markets and institutions, banking and market microstructure and Islamic finance. He has published articles, among others, in *African Journal of Accounting, Auditing and Finance*, *International Journal of Economics and Accounting*, *International Journal of Critical Accounting*, *International Journal of Trade and Global Market*, and *Journal of Business Studies Quarterly*.

Aida Sy earned her PhD with First Class Honours from the Sorbonne. She holds a Master degree, Bachelor and a degree in Chief Manager. She teaches accounting and taxation in the USA, Farmingdale State College, SUNY, edits and co-edits four refereed journals. She was plenary speaker, speaker, Chair and Discussant in the USA and international conferences. She is a member of the American Accounting and European Accounting Associations. She has numerous publications in refereed journals, and a book.

1 Introduction

Many miles below the sea's surface, there are deep fissures in the ocean floor. These fissures are openings that lead to the molten core of the earth. The ocean floor surrounding the fissures is extremely rich in mineral deposits; plant and animal life are warmed by the hot water that flows through the openings.

The fissures are important field-laboratories for scientists. Not only are they thought to be vital in the processes by which the sea rejuvenates itself, but their unique climatic conditions and the presence of certain mineral deposits create a chemical environment similar to that under which life itself may have begun. Thus, they provide a live laboratory of unusual and extreme conditions under which some very important questions may be investigated.

Ponzi and pyramid schemes are to accounting what ocean floor fissures are to biochemistry and oceanography. They represent extreme and unusual circumstances atypical of the mundanities of everyday investing. They are in the same league as the most audacious and extravagant confidence tricks, such as selling the Eiffel Tower, the Brooklyn Bridge, or Buckingham Palace.

From another point of view, however, buying into a California pyramid scheme or a Ponzi scheme is no different from investing in General Motors or Dupont. First, they all involve an outlay followed by an uncertain return (they differ not in principle, but rather only in the degree of uncertainty of their returns). Second, they all attract soothsayers and financial medicine men who can conjure up scenarios that portray risky prospects as sure bets. Finally, the accountant's job is the same in all cases: to decide, at various intermediate stages prior to completion of the venture, how much profit has been earned and what the investment is worth. These commonalities make Ponzi and pyramid schemes especially instructive for accountants. As with the ocean-bed fissures of oceanography, many of the complexities are stripped away; what is left exposed are the elements that disrupt the accountant's fine calculations.

Ponzi schemes are named after Charles Ponzi, a confidence trickster who operated in Boston in 1919 to 1920. Ponzi offered investors a return of $1.40 for every $1 they invested over a 90-day period. Some investors were indeed given such a return, but only in order to elicit a further contribution from them. But these dividends were not paid out of profits earned from trading; they were, in effect, paid out of the capital contributions of subsequent investors. In British terminology, this is none other than the infamous practice of 'teeming and lading'. On either side of the Atlantic, the accountant's puzzle is the same: Were such dividends paid out of capital or out of profits? In Charles Ponzi's case, the courts decided that the payments were made out of capital and sentenced him to five years for larceny and fraud. In the meantime, Ponzi had collected $10 million from investors.

We will examine three cases: two recent Ponzi schemes (Home-Stake Production Company and S-J Mineral Associates) and California pyramid schemes. All three are haunted by one of the most fearsome ghosts ever sent to plague accounting methodologists: the Isit-income, Isit-capital ghost.

2 Mediums and messages: the packaging of financial data

Home-Stake was a Tulsa-based company started by Robert S. Trippet in 1955. Its primary form of business was managing oil and gas drilling projects. Home-Stake's appeal to investors was as an income shield for tax purposes. Every year the company announced its drilling plans and invited subscriptions from investors. A separate company was then setup to manage the activity. Home-Stake usually retained a reversionary interest in the subsidiary that was to be satisfied only after satisfaction of the claims of investors.

The schemes operated as a tax shelter for investors; their entire contribution was allocated to intangible drilling costs. As with all such oil-drilling funds in the USA, this meant that the entire investment could be written off immediately against taxable income. If an investor were in the highest tax bracket, 70%, then 700 out of every dollar of

otherwise taxable income would be saved. In the worst of all possible situations, in which no oil was found, the net loss of the investor was 300 on every dollar invested.

The investors' tax write-off could be increased by borrowing part of the initial outlay, as the entire investment was deductible, not just the investor's own contribution. For instance, an investor could contribute a total of $100,000: $20,000 out of pocket and $80,000 borrowed from a bank. At the 70% tax bracket, the tax savings would be $70,000 even though only $20,000 was contributed from personal funds.

Of course, Home-Stake was never promoted as a mere tax-saving scheme; it was portrayed as an extremely lucrative investment opportunity. Because Home-Stake units were sold directly to the public rather than through brokers, the company avoided much of the expert scrutiny that is part of the SEC's system for monitoring the selling activities of brokers. For example, if Home-Stake had been sold through brokers, investors would have automatically received a prospectus: a document describing various matters concerning the investment, regulated with regard to content, veracity, and mode of presentation. Investors in Home-Stake received a prospectus only if they requested one. Instead, investors and their advisors were sent a copy of the 'black book', a promotional document that emphasised the profit opportunities and tax benefits of the venture. The black book was extremely simple and naive, and it is surprising that so many investors accepted its content without question. A sample form from the black book is provided (p.42): it details the annual profits (before and after taxes) that an investor could expect on a total investment of $20,000. The black book claims that such an investment would yield a before-tax percentage return on investment of 302% and an after-tax return on investment of 76%.

A successful Ponzi scheme relies on much more than unwarranted financial optimism: the key to its success lies in understanding the dynamics of investor expectations and how those expectations may be manipulated overtime. For Home-Stake, the first step in this process was to establish a 'medium', steeped in respectability and reliability, through which to deliver its sales pitch and financial message. Through his own contacts and those of an early colleague, William E. Murray, a well-known tax and estate lawyer, Trippet met key figures in the General Electric hierarchy. Eventually, over 20 current and former officials of General Electric contributed over $3.7 million to Home-Stake's oil-drilling programs. The First National Bank of New York (Citibank) was a similar target for Trippet. With senior executives from Citibank and General Electric ranking among Home-Stake investors, Trippet and his salesmen were able to claim a respectable, high-quality clientele. Hoyt Ammidon, Chairman of New York's US Trust Company, became involved in this way, and he, in turn, was used to bait investors from J. Walter Thompson and other corporations.

Two other key figures were Kent Kilneman, a tax lawyer, and Martin Bregman, who ran a talent agency and managed the careers and monies of famous entertainers. Clients of both men, including Alan Alda, Candice Bergen, and Barbara Walters, made substantial investments in Home-Stake. Investors eventually brought class action suits against Kilneman and Bregman, accusing them of fraud, conspiracy, and failure to disclose their financial interests in Home-Stake (loans and commission). Both men vigorously denied the charges.

Siegel and Golburt, a firm of certified public accountants, was accused by the IRS of receiving $42,000 in illegal commissions from Home-Stake for promoting its investments. Siegel and Golburt enjoyed a fiduciary relationship with its clients and were

therefore especially well-positioned to promote Home-Stake. The firm has denied that the payments were commissions but has not said what the payments were for.

Table 1 Home-Stake's return on a $20,000 investment

	Year	*Disregarding taxes*	*Considering taxes (assume 58% bracket)*
	1970	$ 250	$ 190
	1971	2,520	2,086
	1972	4,300	3,559
	1973	5,480	4,536
	1974	6,460	5,347
	1975	7,150	5,919
	1976	7,260	6,010
	1977	7,600	6,291
	1978	7,350	6,084
	1979	6,920	5,728
	1980	5,810	4,809
	1981	4,810	3,982
	1982	3,990	3,303
	1983	2,765	2,289
	1984	2,140	1,771
	1985	1,620	1,341
	1986	1,280	1,060
	1987	1,625	1,345
		$ 79,330	$ 65,650
Add: salvage		1,055	1,035
		$ 80,385	$ 66,685
Less: budget cost		20,000	7,715
Participants' total net profit		$ 60,345	$ 58,970
Total percentage profit		302%	764%

Source: Data compiled by author

In addition to New York, Los Angeles was the other major centre selling Home-Stake's programs. The late Oscar A. Trippet, Robert Trippet's cousin, was a lawyer, a notable civic leader, and president of the Los Angeles Chamber of Commerce and the Hollywood Bowl Association. Harry Fitzgerald, a senior Home-Stake salesman, visited Oscar Trippet in 1964. Through Trippet, Fitzgerald met Donald McKee, an investment banker, stockbroker, and consultant, and Marvin B. Meyer, a partner in the prestigious Beverly Hills law firm of Rosenfeld, Meyer and Susman. The firm's clients included Jack Benny, Andy Williams, and Bobbie Gentry, all of whom invested in Home-Stake.

The firm of Rosenfeld, Meyer and Susman did not accept any commissions because, as they later testified, it would have been unethical.

Home-Stake's greatest coup in enhancing its respectability involved Harry Heller, former deputy chief of the SEC's division of corporation finance, long-time personal friend of Manuel F. Cohen (chairman of the SEC, 1964 to 1969), and partner of one of Wall Street's biggest and most prestigious old law firms: Simpson, Thatcher and Bartlett. In each of the years from 1964 to 1971, Heller passed upon the legality of, and thus, according to investor suits against him, lent his reputation to the veracity of, Home-Stake's promotion literature. There was no evidence to suggest that Heller acted fraudulently or that any of the other partners of Simpson, Thatcher and Bartlett were in any way involved.

Home-Stake's sales force numbered 24 at one stage and was made up of wealthy former stockbrokers and corporate executives. They were all well connected and held positions as vice-presidents. One was a well-spoken Englishman who had taught economics at Oxford and Harvard. The sales force dealt with the less wealthy and less prominent clients of Home-Stake. It operated on extravagant expense accounts, entertaining potential clients at places like the 21 Club and the Brussels Restaurant in New York City.

There is more to a Ponzi scheme than assembling a formidable selling team, however. More important is the way that team plays the game. Effective game playing requires an understanding of the psychological and social dynamics of investor expectations and of how those expectations can be manipulated. The secret of Trippet's success lay in his appreciation of the importance of these aspects and of serendipity in financial analysis: the importance of pleasant surprises in eliciting additional investment contributions. To this end, investors were not merely promised a handsome re-turn on their initial investment, but frequently received larger and more prompt returns than had been originally promised. For example, a group of New Yorkers committed $200,000 in 1966 and $365,750 in 1967. When their returns exceeded what they had been led to expect, they increased their investments by an additional $2.2 million in 1968 and $1.3 million in 1969. They curtailed their involvement when returns began to fall dramatically below the projected return of 70%.

There was an additional twist to Home-Stake's relationship with its investors: not everyone was paid the same percentage rate of dividends on investments. For example, the former treasurer of General Electric invested $50,000 in 1970 and obtained a return of $2,418 or 4.8%. A Western Union executive invested $60,000 at about the same time and was paid a dividend of $6,220 or 10.4%. The intention of this individualised dividend policy was clear: dividends were ways of making investors happy so they would make further donations. People differ in their happiness thresholds, so dividend payouts were attuned to individual cases.

A surprising number of investors kept silent when their returns diminished or ceased. A few larger investors were given partial refunds and some participants were offered common stock in Home-Stake in exchange for their oil-drilling units. In other cases investors were advised to donate their holdings to a charity and then take a further tax write-off based on an exorbitant valuation of the units by Home-Stake. The valuation was contained in an 'evaluation report', a document that investors could present to the IRS if they were challenged. As soon as units were donated to a charity, dividends on those units were either curtailed or stopped. Charities that benefited from these donations included the American Cancer Society, the American Red Cross, Harvard University, the

Salvation Army, the Boy Scouts, and (a favourite in parts of Beverly Hills) Actors and Others for Animals. Needless to say, the IRS is challenging all tax deductions relating to Home-Stake.

3 The public watchdogs: The SEC, the IRS, and Independent Auditors

A great deal of evidence was available to the SEC that suggested that all was not well at Home-Stake. Investors brought suits against the company in 1966, 1968, 1971, and 1972. All alleged violations of the securities laws. Unfortunately, all were settled out of court and none was disclosed in SEC filings until 1971.

The local office of the SEC in Fort Wayne, Indiana was advised of the disparities in the dividend payments to investors. However, the lawyers in Fort Wayne had little experience; the office was understaffed and was struggling to stay abreast of several other major cases in the area. The enforcement division of the SEC did not act on Home-Stake until 1973. The reason for the delay was the division's backlog of 13,000 written complaints about securities violations, together with the additional daily toll of telephone complaints. Because of this workload, the SEC was unable to investigate reports promptly enough to prevent the frauds; instead it relied on the prospectus to give full disclosure to investors.

The IRS began auditing Home-Stake in the late 1960s. The audits were directed at determining whether the company was paying sufficient tax on its oil-drilling business. They did not set out to establish whether funds that were collected were invested in oil drilling. The IRS passed $100 million in deductions taken by investors, and many of them took this to signify that the company had been scrutinised by the IRS. In reality, the IRS usually does little more than check the addition on the tax returns in such cases.

Home-Stake's activities might have been discovered much earlier if the authorities had noticed a number of irregularities concerning the audited statements. Home-Stake changed auditors three times between 1965 and 1968. The 1967 statements were qualified. Three of the auditors were small Tulsa firms. Although Home-Stake itself was audited, the partnerships through which contributors' monies were supposedly invested annually were never audited. Consequently, there was never any independent verification that the money of contributors had actually been visited.

3.1 The collapse of Home-Stake

In mid-September 1973, the SEC filed a suit against Home-Stake; within three weeks the company was declared bankrupt and was being re-organised. A summary of receipts, expenditures, and assets of Home-Stakes for its entire period of operation (from the early 1960a through 1972) was estimated in mid-1974 a follows.

As the financial statement shows, Ponzi's $10 million was small change compared with the $133 million that Home-Stake raised during the years it was soliciting money from the public. Some of these funds were accounted for in terms of oil-drilling expenses ($21 million), funds returned to investors ($30 million), and assets on hand ($22 million); however, a thumping $54 million was unaccounted for and a further $6 million was allegedly misappropriated by Robert Trippet.

Table 2 Estimates of Home-Stake's receipts and payments from the early 1960s through assets held at September 1974

			$M
Revenues			
From the sale of investment units in oil			130
Issues of common stock			3
Total revenue to be accounted for			133
Expenses and repayments to investors			
Oil drilling expenses	21		
Returned to investors	30	51	
Assets found by Coppers and Lybrand			
Noncash	18		
Cash	4	22	
Assets allegedly misappropriated by Robert S. Trippet		6	
Assets accounted for			79
Assets not accounted for (September 1974)			54

Did Home-Stake invest any funds in productive assets? If we were to rank Home-Stake's investment opportunities by their wealth-creating capacities, what would such a productive opportunity schedule look like? The trouble with undertaking such an isoquant analysis is that it neglects the crucial fact that the entire formulation is mediated by perceptions, and those perceptions may be formed by concrete experience, insight, creativity, daydreaming, fantasy, fictions, and figments of the imagination. All of these elements are expressed when a productive opportunity schedule is drawn. Indeed, some would argue that the more subjective, speculative, deviant, and crazy an entrepreneur's productive opportunity schedule, the better, because it is likely to reflect originality, enterprise, and technological innovation. But in such cases, how do we distinguish hallucination from insight, fact from fiction?

With the advantages of hindsight, we are able to say that there were more fantasies than facts in Home-Stake's productive opportunity schedule. The company supposedly spent $21 million on oil drilling; however, it was difficult to locate the assets acquired with these funds. Some investors did visit a site in the late 1960s in order to verify that Home-Stake was indeed in the oil business. The site was on a vegetable farm near Santa Clara in central California. Five wells had been drilled on the site. In order to make things look official, permission had been obtained from the vegetable farmer to paint some of his gray concrete irrigation pipes oil-field orange and code them with oil field markings. Unfortunately, no wells had been drilled near these pipes. Of the five wells that had been drilled, one was a legitimate 3,500-foot well, and at least three were shallow 500-foot wells. The company knew that there was no oil at 500 feet, but they showed the wells as assets on the books.

In the Home-Stake fraud, some of the richest, most famous, and most financially astute names in US public life were persuaded to part with $133 million. Moreover, the entire operation was carried out right under the noses of public watchdogs: the Securities and Exchange Commission, the Internal Revenue Service, and (last but not least) the firm of independent auditors who had certified Home-Stake's accounts. What does the affair

say about the performance of these regulatory bodies, especially the accounting and auditing profession?

Home-Stake's 'accomplishment' may be attributed to two factors: the medium and the message. The message consisted of the financial details of the investment, which tempted so many of the best and the brightest with tax write-offs and prospective profits and returns. The medium was the manner in which the message was presented, or 'packaged'. While many accountants pay lip service to McLuhan's dictate that the medium is the message, few appreciate its profound applicability to the conditions in which accountants and decision-makers typically operate: conditions of ignorance and uncertainty. In the real world, it is the medicine man, the zealot, the demagogue, or the wizard who is king, not a mythical sophisticated investor. To ignore the overwhelming presence of such actors, by trying to develop narrow, technical accounting standards, is likely to prove disastrous. As Ralph A. Hart, former chairman of Heublein said of Trippet, "he was such a good salesman, I just kept on buying". He bought over $322,000 of investments between 1961 and 1971.

4 Implications for sophisticated investors and superstars

One of the principal assumptions underlying much of the theorising and policy making in financial accounting is the sophisticated investor hypothesis [Dyckman et al., (1975), pp.3–4]. This hypothesis (which is not really a hypothesis but more an article of faith because those who use it show little interest in testing its veracity) asserts that there exists in the stock market a cadre of sophisticated investors who know the 'real' price of any share and are able to make money whenever the actual market price gets out of line with this 'real' equilibrium price. And, so the argument goes, even if the bulk of investors are village idiots and sophisticates are rather thin on the ground, these conditions are quite sufficient to ensure that market prices will equilibrate and that therefore, overall, the market is efficient.

The extremes to which some are prepared to go in order to assert that the free market will give us an equilibrium have come under severe criticism by some eminent members of the economics profession. Many criticisms centre around the likeness between equilibrium theories and fairy tales – that everything will come out all right in the end. But even if we assume that the sophisticated investor is something more than a mythical fairy godmother, we still need to know what she looks like in order to verify her regular appearances at our stock markets. Now fortunately, a large number of very sophisticated people invested in Home-Stake Production Company. If we are to allow the veracity of the sophisticated investor hypothesis to ride on the fortunes of any one group; who better than those who invested in Home-Stake?

A list of the names of those who invested in Home-Stake reads like the cast of a movie starring the best of Wall Street, Hollywood, Main Street, and the legal profession. Estimates of the number of investors range between 2,400 and 3,000. That number includes some of the leading names in entertainment, business, legal circles, and politics. Here is a sample: Bob Dylan, $78,000; Jack Benny, $300,000; Senator Jacob Javits, Republican, New York, $28,500; R. McFall, President and Chairman of Western Union, $394,000; H.D. Brundage, Executive Vice-President of Finance, J. Walter Thompson Company, New York, $38,000; Alan Alda, $145,000; Dean P. Fite, Vice-President and

Group Executive, Procter and Gamble Company, $162,000; David Begelman, President, Columbia Pictures, $25,000; Lewis W. Foy, President, Bethlehem Steel Corporation, $18,000; Ralph A. Hart, Director and former Chairman, Heublein, $322,000; Tony Curtis; Thomas S. Gates, former Defense Secretary and Director and former Chairman, Morgan Guaranty Trust Company of New York, $133,000; Mia Farrow; Walter Matthau, $200,000; Liza Minnelli, $231,000; Paul Miller, President, First Boston Corporation; G. Moore, former Chairman, First National City Bank of New York (Citibank – the nation's second largest) $407,903; W. Morton, President, American Express Corporation, $57,000; Senator E.F. Hollings, $19,000; Ted Westfall, Executive Vice-President, International Telephone and Telegraph Corporation, $466,000; David Cassidy, $300,000; Bobbie Gentry, $98,000; V.B. Day, former Vice-President of General Electric and former member of the Pay Board under the Economic Stabilization Program, $63,000; and F.J. Borch, former Chairman of General Electric, $440,920.

5 General implications

With such a sophisticated investor group, the Home-Stake enterprise case affords an excellent opportunity to study the validity of those finance and economic theories premised on the so-called sophisticated investor hypothesis. These theories support a spectrum of political and public policy positions concerning the desirability of public regulation of auditing, accounting practice, and the stock market. The most 'extreme' public policy viewpoint supported by these ideas is that state regulation to protect investors is unnecessary because a cadre of sophisticated investors exists, who can see through inflated stock prices and will express this judgment by selling the stock (causing a dramatic decline in its price). A corollary of this argument is that 'private' watchdogs, such as the American Institute of Certified Public Accountants, are also unnecessary.

Since the sophisticated investors in Home-Stake faired rather badly, the sophisticated investor hypothesis is put into question together with the assembly of public policy proposals that depend on it. True, Home-Stake was found out in the end, and therefore, it might be argued, the market equilibrated correctly in the long run. What this argument forgets, however, is that while the market might be considered efficient in the aggregate and in the long run, this is little comfort to those investors impoverished in the process. Dynamic considerations are also ignored by those who subscribe to the self-correcting powers of the market. Investors who lose money are less likely to participate in savings and investment decisions in the future. This is an important social 'cost externality' to ventures such as Home-Stake, in which the cost of misdemeanours-such as those perpetrated by Home-Stake-are not born by those immediately responsible but by other enterprises who, in the future, will have to pay a premium to induce now wary investors to part with their cash.

The Home-Stake experience provides little comfort for public watchdogs. When a manager pays a dividend, is that payment made out of genuine earnings or profits, or is it a return of the shareholders' capital? Ambiguity about this issue allowed management to represent Home-Stake as though it were earning substantial profits, an appearance that was convincing enough to entice investors to part with more cash. In other cases, this ambiguity about true profit performance has enabled managers to cover up gross inefficiencies and to misappropriate shareholders' assets. What is capital? And what is income? Are important questions in ascertaining how well managers and directors have

discharged their fiduciary responsibilities to owners. Accountants do not have adequate answers to these questions: the futuristic element in profit and earnings makes it very difficult for accountants to distinguish, with any certainty, between fact, wishful thinking, fantasy, and fraud. These circumstances expose a large number of small investors to predatory practices that, in many cases, the auditor is powerless to prevent.

6 S-J Minerals Associates

6.1 The hour of need

There is nothing quite like an external threat from a foreign power to rekindle a nation's spirit of unity and purpose. There are several rare and precious examples in our history: London during the darkest days of the blitz, or the USA at the height of the Iranian hostage crisis. During such times, internal differences are set aside and replaced with a unified effort for the common good. Old antagonisms and assumptions are put on the shelf; we discover new qualities in our fellow citizens, taste ever-so-briefly the awesome experience of camaraderie in working side by side with others, and forge lifelong memories and friendships.

The era of the oil crisis (and the energy crisis that succeeded it) could also be said to be such a period in US history. The oil embargo and the subsequent demands of OPEC caused the US Government to unleash private enterprise from the fetters of regulation in order to increase energy supplies. Tax incentives, decontrol of oil and gas prices, and a multibillion dollar federal investment program were used to mobilise the private enterprise system to deal with the national emergency. It was a classic opportunity for private interest to work hand in hand with the public good.

S-J Minerals Associates exemplified the speed and flexibility with which private enterprise can react to a national need. The company was setup to exploit coal-mining opportunities. So fast did it respond to the nation's energy emergency that it began collecting money from investors long before it had any land to mine. In fact, because word had gotten around that the company's investments offered one-year-only tax advantages, subscriptions began pouring in before any prospectus had been prepared for potential investors. All this would have been unimportant if the company had eventually boosted the nation's energy stock. Unfortunately, it never mined one bucket of coal.

7 The financial medium and message

One SEC official described S-J minerals as the 'Home-Stake of coal'. There were many similarities between the two, including the presence of a large number of seemingly sophisticated investors and their advisors. Athletes, politicians, entertainers, and others were persuaded to part with huge amounts of money in return for promises of exorbitant profits and substantial tax deductions. Elvis Presley alone put in $505,000. Other subscribers included the former Maryland attorney general Francis Burch, the basketball star Spencer Haywood, and actress-model Margaux Hemingway.

S-J minerals starred four super-salesmen: two members of a Boston law firm and two partners in a firm that, apart from selling tax shelters, sponsored Broadway musicals. (Their one and only hit was Annie.) Investors were offered tax shelter on $150,000 units.

The trick was that they only had to find $30,000 in cash; the remaining $120,000 was contributed by writing a promissory note that the investors could repay out of their shares of the coal-mining profits. Thus investors who contributed $100,000 of their own funds and wrote a promissory note for $400,000, making a total contribution of $500,000, would receive a $250,000 tax reduction, assuming they were in the 50% marginal tax bracket. A total of 720 investors contributed $20 million in cash and $92 million in promissory notes in 60 hectic days. The stock was heavily oversubscribed: instead of floating one partnership, the sponsors were forced to create four in order to keep pace with the level of demand. In the rush to meet tax deadlines, many investors subscribed before knowing which of the four partnerships their money had been committed to. (Each partnership was a separate venture.) Moreover, very few of the investors displayed the degree of financial acumen one might expect of 'sophisticated investors'. One group of Denver residents formed an investment association called US Exploration Associates and donated $100,000 on the strength of an offering memo. They did not run a credit check on any of the sponsors because, according to one of their number, "It was our understanding he [one of the sponsors] was from a well-to-do good family" (the Wail Street Journal, February 5, 1979). When the sponsors did get around to producing a prospectus, they used one that had been written for another tax shelter scheme and attached a legal opinion as to the tax benefits that was written for a different coal mine in a different state. Overall, the projected return on investment was 43%; this would have required mining 2.6 million tons of coal a year and selling it for $10.50 a ton. At the time, they made these forecasts, S-J minerals had not purchased any land and the market price of a ton of coal was only $7.50.

8 The 'real' assets

S-J minerals' process of acquiring land was something of a fiasco. Two of the investors were shown to a tract near a huge mining area in Wyoming. The geologist who took them proceeded to sell them a geological survey for $30,000. This was a copy of a government survey that could be purchased for $3. Finally, the geologist accepted a down payment of $50,000 for the land, neglecting to mention that he didn't actually own it.

Undeterred, the two lawyers from S-J minerals eventually unearthed the real owner of the land and, because of its 'obvious' potential, paid him $300,000 to lease 11,000 acres for one year. Then setbacks began to materialise. First, the IRS ruled that all schemes starting after a certain date did not qualify for tax deductions. The SEC has since claimed that S-J minerals back-dated its lease in order to qualify. Second, it was discovered that the lease only referred to surface rights: all coal below the surface belonged to the federal government (barring 400 acres). With few exceptions, the federal government had not sold a coal lease for several years and was not likely to sell one for several more. Even if S-J minerals had the authority to mine in the area, a survey by a mechanical engineering firm indicated that $20 million would be required for a plant and equipment to mine the amount of coal they wanted to produce. When, after several years, an investor who had put in $30,000 asked why mining had not begun, he was told that a herd of elk was grazing on the land tract and was holding up production.

The SEC estimated that of the $20 million collected by S-J minerals, $3.6 million was taken by its two lawyer-owners; $6.5 million went into companies they owned or controlled; they spent $400,000 on a jet, and $1.9 million was used to buy out another

partnership. The two owners who managed the theatrical agency obtained $1.4 million; other salesmen took $2.6 million, and the law firm that supplied the tax opinion (in which one of S-J minerals' owners used to be a partner) received $370,000 as compensation. These outlays virtually exhausted the $20 million of cash receipts.

Soon after the SEC began its investigations, the four original sponsors of S-J minerals transferred their interests in the assets and liabilities to a newly formed company, Java Mining, and appointed a president for it, James T. Melillo. Neither the new company nor its president had had any previous mining experience. The original sponsors then moved into a new tax shelter: diamond mining in South-West Africa (Namibia). S-J minerals investors were then invited to subscribe for shares in the new venture, a company called Imperial Finance N.Y.

In September 1978, the SEC filed a civil complaint in a federal court in Boston accusing 20 men and 17 companies of violations of security laws. Many have since signed consent decrees in which they have neither admitted nor denied guilt but have agreed to be enjoined from violating securities laws.

The challenge to accounting in the S-J minerals case is much the same as in the Home-Stake case. If, as a society, we wish to improve the efficiency with which we select projects for investment, then the accountant must begin to assess the realism of financial predictions pertaining to these investments.

What can we learn from the antics of those running operations such as Home-Stake? What kinds of accounting, auditing, and other controls should be installed to improve the integrity of investment processes?

A way of investigating these issues is to take the most extreme case of investment uncertainty: the pyramid party. This is essentially a lottery where a successful outcome is pure luck. In such cases, where there is no relevant information about the future, we can study the dynamics of situations without the interference and pretensions of accounting 'insights' about the future.

9 Income determination at a pyramid party

Pyramid schemes started in Oregon in 1979 and subsequently flourished in California. At the height of their popularity, dozens of meetings involving thousands of people were being held every night. Hundreds of people were arrested and fined for contributing to an 'endless chain'. Banks experienced a 50% increase in demand for large-size dollar bills and faced a run on safety deposit boxes requested by winners who wanted to protect their winnings from the IRS. As the police intensified their campaigns against pyramid parties, the sponsors responded with weekend meetings and concerts attended by thousands of people, who celebrated the pyramid phenomenon and reaffirmed their belief in the constitutional rights of citizens to spend their money as they pleased. A prestigious Los Angeles law firm announced that it would champion these rights in the courts by challenging the constitutionality of the position taken by the authorities.

A pyramid scheme works as follows: imagine a pyramid of people with one person at the top level, two at the second, four at the third, eight at the fourth, and so on until we reach the bottom (sixth) level, where there are 32 people. This last level is made up of the latest recruits. They contribute $1,000 each to the pyramid; $500 goes to the person at the top, and the remaining $500 is divided among the people immediately above the new

recruits. As soon as 32 newcomers have been recruited (this may take hours, days, or weeks), the person at the top of the pyramid is fully paid off with $16,000 and leaves. The pyramid then splits into two new pyramids with one person at the top and 16 at the bottom. Each new pyramid then embarks on a search for 32 more new recruits.

The goal of members of a pyramid is to climb to the top for the $16,000 prize. This is in addition to the refund of their original $1,000, which is provided by the 32 new recruits. There is an incentive, therefore, for every member of the pyramid to attract new recruits in order to move up the hierarchy.

Elaborate rituals evolved at the parties at which the transfer of money (ostensibly non-taxable gifts) takes place. The proceedings are usually initiated by 'leaders' or 'shakers' (often salespersons in working life) who bear witness to the profits that can be made and the importance, in times of inflation, of 'helping one another'. New recruits are then invited to come forward and their 'gifts' are divided according to the rules and entitlements of the particular party. Some parties collect as much as $60,000 a night.

With pyramid party membership growing exponentially, it wasn't long before the reservoir of potential recruits began to dry up. Pyramids found it increasingly difficult to fill each successive level; members became anxious that they might not recoup their outlay; arguments, fights, and, in some cases, shootings began to occur. The police received hundreds of complaints every day (especially from concerned spouses), and in desperation, members of existing pyramids applied increasing pressure on neighbours, friends, relatives, sons, wives, fathers and lovers to join.

How does someone decide whether to stake $1,000 at a particular pyramid party? What is the maximum amount someone should pay to buy out a position on an existing pyramid? Having already invested $1,000 in a pyramid, how much can a person reasonably expect to earn at various intervals of progress up the pyramid? (People who answer 'nothing' must be prepared to sell for a zero amount any position they might hold on the pyramid ladder.) The problem of determining the amount of profit that has been earned during a period is a generic problem that applies to 'real' investments as well as to pyramids. Is accountants' advice to investors on forming realistic expectations about 'real' investments any better than their advice on gambling and pyramid schemes? There seems to be strong grounds for believing that, from an accounting viewpoint, there is little difference between capital markets and pyramid parties.

References

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