“Kidder, Peabody & Co.” Questions

In your calculations below, assume the term structure is flat; the interest rate is 1% per month, compounded monthly; bonds pay interest semi-annually on June 30 and December 31; and, bond coupons are such that all bonds are priced at par. Note that Kidder’s Government Trader System (GTS) treats every recon as a sale of STRIPS and a purchase of bonds.

(1) Prepare a journal entry (i.e., accounting debits and credits) to illustrate how to GTS accounted for a $1,000,000 recon to be settled on the transaction date. What is the effect of this transaction on the balance sheet and profit and loss statement?

(2) Prepare:
   a. the trade date journal entry to illustrate how GTS accounted for $1,000,000 recon entered on March 31, 1992 to be settled on April 30, 1992,
   b. the journal entry on April 1, 1992 in which the STRIP position recognized above is marked to market, and
   c. the journal entry on April 2, 1992 in which the STRIP position recognized above is marked to market.

What is the effect of these journal entries on the balance sheet and profit and loss statement?

(3) Explain in words the complications the September 1993 accounting change at Kidder Peabody introduced to Jett’s trading strategy. As further background on that change, note the following:
   In September 1993, in a move unrelated to Jett’s trading, Kidder extended to the government desk an accounting procedure concerning the balance sheet treatment of forward transactions. As permitted by the relevant accounting rules, the new procedure moved forward positions in government securities “off-balance sheet” and thus precluded the continued netting of settled positions (i.e., balance sheet items) against unsettled forward positions (i.e., now off-balance sheet items). Lynch Report, pp. 43–44.

(4) Comment on the effectiveness of control systems in place at Kidder Peabody. It may be helpful to organize your response under the following headings:

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• personnel selection
• incentive systems
• organizational hierarchy and assignment of responsibilities
• exception reporting
• oversight and review by
  – supervisors
  – financial controllers
  – co-workers
  – internal auditors
  – subordinates
• separation of duties
• organizational culture

(5) Is J. Jett’s dismissal merited?

(6) Assume the role of E. Cerrullo in 1995. Looking back over the events of the last four years, what do you wish you had done differently?

(7) Assume the role of J. Welch (CEO of GE) in 1995. Looking back over the events of the last four years, what do you wish you had done differently?