

## “ENRONITIS” AND ITS AFTER-EFFECTS

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**R**ecent financial news has focused on questionable earnings reports – from the outright fraud at Enron to the incredibly complex reporting of large, diversified corporations like Tyco and GE. The accounting firms that audit the financials of these companies while, at the same time, consulting with their senior officials on strategy and management issues, are also coming under closer scrutiny.

**T**he bad news is that, in the short term, such “creative” accounting practices will probably continue to surface at many household-name companies and this will certainly have a negative impact on share prices. In the longer term, the effect can only be good. These unfortunate events will generate a resounding demand for better accounting standards, better disclosure and better regulation.

**D**uring the 1990s, a number of companies worked hard to portray their earnings in a positive light in order to boost shareholder value. The mantra espoused by corporate management during the 1990s was “equity ownership”. Equity ownership was believed to be the quickest path to riches, especially if management could successfully talk up future earnings growth prospects, and most, if not all, senior managers were compensated with company stock, in the form of direct shares, restricted shares or options.

**T**imes change. I bet that most of those employee shareholders, who were banking on 20% annual returns on their equity shares, would now be happy to have cash compensation packages.

**R**emember, though, that free capital markets have a long track record of successfully sifting out the bad and the inefficient. This episode, while unnerving, is a good example of the capital markets adjusting to new information or, in this case, recognizing a lack of reliable information.

**I**nvestment decisions are only as good as the data and information that drive them. The enormous amount of attention given to earnings and forecasted earnings during the 1990s led to serious overvaluations, and probably encouraged some companies to fudge their accounting practices. Creative financial accounting and reporting, and the problems they have caused both individuals and companies, are another by-product of the stock market boom of the ‘90s.

**I**n the short term, skeptical investors will justifiably look with a jaundiced eye on Wall Street’s earnings estimates. Longer term, the issue can be resolved if the following reforms occur: 1) companies must disclose all financial transactions and do so prominently, not just in footnotes; 2) companies must be better regulated by the SEC; 3) the accounting industry must be regulated by a government-run agency which sets and enforces standards; and 4) accounting standards (e.g., FASB 87 which covers pension liabilities and costs) must be more specific and leave little room for interpretation.

**T**hese reforms have been proposed before, but now, under the pressure of recent events, may become reality. Such changes would, I hope, encourage market watchers, analysts, company management and investors to focus on “free cash flow” from operations and the real financial health of a company and to place less emphasis on future earnings—which, by the way, are hard enough to predict even with perfect information! ☺