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Enron-o-Mania and the Insurance Industry

A Dearth of Skepticism, Part 1

The cover of the January 28 issue of *BusinessWeek* reads "Special Report: Accounting in Crisis." The crisis, of course, is Enron. It seems that the media are shocked, shocked to discover that many of America's biggest companies lie, cheat, manipulate their numbers, shower politicians with money, and, when doing all of this, are aided and abetted by high-priced accountants, lawyers, and investment bankers.

"Can you trust anybody anymore?" asks the headline of *BusinessWeek's* special report. The subhead implies that the answer is no: "The scope of the Enron debacle undermines the credibility of modern business culture."

A full-page editorial in *The New York Times* was devoted to "The Enron Hearings: Cleaning Up After the Debacle," and a *Wall Street Journal* cover story declared that 'the accounting industry is in urgent need of reform."

In Washington, eleven Senate and House committees or subcommittees—including Consumer Affairs, Education and the Work Force, and Health, Education, and Labor—will be holding hearings on Enron-related subjects.

Moody's and Standard & Poor's, both of which gave Enron investment-grade ratings until late November, are reexamining their rating procedures and are asking companies for more information about "off-balance-sheet" exposures.

The media are right to excoriate Arthur Andersen, politicians, Wall Street, and others for failing to doubt the Enron pyramid before it collapsed, but their extensive coverage only highlights the fact that the media, too, failed to doubt Enron before its problems became widely known.

"I'm betting $1,000 against generally accepted accounting principles."

Who's to blame for the magnitude of Enron's stock market losses? For starters, how about investors, who threw skepticism to the wind and accorded Enron—a trading operation—a price-earnings multiple that hit 70 at its peak? How could they have believed that an incomprehensible intermediary was worth so much? We'll chalk it up to greed, the madness of crowds, mass hysteria, and the belief that anything was possible in the New Economy. For good measure we'll also blame mutual-fund legend Peter Lynch who, in his 1989 book, *One Up on Wall Street*, preached that the average investor could outperform professional investors, thereby encouraging people to make investment decisions that they were manifestly unqualified to make.

Not long ago, investors valued Cisco, Lucent, Qualcomm, Yahoo, and Amazon at $600 billion, $260 billion, $140 billion, and $110 billion, and $40 billion, respectively. Today they're valued at $140 billion, $24 billion, $33 billion, $10 billion, and $5 billion. Close to $1 trillion of market cap has evaporated from these five companies alone.

At its peak, Enron sported a market cap of $70 billion.

History has shown that investors are particularly willing to suspend disbelief during prosperity, and will accord remarkable valuations to unremarkable companies (and to companies that use remarkable accounting).

What does this have to do with the insurance industry? *continued*

Among the accusations against Enron are the following: it inflated its numbers by engaging in aggressive (and perhaps fraudulent) accounting; it used a multitude of subsidiaries and off-shore partnerships to "manage" its earnings and disguise its true finances; its real financial exposure was much greater than what appeared on its books; and its financial statements lacked "transparency" (therefore investors had to take the company's numbers of faith).

The insurance industry will lose $5 billion or so as a result of Enron. Insurance companies owned Enron's bonds and stock, and issued surety bonds guaranteeing Enron's obligations under oil and gas contracts. V.J. Dowling of Hartford-based Dowling & Partners has estimated that the surety losses could total $3 billion. This figure is notable because surety is only a $3.5 billion market, and—unlike insurance, in which underwriters *expect* to incur losses—is supposed to be underwritten on a zero-loss basis. In theory, sureties examine a principal's finances, capabilities, and character before issuing a bond, and, if there's any doubt about the principal's ability to perform, the surety will require satisfactory collateral to protect it from loss. So much for theory.

The insurance industry's Enron losses call its judgment into question—Do these guys know what the hell they're doing?—but the losses will not impair the industry or any major company.

In fact, many insurance companies, in their ability to manipulate or obfuscate their financials—or in their sheer complexity—bear some similarity to Enron. Insurance companies attempt to "smooth" their earnings by tinkering with loss reserves, fiddling with investments, and engaging in reinsurance transactions.

Although securities analysts project insurance companies' earnings per share to the penny (usually with some guidance by the company), insurance-company earnings should be considered educated guesses. Insurance companies book profits based on estimates of losses that have not yet been reported or paid, and based on investment income that has not yet been earned. Insurance companies are inherently leveraged, and, often, exposures are much greater than either the company or the analyst realizes.

An insurance company's financial statements—both GAAP and statutory—are best viewed over long periods. Insurance is a cyclical business that doesn't usually result in the smooth trajectory of growing earnings so favored by investors. Absent earnings' management, most insurance companies will report lumpy results.

History has also shown that even broad diversification doesn't shelter companies from sharp earnings' fluctuations now and then. In the 1960s, for example, many believed that conglomerates, because of their supposedly countercyclical mix of businesses, were immune to recessions. That was not the case. More recent theories concluded that the growth of the service economy, the advent of just-in-time inventory management, and an omniscient Federal Reserve Bank could eliminate the economic cycle entirely.

Enron, and accounting issues such as quality of earnings and balance-sheet gimmicks, would never be receiving the massive media attention they're receiving were it not for Enron's intimate ties to President Bush. Absent Enron's political clout, this giant debacle would be relegated to the business section of the newspaper, rather than the front pages and the evening news. Absent the political angle, there's no chance that 1,778 Enron-related items would be offered for sale on eBay.

BusinessWeek wrote that "investor confidence is crucial to the success of our economic system," and considers it a bad thing that "the Enron debacle undermines the credibility of modern business culture."

We disagree. Ironically, the Enron fiasco is good news for most investors, and for markets. Investor overconfidence is dangerous. Because Enron was so large and politically connected, it's a subject that won't die soon. A host of issues including quality of earnings, auditors' independence, directors' independence, off-balance-sheet financing, the accounting treatment of stock options, corporate political contributions, and corporate fraud will be exposed to the light of day—and then exposed some more.

In our August 1999 issue we wrote that auditors would stop signing off on the financial statements of companies that are underreserved "when they usually do: after it's too late."

Enron is hardly the first major accounting scandal, and it won't be the last. Reforms will be enacted—just as they've been enacted in the past—and loopholes will be closed. In the end, however, the system can never be fixed completely. As long as gullible, greedy investors are willing to believe in magic, companies will employ hocus-pocus to make their numbers look better.

To be continued. Next week we'll examine some of the Enronesque techniques used by insurance companies.

Also, we'll take this opportunity to remind you that Abraham Briloff will be one of the featured speakers at our April 9th conference. Briloff, a Distinguished Professor Emeritus at Baruch College, has been a certified public accountant for 59 years. He has been called "the conscience of the accounting industry," and has been a leader in exposing dubious, inconsistent, and incongruous accounting practices. He is the author of three seminal books: "Unaccountable Accounting," "More Debits than Credits," and "The Truth About Corporate Accounting."

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