

The real lesson from Enron

The bankruptcy of Enron makes it inevitable that new regulations will govern the relationship between accountants and the companies that hire them. This will probably do more harm than good. Accountants and auditors can be required to protect us from fraud. The auditors of Enron have clearly failed to do this. But what should not be expected of accountants is for them to provide information that will protect us from falling share prices.

The complaint often made when share prices or share markets have badly disappointed is that differences in the measurement and interpretation of company earnings made it so much harder to undertake any consistent valuation exercise. Yet even the most consistent, indeed even the most highly regulated measure of earnings will not provide stable, predictable, equilibrium values for shares. To make the point in another way, price : earnings ratios, however you wish to define the denominator, have not been and never will be a reliable trading metric.

The right way to approach the issue of what measure of income or assets investors should worry about is to find out the combination of accounting numbers that is most consistently aligned with the share price. In other words, let the market itself tell you what accounting numbers to take most seriously. Go from prices to “earnings” or “cash flow” or “net asset” or “embedded” or “enterprise” value or whatever works best to explain share prices, rather than the other way around. The market, if not always the accountants or the analysts, knows the performance measures that matter.

But though interpreting the actions and reports of companies may be difficult, it should not be made impossible. It would become impossible if no credence could be placed in any of the reported accounting numbers. Companies could not hope to attract more money from the public unless they could be trusted to tell at least a large part of the truth about what had been going on inside the business. So once-trusted companies that are caught defrauding and lying to their shareholders cannot escape the severe judgement of the market.

Yet trust is sometimes misplaced and discovered only after the event, which is why crime may be thought to pay. And usually the frauds that are perpetrated by dishonest managers are as much against their auditors as against shareholders. Therefore it is a pity that there is no market in the shares of the leading firms of accountants and auditors, which investors could use as quality control. Or better still, a transparent market in individual auditors.

The raw accounting facts about a business should not be a matter of dispute. Yet the difference between fact and interpretation can be a fine line. And it is mostly along this front line that the firms with their accountants and auditors do battle with the investment analysts and the investors who hire them. This is inevitable and healthy.

Valuing a company is a forward-looking exercise. Interpreting the company reports is a starting point, not the end point of the valuation process. What is required is a view not only of the ability of management to execute its plans and functions, but also of the character of managers and their controlling boards. Value will always be a matter of judgement, not only about the company and its story, believable or otherwise, but also about how well the market has priced the story. It is not just analysis that is required, but market-beating analysis. Mistaken value-judgements will always be made, and there is not much that accountants or their regulators can hope to do about this.

Further reading

Myddleton, DR (1995) *Accountants without standards*, Hobart Paper No.128, Institute of Economic Affairs, London.

This Briefing Paper was written by Brian Kantor, a professor in the science of economics at the University of Cape Town, and first appeared in the Financial Mail on 8 February 2002.