



Random Thoughts

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The American Comedy

The latest evidence that most people know little or nothing about how the real world works is the Enron mess. It's simply amazing to me that the average person knows so little about the way business in America works. Even more amazing is the apparent naivety about the way political parties are financed.

Business and politics affect almost every person in America almost every day and yet most people know more about major league sports teams than they do business and politics combined. No wonder this country has so many problems.

Enron – What Happened?

At this point, one really knows what happened outside of the fact that they went bankrupt. It's a pretty safe bet that they were some major accounting irregularities and some serious conflicts of interest between the company and its auditors. Whether these crossed the magic line between "irregular" and "criminal" is the real question. I can tell you what I suspect.

All public companies have a major problem financing new ventures. In today's world of instant information and "how was your company doing this morning?" analysis it's very hard to start up a new business. Why? Well when you first start a business it usually loses money for some time. The startup costs can significantly affect a company's cash flow. Let me give you a very, very, simple example:

You have a company that's doing well selling memo machines and has a profit margin (cash spent / cash received) of 60%. You also have \$20 million in cash in the bank and want to spend it to get in to the new fangled "Xerox" copier business. It would seem obvious that getting into a new market is a good idea especially if you have the cash to do it. So what's the problem?

That profit margin is the problem. If you start spending money on the new business your profit margin will drop simply because you're spending money on a business that isn't making any money. Never mind that the memo machine business is making just as much money as it ever did, your profit margin is going down.

Now that wouldn't be a big problem, you are still making the same amount of money, but the people who watch your stock will see a falling profit margin, not care that you're starting up a new business, and your stock will probably fall right along with it. That's bad news to everyone who owns it including your employees. So what do you do?

✓ You start a new company! It's a great idea. The new company will be entirely owned by your old company so you get any money it makes. At the same time, the money it's spending doesn't affect

your profit margin. As a nice bonus, it makes it real easy to track how much money you're spending on the new business and see how it's performing. Your happy, the auditors are happy and the stock analyses are happy. It's a good way to start up a new business, right?

Yes, it's legal, it's effective and it's used by a lot of companies. Unfortunately like a lot of other good ideas it can be abused very easily.

Let's say that your company not only makes memo machines but also is big in the carbon paper business. Let's also assume that the carbon paper business isn't doing all that well so it's not making much money. You have this brainstorm: let's start a new business to make carbon paper. With out the low income from that business, your profit margin will go way up making the stock analysis happy and causing your stock price to soar.

This is also legal and often a good idea. But what if you're under a lot of pressure to get your stock price up and pretty desperate? Well when you start the new carbon paper company you can transfer some stuff you really shouldn't to the new company. Like that long term, very expensive, lease on the company office in Birmingham or that piece of land you used to use to dump toxic waste. Without those expenses the memo machine business will look a lot better!

This is still legal if a little shaky and a good auditor would make you confess up. But they may not if you can convince them the expenses really do belong with the carbon paper business. **Convincing them might not be too hard if you're also one of their largest customers in their consulting business.**

That gave you really good year and now the stock market is expecting an even better one next year. So what do you do? Let's say someone in you organization is a little on the sneaky side and not all that concerned with ethics. He comes to you quietly and says; "You know we spend a lot on raw material for our memo machine inks. Why don't we let the carbon paper company, they buy a lot things to make carbon paper that we also use, buy all that stuff and sell us what we need at a lose?"

Now that would make the memo machine companies bottom line look better and no one really cares what happens to the carbon paper business's bottom line. **At this point you may be way over that line between clever accounting and fraud.** Maybe not. You're auditors should defiantly make a big fuss about it. If they don't they're pretty stupid, completely deceived by the company or dishonest.

Obliviously this is all going to end badly, right? I mean sooner or later all those false profits are going to come to light and trash everything.

Not necessarily. Remember that "Xerox" machine company we started? Let's say it does very well and starts making some real money. Now we can quietly close down the carbon paper business and use the profits from the "Xerox" business to hide the games we where playing with the other companies. Result: the market loves us, we look like heroes and our stockholders love us.

Of course maybe the "Xerox" machine company get sued for patent infringement and goes under. Now there's nothing to save us from the truth and it's only a matter of time until some clever analyst or disgruntled employee blows the whistle. Then our stock price goes down by 90% in one day and everyone hates us. Worst case, we have to declare bankruptcy.

This is a pretty simple example but looks to be essentially what Enron did. They created a series of companies to hide losses while taking all the "profits" in the main companies name. This made their bottom line look great and kept their stock price rising for years.

Obviously this was simple a plot by dishonest management. I would guess not. My own guess would be that it was something they drifted into over time for the best of motives. Just like people get deeply in debt using one credit card to pay the bill for another, fully believing they can eventually get out of debt, companies sink into a pit of their own making playing with accounting. Once you get started it's very hard to stop.

I've met quite a few CEOs of large companies over the years and they have all shared a single flaw, or virtue depending on your viewpoint: They all believed they could do anything. I mean really believed it! When you believe you're infallible, it's inconceivable that you want find a way to fix things no matter how bad they get. What I'm trying to say is that there is no reason to believe that the people responsible for the Enron mess didn't think they were doing the right thing and that it would all be right in the end. In other circumstances it might have been.

Enron – The “Looting” of the Companies 401(k)

It may surprise those of you who know me to find out that I have absolutely no sympathy for all those “poor victims of corporate greed” who lost their life's saving in the Enron 401k. I know that sounds a bit heartless but there are reasons why I fell this way.

First, anyone who puts their “life's savings” into a single stock is either a fool or very greedy. Any book on investing, any investment councilor, any TV financial show will tell you that diversity is the key to survival and long term investment. Any single investment, no matter what it is, has some degree of risk. Even that favorite of the conservative investor, US Treasury obligations, are not risk free.

If you buy 30 year T Bonds paying 5% interest and inflation rises up to 16%, as it did for a while, they will be basically worthless at maturity. That's why you have to have a mix of stocks and bonds in a well-balanced portfolio.

Of course that “safe” portfolio will not have the rate of return that a single hot stock can provide. When you choose high returns you automatically choose high risk. The people who lost all their investment in the Enron 401(k) where going for the high returns and paid the price of being greedy. Life is tough!

Second, 401(k)s are by definition not guaranteed investments. In fact, I believe the law actually states that the money must be “at risk” to qualify for tax-free status. Over the years any number of 401(k) investments firms have lost money or went bankrupt. It's just like any other investment. People just don't seem to want to be bothered with understanding how investing works.

A while back I was stood and listened to a gentlemen explain how those greedy investors in the Internet bubble got what they deserved while he had invested in a safe mutual fund. I didn't have the heart to tell him that his “safe” mutual fund was a major internet investor!

Third, where does all this “looting” business come from? I've seen no reports that Enron touched one penny of the 401(k). In fact I'm not sure they could have if they'd wanted to since those funds are almost always run by a third party.

Yes the employees got caught in a timing problem with a lockout on selling the stock but that's nothing unusual. Most 401(k) plans have regular times when the contributors cannot change their asset allocation. I know I lost a lot of money due to one.

I was heavily into Pacific Rim investments back when all their economies collapsed and lost over 85% of my investment. The company was in the process of changing its 401(k) provider at

the time and there was a window of just over a month when you couldn't change your investments. I had to set and watch my money vanish. It was heartbreaking! But it wasn't any fiendish plot, it was just bad timing.

Everyone seems to think it's awful that the executives were selling stock while the employees could not. That works both ways. If I had been able to sell my Nova stock at the same time as the companies' non-exec employees, I would have made over twice the money I did on the stock.

Now if the Enron execs were selling and knew about the companies' problems, then they are open to both civil suit and criminal action. I suspect a lot of people are going to be investigating that subject and we will find out if it happened.

I would like to hope that some serious 401(k) reform will come out of this but I don't expect it. The Republicans would like to increase the contributions employees can make to the plans; the Democrats would like to "regulate" those contributions and maybe lower them. I suspect the result will be gridlock and nothing will change.

Enron – Political Contributions

Watching the media jump on the money that Enron gave to the Republicans was fun. Oh, those evil Republicans taking all that money from a large corporation. What were they thinking? Probably the same thing all those Democrats who got money from Enron were thinking. As of the last report I've seen the totals for 2001 stand at Republicans 55% of Enron's contributions, Democrats 45%. Early years will probably show the Democrats got more than the Republicans since large companies like to put their money into winners.

Do people in America really not understand that large organizations, ranging from labor unions to corporations, finance the political parties? I suppose not.

In this case it looks like Enron got very little for its money from either party. That's not unusual. I remember the CEO of one Fortune 100 Company commenting that all he hoped to get from all their political contributions was to be left alone.

POWs?

There's a lot of airtime being used right now to discuss the status of the American prisoners being held in Cuba. Are they POWs within the meaning of the Geneva Conventions? It's a very serious question that needs to be answered.

Some of those prisoners may well have been soldiers fighting to protect their government. OK, it's not a government that we like or whose actions we approve of but it was the government of Afghanistan. Since they were working for the government and fighting inside the borders of their own country, I think those people are POWs even though they did not wear a standard, government issue uniform or spend a lot of time saluting.

Some of them are certainly terrorists. They are not Afghani natives, they were not fighting against the Northern Alliance but training in terrorist camps. They are not POWs.

I do understand why we have chosen to classify these people as "non legal combatants." We need to question them and we can't if they're POWs. America needs to break up the terrorist networks some of these people were part of and we need to do it soon before we have another major attack. I can just imagine the reaction from those same liberals that are complaining about our treatment of these people if the government "allows" another major terrorist attack.

As much as it worries me, I do think we have taken the prudent path by treating them like POWs, giving the International Red Cross full access to them, but retaining the right to interrogate them. We are fighting a new kind of battle and the combatants just don't fit the traditional model envisioned by the Geneva Convention.

I do find it a little ironic that their own governments would execute a large percentage of them if we sent them home.

Executive Privilege

Executive privilege has been invoked by every president at one time or another. Nixon and Clinton both played large parts in expanding its coverage and, via Supreme Court decisions, helping to define its limits. The idea is simple: Without the ability to hold private conversations and keep private records it would be very hard for a President to do his job.

As much as we like the concept of openness in public dealings, we are always finding ourselves in situations where we need to say things we don't want the whole world to know. Simple things like gripes about our spouses, work or boss and complex things like business deals. Nothing illegal or unethical just stuff we want to keep private. Politicians have a lot more legitimate need for privacy in their dealings than most.

The problem comes when public officials use executive privilege to hide wrong doings or things that some people suspect might be wrong. At the moment we have two examples of the conflict between public desire for knowledge and executive privilege.

The first is all over the news right now: the meetings held by Vice President Cheney to devise a new energy policy for this country. The Democrats have been wild to get their hands on the notes from those meetings ever since they were held. Why?

Silly question, if you're deeply opposed to something you really want to know your opponents strategy to try and get it implemented. The Democrats are fundamentally opposed to two of the main parts of the plan: expansion of the use of nuclear power and expanded development of American petroleum reserves. The difference is so great that there seems little chance of a compromise.

This is a perfect example of the correct use of executive privilege. If the attendees of the meetings were known, they would be attacked verbally in the press and harassed by environmental groups. Their honest statements in the meetings could be very unpopular with their employers and cause them real world harm. If they were not assured of privacy, a lot of them would never dare attend such a meeting and would not be able to give honest advice.

Was it scandalous that Enron employees were present at the meetings? Get real! At the time Enron was the largest energy company in the country, it would have been a serious omission on someone's part if they had not been part of the meetings. Did those employees try to make sure the policy created by the committee was favorable to Enron? Sure, there are very few truly disinterested people in the world and they usually don't have much of value to say. I would guess every single person present at the meetings had some private axe to grind.

The second case has gotten very little press, far less than it deserves, and is a perfect example of how executive privilege should not be used. There is an investigation going on into how well, or poorly, people in the witness protection program are supervised. Sounds innocent? It's not. There is good reason to believe that people in the witness protection program have committed serious crimes, including murder, **and the government knows it and is doing nothing about it!**

The investigation has hit a stonewall since President Bush invoked executive privilege to deny the investigators access to FBI records. Without the records the investigation has little chance of proving anything.

Does the FBI need to deal with really bad people? Yes, most mob operation are broke up by informers and those informers are usually people who have been in the mob for a long time. You don't get deep into a criminal operation being a nice guy. Nor does turning states evidence suddenly transform you into a saint. These are bad people and they need to be watched very closely or locked up.

I think using executive privilege to block an investigation into this problem is a gross misuse of power however good the motive.

Personal Stuff

We have been so very busy ever since we moved up here that I just haven't had time to do anything except work on the house. Fortunately it's almost over. Suzanne and I are going away on a tip to Aruba for a week and when we get back we will have a couple of hard weeks work and then we can go back to having a life. All the major work on the house will be done.

There will be a lot left to do but it's all stuff we can do a day here and a day there. I am so looking forward to being done! That is, by the way, why there are no mailing comments this time. Just no time to work on them. I did scan through the mailing when it first arrived and spotted one thing I do want to comment on.

Five Gold Stars for Gary Brown

Sometimes the political rants in SFPA get so bad I just want to give up on the APA. Fortunately someone occasionally shows some sign of being willing to discuss issues in a more reasoned and less fanatic fashion and I don't quite give up.

After all the ranting discussion about the election in Florida, I was really happy to see Gary's article in the last *Oblio* about the election recount. Reasoned and balanced it's the kind of discussion we should be having. Alas it's all too rare.

Thanks Gary!