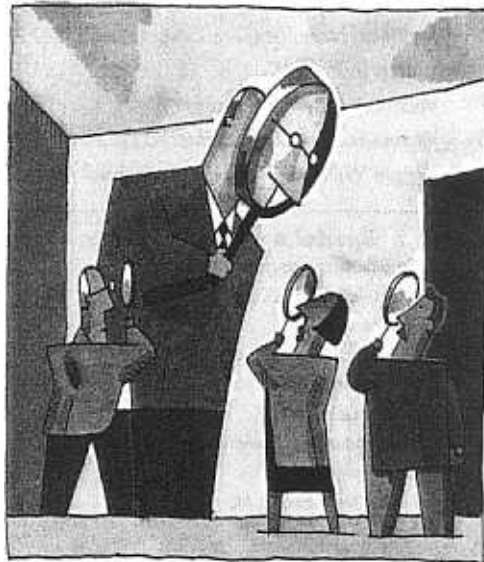


by Stephen Brennan

## The Enron Effect

The impact of Enron's troubles on public companies, including semiconductor firms, will be significant and lasting. Companies will implement more conservative accounting practices, which will likely lower operating earnings. In addition, there will be an increased trend toward independent analyst research, and investors will take a much closer look at the accounting practices of all companies. Don't think these changes will happen overnight, however, especially in regard to independent research. The big Wall Street firms simply make too much money from investment banking to relinquish their cozy relationships. On the other hand, because of the direct role of Arthur Andersen in the Enron debacle, accounting firms are already shedding their equally incestuous relationships of both independent auditor and consultant.



### WHAT REALLY HAPPENED?

To understand the Enron effect, you need to first comprehend what happened. Enron's story is little different from the \$1.5 billion in off-balance sheet losses of rogue trader Nick Leeson, which brought down Britain's oldest merchant bank in 1995. Like Barings Bank, Long Term Capital Management (US\$1.3 trillion in derivatives exposure) or more recently, Allied Irish Bank (US\$691 million in trading losses), Enron was speculating in complex financial instruments without disclosing the true risks of those investments to shareholders.

When trades worked out, Enron booked the profits. When they resulted in a loss, Enron sold them to one of the numerous third-party entities it created with the help of Arthur Andersen and run by people connected with Enron. The securities were appraised at a value that allowed the company to show a profit to Wall Street analysts and backed by steadily appreciating Enron stock, buoyed by those same analysts who never fully probed the remarkable earnings growth. This house of cards – which became one of America's largest companies – fell apart when it was hit with the double whammy of accelerating losses and a falling stock price.

### THE FALLOUT

The greatest fallout from the Enron debacle will be a drag on operating earnings reported by public companies. Even IBM, one of the most respected technology companies

in the world, was recently forced to disclose, after the fact, that it met its quarterly operating earnings number by including a \$300 million sale of a business unit as operating income. During the bull market, numerous companies used accounting tricks to manipulate earnings. Yet, the days of Cisco beating its earnings expectations by a penny or two a share quarter after quarter may now be gone forever.

For most semiconductor stocks, I expect the immediate Enron impact to be fairly mild. For example, I have zero expectations that any company in this industry will

implode in derivative trading excesses linked to their foreign currency activities. Unlike other industries, the math for semiconductor companies is fairly straightforward: orders produce revenue, which drives operating earnings. Of course, this is a capital-intensive business, and investors will be paying closer attention to any liabilities that are not on the balance sheet. There will likely be some relatively minor issues raised about operating earnings and liability disclosure. Perhaps the most compelling fallout from the demise of Enron is that it has signaled the death knell of the longest bull market in U.S. history.

### STILL BEARISH ON TECH

People keep asking me what I think of technology stocks. My last column stated my expectation that the broad market will end the year flat with another tough year for semiconductor companies. I have not changed my opinion, and still believe the Nasdaq and the SOX will underperform the broad market and disappoint investors. Despite falling from their gravity-defying heights, investors remain infatuated with these stocks, and their multiples are still relatively expensive. My expectation is that high-growth stocks are in the process of falling out of favor with investors, as value stocks with boring accounting practices continue to look increasingly attractive. ■

### About the Author

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