

Sheep in wolfs clothing

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September 2002

I have been very struck in recent weeks by the pictures of shell shocked looking executives of failed companies such as Enron or World Com in handcuffs facing up to the consequences of a bit of creative accounting. There is no doubt about the severity of the losses that have occurred, but did these sheepish looking individuals deliberately set out to commit frauds on a grand scale? Did they plan their deceptions with the meticulous care of a master criminal? Were the secret bank accounts and new identities all prepared for them to vanish into a parallel universe of unnecessarily ostentatious bathrooms and beautifully impractical cars? I think not. On the whole I think they are fairly ordinary chaps maybe promoted slightly beyond their level of competence or integrity who have blundered (and possibly fibbed) their way into an impossibly compromised position. So if they are not master criminals why do they do it, and how did they get away with it for so long?

There is a natural dynamic in business life between the creative optimism of an entrepreneur and the cautious analysis of an accountant. Both are necessary elements of an enterprise culture. There is however a third element of less obvious value and that is the purely speculative input of the professional gambler. By that I mean anyone who is investing in businesses, not because they believe in the value proposition of a new idea or in the sustainable profitability of an established and well run business, but simply in the hope that the shares will go up because of some abstract market trend.

There is nothing wrong with an honest wager and I'm sure that bookmaking has been around almost as long as competitive sport. The betting industry is founded on the premise that the outcome of a competition is independent of any bets that are placed on it, in other words that competitors are purely interested in winning and officials are scrupulously unbiased in their application of the rules. When this is questioned as it has been in several sports in recent years it causes a huge scandal with the culprits being banned from their sports, often for life. Betting is all about fair competition leading to unambiguous results, tamper with either of these and the whole business falls apart.

In fact sports betting illustrates one explanation for the phenomenon of recklessly overvalued companies. Imagine the management of a company are the players, the firms who audit them are the match officials, the final score is the audited accounts and the share price is the bookies view of the companies' prospects. If either the management or the auditors or, worse still, both are motivated more by the bookies view of matters than by the final score we are bound to see more emphasis on sustaining the valuation than on the fundamental financial health of the business.

Business is however (arguably) a little more complex than football and in normal circumstances the financial health of a company in terms of its cash, profit margins and balance sheet are also the factors which drive the share price and consequently there is little conflict between good management and the maintenance of the share price. The problem really only arises when speculative activity drives share prices way beyond any reasonable valuation of a company. I'm sure it feels great to be at the top in a business on the way up, but once there it must become increasingly difficult to interpret the duty of care to the shareholders in a way which is compatible with sound financial management.

Sustaining shareholder value is a primary responsibility for any senior executive so what do you do when the share price bares no relation to the facts? Sit tight, count your options and hope for the best, or bring on the bad news and watch your shareholders loose their paper profits? With the benefit of hindsight the answer is of course obvious but it probably wasn't always so obvious at the time. So who are the villains of the piece? Personally I think that most of us are guilty to some degree of the crime of complacency when the going seems too easy, couple that with a bit of gambling and an over friendly referee and suddenly we are all too busy believing our own propaganda and counting our capital gains to go out and compete. If anything is to blame it is the way in which people have been encouraged to speculate rather than invest by the markets themselves. And when the managers of a business start to believe the speculators more than the accounts then they truly are sheep in wolves clothing.