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WHEN BULL MARKET MYTHS UNRAVEL

GRETCHEN MORGENSON*

As a New York Times journalist charged with covering the financial markets in the late 1990's, I had a front row seat to watch the biggest stock market bubble of all time inflate. It was nothing short of amazing to witness an era of rapacious speculation in the financial markets that will stand as a record for decades, if not generations.

Today, three years later, the mania seems almost to have become a dream, so quickly has it receded into memory. But its unraveling has also become a nightmare that investors, regulators and corporate executives find difficult to shake.

As investors seek answers to why they lost trillions of dollars in the stock market in the past three years, one path of blame leads directly to the door of many financial journalists who abandoned their jobs as outsiders, truth-seekers and skeptics. These reporters, whether they realized it or not, became collaborators with executives in what later proved to be deceptions and lies.

While much has been written about the shocking failures of the accounting industry to identify corporate chicanery in financial statements, much less has been told about the appallingly lax performance by the financial media.

Journalists are always tempted, of course, to put powerful people on ever loftier pedestals. And in the 1980s and 1990s, CEOs had amassed an almost cult following. All too often the crowd cheering the CEOs on included journalists.

The problem with reporters worshipping the people they must cover is that it results in journalists becoming little more than an arm of a company's public relations machinery. In such a circumstance, journalists lose their objectivity and cannot question what the executives tell them.

Some financial journalists may have been gulled during the stock market's bubble years into believing that the so-called New Economy meant share prices would only go up and that the people running these companies were nothing less than geniuses. But in some cases, journalists became active and even forceful defenders of management, aiding and abetting their dubious practices by refusing to question the executives either in print or in

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interviews. Some reporters also failed by not questioning what passed as conventional wisdom but which turned out to be so foolish.

Call it the Emperor's New Clothes, bull-market style. There were far too many examples of corporate spin, half-truths and lies that financial journalists helped to promote during the bubble years.

Consider the Enron Corporation, known and admired for years as one of the nation's most innovative companies. Now, of course, the only innovations the company will be remembered for are the labyrinthine schemes it used to mislead investors about its financial position.

Since Enron filed for bankruptcy in late 2001, it has become painfully clear how often Enron substituted fantasy for reality in its reports to shareholders. As a result, many investors were stunned that a company as big, profitable and powerful as Enron could slide into oblivion as quickly as it did that autumn.

One reason Enron slid so fast is that it was neither as large nor as profitable as it claimed. Consider Enron's rank in 2001 as No. 7 on the *Fortune* 500 list of largest American companies. The company's \$101 billion in reported revenue placed it between two powerhouses—Citigroup and I.B.M.—on the prestigious *Fortune* list.

But Enron was able to rise to that level only because energy trading companies are allowed to record the total amount of their transactions as revenue, rather than the actual profits made on each trade, as is typical at brokerage firms. If viewed the way other trading firms are, Enron's revenue would have been \$6.3 billion that year, pushing it to the bottom half of *Fortune's* list. If *Fortune's* editors had calculated Enron's revenues in the traditional fashion, the company would have come in at number 287, wedged rather more unglamorously between Automatic Data Processing and Campbell Soup.

By including Enron in its pantheon of top ten companies, *Fortune's* editors were not technically in error. After all, the company's appearance on the list was based upon its annual report, a document which most reporters consider reliable.

But the Enron ranking in *Fortune* did help the company burnish its image as a genuine player instead of the cipher that it was. And since those revenues were artificially high, Enron's inclusion on the list certainly looks unjustified now. And more than a little embarrassing.

Also embarrassing was the way financial journalists reported on day-traders, that quintessential bull market phenomenon in which otherwise sensible people quit their day jobs to sit in front of computer screens and try to make a living trading stocks.

In the early years journalists gave daytraders' claims of easy money far too much credibility. Many reporters who wrote about daytraders took the

people running the brokerage operations at their word when they told them that most people make money daytrading stocks. Never mind that even the professional traders at some of the firms lost money daytrading stocks. My fear is that such stories may have helped lure unsuspecting investors into such daytrading rooms.

While it is always problematic for journalists to let down their guard, it was particularly dangerous during the stock market mania for reporters to believe everything that corporate executives told them. The danger was greatest to the stock market novice, the reader or television viewer who knew little about investing. Because there were so many more of these people entering the market during the 1990s, reporters and their editors should have been on heightened alert to protect them. These unsophisticated investors needed protection and we journalists let them down.

Corporate executives, on the other hand, got way too much protection from journalists. In effect, some reporters actually helped corporate spinmeisters at their games, which wound up hurting investors.

One example of this was in the charade of reporting, breathlessly, that a company had “beat” its earnings estimates by the proverbial penny per share. Everyone knows that a penny isn’t worth much nowadays. Only Wall Street could figure out how to make a penny worth something very significant—a rising stock price.

While these naïve reports of earnings gains made it seem that corporate earnings were surprisingly higher than expected, in fact the “penny better” nonsense was a manipulative and cynical design of the companies involved. Corporate executives talked Wall Street analysts down to a level in their estimates that the executives knew they could beat and then—surprise! They beat them.

Research organizations like First Call/Thomson Financial compile analysts’ earnings estimates daily to provide a consensus of what Wall Street analysts think a company will earn. With all eyes on the magic earnings number, and this was especially the case during the market mania, not meeting the number could kill a stock. At the same time, when a company beat the magic number, its stock often went soaring.

On December 14, 1999, for example, after the close of trading, Oracle announced that it had beat earnings expectations by four cents a share. Its stock immediately leaped 9%.

But the National City Corporation of Cleveland, the nation’s tenth-largest bank, received decidedly different treatment from traders. In October 1999, when it announced third-quarter earnings of 57 cents a share, the bank’s results were 9.6% ahead of those achieved in the same period a year earlier.

But because Wall Street had been forecasting 58 cents a share, a penny more than the bank actually reported, investors fled the stock, lopping more than 5% off its value the day of the announcement.

None of these gyrations would really matter, of course, if corporate executives' compensation wasn't so heavily reliant on rising stock prices. But these compensation packages are stock-price obsessed, even today. As a result, the power of positive corporate spin has become crucially important to managers in recent years. And beating Wall Street estimates, if only by a penny, helped enrich executives.

Investors ended up being worse off for the charade, however, because while the earnings reports drove up stock prices temporarily, they didn't really translate into long-term gains for shareholders. In fact, these manipulations were one of the reasons stock prices got so outlandish in 1999 and 2000 and why these prices have crashed so dramatically since then.

Financial journalists were also far too willing to accept and print dubious profit calculations that companies have come to call pro forma earnings. These are earnings that are not calculated according to generally accepted accounting principles but are a company's results as if Dr. Pangloss were running the books. Pro forma reporting of earnings presents the best of all possible corporate worlds. Or as Lynn Turner, the former chief accountant of the Securities and Exchange Commission called it, earnings before all the bad stuff.

How each company computes its pro forma earnings varies, but the figures are always employed to make the financials prettier than they otherwise would be. Pro forma numbers often exclude such expense items as payroll taxes or interest costs, and mean that the company's results appear far better than they actually are. I would like to be able to show a personal income statement that does not include my mortgage interest, who wouldn't? But asking investors to ignore these costs—which the companies must pay, after all—is asking them to accept a fiction about a company's results.

It is one thing for companies to try to pull pro forma fast ones on investors. It is quite another for journalists to allow them to do so in print. But that is exactly what happened during the mania and to this day it is still a problem among some reporters.

Pro forma reporting has gotten a bad name recently among investors battered by numerous corporate scandals and they are all too aware, now, of the damage that aggressive accounting can cause. But for far too long, journalists swallowed pro forma figures from companies without question and published them as though they were fair representations of a company's operations. Which they were not.

Reporters also trumpeted the bull market notion that so-called new economy stocks were a breed apart and should not be held to stringent, old

economy investing standards. Internet companies and cutting-edge telecommunications concerns were, after all, revolutionizing the world. As a result, many journalists argued, their share prices deserved equally radical valuation methods. Out went traditional methods used by securities analysis that prized genuine cash flow and earnings. In came freewheeling measures of worth, like revenue growth, Web site traffic and even customer “share of mind.” Never mind that none of these measures took into account how much money a company could make from its customers.

While Mary Meeker, the star Internet analyst at Morgan Stanley, may have believed that baloney, journalists should not have. After all, journalists should not be simply stenographers; they are supposed to be tough-minded, independent-thinking skeptics. Or as the Hungarian proverb puts it, the believer is happy but the doubter is wise.

I know well that it is not easy to be contrarian; the journalists who sowed the seeds of reasonable doubt in stories about Tyco International’s accounting were not likely to get invited to the Gatsbyesque party thrown by Dennis Kozlowski on the island of Sardinia for his wife’s 40th birthday. But not receiving such invitations should not bother a reporter. Being off that list should be viewed as a badge of honor.

While it is a surprise as well as a disappointment how assiduously the financial press aided and abetted the other, more corrupt members of the bull market cheerleading squad, the degree to which securities regulators let novice investors wade happily into the stock market’s shark infested waters in the late 1990s is equally disillusioning.

Both the press and the regulators should have been working to let the hot air out of the enormous bubble that Wall Street and corporate executives had inflated. Instead, there was a disturbing breakdown of the safeguards put in place to protect investors from themselves and from corrupt brokers or analysts. Securities regulators, the financial media, and of course the major accounting firms all failed dismally to rein in the frenzy, spotlight the perpetrators and bring reason to the irrational exuberance.

While regulators will always be overworked and underpaid, the manner in which the Securities and Exchange Commission (“S.E.C”) acquiesced to corporate heavyweights on one crucial issue in 1995 probably contributed more to the construction of the mania and the destruction of wealth that followed it than any other single event. That issue was the fight over how to account for stock options.

Back in 1995, the Financial Accounting Standards Board (“FASB”), the standards-setter for accounting rules, tried to force companies to account for stock options they dispense as an employee cost. The FASB, which has little clout when it comes to battling powerful corporations, came under severe pressure from technology companies to retreat on the issue. Congress joined

in the fray, siding with the companies who were pouring money into their reelection coffers. And when the standards board asked for help from the S.E.C. on the issue, the regulators caved. And FASB could do nothing but retreat as well.

There were two results of this retreat. In the simplest terms, companies were allowed to continue handing out oodles of options to their executives and not deduct their enormous costs from the company's coffers. And because stock options did represent a cost to shareholders, the inaction on them encouraged companies to misrepresent their financial positions to shareholders.

But in a much broader sense, I would argue that the big cave-in on options was the single largest contributor to the mania, the corporate chicanery, and the ensuing wealth destruction that has shaken America to its core. Today's deplorable corporate greed could not have been satisfied without stock options. Put another way, the love of stock options is the root of all evil in corporate America.

Enron, Global Crossing and WorldCom were very different kinds of companies. But their collapses have a common thread. By misrepresenting the financial position of their companies, executives watched their stock prices soar and became richer in the process. After the misrepresentations were disclosed, shareholders and employees were left with little or nothing.

Stock options were a part of all these failures. They were crucial to both the misrepresentation and the enrichment that have caused a crisis of confidence in business and financial markets. Options are doled out as free money to executives and are the force behind the increasingly lucrative compensation packages at American companies. Because they are tied to the company's performance, they can be powerful incentive for executives to make their results look better than they actually are. To cook the books.

At the same time that stock options enrich corporate executives, they harm shareholders and investors.

Because of the way options have been treated in financial statements, they helped executives shade the truth in two ways. First, they allow companies to overstate their earnings because the costs of options has not been deducted from a company's revenues as salary or compensation. In addition, options generate significant cash flow from employees that has nothing to do with day-to-day operations.

Options also help companies pad earnings by reducing and even eliminating taxes owed to the federal government. Since executive pay is often linked to a company's earnings, the overstatements that stock options produce can mean fatter paychecks for management.

Once a rarity, options are now ubiquitous at American companies; in the last ten years, options have risen from 5% of shares outstanding at major companies to 15%.

The numbers at some companies are enormous. According to Bear, Stearns, option costs at Microsoft came in at \$3.3 billion last year, almost a third of the company's reported net income. The cost of options at Cisco Systems was \$2.6 billion and at Nortel Networks it was \$2.5 billion. Cisco and Nortel reported losses for the year, and they didn't even deduct the cost of stock options from their results.

Heavy use of stock options dilutes existing shareholders' stakes by greatly increasing the shares outstanding. In order to tame this growth in shares, companies must buy back stock. In recent years, many companies have paid exorbitant prices to buy back their shares and some have even borrowed money to do so. This is not a good use of company cash.

As options have become more popular, their beneficial effect on company earnings has done so as well. One New York City brokerage firm estimates that if the nation's 500 largest companies had deducted the cost of options from their revenues, their annual profit growth from 1995 to 2000 would have been 6%, not the 9% these companies reported.

Back to the recent corporate scandals. WorldCom, for example, was a big user of stock options, and its financial results looked much better, for a time, because of them. Of the large companies in the telecom sector, WorldCom's earnings were the most greatly enhanced by its option grants. Had the company accounted for options as an employee cost in 2001, its earnings would have been 57% lower. In 2000, WorldCom's earnings would have fallen almost 30%, and in 1999, results would have been 22% lower.

When employees exercise options, the tax they owe on the transaction becomes a deduction for the company issuing the shares. As a result, profitable companies that are heavy users of options, including Microsoft, Cisco Systems and Dell Computer, have erased much if not all of what they owed to the federal government in taxes in recent years. At Enron, for example, deductions for stock options helped eliminate more than \$625 million in taxes that the company owed to the government from 1996 to 2000.

Companies reap another benefit when their employees exercise options. An employee pays the company to buy the shares outright. That generates excess cash flow, which only attentive investors will see has nothing to do with day-to-day operations. At WorldCom, for example, half the company's free cash flow in 1999—\$886 million—came from workers exercising options.

Proponents of options say that they help to align management's interests with those of shareholders. If an executive performs well, his or her company's stock price will rise and all stockholders will benefit.

Even now, after all the scandals, these people still argue that the costs of options should not be deducted from companies' income because that would discourage the use of options and ordinary workers would be denied a source of wealth. And once again, certain members of Congress—especially those who receive money from Silicon Valley executives—are trying to make sure that options are not accounted for properly.

But in the current environment, arguing for an accounting practice that can be viewed as clouding a company's results rather than clarifying them is becoming tricky. And the argument that rank-and-file workers will be hurt most if companies stop issuing options loses credibility after an examination of corporate filings.

Top executives reap the primary share of options granted at most major companies. According to a recent study by Joseph Blasi and Douglas Kruse, professors at Rutgers University, 59.4% of options went to the top five executives of Baker-Hughes, an oil drilling concern, on average between 1991 and 2001. At Alcan, the percentage was 52.1, and at Dillard's Department Store, 47% of all the options dispensed went to the top five executives.

Once again, accounting rulemakers are trying to force companies to expense stock options. But the damage has been done. What started as a tool for corporate good has really ended up in many cases as just another instrument to allow the siphoning of wealth to senior management from shareholders.

One of the reasons options are so pernicious is that they encourage executives to do whatever they must to keep their stock prices up and their options valuable.

Obsessing about the stock price gives management the incentive to dress up their companies' earnings through the use of questionable accounting or, even worse, cooking the books. Caring too deeply about a stock price gives managers a reason to put out opaque financials to shareholders. After all, if the news is not good, why detail it? That would surely drive down the stock. No need to make the shareholders worry their pretty little heads over things like off-balance sheet financing or special purpose entities!

Obsessing over stock prices also gives executives a perverse incentive to drive their stock lower to get new option grants at bargain basement prices. It is almost impossible to believe that anyone would resort to such a thing, but the incentives are surely there.

And when executives have so much of their compensation tied to the price of their company's stock, they are encouraged to be stock promoters or even crooks like Dennis Kozlowski is accused of being. Chief executives used to be more concerned with corporate operations. Now they are chief cheerleaders or spinmeisters. And in some cases, chief book cooks.

Consider what went on at WorldCom. In determining its top executives' bonuses in 2001, the proxy says, the company assessed revenue, earnings and the market value of its common stock. But it also used an unusual measure: billings by WorldCom under service agreements with its customers. Customer billing records are among the documents that the S.E.C. requested from WorldCom last March as part of its investigation into the company's accounting practices. Questionable billing practices are among the problems dogging WorldCom.

It is far too simple of course to conclude that executive compensation plans can serve as a road map to where corporate cheating might go on, but it is becoming distressingly clear that the pay-for-performance philosophy that was supposed to align executives' interests with shareholders' has been badly distorted.

The fact is, chief executives have pulled off one of the greatest heists in history: the transfer of shareholder wealth in clear light of day in recent years has been nothing short of amazing.

And by not backing FASB in forcing companies to expense the costs of their options, the S.E.C. must take some responsibility for the mess. To his credit, Arthur Levitt, the former S.E.C. chairman, identified this as the biggest mistake he made during his tenure in his book *Take On The Street*.

Where were the editors, for example, when their reporters allowed analysts or fund managers to tout stocks that they owned or had an interest in seeing rise? Where were the business editors when their reporters quoted or highlighted the views of fund managers or strategists whose records in stockpicking or forecasting were abysmal? I can recall seeing fairly many quotes from a fund manager who may have been quite quotable but who had in a recent year lost his investors 80% of their money.

Many journalists were happy to quote analysts on companies' prospects without knowing or checking whether some of them owned shares in the very companies they were promoting. And many reporters assigned credibility to analysts' opinions even though their independence was corrupted by massive investment banking fees they helped their firms to generate. These people were nothing like unbiased, but their views were presented as such by far too many journalists.

Equity analysts have always been conflicted, they have always served too many masters. But analysts' biases became far worse during the bull market than they had been in previous decades. During the mania, many of them didn't even try to serve investors. Instead, they worked singlemindedly toward their portion of the investment banking fees that promised to make them even richer than they already were.

Unfortunately, many reporters and editors were slow to see how analysts' conflicts had grown, and they relied upon them for far too long. In so

doing, reporters and editors helped to make stock analysts the investing world's equivalent of rock stars.

Prior to the bull market mania, equity analysts operated in obscurity. Nobody knew their names, much less what they looked like. But during the bubble years, thanks to what became widespread interest in investing, analysts became regular features on television programs and in news columns. They commanded packages of millions per year based largely on their ability to bring investment banking fees to the firms they worked for.

But they could not earn these millions if they made negative utterances about the companies they followed. So while the stock market rose to at all-time record highs, there were few outright sell recommendations among large brokerage firm analysts. Instead of warning investors away from the precipice, analysts egged them on.

With stock analysts less inclined to produce unbiased information, many financial journalists lost what had been a significant source of data. Now they must look elsewhere for guidance, story ideas or opinions. Or they must sharpen their pencils and do the work themselves.

As millions of investors rushed into the stock market in the 1990s, they did so believing that Wall Street was at least a fairly level playing field. They have since learned how illusory that notion was, and this loss of innocence continues to weigh heavily on the stock market overall.

But there is some good news in the ugly corporate stories that we have seen in recent months. At least now the euphoria that characterized investing in the late 1990's is gone. The wide-eyed acceptance of every word corporate executives uttered, of every financial statement they released, of every outlandish projection an analyst made has been replaced by a sense among investors that trust must once again be earned, that skepticism is a worthy trait, that the advice of analysts can be costly.

Journalists have also learned some lessons. The days when reporters chose to celebrate CEOs appears to be over. More reporters and editors now know that they must carefully scrutinize the numbers fed to them by companies, and question the analysis of deeply conflicted Wall Street research departments.

It is clear that investors have learned a great deal in the three years since the stock market peaked. It has been a painful but necessary experience. My hope is that going forward, executives, their companies, and securities regulators will be more vigilant about eradicating fraud and bad corporate behavior. And financial journalists in coming years need to be more skeptical of what they are told and must work harder to be advocates for investors rather than celebrators of the perpetrators.