



The Legacy of Enron

Enron's bankruptcy, the largest in history, cost 4,000 employees their jobs, many of whom lost their life savings. Investors lost billions. Sixteen people pleaded guilty for crimes committed at the company. After a lengthy trial, founder Ken Lay was found guilty of six counts of conspiracy and fraud and CEO Jeff Skilling was convicted of 19 counts of conspiracy, fraud and insider trading. Both could spend the remainder of their lives in prison.

Shortly after Enron filed for bankruptcy, Congress passed the Sarbanes-Oxley Act of 2002 (SOX). The Act requires the CEO and CFO of all publicly traded companies to certify that annual report disclosures "fairly represent, in all material respects, the operations and financial condition of the issuer." In addition, the Act increases the penalties for making false disclosures in financial statements.

I have no quarrel with SOX regarding these two provisions. A corporation's top executives should fairly disclose material facts regarding the company's operations and its financial condition to the public. Those that don't should be severely punished.

However, Section 404 of the Act requires that each public company's annual report contain an "internal control report." This requirement has cost shareholders billions of dollars. Public companies have been forced to add superfluous internal controls, hire cadres of accountants, and undergo excessive surveillance by public accounting firms.

For most small public companies, the additional costs of implementing Section 404 are onerous. The cost of new control systems for small companies can run from several hundred thousand dollars to a few million. And who bears the cost? The company's shareholders, of course. Here's a hypothetical example.

A small public company has 10 million shares outstanding, annual earnings of \$4 million, and sports a price-earnings ratio of 20. The company earns \$0.40 a share and at 20 times earnings its share price is \$8.00 and its equity market value is \$80 million. Suppose that the additional controls mandated by SOX cost the firm \$300,000 after taxes. The costs reduce annual EPS to \$0.37. At 20 times earnings, its shares are now valued at \$7.40 and the company's market value is \$74 million, a loss of \$6 million. Multiply this loss by the 4,000 small pub-

lic companies traded in the U.S. and you get a whopping aggregate decline in market value of \$24 BILLION! That's the price that small company investors could end up paying for the supposed protection SOX provides.



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The authors of SOX admit that the Act increases corporate expenses. However, they also argue that the concomitant reduction in risk should lower shareholders' required rates of return with the net result being a boost in share prices and equity market value. To this I say baloney!

Most investment professionals know that company specific risk (for example, the risk that a company's executives are crooks) can be diversified away. In other words, diversified investors bear the costs of SOX without receiving any of the benefits.

A movement to reduce the onerous requirements of Section 404 for tiny companies was recently nipped in the bud by regulators. As a result, a number of public companies are considering the option of "going private" instead of implementing 404, and a handful have already delisted their stock and now trade on the "pink sheets."

My gripe is that compliance with the Act needlessly costs shareholders a bundle. Non-compliance (a sale to private investors or delisting its shares) also short-changes small company investors. In short, all of us that invest in the stocks of tiny companies will needlessly end up paying a hefty price for a law targeting a few corporate white-collar criminals.

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