

Cleaning House
by John Tuccillo, Economist, PhD
March, 2002

When a college athletic program comes under investigation by the NCAA, the degree to which penalties are levied are inversely proportional to the degree of cooperation on the part of the university. If the guilty are fired and if the institution penalizes itself, then external sanctions will be lighter. The ability of contrition to ease punishment is a constant in life, whether in the criminal court system, the NCAA or the Catholic Church. And now we have two marvelous examples of the rule, one very close to home.

On the front page, the Enron debacle has reached the status of national scandal. Accounting irregularities, fraud, and even political influence peddling have characterized the fall of what had been one of Wall Street's high fliers. More than that, Enron in its own way is a symbol of the new economy. It grew on the heels of power deregulation, which itself came about because of the gradual retreat of the Federal government from business and the economy. It is likely that Enron's failure may spell the end of the deregulation experiment, and thus cause a halt in what have been declining consumer energy prices.

Enron is not the only casualty here. The accounting firm of Arthur Andersen is likely to go down with it, largely owing to the fact that its employees did a swell impersonation of the lookouts on the Titanic. Andersen and Enron have not cooperated with the investigating bodies, regardless of what their PR mills say. They both covered up fraud and destroyed documents after the SEC began its investigation. No amount of firings will cover that over. The Feds will come down hard on both companies and add yet another depressing note to the recession winter of 2002.

The second example, the one close to home, is Homestore. Once again accounting shenanigans are at the root of the issue. The allegation is that Homestore overstated its revenues in an effort to bolster the price of the stock. If this is true, there will be sanctions (and more -- there are already at least four class action lawsuits on behalf of shareholders filed.) The magnitude of the sanctions is unclear, but they could include fines and other criminal penalties. The difference between Homestore and Enron, though, is the degree of cooperation. Homestore changed its management and is cooperating fully with the authorities. It has named as Chairman Joe Hanauer, the industry's equivalent of Clark Clifford or Cyrus Vance, in an effort to both restore confidence and indicate its willingness to reform.

The fallout for the real estate industry is yet uncertain. NAR has taken pains to ensure the integrity of realtor.com, which is the right thing to do. In all likelihood, the impact will be small. Homestore performed a real service to the industry by getting the listings on the Internet. Brokers and agents have taken it from there and produced their own sites, often better and more attractive than realtor.com. Maybe it's time to declare victory and withdraw, leaving Homestore to recover on its own.