

The Importance of “Accounting Validation”

Recent events surrounding the bankruptcy of Enron have caused investors a great deal of concern. How could one of the largest, fastest-growing, and most successful companies in America (or so it was thought) suddenly evaporate? Enron’s dramatic collapse has raised the ire of regulators, the scrutiny of the United States Congress, and the concern of the investing public. Given the current environment of weakened investor confidence, we believe it appropriate at this time to review topical issues relating to United States Generally Accepted Accounting Principles (U.S. GAAP). Specifically, we would like to address the events and issues that led to the Enron disaster, and put them in their appropriate historical context.

First, it is important to emphasize our belief that the current accounting-related volatility will be temporary. In the long term, financial markets should normalize, and investors should return to focusing on fundamentals. A more vexing question would be: could the Enron debacle result in an equalization of valuations across global markets? The U.S. market has traditionally traded at a premium to foreign markets owing, in part, to the perception of superior accounting and better disclosure. Could, then, the lessening of this perception bring U.S. valuations more in line with foreign markets? While it may be premature to draw this conclusion, the possibility is being closely monitored. In the near term, however, the effects of Enron’s meltdown have had a noticeable effect on the U.S. financial marketplace. Already, we have seen certain sectors experience negative volatility, often with nothing more supporting these sell-offs than rumor and innuendo. Meanwhile, the response in both European and Asian financial markets has been more muted.

Secondly, it is important to note that the off-balance-sheet financings that caused the undoing of Enron were not the first vehicles of their kind, nor will they be the last. Myriad industries and companies (as we will discuss below) engage in various forms of off-balance-sheet financing. While these facts should not undermine the broad faith which investors place in U.S. GAAP and the auditors of the companies in which they invest,

they should remind the investment community that they should not rely solely on auditors’ opinions.

Balance Sheet Abuse: A History

The Enron disaster came as a result of Enron’s attempt to put a new twist on an old tale: the company stretched the letter of accounting rules to their limits to optimize the appearance of their financial statements. In the case of Enron, the crux of the disaster lies in off-balance-sheet financing vehicles called Special Purpose Entities (SPEs); through their use, Enron was able to circumvent the Principle of Consolidation, one of the cornerstones of modern accounting. The Principle of Consolidation states that the consolidated balance sheet of a corporation represents all of the assets and all of the liabilities of that corporation, and of any subsidiaries or other entities in which that corporation has an ownership interest in excess of 50%. The intention of the 50% threshold is to ensure that all of the assets (which are controlled by the corporation) and all of the liabilities (which are the economic obligations of the corporation) appear on the corporation’s consolidated balance sheet. Through the use of SPEs and their very peculiar accounting rules, Enron was successful in accounting for significant amounts of debt (almost all of which were the economic obligations of Enron) off of their consolidated balance sheet. In addition, through Enron’s own transactions with these SPEs, the company was successful in manipulating the appearance of its income statement. The magnitude of Enron’s success in these endeavors lies at the center of what has shocked both the market and the public.

It is important to note that this is far from the first time that a major, well-known corporation has attempted to stretch the limits of accounting rules to mask the economic reality of its financial statements. The first attempt to manipulate accounting methods to this end came in the form of companies abusing the 50% equity interest rule to “off-load” expenses. These expenses might then be placed in “minority-controlled” subsidiaries (or subsidiaries funded through the use of debt), thus making the parent’s income statement appear more profitable.

Boston Chicken provides a prominent recent example of such a situation. Seeking to create the appearance of healthy margins and growth on its consolidated income statement, Boston Chicken financed its expansion in a way that hid the relatively poor profitability of its newly opened restaurants. To do this, Boston Chicken aggressively funded its expansion of new restaurants by lending capital (in the form of convertible debt) to franchisees of Boston Chicken restaurants. Since GAAP requires a 50% *equity* interest in a company for consolidation, Boston Chicken’s convertible loans, as *debt* interests, did not trigger any consolidation requirements. As such, although Boston Chicken did account for the debt associated with these investments on its balance sheet, it was successful in keeping the initial (generally poor) profitability of its new restaurants off the company’s consolidated income statement.

While Boston Chicken’s practices satisfied accounting regulations, many analysts argued that the company effectively controlled, from an economic and operating perspective, its franchised restaurants. As a result these analysts claimed the company should have consolidated these restaurants on its income statement. Since it did not, analysts argued that Boston Chicken’s true profitability was greatly overstated. Thus, despite its apparent profitability and much to the surprise of the investment community, Boston Chicken eventually folded under the weight of debts resulting from monies lent to franchisees, who had opened restaurants which never become profitable enough to repay those debts.

However, Boston Chicken (or Enron for that matter) should not be singled out as a one-time event in accounting history. Other areas of continuing concern include loosely defined operating and capital lease accounting rules. The abuse of these rules has allowed companies to prevent the consolidation of debt associated with their long-term leases on their consolidated balance sheets. Numerous illustrative examples of companies which have aggressively stretched the limits of these rules can be found in both the airline and retail industries.

In the airline industry, companies have long materially understated their true leverage via the use of off-balance-sheet entities as a conduit for leasing airplanes. Frequently, these off-balance-sheet entities acquire and own the planes which airlines subsequently lease from them. In almost all cases, these leases are

classified, for accounting purposes, as operating leases, and the airline typically has little or no equity stake in the leasing company; therefore, the airline is successful in disassociating itself and its balance sheet from the debt associated with the airplanes. From an accounting perspective, this is acceptable despite the fact that, from an economic perspective, the airline “owns” the airplane (its lease runs through the end of the airplane’s useful life) and the debt associated with the airplane is, in reality, a debt of the airline itself. As a result, the airline’s consolidated balance sheet describes less leverage than the airline actually bears.

Similarly, the retail industry often employs accounting practices that materially understate the leverage associated with the company. As airlines do with airplanes, retailers often engage in very long leases for the properties in which they operate. By carefully structuring the terms of these leases, retailers are often successful in accounting for them as operating leases. However, from an economic perspective, these leases often represent the useful lives of the properties, regardless of their accounting classification. As such, the payments associated with the leases represent a debt of the company. So, while these leases should be accounted for on the consolidated balance sheet of the company, they are not; hence the company appears less indebted than it truly is.

The Enron Debacle: The latest Off-Balance-Sheet Scheme (and more)

As described above, many companies have for some time been seeking to stretch the limits of accounting rules in order to optimize the appearance of their financial statements. The Enron debacle and Enron’s use of SPEs represent the latest, and perhaps most troubling, off-balance sheet financing technique. SPEs are, by definition, “special”. Historically, capital-intensive companies have used SPEs to separate certain assets from the rest of the company. For example, SPEs have been used by leasing companies as a means of disassociating certain (presumably less lucrative) assets from the parent company’s consolidated financial statements. However, SPEs have not solely been the province of leasing companies; banks have also been known to use SPEs as a means of separating themselves from problem loans.

Under current accounting rules, for an SPE to remain off of the balance sheet, it needs to satisfy two requirements: (1) the assets must be legally transferred

to the SPE; (2) an independent party must make at least a 3% capital investment in the SPE. Enron, in most cases, satisfied both of these rules. As one might ascertain, the spirit of the first requirement is that the SPE should be a stand-alone and separate entity. Further, the second requirement seems like an attempt to prevent “self-dealing” through the required inclusion of outside investors. However, like Boston Chicken, certain airlines, and certain retailers before it, Enron appears to have met the letter but stretched the spirit of both of these rules.

In the case of Enron, the SPEs took the form of limited partnerships, with Enron’s Chief Financial Officer as the partnerships’ General Partner. Clearly, as the General Partner of the SPEs, Enron’s CFO was in control of the SPEs. In addition, these SPEs were engaged solely in the business of trading energy contracts with Enron. As such, the parallels between the Enron situation and Boston Chicken’s are astounding. While the circumstances and legal vehicles are different, the principles were violated precisely as described above. Just as Boston Chicken clearly controlled its franchised restaurants (via its role in their marketing, its majority capital interest, and its position as logistical backbone of the restaurants’ operations), so did Enron “control” its SPEs (via the CFO’s role as General Partner and Enron’s up to 97% capital interest in the SPEs). Second, just as Boston Chicken’s newly opened franchised restaurants (whose sole business was operating under their Boston Chicken franchise agreement) were entirely dependent on their relationship with Boston Chicken for their ongoing operations, so Enron’s SPEs were entirely engaged in the business of trading energy with Enron. Thus, once again, despite the span of several years, accounting failed to capture the economic reality: that the associated profitability of Enron’s SPEs should, from an economic perspective, have been included on the company’s consolidated income statement.

Finally, there are two additional aspects of the Enron debacle which, in our view, exacerbate the wrongdoings committed. First, the way in which Enron accounted for the revenues and profits generated through trading with its SPEs was disturbing. Because the energy contracts in which Enron traded with its SPEs were highly illiquid, Enron had an enormous amount of discretion in valuing the contracts traded. For example, because Enron was marking its own book, it could

“buy” an energy contract from an SPE at a certain price and “sell” it back at another price. Both the buying and selling price of contracts, from an accounting perspective, were at Enron’s discretion. In this way, it is believed that Enron booked millions of dollars in “phantom profits”. Second, unlike Boston Chicken (which consolidated all its debts on its consolidated balance sheet), Enron (despite having contributed as much as 97% of the capital) may have acted improperly in not consolidating its SPE debts on its consolidated balance sheet. If that is the case, it greatly understated the company’s true leverage.

Financial Analysis: A Primer

So how can one hope to avoid investing in companies like Enron? Validating the accuracy of financial data used is an important part of a sound investment process. Why is this necessary? While, in the broad sense, one should recognize and value audited financial statements as a useful starting point, investors should also recognize that relying solely on auditors’ opinions of these statements can be dangerous (as the Enron debacle should make clear). Rather, through the rigorous application of fundamental analysis, investors are likely to benefit from examining, testing, and re-testing management’s assumptions and practices to ensure the underlying validity of the three primary financial statements: the income statement, the balance sheet, and the cash flow statement.

The income statement and the balance sheet are frequently subject to management’s application of good judgement. As noted above, the balance sheet is subject to numerous opportunities for abuse (with off-balance-sheet items being only one possible method of manipulation). Management can also severely distort reality through their significant discretion in the valuation of balance sheet items.

But the balance sheet is not the only financial statement subject to management’s judgement. Another foundation of U.S. accounting is the Principle of Accrual Accounting. Through accrual accounting, companies and their managements seek to “match” the representations of their financial statements to reflect actual economic activity. In certain cases, where transactions may be stretched over long periods of time (such as building airplanes, or providing long-term contract services), management may record revenues and earnings to reflect their best estimate of actual

economic activity. As a result, the quality of earnings reported may depend on management’s ability to assess their own progress accurately.

Finally, there is the cash flow statement. The cash flow statement accurately details the in-flow and out-flow of cash. Given the reality that many companies engage in a variety of long-term and short-term operations, the cash flow statement acts as a fulcrum balancing the assumptions that management may have applied to the income statement and balance sheet.

Recognizing these realities, investors should focus their efforts on analyzing the sustainable cash-generating ability of their investments. Further, the crucial step in many instances will be testing the interplay between all three financial statements, management’s assumptions and projections, the realities of the marketplace, and any fundamental data which have been uncovered. In that way, many investors will find that sound accounting analysis will typically be best exemplified by those investments that they have *not* made.

Conclusion

While the Enron debacle has unmasked certain shortcomings in U.S. GAAP (in particular, certain problems in off-balance sheet financing and revenue recognition accounting), there is strength in its principles and the consistency of its application by the majority of companies’ managements.

Investors should be focused on anticipating, analyzing, and avoiding these situations, typically characterized by extensive use of obscure accounting rules and limited cash flow. Indeed, the possibly irrational extrapolation of Enron’s woes onto the broader market may very well present some opportunities. Should current conditions continue, it is possible that certain strong companies, whose accounting may be inappropriately maligned, may see their shares decline undeservedly. As such, adopting a contrarian stance on the implications and knock-on effects of Enron’s woes in the world’s financial markets may unveil opportunities.

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