

Accounting Abuses and Proposed Countermeasures

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Accounting Abuses

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Standard & Poor's Responds

The epidemic of accounting abuses by U.S. corporations has severely undermined analysts' and investors' confidence in the veracity of financial reports. Numerous companies have been found to have significantly overstated their revenues, earnings, cash flow, or assets, or to have understated their liabilities. Lax corporate boards and outside auditors have evidently helped give rise to this phenomenon. Certain out-of-date accounting standards, gaps in the standards, or even the complexity of standards have also played a role, as has the intense pressure on managements to "make the numbers" and meet Wall Street's growth and earnings expectations.

Responding to the current crisis, the U.S. Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) are now pursuing various initiatives to restore confidence in financial reporting and disclosure. Standard & Poor's expects that much of the resulting information will benefit its analytic process and surveillance. The current initiatives, however, are likely to provide only a partial solution, and heightened attention to accounting-related matters--and skepticism by analysts--will continue to be appropriate.

Accounting Abuses

The greatest concentration of abuses has been in revenue reporting. Such improprieties have accounted for the dominant share of the restatements mandated by the SEC in the past few years. Notable recent examples include the following:

- Some energy marketers have admitted to engaging in phantom, or "round trip," trades in electricity contracts. These are essentially back-to-back swaps with no business purpose except to artificially bolster apparent trading volume and revenue.
- Similarly, in the telecom sector, Global Crossing Ltd. and Qwest Communications International Inc. are reportedly being investigated by the SEC for back-to-back swaps of fiber-optic capacity.
- In the pharmaceuticals sector, Allergan Inc. and Elan Corp. PLC have entered into transactions in which they formed joint ventures (JV) with third parties, made cash investments into the JV entity, but then got back some or all of the cash in the form of fees for performing R&D, these fees having been reported as revenue.
- Manufacturers of telecom equipment such as Lucent Technologies Inc. have made highly aggressive use of vendor financing in which, on sales to financially shaky buyers, profits are reported up front, with the financing being provided by the seller. Lucent's vendor notes receivables reached \$8.4 billion at year-end 1999. Among its biggest vendor-financing deals was a \$2 billion, five-year pact signed in 1998 with Winstar Communications Inc.: Winstar filed for bankruptcy in 2001.

Also, companies have increasingly made use of large, one-time, "big bath" restructuring charges or have regularly booked smaller restructuring charges--hoping these would be disregarded by analysts and investors--to accelerate the recognition of operating expenses with the objective of bolstering

subsequent reported earnings. Among the many companies that Forbes magazine has termed "serial chargers" are Allied Waste Industries Inc., Cisco Systems Inc., Compaq Computer Corp., E.I. DuPont de Nemours & Co., Fortune Brands Inc., Tenet Healthcare Corp., and Waste Management Inc.

Moreover, notwithstanding the generally poor pension investment portfolio returns of the past two years, most companies have clung to seemingly aggressive long-range–return assumptions (i.e., 9.5% to 10.0% per year), enabling some of them to continue reporting material non-cash pension credits. For certain companies, including Ethyl Corp., United States Steel Corp., Weirton Steel Corp., Verizon Communications Inc., GenCorp Inc., Northrop Grumman Corp., and Allegheny Technologies Inc., pension credits represent a substantial portion of their total reported earnings.

Although the statement of cash flows is much less susceptible to accounting manipulations than the income statement, recent developments have shown that it is far from sacrosanct. Thus, WorldCom Inc. has just admitted that it improperly reported \$3.8 billion of expenses as capital expenditures within the past five quarters, thereby bolstering reported net cash flow from operating activities.

Along with the trend of overstating their financial performance, some companies have seemingly put renewed emphasis on innovative means of concealing debt:

- Companies—including Enron Corp.—have employed share trusts in which assets are "sold" to off–balance-sheet, special-purpose entities (SPEs), but in which the transaction's funding is supported by the seller in some manner such that the seller effectively retains the economic risks associated with the assets.
- Companies reportedly have entered into prepaid transactions under which they receive payment up front from a financial counterparty for future delivery of some commodity and reporting the transaction as deferred revenue rather than debt, even though interest expense is imputed in the terms of the transaction. There is no intent to make physical deliveries to satisfy the commitment; rather, the goods are ultimately sold back to the seller.
- Companies have entered into synthetic leases, which are structured to qualify as operating leases for financial reporting purposes, and finance leases for taxation purposes. Analytically, they are viewed by Standard & Poor's as a debt equivalent, just as are conventional operating leases. The insidious aspect is that they are not just off–balance-sheet, but are largely "off-footnote": Because the initial term of the lease is kept artificially short (for tax purposes), and in some cases the lease is nominally cancelable, the disclosed minimum future lease commitments understate the extent of the true economic liability.
- Finally, companies have entered into borrowing, derivatives, and operating agreements that include credit triggers—such as rating triggers, financial covenants, or material-adverse-change clauses—which can greatly magnify the consequences of erosion in credit quality, but which have often been poorly disclosed (see "Identifying Ratings Triggers and Other Contingent Calls on Liquidity, Part 2," published on May 15, 2002).

Countermeasures by the Rule Setters

In recent months, the SEC has greatly increased the number of investigations (formal and informal) it is pursuing regarding accounting-related matters. This has led to a large number of restatements by companies and, in several high-

profile cases, the levying of fines.

The SEC has taken some steps that could lead to enhanced disclosures. Of these, Standard & Poor's views the following SEC proposals as particularly promising from an analytic perspective:

- A rule that would require companies to make disclosures about critical accounting policies and the effect on reported financial performance if the company were to assume that certain key estimates were changed;
- Accelerated and more comprehensive disclosure of insider company equity transactions, plus "loans of money to a director or executive officer made or guaranteed by the company or an affiliate of the company." Presumably, such a requirement would have revealed the abuses at Adelphia Communications Corp., where the founder and controlling owner, and members of his family, borrowed under a credit facility shared with--and guaranteed by--the company, using the proceeds in part to acquire shares of the company;
- Companies accelerate filing their quarterly and annual reports: 10K's would have to be filed within 60 days of the end of the fiscal year, rather than the current 90 days, and 10Q's would have to be filed within 30 days of the end of the quarter, rather than the current 45 days. The only downside could be the increased potential for errors as companies rush to meet the tighter deadlines; and
- Expansion of the list of events that require a company to file an 8K, and an acceleration of the deadline--to two business days from five to 15 days--for filing such a report.

Separately, the SEC has offered as guidance, in "Management's Discussion and Analysis of Financial Condition and Results of Operation" section of the financial statement, that companies consider including:

- Provisions in financial guarantees or commitments, debt or lease agreements, or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity, or the creation of or an additional financial obligation. Such provisions could include adverse changes in the registrant's credit rating, financial ratios, earnings, cash flows, or stock price, or changes in the value of underlying, linked, or indexed assets;
- Circumstances that could affect the registrant's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable, such as the inability to maintain a specified investment-grade credit rating, level of earnings or earnings per share, financial ratios, or collateral.

The SEC also stated that companies should consider the need to "provide disclosures concerning transactions, arrangements, and other relationships with unconsolidated, structured-finance or special-purpose entities or with other persons that are reasonably likely to materially affect liquidity or the availability requirements for capital resources."

Such disclosure could significantly enhance Standard & Poor's ability to maintain surveillance of credit triggers, but the SEC has instructed companies to consider disclosing only circumstances "that could materially affect liquidity if such circumstances are reasonably likely to occur." This, of course, is subject to interpretation.

The FASB, too, has launched a number of initiatives to address shortcomings

in financial reporting. Broadly, these initiatives are also welcomed by Standard & Poor's. Most notably, the FASB is developing an "Exposure Draft" that would provide rules for determining when an entity (termed the "primary beneficiary") should consolidate an SPE that functions to support the activities of the primary beneficiary. With this initiative, the FASB's aim is to require the consolidation of SPEs that "lack sufficient independent economic substance." The FASB is clearly targeting the type of abusive schemes employed by Enron.

Nevertheless, preliminary indications are that the FASB is seeking to require consolidation of a number of types of "plain vanilla" securitizations, including collateralized debt obligations and multiseller commercial-paper conduits. On one hand, this could be seen as a non-event from a ratings perspective: Analytically, most securitized assets and related debt are added back to the balance sheet anyway because the corporate sponsor typically remains in a first-loss position and given the concerns regarding moral recourse, i.e., the reality that companies feel they must bail out a troubled securitization although there is no legal requirement for them to do so. (See "Substance, Not Form, of Securitizations Drives Standard & Poor's Leverage Analysis," published on April 18, 2002.)

On the other hand, Standard & Poor's would need to be alert to the potential practical ramifications of such accounting changes. For example, some companies might be in violation of financial covenants upon the consolidation of securitizations. Moreover, there is the risk of a chill being sent through segments of the asset-backed securities market on which certain companies are highly dependent.

In addition, the FASB has issued an exposure draft of a proposed interpretation of guarantees ("Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," May 2002). This exposure draft essentially reiterates existing compliance with which has been lax, requiring the guarantor to make the following disclosures, "...even if it is probable that the guarantor will not need to make any payments under the guarantee":

- The nature of the guarantee, including how the guarantee arose and the events or circumstances that would, under the guarantee, require the guarantor to perform;
- The maximum potential amount of loss under the guarantee; and
- The nature of any recourse provisions or collateral that would enable the guarantor to recover amounts paid under the guarantee.

The FASB is also undertaking an ambitious project that would consist of a comprehensive review of standards governing revenue recognition. Given its sweeping nature, such a project could take several years to complete.

Standard & Poor's Responds

In the wake of recent developments, Standard & Poor's, in its credit review process, is placing significantly heightened emphasis on the assessment of accounting quality and information risk. Standard & Poor's also plans to incorporate expanded commentary on accounting-related factors into its industry- and company-specific research reports.

In addition, Standard & Poor's intends to take a more active role in commenting on proposed changes in accounting standards and financial disclosure regulations. Last month, Standard & Poor's called for more discipline and standardization in the reporting of core earnings (see "Standard

& Poor's to Change System for Evaluating Corporate Earnings," published on May 14, 2002, and "Core Earnings and Ratings Analysis," published on June 4, 2002).

Moreover, to be fully responsive to market needs, Standard & Poor's intends to hold regular discussions with key constituents to consider ways in which its debt-rating policies and research could enhance investor recognition and understanding of accounting quality. To this end, Standard & Poor's sponsored an accounting forum on June 17 and plans to sponsor other such programs.

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