

Educational Piece –Transferring Risks Off of the Balance Sheet and the Income Statement (2/19/02)

Since the collapse of Enron, Inc. in December 2001 and subsequent investigations into the factors that caused it, there has been significant focus on how the Company (and others) was able to transfer large amounts of risk from its financial statements. Many now allege that Enron achieved this goal through, in part, abuse of generally accepted accounting principles. As investors scrutinize other companies in search of the next “Enron”, certain questions arise which this report will attempt to address:

- *What methods do companies employ to try to exclude debt and losses from financial statements?*
- *Where should an investor or analyst search to uncover potential problems?*
- *What methods do companies employ to try to exclude debt and losses from financial statements?*

There are a variety of ways that companies use in order to achieve off-balance sheet (and income statement) treatment of debt and losses:

1. Use of operating leases: Leases allow a company to pay for the use of an asset over a period of time. If a lease is accounted for as a “capital” lease, the leased asset and the associated lease obligation must be included on the company’s balance sheet. The asset is depreciated over the life of the lease, with the depreciation included on the income statement. On the other hand, if the lease is accounted for as an “operating” lease, the asset and related obligations are *excluded* from the balance sheet of the lessee. Lease payments are included on the income statement as rent expense. More discussion of operating versus capitalized leases in our educational piece “Accounting for Leases”, dated August 9, 2001.

Example:

A company can achieve off-balance sheet financing by, among other things, engaging in a sale-leaseback transaction which is structured as an operating lease. This type of transaction would allow a company to convert an asset (for example a building), into cash, which would be repaid as lease payments over time. As discussed above, the operating lease treatment would allow the lease obligation to be excluded from the balance sheet of the company. *For example*, Hanover Compressor Company (“HC”) has engaged in several of these transactions, with approximately \$1.2 billion in off-balance sheet lease obligations as of September 30, 2001.

2. Non-consolidated subsidiaries: A parent company need not consolidate a subsidiary which is less than 50% -owned and is not subject to the control of the parent company. In this case, the parent company includes the investment in the non-consolidated subsidiary in one line item on the balance sheet (investments). In this way, any debt of the subsidiary is excluded from the liabilities shown in the parent company’s balance sheet. Additionally, only the parent company’s share of the income or loss of the subsidiary is included in the consolidated income statement of the parent, and it is reported separately as one line (equity in income of non-consolidated subsidiaries). Details regarding the components of the income or loss are *excluded* from the face of the consolidated income statement of the parent company.

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Example:

A 49% owned subsidiary by a parent company may have significant amounts of debt. As long as the parent company does not exercise management control over the subsidiary, the parent may report its investment in the subsidiary as a one-line consolidation, showing only its share of the net assets of the subsidiary in as an “investment” in the parent company’s consolidated balance sheet. On the other hand, if the subsidiary were consolidated, each component of the subsidiary’s balance sheet (including the significant level of debt) would be included in the consolidated balance sheet of the parent. *For example*, the Walt Disney Company’s (“DIS”) cable and international broadcast operations segment includes several consolidated subsidiaries and several unconsolidated subsidiaries. Among DIS’s many unconsolidated subsidiaries at September 30, 2001 were Lifetime Entertainment Services (50% owned by DIS), E! Entertainment Television (39.6% owned by DIS) and A&E Television Networks (37.5% owned by DIS). DIS’s share of the results for these entities is included in one line on DIS’s consolidated statement of operations, and DIS’s share of the net assets of these subsidiaries is included in one line on DIS’s balance sheet.

3. Transfer of assets and liabilities to off-balance sheet vehicles, including special purpose entities (SPE): Accounting rules currently permit companies to transfer certain financial assets and liabilities to off-balance sheet entities. According to Robert Herdman of the Securities Exchange Commission, “SPEs are commonly used as financing vehicles in which assets are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust.”¹ As long as the SPE meets several specific criteria, its assets and liabilities are excluded from the consolidated balance sheet of the sponsoring company. A more detailed discussion of transactions with SPEs can be found in our educational report entitled “Transactions with Special Purpose Entities in the Wake of Enron”, dated January 7, 2002.

Example

Many companies securitize accounts receivable, particularly long-term receivables, by transferring them to SPEs for cash. This provides the company with faster access to cash. Also, as long as the SPE meets the relevant criteria, any corresponding debt issued by the SPE to fund the asset securitization is *excluded* from the consolidated balance sheet of the company which transferred the receivables. As the debt is excluded, it might provide the sponsoring company with a lower cost of capital, as lenders will only the debt obligations which are included in the consolidated balance sheet. *For example*, Lucent Technologies, Inc. (“LU”) enters into securitization transactions with off-balance sheet parties, including special purpose entities. LU sells interests in accounts receivable and customer finance loans, retaining a small interest which remains on LU’s balance sheet. The value of the retained interest varies depending on the credit ratings of LU and the customer. In certain cases, LU must repurchase the receivable. LU services (collects cash payments for) the securitized receivables, thereby earning a fee. Any debts of the outside entities are excluded from LU’s consolidated balance sheet.

4. Related Party Transactions: The Miller 2001 GAAP Guide defines a “related party” as “one that can exercise control or significant influence over the management and/or operating policies of another party, to the extent that one of the parties may be prevented from fully pursuing its own separate interests.”² When a company engages in transactions with related parties, there is concern that the economics of the deal may not be the same had the transaction been negotiated

¹ Testimony Concerning Recent Events Relating to Enron Corporation (Robert Herdman, Chief Accountant, U.S. Securities and Exchange Commission, December 12, 2001 (www.sec.gov/news/testimony/121201tsrkh.htm))

² 2001 Miller GAAP Guide: Restatement and Analysis of Current FASB Standards, Jan R. Williams, Ph.D., CPA. Harcourt Professional Publishing, San Diego, 2001, pg. 39.03.

by two independent parties at arms-length. Therefore, companies could possibly utilize related party transactions in order to shift profits or losses to the other party.

Example

Most companies engage in some related party transactions. However, when related party transactions at a company grow, caution should be exercised when analyzing the consolidated results of operations. *For example*, Enron Corporation's ("ENE") related party transactions have become well-documented during the recent several months. ENE set up many partnerships which were managed by ENE's Chief Financial Officer and other company personnel. Transactions between ENE and these related parties were not negotiated at arms-length, allegedly allowing profits and/or losses to be manipulated.

Where should an investor or analyst search to uncover potential problems?

While there is no one place to look for the types of items discussed in this report, there are certain required disclosures companies must make which should be reviewed in order to uncover possible problems in these areas.

The first source would be the footnotes to the company's annual financial statements on Form 10-K. The 10-K financials will usually include more robust disclosure than the quarterly financial statements filed on Form 10-Q. While the disclosures will vary from company to company, good footnotes to pay close attention to include the summary of accounting policies (usually the first footnote), equity investments, debt, financial instruments, contingent liabilities, and lease footnotes. This list is not all-inclusive however, and a thorough review of the entire set of disclosures behind the financial statements will be helpful in a search for off balance sheet lease obligations, significant asset securitizations and significant investments in unconsolidated subsidiaries.

Another excellent source of information is the annual proxy statement filed by companies. The proxy is sent to every shareholder each year and includes items which require shareholder approval. Additionally, because the proxy is mailed to each shareholder, the Securities and Exchange Commission also requires other items to be disclosed in the proxy. These include significant related party transactions, executive and director compensation and disclosures about beneficial ownership of the company.