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Investment World - Insight

Off-balance-sheet partnerships -- Chic no more

Sujata Srinivasan

ENRON Corporation's demise has taken a toll on investor confidence in the United States. In accounting, where numbers mean everything, it is disturbing to pick up a balance sheet and realise one cannot trust those figures anymore.

Enron has raised a barrage of questions on accounting practices and financial disclosure norms. Everything from campaign finance reform to new norms in financial disclosure and accounting is being heatedly debated. Given the global reach of American corporations, changes debated and implemented in the US are bound to send ripples across subsidiaries and partnerships worldwide. It is yet to be seen how comprehensive these changes might be, and whether they will be adequate to prevent future Enron-like situations. But let us consider some of the points being debated, and if implemented their impact.

Off-balance-sheets partnerships are perfectly normal, but Enron obviously pushed this to the limit. In one of its off-balance-sheet partnerships, the Raptors deal alone, about $504 million was kept off the books, thereby hiding debt, inflating earnings and inflating stock price.

Among several of Enron's dubious accounting practices, the one that seems to have been abused the most is the use of special purpose entities to hide liabilities. Currently, in corporate accounting practices, companies setting up these entities can keep them off their books if external investors put up a minimum of three per cent of the equity. The Financial Accounting Standards Board has proposed to raise this to ten per cent. However, some feel this is not sufficient.

According to Krishnagopal Menon, Professor and Chairman, Department of Accounting, Boston University School of Management, "I am sure this (raising the threshold to 10 per cent), will help curb misuse of special purpose entities, but I think the threshold should be a lot higher. I would say 50 per cent."

Points out Dimitri Vayanos, Professor of Finance, MIT, that when Enron sold an asset to a subsidiary, the subsidiary would treat it as an investment and depreciate it over time. Enron

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meanwhile, would treat the proceeds from the sale as revenue.

"So, for example, if Enron sold a machine for $5,000, Enron would add a revenue of $5,000 to its earnings, while the subsidiary would subtract only $500 from their own earnings, because they would depreciate the $5,000 over the life of the machine — assuming it was ten years. This would increase the total earnings of Enron plus the subsidiary, but would not create any value."

Prof Vayanos says that while there are accounting rules to prevent such tricks, Enron managed to get around them. "One reason was that many of these sale of assets involved complicated financial products, and a proper accounting was hard, there were loopholes. The other reason was that Enron's auditors seemed to have been quite complacent."

One of the biggest changes rooted for is new safety-nets for 401 (k). Prof Stiefel points out there should be no pressure anymore on employees to keep 401(k) savings plan accumulations in employer stock. "So it should be okay to force employer matching contributions into employer stock awhile, five to ten years; but it should not be okay to pressure employees to put their own contributions into employer stock or to force them to stay with the employer stock longer," he says. Also, senators have introduced a bill that will allow the cost of stock options to be deducted from profits. Industry experts point out this could have big implications on earnings, and options might not be so hot anymore. All this is leading to more questions on incentives structured primarily around stock-price.

Says Prof Chinmoy Ghosh, formerly from IIM Calcutta and currently the Director of Student Managed Fund, University of Connecticut: "When you structure incentives around stock price, the downside is a tendency to manage the stock price, which is what happened to Enron."

With the cross-border global flow of capital, it is crucial to standardise accounting procedures. Points out Prof Stiefel: "Foreign operations of US-based companies should standardise their accounting — otherwise, it would be too easy to transfer US cash flows to foreign subsidiaries. Also foreign companies with major presences in the US should be subject to rules as a condition for operating here."

When life-savings of hundreds of employees vaporise amidst the greed of a group of power-drunk people, accounting loopholes and smart number gimmicks do not appear so chic anymore. It is time for big changes and it is starting to happen. Ironically, that seems to have been the only good that Enron unknowingly did.

(The author is a freelance writer.)

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