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New Accounting Practices Work When Done Properly And Fully

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“Mark-to-Market” is an accounting method that makes it legal to count your chickens before they hatch! The much-discussed method is a way to evaluate a company’s value in the current market and current dollars even though it might have deals affecting its financial strength going out many years. The standard business method, accrual accounting, only counts money when it come into the “till.” Mark-to-market accounting allows a company, and energy trading companies, to count today the profits it anticipates receiving in future years, as far out as ten or 20, from contracts it is selling now even though the actual cash will not be received for years to come!

Because no one knows for sure how many eggs will hatch — or what hatching really is — the method provides plenty of leeway for having “fun and games” with the company’s accounting records and signs of profitability. All of the good measures needed by investors to evaluate securities — to be blunt, the value of the company’s stock — can be manipulated because of the weaknesses in the mark-to-market accounting systems.

Not that mark-to-market methods of accounting are totally bad. In today’s complex business world, changes in the accounting systems were needed. There is a need to know a company’s current value, even though it is looking at billion-dollar deals that may run for short- or long-term periods. Management and that very important outside group, investors, must know on a routine basis what the company’s profitability and financial condition is at that moment. That is mark-to-market’s value, strength and weakness!

A major problem is the many uncertainties with the system itself and that the user is allowed to make its own decision on how to “fill the blanks.” The accounting method also relies heavily on forecasting and projecting future events, especially the prices for energy products one, two or as far out as 10 to 20 years down the road. The uncertainty of forecasting and the role perception plays in making future projections only adds to the potential for crafting the results to meet one’s own desires and profits rather than reality.

Some companies use it on an annual or quarterly basis for those parts of the business requiring such a system. Companies that have a large portion of their business in trading operations such as energy companies, security businesses and mutual funds, use it on a daily basis at the close of business. Still, taking all of the weaknesses and dangers into account, it can be a good system for today’s companies for that part of the business that does heavy trading in commodities, stocks, bonds, and what are termed “derivatives” in the energy business when it is used right. For emphasis, remember the key words — “when it is used right!”

When it is used right, it still leaves a lot of room for those wanting to push the lines of both ethics and laws, especially as it covers longer periods of time since the estimated parts of the business become so much more unpredictable. With the many soft areas of the methodology, greed and arrogance can do a lot to make a real good story that is totally false.

Enron will be the classic example of how mark-to-market accounting was used to stuff the pockets and egos of many executives and employees. While not totally the

cause of Enron's downfall, mark-to-market accounting was a key element in what is being termed the "accounting irregularities" leading to Enron's collapse. Certainly, the use of bogus companies and "special purpose entities" played a big role in the largest bankruptcy in history.

According to *The Wall Street Journal*, in 2000, mark-to-market gains accounted for over half of Enron's reported pretax earnings and in 1999, accounted for a third of its profits. Care must be exercised in reporting financial data from Enron as the numbers are changing with time. How many billions of dollars will be found to have been "misstated" and need to be corrected is unknown. A *Houston Chronicle* front-page headline on April 23, 2002 read, "Enron says values off by \$24 billion," is a good example of the changing numbers.

As we all know, Enron was not the only energy company using mark-to-market accounting to state part of its profitability. Companies like American Electric Power (AEP), Aquila, Dynegy, Duke, El Paso, Entergy, Mirant, Reliant Resources, Williams and others playing in the financial and physical energy markets used the same accounting methods to give a "snap-shot" of the company's value. Mark-to-market accounting methods are standard in the accounting industry and have FASB (Financial Accounting Standards Board) approval. FASB 133 are the rules and regulations for mark-to-market accounting. Again, the key issue is using the methods correctly and honestly.

Project analysis to show the full value of a contemplated deal is nothing new in the business world. Whether it was drilling a well, developing mining properties, or even building a new amusement ride at Disneyland, engineers, financial planners, and accountants all did the analytical and mathematical analysis to see what the value of the project was over the project's estimated life.

During the 1950s, financial planners made a big change in their projections by introducing "discounted cash flow" into the analysis. Money now had a time value built into the calculations. The analysis was done to determine if the planned project would meet the desired "rate of return" for the money or capital required to invest in the new project. The rate of return, many times referred to as ROR or ROI for "return on investment," was the hurdle for the project to meet to be accepted by management. Depending on the time in history and the value of capital, RORs in the range of 15-40 percent might be required to receive a go-ahead on a given project.

All of this analysis was speculative in nature. In the natural resources business, while the raw material costs were essentially

set once the basic resource was purchased, product prices and sales volumes were based on projections and estimates. Anyone in the manufacturing business had the added difficulty of uncertainty in forecasting raw material prices. The analysis was only as good as the people doing the project. Their expertise would be known in the years to come only if the project met expectations.

But for the moment, the only cash payment dependent on the analysis was to either do or not do the project. Using various risk factors to compensate for some of the unknowns, did it meet the "hurdle rate" or not was the question. While most analyzes were good, the graveyard is filled with chemical plants that did not make a perceived ROR, mines that had to be closed because they were uneconomical to operate and other such economic disasters.

Enron's use of mark-to-market accounting, which it began in 1991, even before it had approval from the accounting board, opened a new Pandora's box. In addition to the benefits it received from keeping the company's stock price high as a result of the mark-to-market accounting, use of entities and other plays are coming out as the case is being investigated. Enron awarded bonuses to managers at the time of the deal's closing on the perceived mark-to-market value. These awards were usually in the form of stock options. Now, the managers and employees working on project development had a new incentive for seeing that their projects had "excellent projected" rates of return and received management go-ahead.

Now, they personally would get a monetary gain and almost instantly! No waiting for a year or two or even five to ten years to get the benefit of their hard work. So what if two, three, four or some years later the project fizzled and instead of a 40 percent ROR, it only did 8 percent? The originator made his money even if in future years the cash realized from the deal gave a rate of return that was even less than the money it cost to finance the project! Need say more?

The immediate gratification caused a second problem. Since most of the bonuses were made as stock options, employees had a personal, immediate benefit in seeing the company's stock reach all-time highs and stay high - at least until those stock options could be cashed in. In pure simplistic thinking, these were all good ways to keep your best employees working hard for the company's benefit as well as their own well being.

There was a shared common interest in maximizing the company's value for its good and "my good." But greed and arrogance had to be accounted for in the operations. Too many people were benefiting from the system to worry about these details. This was a

big part of the historic bankruptcy.

The other energy companies using mark-to-market accounting are now finding the Securities and Exchange Commission reviewing their financials to ensure that they are not hiding any irregularities or debt that should be reported. Indications are that some companies are taking seriously the problems Enron had with mark-to-market accounting and are making changes to prevent serious consequences. Some of the companies mentioned previously have already made changes or have announced changes will be made by selling capital, cutting operations, etc. to save money and correct problems not fully disclosed in their mark-to-market reporting.

The Dutch bank ABN AMRO has made a study of major energy companies using mark-to-market accounting. This includes the companies mentioned here as well as others. The company with the highest percentage of earning from mark-to-market areas was Aquila. Companies in their financial statements are now showing information regarding this form of accounting. Many are making changes to provide clearer information. In addition to those listed earlier coming under SEC review, a class action lawsuit was filed against Williams in Oklahoma.

Mark-to-market accounting is good when it is not abused. However, the need for forecasting and the ability to make changes within the methodology provide too many possibilities for abuse. It can provide management and investors with good information on what is happening in projects that span a considerable amount of time, but unless it is conducted honestly and ethically, accrual accounting is a much safer and simpler method for reporting a company's financial health. New or additional rules will not really help avoid possible abuses. Making companies play by the rules that are already in effect will clean up some problems that are now history with Enron and others.

Ensuring that companies using mark-to-market accounting are using valid price forecasts for future energy product prices and other variables such as market demand will help. Keeping accounts current, as project values change up and down, will also help investors know the true value of the company. But mark-to-market still contains a large speculative element. It may be useful to a company in its operational strategy or in its day-to-day business, but as a financial reporting tool to evaluate a company's current value, it leaves too many loopholes to be trusted fully. The reality of counting the money as the company sees the revenues — accrual accounting — is less vulnerable to abuse than using perception as to what might be made over time.

In other words, show me the money! ■