Class #20
"Off Balance Sheet Activities"

Where have we been/where next?

- Quiz #2 will be handed back in Class on Thursday
- Overview of Part 2 of Projects
  - Key due date is Friday, May 9, 2003.
- Today: Off Balance Sheet Activities
  - Readings: Skim Section J of Course Reader “Leases and Off-Balance-Sheet Debt” (pages 531-540, 547-551)

Off Balance Sheet Activities

- Start with a simple example of lease accounting:
  - Understand the rationale for leasing and the distinction between O*perating* and *Capital* leases
  - Understand the Income Statement and Balance Sheet differences between *Operating* and *Capital* leases from the lessee's perspective.

- Examine the details of *Off Balance Sheet* Activities at Enron

The Nature of Leases

- A lease conveys the right to use property, plant or equipment for a stated period of time.
  - Lessee (the user or renter)
  - Lessor owner of the property

- Economic Rationale for Leases:
  - Operational:
    - Leasing for short periods protects against obsolescence.
    - Lease “ready-to-use” equipment avoids set-up costs.
    - For equipment that is used seasonally, temporarily, or sporadically.

Economic Rational for Leases

- Financial Advantages to Lessee:
  - Lease payments can be tailored to suit the lessee's cash flows (up to 100% financing, instead of the 80% limit by banks)
  - Properly structured leases my be "off-balance sheet", avoiding debt-covenant restrictions
  - Leasing provides tax advantages from accelerated depreciation and interest expense.

Economic Substance of Leases

- Operating Lease: Lessee rents the property. Lessee records rent expense on income statement.

Lease

Rent ——————————————— Purchase

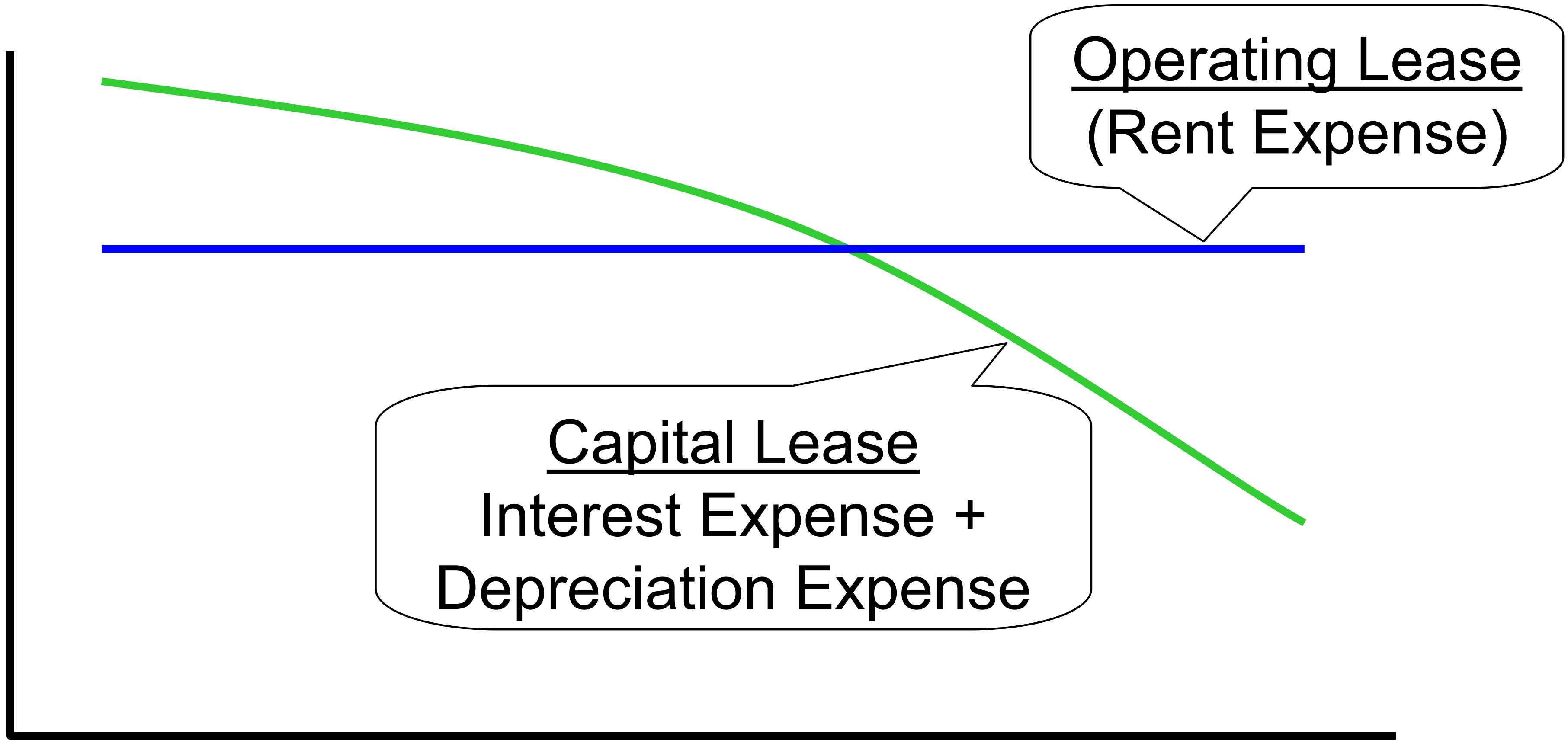
- Capital Lease: Lessee economically owns the property. Lessee records the leased asset on balance sheet (ie capitalizes the asset) and reflects the corresponding lease obligation.

Accounting Criteria for Lease Capitalization

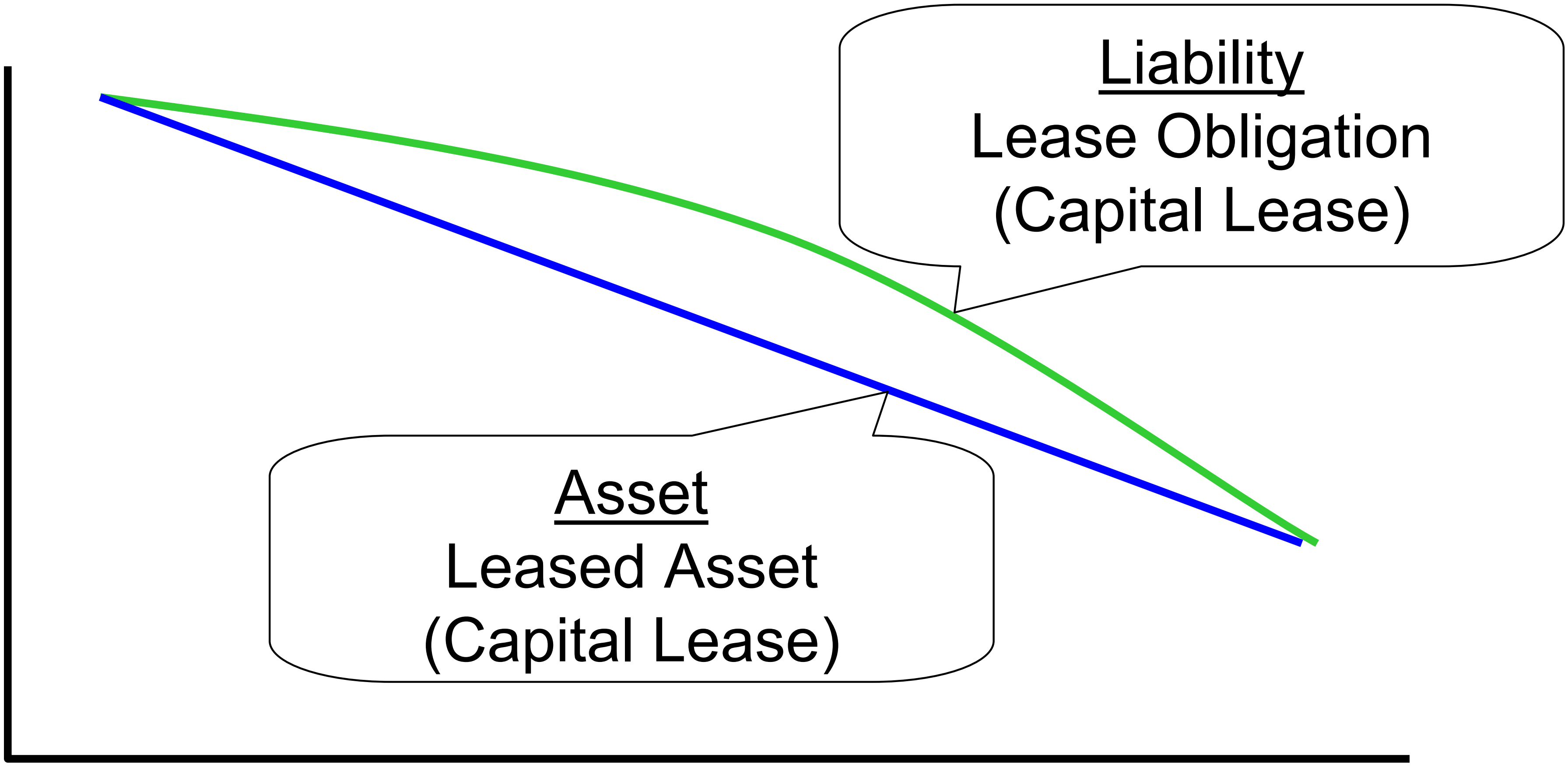
- A lease is considered a capital lease if **ANY** of the following conditions apply (SFAS 13):

  – Transfer of ownership at the end of the lease term.
  – Existence of a bargain purchase option payment below market value after the lease term.
  – Minimum present value of lease payments at least 90% of asset's market value.
  – Lease term is for 75% or more of the asset's remaining useful life.

Capital Vs Operating Lease: Income Statement Effects



Capital Lease: Balance Sheet Effects



Background on Enron

- On December 2, 2001, Enron Corp (7th largest U.S. company) declared bankruptcy.
- Stock closed at $1 (down $83 within 1 year).
- U.S. Senate Committee concluded that Enron's Board of Directors failed in its duties:
  - Approved Off-Balance Sheet Partnerships run by Enron Employees
  - Failed to effectively monitor these partnerships
  - Failed to react to warnings about those transactions as they came to light

The Bottom Line on Enron:

- During 1990's, Enron's growth was driven by large investments in energy trading & energy, water and broadband assets → long delay before CF returns.
- Instead of issuing equity, Enron chose borrowing through Off-Balance Sheet Partnerships (or SPE's) to finance growth.
- The SPE's borrowed money from lenders who often required Enron to guarantee the debt (often done using Enron's stock).

The Bottom Line on Enron:

- The effect of the SPE transactions was to link Enron’s credit rating (which was necessary for conducting its trading operations), and thus its viability, to its own stock price.
- The effects of the slowing economy, poorly performing international investments, and the failure of a broadband initiative led the following:
  - Stock price decline, contingent liabilities realized, earnings hedges became insolvent, and finally bankruptcy ensued. All VERY fast!

The Bottom Line on Enron:

- Enron used financial leverage to manipulate reported earnings
- Poor corporate governance placed firm in this position:
  - Lack of board independence & oversight
  - The auditor (Arthur Andersen) failed in its role as an *independent* certifier of results.
  - Compensation plans provided managers with incentives to maintain stock price at any cost.

Prior Accounting Issues at Enron:

- Enron reported 60% annual growth in revenues between 1995-2000
  - Most of this was from energy trading revenues
  - Enron reported total dollar value of its trading volume as revenues (and cost of filling those contracts as COGS) – industry practice at the time
- In 2001, Enron restated financial statements for 1997-200 to reflect the consolidation of previously unconsolidated SPEs:
  - Little impact on reported EPS: The consolidation did not reflect the debt of <u>other</u> unconsolidated SPEs

The Death Spiral at Enron:

- When Enron's credit rating declined, counterparties refused to trade, unwound existing positions, and Enron's trading business ground to a halt.
- Enron had contingent liabilities (through SPEs) & exposures were revealed -> large magnitude of exposures hurt Enron's credit rating. Enron could no longer support its energy trading operations.

Off-Balance Sheet SPE's at Enron:

- SPE: an entity created by a sponsoring firm to carry out transactions:
  - Limited partnership, limited liability company, trust, or corporation
  - Sometimes called "Structured Financing Vehicles" if used to raise money or manage risk
- In 1999, Enron had $33 billion of assets on its balance sheet and had an additional $27 billion in off balance sheet SPEs.

Controversy over Enron's SPEs:

- Several large SPEs formed at the beginning of 1997 were run by related parties (Enron employees)
- SPEs contained contingent liabilities that were not consolidated with Enron's financial statements.
- Some SPEs did not meet requirements for Off-Balance-Sheet reporting and should have been consolidated
  - Chewco Investments, L.P.; LJM Caymen, L.P.; LJM2 Co-Investment, L.P.

Questionable Financial Reporting: Chewco Investments, L.P

- Enron established Chewco SPE with financing guaranteed by Enron (managed by Enron's Michael Kopper)
- For non-consolidation, 2 requirements:
  1) Have at least 3% outside equity at risk. But Kopper's stake was not equity at risk!
  2) Sponsoring firm (Enron) cannot control the SPE. But, Kopper was employee of Enron and under control of Enron.

Earnings Hedging Transactions: LJM Cayman, L.P.

- Established in 1999 by Enron CFO Andrew Fastow (general partner) – Fastow invested $1 million and receive a 25% return plus a management fee
- Enron had $300 million in gains in investment in Rhythms NetConnection stock.
  - Enron recorded prior profits on gains on stock using mark-to-market accounting. But, Enron wanted to avoid mark-to-market losses if investment lost value.
  - Enron used LJM Caymen SPE to enter into agreements with banks using forward contracts. If the value of Enron's stock went up, then so did forward contracts.
  - Normally, you cannot realize gains in your own stock price as profits.
    - Solution: Enron settled the forward contracts in return for shares of Enron stock. Then, Enron sold these shares to LJM1 for a note receivable and a put option on the Rhythms NetConnection shares.

Earnings Hedging Transactions: LJM Cayman, L.P.

- Key element of LJM Caymen L.P.:
  - The value of Enron's Rhythms' put option was the fact that it relied on Enron's share price.
  - This meant that the hedge was really only intended to convert the embedded value of the forward contract into a form that could be recognized as income (ie the payoff to the put option)

Next Class:

- Next Class: Pension Plans: The Next Accounting Disaster?
  - Reading from Course Reader: Section K "Valuation of Firms with Pension Plans and Other Post Retirement Benefits" – Pages 349-364.
- Assignment #3 will be distributed next class
  - Due in class on Thursday, May 8.