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DOES OUR ACCOUNTING MODEL ADEQUATELY PORTRAY THE MAGNITUDE OF A COMPANY'S FINANCIAL OBLIGATIONS? : THE RECOGNITION AND MEASUREMENT OF LIABILITIES

by
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[Introductory note: As vice chairman and managing partner of Ernst & Young Kenneth Leventhal Real Estate Group, Stan Ross is responsible for the overall business planning, direction, and operations of the firm. He is also a member of the firm's Executive Committee. His responsibilities within the firm relate primarily to accounting and technical matters, professional development, and client activities. He is widely recognized for his experience in significant reorganization, restructure, and bankruptcy engagements with both real estate and non-real estate organizations, banks, and REITs. He is also recognized as the architect of the multi-builder mortgage-backed bond, an important financing tool for builders, and is currently active in the securitization of real estate portfolios.

A frequent lecturer at accounting symposia, real estate conferences, and institutional seminars, Mr. Ross has written numerous articles concerning real estate and accounting related matters. His articles have been published in both accounting and real estate professional periodicals. As a past member of the AICPA's Senior Committee on Auditing Issues in the Accounting Profession, Mr. Ross participated in the task force that wrote the rules on profit recognition for real estate transactions. He was also active in this position in the writing of "Planning & Supervision," a statement of auditing standards.

Mr. Ross received his B.B.A. from Baruch in 1956. He is affiliated with the American Institute of CPAs; the California, Ohio, and New York Societies of CPAs; and the Urban Land Institute. He is a former member of the President's Council on Quality Control.]

I'm honored to be a guest lecturer at the Emanuel Saxe Distinguished Lectures in Accounting. As I was preparing for this speech, I was remembering fondly my lectures with Manny Saxe back when I was at the University. Professor Saxe had a tremendous influence on my life. He taught me a great love for accounting. He influenced me in looking beyond numbers into searching for something more than existed. He was into analytics and understanding the needs of financial users way before it was part of our thinking. So I'm proud to be standing here this evening delivering this lecture and continue to perpetuate and honor Emanuel Saxe.

It's appropriate that the topic that I pick is one that Manny, as we respectfully called him, would have loved. The title, "Does Our Current Accounting Model Adequately Portray the Magnitude of a Company's Financial Obligations," raises the issue of looking beyond the financial statements and feeling comfortable that we are satisfying the needs of the users.

I don't think Manny would have forecasted, nor would have I when I sat in his classes, the magnitude of debt that would be manufactured and created in private industry as well as the government -- not only in terms of dollars, but also the peculiarities and the various types of instruments that exist.

It's always been my belief that too much emphasis has been placed on the asset side. The accounting standard setters should set their primary focus on the measurement and reporting of liabilities. I believe that many of our problems where companies have gotten into trouble -- especially in the financial crisis of the eighties where companies filed bankruptcies, had reorganizations and restructures, were unable to meet their debt obligations, and, as a result, either went out of business, substantially lost their value, or the asset side was foreclosed out by the liability side -- a lot of this could have been avoided or moderated. In a debt-driven environment, if we can focus proper attention now, we could avert or moderate future crises.

We're going to be spending the next hour looking at this right-hand side of the balance sheet. I'll try to weave together a variety of themes that evolve out of that focus.

First let me recap the major themes that we'll be pulling together. I will discuss:

1. The attention standard setters give to assets vs. liabilities.
2. The repercussions of the "mega-deals" of the 1980s and the concept of the impaired liability.
3. What users face in dealing with off-balance-sheet liabilities.
4. Some observations about societal accounting.

If you looked and went through the accounting literature and go through the FASB's, you would observe a fixation by the accounting standard setters, perhaps an unconscious one, on the asset side of the balance sheet. When I went to school we all focused on the asset side. Let's look at some of the more recent topics addressed by recent FASB statements and projects:

Impairment of long-lived assets
Disclosures about derivatives
Sale leasebacks
Rules for not-for-profit organizations
Accounting for the impairment of a loan
Accounting for certain investments in debt and equity securities
Consolidations
Cash flow statements

Mostly asset driven. Now, compare that list with some of the recent topics related to the liability side of the balance sheet:

Accounting for income taxes
Accounting, for income taxes again (FAS 109 replacing FAS 96)
Employer's accounting for post-employment benefits

I could have scratched out a larger list on the liabilities, but the clear majority of the notable FASB projects deal with assets, not liabilities, and *certainly not ordinary liabilities.* FAS No. 5, often referred to as the seminal accounting rule for liabilities, was actually written primarily to address the accounting for loss contingencies, and never sought to address the entire universe of potential liabilities. As a matter of fact, FAS 5 had its origins in *denying* casualty insurance companies the ability to smooth income by setting up allowances for generations of potential future losses, not, as many believe, to establish when a liability *should be* booked.

I think we should flip the balance sheet upside down and place the higher priority on the liability side, especially as companies increase their debt, downsize, merge, and access capital in new forms. I don't look at the assets unless I get past the liabilities.

Leveraged Buyouts

Why? Well, let's look at this in some more detail. As I previously indicated, the 1980s witnessed the creation of debt unparalleled in our history. So much was created, in fact, that they had to invent new names for it. "Adjustable rate convertible subordinated debentures" was one you could at least understand. There were also COPs, CREMs, KIWI Bonds, Harmful Warrants, ICONs, JETs, RIPs, Sirens and Yelps, to name a few. But let's talk about debt created in a particularly notorious form of transaction for which the 1980s were infamous: the leveraged buyout, frequently called "junk bonds" (or politely referred to as "high yield debt instruments") such as junior debt, senior debt, and how about senior subordinated debt.

Clearly, the liability side of the balance sheet, not the asset side drove most of the mega-deals of the 1980s and their subsequent failures. Most of these failed businesses were the creations of leveraged buyout transactions (LBOs). Hindsight tells us that the amount of high yield debt placed by the underwriter was what drove the initial measurement of the assets purchased by the newly formed entity, rather than a direct measurement of the value of those assets based on their respective fair values. The theory was then, and still is, that assets acquired with newly issued debt and cash must be worth the sum of those amounts. Why would an investor commit hard dollars if the value wasn't there? And, of course, if tangible and intangible assets could not be identified, goodwill was the recipient of the difference.

You can see even in today's world how the debt side and the financing drives it. On the Chrysler deal, when Kerkorian made the bid with Iacocca last month for $20 billion, the issue was whether or not they could line up the financing side. It never got to the asset value and the deal fell through because they couldn't support their financing.

My view is that most of the problems of the 1980s occurred because so many transactions were overvalued. The cause of this over-valuation of LBOs initially was the valuation of the debt, not the assets! The assets were simply the recipients of the overvaluation.

During this period the FASB's Emerging Issues Task Force expended a vast amount of effort answering the question of whether the assets contributed to a Newco should initially be measured at their fair values or predecessor basis, a focus generated by the SECs long-standing rule set forth in SEC Accounting Series Release No. 8 and interpreted in their Staff Accounting Bulletin No. 48. These rules wisely demanded predecessor basis accounting for assets contributed to registrants, especially new registrants, by control persons. The SEC's idea, in short, was, if you want the increased net worth, you have to sell the asset and realize the gain to prove the asset was really worth it. The standard setters, in this instance the EITF, set up criteria for whether an LBO would result in a write-up of assets, in essence, whether the transaction was going to be treated as a purchase or as a pooling under which no revaluations would occur -- a variant on the SECs position. Contrary to the twelve rules of APBO 16, which had to be met in a pooling with another entity, the LBO rules focused on whether there was a change in control, not whether the value of the liabilities was determinable or whether amounts assigned to assets were reasonable. The reason was simple: there was only the company and its stockholders; no other corporate merger partner was in the deal. The theory here was that if enough new people bought in, the write-up of assets to their imputed values would be justified.

Rather than becoming concerned about asset write-ups, perhaps the standard setters of the day should have explored the question of whether there was enough earning power in the company on a go-forward basis to service these liabilities (the high yield debt instruments). When you step back and consider how the typical LBO came together, the assets and the debt seem to be mutually exclusive events: a bundle of assets and the issuance of high yield debt securities that were, in theory, priced in part by the perceived earnings capability of the assets, but, in reality, priced instead by the synergistic effects of a liquid market for similar instruments. If LBO company "A" priced its high yield (junk) debt instruments to yield 17 percent, shouldn't LBO company "B" at least do the same?

The more debt that could be raised to do a deal, the higher the price and the greater the chance that the amount paid was in excess of the fair value of tangible and identifiable intangibles. Accounting standards then and now lacked the discipline necessary to ferret out the extent to which the pricing effects of the high yield debt market escalated the value of the assets beyond reasonable levels. This inability to properly evaluate goodwill had the effect of allowing the underwriter to place additional debt securities, a vicious simultaneous equation. It was reasoned that goodwill had to be right, since it was just purchased. For example, if an S&L had a negative net worth of $500 million and it was acquired for $1 million (or even one dollar), ignoring slight adjustments to loans and deposits, roughly $500 million of goodwill was created to balance out.

Altogether, some $400 billion of LBOs were put together in the eighties. Many of them are just beginning to unravel. Today's LBO is called "platform investing" or "leveraged buildup." The concept builds off of buying overall companies and adding multiple smaller ones to get to critical size and increasing leverage simultaneously. While these years have passed, the scars made by LBOs linger on, and LBOs are back in different forms. LBOs were generally financed with 10 percent or less equity put up by limited partners and 90 percent by bank loans and subordinated debt. The subordinated debt frequently came from high yield or "junk" bonds floated by Drexel Burnham Lambert and others. The use of junk bonds in LBOs enabled dealmakers to bid up prices beyond reason.

In 1989, Kohlberg, Kravis & Roberts (KKR) became the undisputed king of the LBO market when it pulled off the takeover of RJR Nabisco in a $25 billion deal. A movie was even made about it. And recently, the *Wall Street Journal* described it as "the biggest buyout in corporate history' and as "a resounding flop for KKR and for dozens of institutional investors whose money they used." It's appropriate to discuss today.

Analysts say KKR got caught up in a frenzied takeover fight and paid too much for RJR at the peak of the eighties merger boom deal mania. The $25 billion price tag was roughly double what the stock had been trading at before the bidding war commenced. All but $1.4 billion of the purchase price was financed with debt. To put it another way, this $25 billion deal was accomplished primarily with "other people's money" -- less than 6 percent of equity and more than 94 percent of borrowings. This was typical of LBO capital structures in the 1986-1989 period. By 1991 they learned some lessons and the typical LBO capital structure included 20 percent of equity.

Let me give you other examples of the LBO merger problems:

1. Walter Industries, the former Jim Walter Corp., a construction products company, was bought by KKR in 1987 for more than $2.4 billion. It was forced into bankruptcy in 1989, largely because of junk bond problems and litigation over asbestos liabilities.
2. Seaman Furniture Co., a retailer, was bought by KKR in 1987 for $360 million. It went into bankruptcy in 1992.
3. In late 1986, Revco's former top officers spearheaded a $1.5 billion leveraged buyout of the company. The deal, much of it financed by junk bonds, saddled Revco with massive debt obligations just as earnings in its aging and far-flung store base went sour. Hampered by crushing debt payments, the company missed a $46 million payment deadline and filed for Chapter 11 protection in July 1988, despite the best efforts of a largely new slate of top managers.

AICPA Bankruptcy SOP

Maybe we learned something from the LBOs. Maybe the lesson was learned because by then, many of the LBOs had found their way into bankruptcy. Standard setters specifically did not want overvalued liabilities to drive the value of the assets. An accounting rule for bankruptcies issued by the AICPA in 1990, SOP 90-7, "Accounting by Entities in Reorganization Under the Bankruptcy Code," which was written by our national and New York offices, contains specific guidance for entities emerging from bankruptcy. Such entities, meeting certain tests, are required to use "fresh start accounting" by restating all assets and liabilities to their respective fair values like the LBOs. The rule is intended to prohibit the parties to the bankruptcy from ascribing dollar amounts to the various debt and equity instruments issued out of the bankruptcy and inferring those amounts to the value of the company as a whole, without discipline. Under the rule, companies required to use fresh start accounting must determine the go-forward (or reorganization) value of the company. This amount becomes the ceiling for the amount of debt and equity that can be issued by a company emerging from bankruptcy. It is a noble experiment. The jury is still out on whether preparers will honor the SOP 90-7 concepts.

Impaired Liabilities

What we've been talking about here, both in LBOs and bankruptcies, is that perhaps there is such a thing as an impaired liability. What is it? Perhaps an impaired liability is a liability that a company cannot fully service, whether an old debt or even -- an extreme idea -- a brand new liability. SOP 90-7 touches on the issue but perhaps it should be extended to the entire accounting model. This would likely provide additional safeguards against asset overvaluations. It would also ease the burden placed on the independent auditor to evaluate whether it is likely that the company will continue as a going concern for a reasonable period, if preparers had primary responsibility for such considerations. The notion of the impaired liability concept might well be a good first step in such a reallocation of responsibility. The impairment issue has been addressed on the asset side in the recently issued FASB Statement titled "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of."

Recourse vs. Non-Recourse Debt

When you look at the liability side, you just can't lump all liabilities together. There's a big difference between accounts payable, short-term debt, long-term debt, and debt with covenants and restrictions. I also think there's a difference between corporate recourse debt and non-recourse debt. In my industry -- the real estate industry -- a non-recourse loan is a loan where in the event of default, the lender cannot proceed against assets of the borrower other than the real estate collateralizing the loan. Such loans are also commonly referred to as in rem loans, loans where the borrower is exculpated or where the loan has an exculpatory clause. As is often said in the real estate industry, "a dollar borrowed is a dollar earned."

A recourse loan is one under which a default permits the lender to proceed against other assets of the borrower as well as the real estate. The problem is that accounting does not currently give adequate attention to the significant difference in the legal attributes of the two kinds of loans.

The non-recourse attribute can be viewed as a borrower's put option embedded in the loan. At the time the loan is made, the lender has agreed to limit its recourse to the value of the underlying collateral. If the borrower defaults, the lender takes the asset. If the fair value of the asset is less than the carrying amount of the loan, the lender suffers a loss equal to the amount of the deficiency in the value of the collateral.

If there is a limitation on the non-recourse or exculpated debt, should there be any consideration of netting when the company has the obligation and responsibility to keep servicing the debt, but it's within their corporate control as to when they can stop and just let the asset go without causing any economic harm to the company? Something to consider as we evaluate the liability side.

Floating Rate vs. Fixed Rate Debt

Recourse/non-recourse is one issue. Companies must be able to manage their exposures to risk. A company also exposes itself to different risk characteristics when it chooses between a fixed interest rate or a floating interest rate on borrowed money. The question: Does our accounting model adequately inform readers (either through footnote disclosure or balance sheet recognition) about the impact of the liability risks when a company's borrowing rates fluctuate as interest rates change? Analysts for the real estate industry put the REITs on a "watch list" and downgrade them when they have excessive amounts of floating rate debt. Does the accounting profession have to respond? I think so.

Off-Balance-Sheet Liabilities and the Rating Agencies

Now, let's move to the so-called "off-balance-sheet" liability. Most users and the government search for off-balance-sheet liability strategies. Such liabilities are not recognized in the financial statements because the current definition of liability does not require their recognition. This can also be a contingent liability that is not recognized because (1) it's either too early to tell whether it is probable that a future event will confirm that an existing condition has either created a liability or impaired an asset or (2) the amount of the contingency is not reasonably estimable.

The existence of off-balance-sheet liabilities frustrates many users. Rating agencies, for example, perform in-depth analyses of corporations attempting to issue a variety of short- and long-term financial obligations, from bonded indebtedness to preferred stock. Per *Standard & Poor's Debt Ratings Criteria: Industrial Overview*, there are a number of off-balance-sheet items it factors into its leverage analysis of a company. These items include:

> Operating leases
> Pension obligations
> Debt of joint ventures and unconsolidated subsidiaries
> Guarantees
> Take-or-pay contracts and obligations under throughput and deficiency agreements
> Receivables that have been factored or sold with recourse
> Potential legal judgments or settlements of lawsuits
> Contingent liabilities (especially environmental cleanup liabilities)

A rating agency such as Standard & Poor's must take into consideration all of these items when determining the magnitude of a company's liabilities. Although various FASB Statements require disclosure of the existence of several of these off-balance-sheet liabilities, disclosure is obviously not as helpful as full recognition and measurement.

Talking about off-balance-sheet items, let's discuss some of the so-called "soft" liabilities we encounter, which are the result of loss contingencies. Some good examples are environmental remediation liabilities, certain pension obligations, and legal claims. Estimates of the total obligation to remediate environmentally contaminated sites approximate the total amount invested in mutual funds. To date, companies have resisted recognition of these environmental remediation obligations. Accounting standard setters have also avoided offering explicit guidance on the recognition and measurement question. The AlCPA's Accounting Standards Executive Committee will issue an exposure draft that, for the first time, offers explicit recognition, measurement, and disclosure guidance for companies that have been motivated by law to remediate an environmentally contaminated site. This issue is not just an accounting issue but a societal issue that affects our quality of life.

Societal Accounting

This leads me to my final topic -- distinctly different but containing similar issues that cause many well-meaning corporations to ignore what they might otherwise be inclined to do to help society. Our current accounting model provides disincentives to those companies that might otherwise be socially responsible; further, it fails to properly measure such efforts. This occurs because most costs of either complying with environmental requirements and voluntarily initiating remediation or contributing to society in any form are charged to income as incurred and are not treated as an investment. The corporation is in a bind: if it does good work, its earnings suffer; if it does not, they improve.

What a responsible corporate entity ought to be doing, but is not doing, is characterized in a new theory. That is a "stakeholder theory," which asserts that companies should attend to or be responsive to the needs of their many constituents (e.g., investors, creditors, consumers, and employees). In a recent annual report, Ben " Jerry's prominently disclosed its Statement of Mission, which consists of three interrelated parts: Product, Economic, and Social.

> Social Mission: To operate the company in a way that actively recognizes the central role that business plays in the structure of society by initiating innovative ways to improve the quality of life of a broad community -- local, national, and international.
>
> The best way for us to be financially successful and be pioneers of a new role for business in the community is to hold fast to our commitment to this dual mission.... Business must assume a greater share of responsibility for the health of our society.
>
> We believe that success on these fronts (improving the quality of life in our community) is the best way to increase shareholder value.

Results of a study by Bernadette Ruf et al. indicate that corporate social performance has a statistically significant positive relationship with concurrent and future growth in sales, return on sales, and return on equity. A significant finding: Companies experienced a 2 percent annual sales increase that was directly related to changes in corporate social performance. Seventy-five percent of U.S. consumers include environmentalism in their shopping decisions.

By meeting the needs of all stakeholders, this theory contends, in the long run, shareholders' wealth will be maximized. I believe this.

Consider for a moment the Exxon Valdez accident. The spill resulted in a net loss of $850 million. Because of legislation and public expectation, Exxon assumed financial responsibility for the Valdez damage, which fifty years ago might have been ignored. How are we accounting for this implied social cost? Should there have been an accrual for the Exxon Valdez accident?

After the 1984 Union Carbide chemical leak in Bhopal, India, all companies within the chemical industry experienced a negative market reaction. However, firms with more extensive environmental disclosures prior to the accident experienced less negative market impact than companies with less disclosures.

Another example: In 1989, Dexter Corp. disclosed in its 10K (but not its annual report) that it faced possible environmental problems. The impression conveyed was that the trouble was minor when in fact the company eventually accrued a $9.1 million charge to earnings, driving its EPS down by almost 50 percent.

Resistance by the accounting profession to develop social disclosure requirements has largely been due to the difficulty in arriving at a consensus on which social issues are of importance to warrant the additional cost companies will have to take on as a result of producing such information. For example, what's of greater importance -- crime, children, education, or the environment and quality of life?

A New Accounting Model

I would like to leave an accounting legacy to my grandchildren and subsequent generations, a legacy in the form of an accounting model that appropriately measures the contributions (both positive and negative) that corporations make to the quality of life. As I've stated, the empirical research demonstrates that the decision-making process of consumers and investors is influenced in part by a corporation's societal behavior. I believe we need to modify our existing accounting model to aid this decision process by producing relevant information to further enhance and provide a measure of consistency to this "societal impact" decision process. I believe that such a model, when integrated with the accounting for liabilities that I have suggested, would result in an over-all model with the capacity to produce information about our existing resources and financial capabilities, thereby enhancing the process of allocating scarce resources in a more efficient manner and helping society to live within its means. Hopefully, such an information set will foster a market that will not over- or underindulge itself, to the detriment of future generations.

I hope I have now convinced you that liabilities can be harmful to your health and are more important than many have previously considered. Thank you.

QUESTIONS AND ANSWERS

Question:
I understand that you are saying you can't pay or repay the debt, get it off the books; am I correct? I think there's been a history in the eighties of getting debt off the books and it often took the form of buying it back or having various redemptions at smaller amounts than the carrying amount, and when we say get it off the books, it resulted in gains.

Answer:
Well, I spent a lot of my time in the last decade getting debt off the books. We have done a few reorganizations and restructures and taking companies through bankruptcy. And, you know, my concern is, you're right. When we take it off the books, what happens is we have a gain, cancellation of debt or an extinguishment of debt or a purchasing of debt at a discount, or in some cases we have a write-down on the asset side and they both take place concurrently. My concern is, I would like to move the calendar back a little bit. I believe when the debt is put on the books, the asset side and the liability side both have to be looked at. And my further concern is that we need a disclosure with respect to a company's ability to service its debt. My belief is that there is a lot of debt that is put on the books that I call "impaired debt," where a company has an existing debt load. It meets the going concern; it clearly is a going concern. But over a longer-term period, its inability to service its debt will either cause it to go under or cause it to go through a reorganization and restructure and then have a write-down of assets.