FINDING A CURE FOR ENRONITIS

THE COLLAPSE OF ENRON HAS SPURRED THE US ACCOUNTING COMMUNITY TO TOUGHEN FINANCIAL REPORTING, BUT WHAT'S IN IT FOR TREASURERS? **JOSEPH NEU** OFFERS THIS.

Attempts to re-establish confidence in financial reporting, after a string of confidence eroding 'incidents' (starting with Enron), is the most important corporate finance trend coming out of the US right now. In response, some outside the US have pointed to inadequacies in US accounting, including the rigid rules versus concept orientation of our generally accepted accounting principles (GAAP). Accounting in the UK, in Europe, or elsewhere, including that under the International Accounting Standards Board's IASs may be arguably better, or worse, in comparison. But the varying nuances are not really at issue. What is needed to rebuild confidence is a direct tying of performance to tangible measures, of which cashflow is the most recognisable.

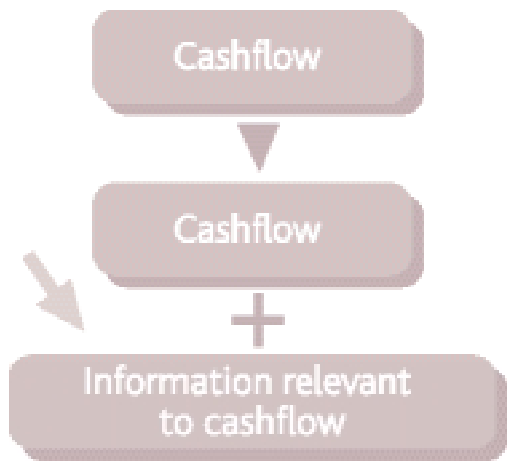
An equally valid reason to focus on cash at the moment is the increasing need for liquidity, which, until a short time ago, was probably not considered to be significant exposure for most multinational firms. In the current environment, where balance sheets, income statements, and even cashflow statements are suspect, any company must consider the consequences of an unanticipated rating downgrade and/or the inability to rollover short-term paper or renew a revolver. What's become clear in the wake of Enron is how vulnerable companies can be to 'runs,' where creditors and investors pull out their funds in response to some 'trigger,' real or imagined (see box on page 56). Against a backdrop of tight profitability, coming out of a recession, the ability to make the most of internal cashflow is key.

This is particularly true of companies that have overly subscribed to new economy tenets of becoming virtual, shedding real assets in favour of leveraging intellectual capital. US Federal Reserve Chairman Alan Greenspan spoke to this point in his Congressional testimony last February: "As the recent events surrounding Enron have highlighted, a firm is inherently fragile if its value added emanates more from conceptual as distinct from physical assets. A physical asset, whether an office building or an automotive assembly plant, has the capability of producing goods, even if the reputation of the managers of such facilities falls under a cloud. The rapidity of Enron's decline is an effective illustration of the vulnerability of a firm whose market value largely rests on capitalised reputation. Trust and reputation can vanish overnight. A factory cannot."

This dual focus on cash should have profound consequences for treasurers around the world. On the one hand, it places more pressure on them to perform in their role of managing cash and liquidity – as part of their core treasury mandate. More importantly, however, it offers them an opportunity to expand upon their mandate: to assume responsibility for cash-based reporting and communicating efforts to maintain financial flexibility to shore up perceptions of adequate liquidity. This is what we now call the treasurer's new financial reporting mandate.

STEPS TOWARD THE NEW MANDATE. One of the most important, and potentially overlooked, aspects of cash management is the information that can be gleaned from the cashflow. This aspect of cash management is tailor-made for the current business climate. It is also why treasurers, who've always known why cash is king, should now be part of the broader mandate to build confidence in the

FIGURE 1
INFORMATION IS WHAT'S IMPORTANT.



THE CLASSIC 'BANK RUN' NOW A CORPORATE REALITY.

As more and more companies choose to run their internal treasury operations as something akin to an in-house bank, they must face some of what used to be bank-only problems.

In particular, as the Enron case illustrated, non-banks are no longer immune to the classic bank run, as pressures in one investor community reverberate throughout the maze of contracts and cross-guarantees eventually creating a domino effect of lowering credit qualify and cash-call demands.

While Enron was a case study in excess in many ways, the risk of similar bank runs is not limited to sheer excess. Many companies today rely on structures not unlike the ones Enron utilised, which contain embedded "triggers" related to both equity and debt levels and can be activated to similar ends.

In the wake of Enron, there will be extra visibility afforded to these triggers. Already, new 10-Ks annual reports voluntarily report some of these. More to the point, disclosure rules will likely require that companies spell out the debt and equity-level triggers that could activate cash calls by banks and other creditors, just as liquidity options (including commercial paper and revolvers) are becoming more scarce.

Hence, this domino effect has shifted from the theoretical sphere into daily reality, and it is one treasury will need to watch and manage very carefully.

Speaking at a EuroFinance conference in March, Daniel Gates, a Senior Vice President with Moody's, said the agency, too, is looking more closely at such triggers to assess what might happen to a company if the rating agency decides to downgrade its debt. More recently, Standard & Poor's has named 30 or so US companies which have critical downgrading-triggers in their debt or financing covenants.

What can treasuries do? Aside from identifying the triggers and running simulations to see how they would react in times of liquidity stress, the key is to manage liquidity with that "trigger risk" in mind.

"You should always have a contingency plan," warns Mark Gibbens, Assistant Treasurer at Lucent, which throughout 2000 worked hard to fend off a massive cashflow squeeze and negotiated a $4bn revolving credit line while its basic business was eating up more cash than it was generating. Treasurers take note.

quality of their firm's performance through better reporting of cash-related information.

In so doing, treasurers can also add to their strategic value by assisting chief financial officers with what McKinsey consultants Timothy Koller and Jonathan Peacock have identified[1] as a traditional role – as guardian and leader of good planning and performance management – which "has lapsed into neglect". Here's how.

Start with a direct approach. More and more analysts, it seems, are asking for a direct method accounting of cashflow. This is corroborated by the US Financial Accounting Standards Boards' (FASB) recent work on a proposed project on financial performance reporting. In a summary of its interviews with financial statement users, the FASB noted: "Many, if not most, users prefer a statement of cashflows that reports operating cashflows under the direct method – that is, clearly discloses amounts for items such as cash

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paid to suppliers and employees and cash collected from customers." For treasurers, making such financial reporting a direct output of their cash management system will ingrain better cash utilisation into their firm's performance measurement.

Tie it to value creation. Whole books have been written on the subject of value reporting and all its potential nuances.

The revolution promoted by PricewaterhouseCoopers in its book[2] (co-authored by new FASB chairman Robert Herz) calls for "managers to adopt a philosophy of complete transparency – to report information to the market on all the measures they use internally to manage."

Of course, this methodology implies that companies need to first figure out what drives value in their business, then work through the risk/tax strategies to preserve that value – and finally communicate those values to their shareholders (without revealing too much to competitors).

Yet, as the McKinsey consultants note: "It is surprising how many executives don't know exactly how their business units create value (by such measures as profits and cashflow)." Instead, they may be focused on applying the measures of the day, such as economic profit, balanced scorecard and the like, which can provide a misleading picture of value creation, if applied inappropriately, when compared to cash.

Cashflow alone, however, is not a silver bullet. The McKinsey consultants cite the story of a successful business unit of a leading consumer packaged-goods firms. The unit reported substantial operating-profit growth year after year. However, it achieved this growth by raising prices, which allowed competitors to win market share and undercut its ability to continue to grow. This example underscores the importance of putting cashflows in context, so as to identify the sustainability (or quality) of cashflow growth.

Therefore, treasurers need to reinvigorate their dialogue with operating managers if they are to add value to a cash-oriented performance-reporting mandate. On a practical level, they have to sort out where they can add incremental value by injecting cash awareness into the business operations and where they can receive value by increasing their understanding of other value measures which might influence cashflows further down the road.

FOCUS ON THE FUTURE. The greatest value in cash-related performance measures is their forward-looking ability (as opposed to the backward looking view of most traditional accounting measures). The textbook value of a firm, after all, is the discounted value of its future cashflows.

According to the FASB interviews: "Information useful in forecasting future cashflows is most important to both equity and credit analysts, therefore, information with predictive value is highly relevant. Forecast periods sometimes go out to 10 years, but the next two to three years are critical."

'MCMAHON'S STORY SHOULD SERVE AS WARNING TO TREASURERS THAT THE PROFESSIONAL VALUE TO BE DERIVED FROM THIS NEW REPORTING MANDATE DEPENDS ON HOW WELL THEY FULFILL IT NOW'

Unfortunately, as every treasurer knows, cashflow forecasts tend to be inaccurate and this inaccuracy increases the further out they go. For any cash-oriented reporting model to prove successful, treasurers will have to solve the perennial problem of cash forecasting inaccuracies.

HIGHLIGHT LIQUIDITY AND FLEXIBILITY. Liquidity helps establish certainty, whatever the context, which is why treasurers are becoming more adept at highlighting current liquidity and communicating their firm's flexibility to add liquidity in the future. Part of today's liquidity management is to show the market both how liquid you are and how liquid you can remain. As the FASB interviews reveal: "Analysts providing credit ratings have a high interest in information about a company's financial flexibility, liquidity, and its ability to meet its obligations, including contingent liabilities – guarantees and so-called off-balance sheet obligations."

Recent variability in ratings has spurred treasurers to be proactive in communicating information about these underlying variables in support of their credit standing (as opposed to the best possible rating). This is true in Europe, as well. A presentation at April's UK Treasurers Conference by food and beverage concern Diageo's Treasurer, Robert Moore, drew much interest in the analytic framework Diageo uses to balance the linear benefit curve of tax shields with the non-linear risks of financial distress and the loss of financing flexibility incurred with increased leverage.

Diageo has used this framework to optimise its capital structure in anticipation of some $10bn in excess cash to be generated from its sale of Pillsbury and the announced separation of Burger King. Rather than support the best rating possible, treasury's analysis suggested a middle path of targeting a single A rating and A1/P1 short term by returning some of the cash to shareholders, but leaving a reserve of five to eight times interest cover. In part, this decision was made in the name of financial flexibility to keep Diageo's access to the US commercial paper (CP) market.

Growing involvement with investor relations. Due to their role in debt, as well as cash management, treasurers have traditionally been a logical interface for credit analysts (both to the rating agencies and at fund managers) – and increasingly with equity analysts looking for warning signals.

A year ago, *Euromoney* quoted a bond fund manger lamenting how fixed-income managers and credit analysts get short-changed: "For one thing," he said, "we usually get to see the treasurer, whereas equity investors get the CEO and the CFO." The implication, of course, is that treasurers are not only less important, but deliver too narrow a view on a company's earnings outlook to satisfy debt holders.

This is a sad commentary on how much fixed-income fund managers respect treasurers. Yet it presents treasurers with an opportunity to improve the nature of their dialogue with debt holders and credit analysts. Chances are these analysts will be more receptive to a 'narrow' (aka reality-based) view on a company's earnings outlook than they were a year ago.

A growing number of treasurers are involved in general investor relations (IR) activities (and on the equity side, too) – if nothing else, to help clarify technical questions that affect earnings per share estimates and cashflow. Treasurers should take this role seriously. It used to be that treasurers could make their entire careers on their ability to finesse the rating agencies. These closed-door sessions are still important, but, increasingly, debt holders are relying on information apart from formal ratings. Treasurers need a plan on how best to provide such information and what information to provide – before fund managers find a reason to stop 'taking up' their debt and/or crater their stock.

GUARDIANS OF ACCESS TO CAPITAL MARKETS. Ultimately, the new financial reporting mandate offers treasurers an opportunity to expand their role as guardians of their firms' access to capital markets. The fund manager quoted in *Euromoney* wanted to hear from the CEO, but it is rarely in the company's interest to have the CEO speak in the context of liquidity concerns. Better that the treasurer impress analysts (and fund managers) by 'inviting' the CEO to speak to them about a treasury supported, cash-oriented financial reporting scheme.

The treasurer's ability to build a case for financial stability and creditworthiness is also why treasury backgrounds are increasingly viewed as important for executives of firms in distress. In part, this is why Enron made Jeff McMahon, its former Treasurer, CFO and later President and COO in the wake of its debacle.

Yet, McMahon's 'past' with credit analysts came back to haunt him, and he has been forced to resign. It was his presentation to Standard & Poor's, where he claimed all of the SPE debt had no recourse to Enron, that was highlighted in the rating agency's Congressional testimony as a prime example of how it had been misled in its rating guidance by company officers.

McMahon's story should serve as warning to treasurers that the professional value to be derived from this new reporting mandate depends on how well they fulfill it now.

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Notes

[1] "Time for CFOs to step up," The McKinsey Quarterly, 2002 Number

[2] *The ValueReporting™ Revolution*, Robert G. Eccles et al. 2001: John Wiley & Sons