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Penn West, WorldCom: The warning signs we may have missed

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Describe the accounting problems Penn West Petroleum Ltd. disclosed last week to those who follow financial shenanigans, and one name quickly comes up: WorldCom.

It is not, it should be said, because top executives of WorldCom ultimately went to prison and the company became, at the time, the largest bankruptcy in history. There is no determination in any court, at this early stage, that there has been wrongdoing at Penn West. And the company, despite a significant debt load, seems able to meet its obligations. (Penn West declined to comment for this article.)

Instead, the comparison comes because of the kind of “accounting practices,” as Penn West called them in a lengthy July 29 disclosure, that shifted nearly \$400-million in costs from 2013 and 2012 away from operating expenses and into areas such as capital expenditures and royalty payments. Similarly, the key accounting issue at WorldCom was an attempt to reclassify expenses to make operating numbers look better.

“All the irregularities that have been identified all served to inflate key metrics that investors use to evaluate the performance of an energy company,” says **Anthony Scilipoti**, CEO of accounting-focused firm **Veritas Investment Research**. He says Penn West’s operating cash flow and its netbacks, a measure of the profitability of one unit of oil, were enhanced by the accounting choices. “That is very troubling.”

Mr. Scilipoti is particularly disturbed by the classification of operating expenses as royalties because it would seem to be difficult to make inadvertent errors in that accounting. “Royalties are paid to a partner or the government. Generally, it’s pretty clear what the amount is and what it’s for.”

Penn West’s accounting “is like what happened at both WorldCom and HealthSouth,” says Lynn Turner, who served as chief accountant of the U.S. Securities and Exchange Commission in the waning days of the Bill Clinton administration and has been a critic of companies’ financial reporting ever since. “They took things that should have been expensed in the profit-and-loss statement that would have driven their income lower and instead threw it up as an asset on the balance sheet when, in fact, it didn’t really exist. That allows them to make the company look better.”

Since WorldCom, investors have commonly been told to be skeptical of companies that easily outclass their peers in certain financial metrics. It was said that other telecommunications companies wondered how WorldCom achieved such sterling operating margins – until it was revealed WorldCom hadn’t really done it all.

In Penn West’s case, however, that red flag didn’t exist. When the company issues its restated financials for 2012 and 2013, it will make a bad performer look even worse, says analyst Robert Bellinski of Morningstar. “Penn West continually suffered from high costs,” he says. “While the restatements will just reclassify the expense, and therefore should be neutral from a cash flow

perspective, they will load more of the cost into lease operating expenses, which is critical for comparisons versus peers.”

Analyst Jeremy McCrea of AltaCorp. figures that, based on Penn West’s recent disclosure, overall operating costs should have come in at about \$20.65 per barrel-of-oil-equivalent in 2012, versus the reported \$17.25/boe. For 2013, he figures the correct number at about \$20.75/boe versus the reported \$17.30/boe. In both years, then, Penn West understated operating expenses by about 16 per cent.

It could be said that there were other warning signs about an investment in Penn West:

- Some analysts have questioned the amount of goodwill on its balance sheet for some time. Goodwill is an asset created when one company buys another for more than the fair value of its assets. When those purchased assets can no longer be expected to deliver the cash flow necessary to support the goodwill, a writedown should occur. While a writedown is non-cash, it affects a company’s leverage and serves as a dramatic statement that past acquisitions have failed.

Penn West wrote down \$48-million of goodwill in 2013’s fourth quarter. Mr. Bellinski argued last October that Penn West should write off its entire \$2-billion goodwill balance. He says that in discussions with the company, he learned Penn West said the value of its contingent resources, in addition to its proven reserves, meant goodwill was not impaired. Mr. Bellinski then calculated that Penn West’s argument implied a value for its contingent resources of well over \$3 per barrel, even though data from Penn West’s principal play, Cardium, suggested values of less than \$2, he said.

- Penn West continues to face allegations in an investor lawsuit that it manipulated stock options to benefit company insiders. The lawsuit cites the opinion of Erik Lie, a professor of finance at the Tippie College of Business at the University of Iowa, that 15 of Penn West’s 27 option grants between 1993 and 2010 featured strike prices at a low point compared with 20 subsequent trading days. Mr. Lie calculated the probability of this pattern occurring randomly as one in about 5,000. Penn West declined to comment because the case is before the courts.
- Penn West’s disclosure of the departure of chief financial officer Todd Takeyasu on March 24 lacked detail. It said merely that he was “stepping down from the role” that day, with no continuing role at the company or no new job.

Penn West’s July 29 announcement said the accounting practices “came to the attention of the company’s new senior vice-president and chief financial officer, David Dyck, who assumed that position on May 1.”

In an interview with The Globe and Mail July 29, Mr. Takeyasu said the concerns of Penn West’s audit committee could be a result of different interpretations of accounting methods, and new board members and executive officers may have a “will to do things slightly differently.”

“Some of this stuff is grey, but I’m probably not at liberty to say much. Some of that is possibly a matter of documentation,” he said. Mr. Takeyasu declined a request Aug. 6 to speak again.

Says Mr. Turner, the former SEC official: “You bring in a new CEO, and a year later, the CFO goes, the question becomes: Why did he go, and was there a reason the CEO knew about but wasn’t transparent with respect to? Did we have a situation where the CEO wasn’t comfortable and said, ‘You’ve got to go, I’m going to bring my own CFO in.’ There are a lot of unanswered questions here, probably more that have been raised than have been answered.”

Indeed, the matter will continue. Penn West says it is currently reviewing 2014’s first quarter, as well as the full years of 2011 and 2010, because it believes the “accounting practices” to have existed in years prior to 2012. The company says it “currently believes” that the remaining accounting practices

it's reviewing "are quantitatively less significant" to the previous financial statements. It has not said they are not material, or small, however.

"It reflects very poorly on the governance of the company, the integrity of management, and on the ability of the company itself to generate reliable data on which to base investment decisions," Mr. Turner says.

"I don't think it's over," **Mr. Scilipoti** says. "It's kind of like the cockroach theory," which suggests seeing one cockroach is usually evidence that there are many more that remain hidden. "But I do believe that as long as the oil is still in the ground, the value of the company didn't change, except we now know it cost them more to get it out of the ground than we thought it did."