Auction-Rate Securities Under Fire

Amid Pressure, Companies Stop Grouping Investments As Cash or Its Equivalent

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NEW YORK—One of corporate America's most popular cash-management tools is being called into question.

Under pressure from the Big Four accounting firms, U.S. companies have been correcting the way they account for investments in so-called auction-rate securities, long-term bonds and preferred stocks that appear more like short-term instruments because their interest rates are reset at periodic auctions.

The market for auction-rate securities has ballooned in recent years amid low interest rates as investors look for short-term investments that offer better yields than Treasury bills, certificates of deposit or money-market funds. Issuers, who enjoy the ability to raise long-term money at short-term rates and retain the right to change the reset frequency, range from corporations to mutual funds, municipalities and student-loan agencies.

Many corporate investors have treated these securities as cash or cash equivalents on their balance sheets. But in recent weeks, accounting firms have been advising their clients that, in most cases, this classification is inappropriate.

In a memo published in late February, **PricewaterhouseCoopers** warned clients that while auction-rate securities act like short-term securities in some ways, there is one important distinction: investors rely on the broker-dealers who conduct the auctions to provide liquidity, rather than the issuers themselves.

That means that, in the event an auction fails, existing investors are left holding their securities until the next auction, with no access to their funds.

"The legal maturity of auction-rate securities is 20 to 30 years and, as such, the securities ordinarily should not be classified as cash equivalents, but rather as investments," PricewaterhouseCoopers says in the memo. It says the three other major accounting firms, **Ernst & Young, Deloitte & Touche** and **KPMG**, hold similar views, although some have only recently come to their current position.

As a result, there has been a flurry of statements from companies including **PetsMart** Inc., **Network Appliances** Inc., **Citrix Systems** Inc., **Geac Computer** Corp. and **JetBlue Airways** Corp. which have reclassified or plan to reclassify auction-rate securities as short-term investments.

It isn't entirely clear how auction-rate securities emerged as a hot-button issue, or why some auditors have allowed their clients to classify the securities as cash equivalents for so long.

But the move to reclassify the securities comes amid greater scrutiny of how companies apply existing accounting rules in the wake of corporate scandals such as those at former energy giant Enron Corp. and WorldCom Inc., which recently emerged from bankruptcy protection as MCI Inc. Indeed, some companies that are correcting their method of accounting for auction-rate securities also are correcting their accounting for other items such as leases.

Moreover, the market for auction-rate securities itself has attracted regulatory scrutiny. Last year, the Securities and Exchange Commission said it was looking into the possibility that some brokers who run the auctions may have tipped their clients to other investors' bids.

Reclassifying auction-rate securities doesn't affect a company's cash flow. But it could result in technical default for some companies with loan covenants that require them to maintain certain current ratios, or assets divided by liabilities. That could make auction-rate securities less attractive as cash-management tools for many corporate investors who also are borrowers.

The attention generated by the accounting issue also has highlighted the relative risk of holding auction-rate securities as opposed to other instruments that are truly short-term in nature. "Often times, when people are reaching for yield, headline risk falls by the wayside," said Zak Green, vice president of institutional sales at The Reserve Funds, a New York money-market fund manager and cash-management consultant. Mr. Green said the firm has received a number of inquiries about auction-rate securities in the wake of the crackdown by auditors, and some of its Fortune 100 clients have been switching more money into its money-market funds.

Some companies still are big fans: PetsMart Chief Financial Officer Tim Kullman says he likes the fact that the securities allow him to lock in a relatively high rate of return on cash for as long as 13 months. And since the company isn't a borrower, the geography of its balance sheet isn't so important, he says.

PetsMart said earlier this month that it plans to reclassify as investments $314 million in auction-rate securities that historically would have been classified as cash and cash equivalents. As of Oct. 31, the company had $346 million classified as cash or cash equivalents.

Mr. Kullman is skeptical that there will be wholesale selling of auction-rate securities by other corporate investors. "If anything, we've seen more activity in the marketplace" over the past few weeks, he said. "I don't think that equates to less stability."

But even if auction-rate securities retain their popularity as a cash-management tool, corporations are likely to demand higher yields to compensate for the additional risk they now realize they are taking on. "The market will adjust," said Joseph Fichera, founder and chief executive of Saber Partners LLC, a New York financial adviser to corporations and municipalities. "The auction mechanism is designed to reflect, in the dividend or interest rates, all market developments. In the absence of manipulation, it's a responsive security."