"A CASE OF BALANCE SHEET GEOGRAPHY": A VIEW OF ACCOUNTING PRACTICES DEPLOYED BY BRITISH NUCLEAR FUELS plc

by

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In a recent finding of The Financial Reporting Review Panel, concerning profit overstatement in the accounts of a relatively minor quoted plc, Panel Chairman Richard Sykes is reported as opining that: "Investors and all those with an interest in a company must be able to rely on its published accounts". In a response to the finding, the plc Chief Executive produced a novel even sublime explanation of the position: "..impropriety was not involved but a question of balance sheet geography". Indeed, the principle appeared to be the underlying concern of The Panel, as the level of quantum was, apparently, in the range of £70M covering a five year period, with profits booked in advance of the event.

In the case of BNFL, the question of possible profit and balance sheet overstatement may fall in the area of £3,000M - considering the range and nature of policies deployed by the Group. Naturally, this is only an opinion of the author as BNFL's accounts have been fully audited in accordance with the requirements of The Companies Act 1985. Whatever, "balance sheet geography" is most certainly a factor in play.

One cannot begin to understand the corporate BNFL and its problems without some grasp of the financial base upon which the nuclear industry, as a whole, was founded. The best exposition of such demonstrated in the television documentary "Pandora's Box", wherein a very senior civil servant, intimately involved in the formative years of the commercial industry, admitted that the financial projections upon which crucial decisions were taken were entirely fallacious. He went on to further state, the position was known at the time, but no one was prepared to openly admit to the same. That state of affairs may well be the cause of the revealing statement by former Secretary of State for Energy, Anthony Wedgwood-Benn, in his "tape diaries": "..you cannot believe a word they (nuclear industry) tell you ...".

In the case of BNFL, it is a matter of record that there exists an history of the Group obtaining approval for projects at one level of costs, only to disclose, at a later date, an entirely higher cost profile. The THORP reprocessing plant and the currently contentious Sellafield MOX Plant being prime examples of the genre. In respect of the latter, built speculatively, BNFL's projections exclude the capital cost of the plant in arriving at its profit forecasts for the same. Current BNFL Chairman, Hugh Collum, is on record as acknowledging the deficiencies inherent in his Group's forecasting ability.

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It is surely a foregone conclusion, that if projects are floated on the basis of deliberately understated, or, deliberately overoptimistic, cost and earnings profiles, then there can only ensue profit & loss account and balance sheet chaos and so it has been with BNFL. Further, such must be the stress generated within the organisation that even client relations may suffer as a result of any earnings shortfalls. That is, even now, manifesting itself within BNFL. When one adds to this potent brew: Government departmental politics (D.Engy/DTI - DETR - Treasury); a lax and leaky BNFL treasury; poor project management; and, vast sums taken on-account from Clients; there exists a recipe for ultimate disaster. It must be added, let alone the issues relating to long-term nuclear liabilities.

BNFL's incorporation came about, as a result of the 1971 Atomic Energy Act, on April Fool's Day of that year. Its assets extended to some out-of-date plants in Cumbria, Lancashire and Cheshire, as also power generating stations in Cumbria and Dumfriesshire. The Company was valued at circa £21M, with some 17,668,000 shares issued to the U.K. Atomic Energy Authority, from whose womb BNFL had sprung, in respect of the same. Part-privatisation was the intention from the very outset, with a trade-sale of 49% of the equity envisaged, that to mitigate the cost to The Treasury of the necessary plant modernisation and Company expansion plans. To-date, no one has been able to bring such aspiration to fruition, notwithstanding that it has been a recurring theme over the years. It later became the position that all but one of the shares in issue were vested in the personage of the appropriate Secretary of State, currently for Industry, whom, under Section 741 of The Companies 1985, is held to be a Shadow Director of the Company.

BNFL's first accounts had Fixed Tangible Assets of £23M and Nett Assets of œ21M, with Pre-tax Profits at œ6M against a Turnover of £64m. By 1977, the respective figures were: £70M; £51M; £8M; and £128M. It was against that background that BNFL was to embark upon a multi-billion capital programme, covering: the reconstruction of existing capital plant; new capital plant ventures, principally THORP; and, the provision of prestigious office accommodation.

Other than a two tranche further share issue, raising £15M cash from The Treasury, Government have invested no further capital in the BNFL business, though they did guarantee certain loans and BNFL did have the benefit of Regional Development Grants available to it - as would any other industrial company of the period. In exchange for this munificence The Treasury exacted a heavy price from BNFL, such by way of a formal agreement that the Company would pay regular annual dividends into the Consolidated Fund, plus whatever Corporation Tax might fall due - in effect a double dividend. It might be construed, that had BNFL not acquiesced to this arm-twisting, they would have been threatened with a withdrawal of support for THORP.

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The dividend and taxation profile indicates that The Treasury have used BNFL as a milch cow, on occasions having milked the animal dry. In addition, The Treasury has ensured that full provision has been made for them to extract substantial Deferred Taxation from BNFL - that is, if the cash is ever available so to do. Clearly, a company can only cover a dividend if it is making a profit, unfortunately in this instance, almost immediately upon the formal agreement on the matter, BNFL ran into a loss-making position. At which point, in order to mask the situation, BNFL ventured upon a de facto irreversible accounting policy, they began capitalising their general costs - thereby converting annual losses into annual profits. In addition, of course, there also arose a betterment to the Company balance sheet. A double benefit at a single stroke. The principle of such capitalisation is not at issue, but the quantum thereof is certainly open to question. Moreover, for each and every year since the policy was adopted, with only minor qualified exceptions, but for the said capitalisations BNFL would have posted a pre-tax loss.

As at the 31st. March 2000, the aggregate of general cost capitalisations stands at £2,837M, covering the period from 1982-83. Had the monies in fact been capitalised and then depreciated in line with BNFL's apparent applied levels thereof, some £1,500M of such capitalisation will still remain within the Company balance sheet. The level of capitalisation constitutes a 50% add-on to the otherwise cost of capital plant. But for the general cost capitalisations, not only would BNFL have been shown to be unprofitable, but, it would also have been shown to be hopelessly insolvent. The 50% add-on level may fall to be a matter of opinion as to its validity, it may be assumed

therefore, that BNFL have convinced their auditors, and Board Audit Committee, that a 50% on-cost is appropriate. To place a somewhat different perspective upon the matter, BNFL have capitalised: every third toilet roll used within the Company; every third cup of beverage consumed; every third glass of whatever might be imbibed at their renowned soirees and people persuading functions; and so on - that is the ultimate effect of the adopted capitalisation policy.

This and other matters of consequence have been raised both formally and informally. In respect of the capitalisation policy BNFL stand-firm but refuse to explain, or give proof, as to the basis of quantum. On other matters, the accounts have been changed, embarrassing figures deleted, and, in one case, an escalating provision has been introduced commencing, retrospectively, at £269M and currently standing at £407M. To concede on the issue of the capitalisations would, of course, have far-reaching ramifications, the policy adopted, therefore, is for both BNFL and DTI to bluff the matter out.

The situation would be bad-enough if it were only the capitalisation policy at issue, but in order to keep the ship nominally afloat various other stratagems have been deployed.

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The THORP project was of doubtful viability, in the immediate term at least, its raison d'etre being overtaken by changing circumstance. Nonetheless, the plant was eventually commissioned in the dying hours of the fiscal year 1993-94. Whereupon, the substantial representations, and may one add spin, made to retain support for the project were cast aside. The accounting policies, then adopted for THORP, fundamentally differed from those earlier formal representations in that respect. Essentially, Foreign Clients had paid for THORP up-front and it was vehemently asserted by BNFL that the plant would be written-off over the first ten years of its life - instead a forty-year depreciation policy was adopted. In addition, there was made a change in the balance of depreciation being taken between land & buildings and plant & equipment, but because the parameters, given within the published accounting policies, were so widely drawn, there existed no obligation to disclose the changes which had taken place - as would normally be the case. There was also a change in depreciation level being taken against the balance of BNFL assets in the aforementioned categories, again with no obligation to disclose the change taking place.

Whilst THORP is being depreciated over such a lengthy period, independent assessment has lately informed Government that production from the plant may cease, at best, after only sixteen-years of life - in 2010. BNFL have already been forced to provide, relative to the anomaly twixt the level of depreciation being taken and cost recovery from Clients, both U.K. and Foreign, the previously mentioned escalating provision. Nonetheless, the BNFL accounts were inaccurate for the operational years prior to that provision being made and, on the modus adopted, the profit & loss account has similarly benefited and continues so to do. The overall benefit, arising from the various stratagems deployed, may be of the order of £200M per annum to that account.

It has only recently come-to-light that, in respect of THORP, there has been a substantial over-billing by BNFL to Clients, with such taken into the profit & loss account. The latest analysis also brings into question other fundamental representations, given by BNFL, in respect of cost-recovery related to the THORP project. The same may have, if confirmed, far reaching effects upon BNFL's already precarious financial standing. Depending upon how these latter issues are resolved, BNFL's profit & loss account overstatements, in this respect alone, will fall in the range £600M to £900M for the three-years 1994-95 to 1996-97. As at the 31st. March 2000, the amortised balance

of the overstatement may fall in the range zero to £430M. It is assumed that the incoming BNFL Chairman, Hugh Collum, has intervened to regularise the position.

BNFL's answer to their burgeoning problems has been not to retrench and consolidate, but to expand - for which they are under-capitalised. To side-step the problem they have deployed funds which should have been set-aside to cover their long-term nuclear liabilities - a policy endorsed by Government.

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Firstly BNFL moved into the USA as a consultant, followed up by a policy of niche acquisitions. Commencing in 1990, first operational profits were declared in 1999, only to be cancelled in the 2000 accounts. Prospects for the USA business were being touted in telephone numbers, but turnover was marginal and profit non-existent. Latterly, BNFL hit the acquisition trail big-time, taking-on liabilities and consequentially some £850M of goodwill. In addition, as a junior partner, it has involved itself in a whole-risk-bearing contracting joint venture. In order not to increase the goodwill level, the capital input has been classed as loans.

The vision of being a global nuclear player has been trumpeted without a thought as to the capital requirement for such a move, nor of the hefty learning-curve cost, nor of the overhead and operating costs in establishing that position. Equally to the point, is the question as to why fully capitalised major industrial conglomerates are divesting themselves of nuclear interests, not being prepared to sink endless amounts of capital into, apparently, a business of doubtful validity. Further, only a very select band of U.K. companies have prospered in that commercial alligator-pool the USA. BNFL have, so far, not demonstrated the business acumen to achieve in that market.

BNFL clearly recognised that they would have to make-good the shortfalls which would arise from the THORP operation and it is only now that one is able to discern the possible extent of the same. The USA was to be one-arm of the strategy of rectification, the other turned-out to be the acquisition of the Government-owned Magnox Electric plc generating operation. They owned and operated the ageing Magnox reactors, being the final rump of the old CEGB operation.

BNFL now proclaim they have been sold-a-pup by Government and are blaming both the USA and Magnox Electric as the cause of their woes - an audacious claim in all the circumstances! It might be more to the point that Magnox Electric require protection from the predatory BNFL - much as a normal company might have under the Companies Act.

The Magnox Electric deal was a horse-trade between the DTI, Treasury and BNFL. The DTI were to get all its nuclear problems under one roof and hoped to pass on the same by way of partial-privatisation - a somewhat naive hope. The Treasury were able to cancel some £581M of financial obligation to Magnox Electric - again somewhat naive. BNFL: well they hoped to benefit, by way of cash-flow, from electricity sales; they would benefit, or so they said, from extending the life of the already written-down reactors; circa £1,200M of advance payment from Magnox Electric would become a notional benefit; as originally structured there would be no dilution in nett asset value; they were granted leave to take a œ300M pensions holiday - £20M per annum, every little helping; and, last but not least, they could plunder the £3,000M Magnox Electric cash reserves.

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In acquiring Magnox Electric, BNFL were taking-on a major customer for both their fuel and reprocessing services, with that trade becoming an internal transaction. As a result, much is lost,

upon consolidation of the figures, into the Group accounts. Total internal trade constitutes circa 25% of BNFL activity - with a restricted envelope in the selling-price of electricity available. Further, consolidation of the figures converts a œ1,939M balance sheet deficit in the Magnox Electric accounts, to one marginally greater than a £120M deficit in the BNFL Group accounts dependent upon the value placed upon BNFL's own Magnox reactors.

In order to better its own position, vis a vis Magnox Electric, BNFL has lifted its reprocessing charges by circa 150%, which excess can be set against the amortisation of the £3,000M loan extracted from Magnox Electric.

Both BNFL and Magnox Electric remain afloat by virtue, inter alia, of an obligation by The Treasury to make a balancing contribution towards the eventual cost of the long-term nuclear liabilities of the latter. This by way of a capital sum and escalator formula for discharge in tranches between 2008 and 2016, the aggregate sum for discharge will be of the order of £9,000M. The escalator, of the order of £270M per annum rising, is brought into the accounts as interest received, and, upon which tax is paid. The Treasury giveth with one hand and taketh with the other - this time in advance. All things being equal, The Treasury expected to claw back circa £1,000M prior to meeting even the first payment against their promissory note. It may be the case that the liability for tax might well be cancelled as a result of a liability adjustment taken in the profit & loss account.

In the same vein is the balance between Government financial input and take-out at BNFL. Including the original assets, additional share issues and grants, the total input has been of the order of £240M. On the other hand, the take-out has been between £1,000M and £1,450M depending upon the actual taxation paid to-date. The difference, between the two figures, arises from differing sources of data, headline taxation and source-and-use-of-funds. In addition there also exists the full provision for the payment of some £684M of deferred taxation. Within the above figures, BNFL has paid circa £673M in dividends, regardless of the underlying position of the Company.

It is normal for groups to be excused the publication of parent company profit & loss accounts - per Section 230 of the Companies Act 1985. Such, therefore, precludes any ready assessment of BNFL core financial performance, which is unfortunate. However, an extrapolation of the figures indicates that, for the six-years of THORP operation, BNFL core activity has made a loss of some £749M. Such may be the reason for BNFL ramping the reprocessing charges to Magnox Electric.

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BNFL accounts are now so convoluted, not to say byzantine, in their make-up, that the only ready measure of financial performance and health is by way of reference to and movements in BNFL's cash and "free cash" position. Whilst BNFL holds substantial tranches of cash and near cash assets, these are swamped by obligations to the point where both Group and Company "free cash" levels are of a negative disposition. At Company level, including the Magnox Electric loan liability, that negative position is of the order of £7,000M.

Such is the apparent cash position within BNFL that they had perforce to dip-into their nuclear liabilities cash reserve to take out a mere £80M, presumably to cover day-to-day obligations. That movement was then masked by an increase, by way of indexation, of certain of the securities held within the reserve.

It is common practice, these days, for published accounts to, as in the words of the old song, "accentuate the positive" and disguise the negative. In the BNFL case, future assets are taken above-the-line, whilst even related future liabilities are taken below-the-line - highlighting a figure of £22,000M against a nett worth, by their own computation, of only £312M.

FRS 12 is the latest accounting standard to provide scope for yet further obfuscation. At Group level the BNFL balance sheet carries £527M (plus circa £300M relating to a late deal) of goodwill and £1,692M of FRS 12 money , without which the Group would be in deficit to the tune of £1,907M. At Company level, FRS 12 is a whopping £2,932M, without which the deficit would be £2,719M. The increase in FRS 12 levels for 1999-00 are: Group £628M and Company £1,050M. These FRS 12 monies actually represent liabilities, upon amortisation creating an accounting reserve to cover the cost of the work in respect of the same, but are shown as fixed assets. The new standard would appear to be the saving of BNFL, for the time-being at least, but is that what the Accounting Standards Board had in mind when drafting and publishing the same.

There has been much discussion upon the issue of a segregated ring-fenced fund relative to nuclear liabilities, indeed the privatised nuclear generators operate such scheme, but for BNFL to do the same would expose the true position within the Group, both as to its trading assets and the adequacy of the apparent provisions. On that basis the segregated fund will remain just talk.

The gross value placed upon BNFL activity for 1999-00 is £2,739M of which £675M is an internal trade, as stated 25% of the total and non-cash generative. Under the same heading is circa £320M amortisation of client advance payments, therefore, a total of 36% of physical activity is either non-cash, or, non-new-cash activity. There is also £273M of escalator non-cash taken as income and circa £490M of capital plant expenditure, giving an overall total of £,758M.

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It is necessary to add to the previous £1,758M circa £1,550M of operating costs, with a grand total of £3,308M arising, with such figure exclusive of the £963M of provisions injected into the BNFL accounts for 1999-00, under the new regime. The position speaks for itself.

As at the last balance sheet date, 31st. March 2000, BNFL carried a liability of £5,655M in respect of client advance payments received, the same having risen steadily from a level of £3,970M in 1995. Throughout the years, certainly since 1982, the availability of these monies has engendered, within BNFL, a laissez-faire attitude. There appears to have been a lack of grasp that the said monies would, one-day, have to be redeemed against work to be carried-out at a reduced level of cash income - with it being far from clear that production costs would be covered by such balance inflows. It would be a useful exercise to establish the extent to which the advance payments have been, themselves, ring-fenced. It would appear that the existence of the said monies kept BNFL from facing up to reality, prompting them, in response to difficulty, a micawber strategy.

The other factor which assists in keeping BNFL afloat is their handling of long-term nuclear liabilities provisions. They recently, under the new regime, conducted an audit of the same, giving rise to an increase on the gross side, of the provisions, of circa £7,000M. However, by the time discounting had been brought into play, that figure was reduced to £1,300M. In one instance, waste management, an increase on the gross side ended-up as a £1,127M reduction at the discounted level. This sleight of hand was facilitated by a postponement of the related work for a number of years, demonstrating, thereby, that liabilities can be discounted almost out of existence. BNFL admit the figures are little better than educated guesses, but in one instance the author has been able

to substantially challenge the quantum with BNFL's own figures - which had been presented elsewhere.

Whilst the principle of discounting is not in dispute, the knife-edge solvency of BNFL dictates that the related calculations should not be manipulated to an extent which might bring the validity of that solvency into yet further question. It must be questionable that shorter term, i.e. ten-years, nuclear liabilities should be the subject of discounting. In such respect BNFL initially applied a minor level of discounting to the liability, but have since done so at a deeper level. Likewise, BNFL when reassessing the level of liabilities have mitigated the rises therein by the application of deeper discounting.

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Upon issues being raised, BNFL had a tendency to either muddy-the-waters, or, delete the offending data from subsequent accounts. One interesting issue, so treated, related to the extent to which they were paying bank commissions - in the range £46,500 to £66,750 per day per 365-day year. The excess over bank charges, then circa œ1M per annum, probably related to the cost of outsourcing fund management operations - clearly it was a matter of some embarrassment. Similarly treated was data related to a decline in BNFL's working capital position, such was secreted at the back of the accounts, a la Terry Smith, indicating a positive position of £4.5M in 1982 deteriorating, annually, to a negative £2,243M in 1994. This data tended to support the assertions being made, in the mid-1990s, that all was not well within BNFL.

A further anomaly arises out of BNFL's treatment of a 74.5% direct and indirect holding in the company UK NIREX Ltd. That company has booked intangible assets of between £800M to £900M with a related nett worth of £223,000 (not a typing error), if that, with its only real asset some very arcane intellectual property. BNFL have refused to consolidate NIREX, treating the same as a joint venture.

Double standards within BNFL is further demonstrated by the Sellafield MOX Plant saga. As stated, the financial projections presented in support of their case to have the plant approved for operation, exclude the capital cost thereof - circa £462M rising. However, the plant will not be written-off in the balance sheet, as to do so would take BNFL, even in their own terms, into a deficit situation. It might be assumed that if they were to apply a forty-year depreciation to the plant, that would provide some amelioration of the problem. However, at best, the plant has only twenty-years of work - with that figure very debatable.

The issue of BNFL's accounts has been bubbling-away since the mid-1990s, to-date, no-one has disputed the several volumes of analyses which the foregone reflects and no writs for libel have been issued, or, even threatened. One former Secretary of State, Michael Heseltine, referred the author to the appropriate authority notwithstanding he being The Shareholder and Shadow Director of the Company. An earlier incumbent of the post asserted it was none of his business, whilst the current one is keeping his-head-down and saying nothing. Two past Secretaries of State were eminently qualified to understand and fully grasp the various and several issues presented - one being a chartered accountant with wide plc experience, the other a business entrepreneur. Likewise a former chairman of the Conservative Party - an accountant and lecturer in the science thereof.

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Sundry Departmental officials, even auditors, claim not to have any locus in the matter of BNFL. Former Minister of State, Helen Liddell, and her advisers: basically no comment , but an expressed

wish that the author cosy-up with BNFL to resolve the issues. BNFL, themselves, refuse to make any comment upon the figures and analysis and seek to restrict the agenda for any meeting to the point of meaninglessness. The Trade & Industry Committee have taken evasive action having effectively side-lined the matter, of a submission to them, by reference of the same to the National Audit Office - notwithstanding that within the said submission was the issue of National Audit Office lack of powers in relation to BNFL. In fact the National Audit Office are barred by statute from access to the books and accounts of BNFL and the latter have, on occasions when asked, refused to concede that embargo - as have Whitehall Mandarins from within the sponsoring Department.

It is a generally accepted principle, relating to direct and indirect government contracts, that if the contractor is making a claim against the employer the latter is entitled to have access to the accounts of the former in order to verify the validity of the costs incorporated into the contractors claim submission. BNFL are, in effect, making a claim against their THORP Clients in the form of increased charges, yet they are frustrating the accountants representing the Clients from executing such verification process - notwithstanding that the contracts concerned are on a cost plus fixed fee basis. Bearing in mind that the Secretary of State for Industry is The Shareholder in BNFL does this not exhibit a massive tendency to double-standards.

The various facets of Government, concerned with BNFL, hide behind a purported reliance on the statutory external audit of BNFL accounts to justify their stance of non-intervention, thereby, de facto, creating an organisation, in BNFL, which is responsible only to itself. Nonsense, of course, but sufficiently obfuscatory to keep unwanted and prying eyes at bay. For Government to concede might possibly open the door to a position, if wrong-doing under the Companies Act were uncovered, whereby the DTI would find itself in the invidious position of having to prosecute, in addition to its own ward, BNFL, itself! In the light of such nothing will be done - one law will exist for all companies, but from which BNFL will be exempt. Aspects of this matter might be likened to the Brent Walker affair, where George Walker and another were prosecuted on information laid - by The Secretary of State for Trade & Industry!

The author would welcome any comments, views and elucidations, as he would relative to any exposition on the matter of FRS 12 and the deployment, thereof, by other organisations.