

Searching for Eastern's Bottom Line

by Mike Locker and
Steve Abrecht

Over the last two years labor unions have faced escalating demands for concessions and give-backs. To counter the spread of concession fever, many unions are trying to develop a more sophisticated picture of a company's financial condition and overall strategy. First and foremost they are taking a closer look at the factors that determine a company's bottom line. The underlying assumption is that management uses financial accounting gimmicks to "reduce" profits and justify concessions.

This is not an easy task, primarily because the expertise and data needed to investigate a company's performance is not readily available to most unions, especially at the regional or local level. In-house capacity in this area usually resides at the national level where in-depth research on specific companies is either inaccessible or non-existent. Very few accounting, consulting or research firms serve unions; most have a strong pro-business bias that accompanies their reliance on large corporate accounts. As a result, most unions stand at a distinct disadvantage when it comes to refuting company claims of hardship. This weakens both the leadership and membership, and makes it difficult for unions to present their case to the press and the public.

At Eastern Air Lines, two unions used very different approaches to analyze the company's financial condition. The pilots hired a prestigious corporate accounting firm. A partner in this firm flew down to Eastern's Miami headquarters for a half day presentation.

Mike Locker and Steve Abrecht are founders of the Corporate Data Exchange and, more recently, of Locker/Abrecht Associates. They were the chief financial analysts for IAM District 100 in the negotiations with Eastern.

In a subsequent 30-minute oral report to the union leadership he "confirmed" that Eastern was in bad shape, thereby justifying concession demands. Nothing was put in writing for the membership and the fee was \$5000.

IAM District 100 took a different approach. The leadership decided first to educate themselves about Eastern's finances in order to independently assess the company's condition. They realized that this required a solid understanding of basic accounting principles. For guidance, they turned to experts not beholden to company clients. Finally the IAM leadership educated the total membership about what they had learned.

Starting with Basics

Most people think of profits, revenues, assets and other measures of economic activity in the same way as they think of their bank account and personal possessions. Inflows and outflows and the cash value of all possessions held at a particular moment in time determine one's financial well-being. But corporate accounting creates *timing differences* between *cash* transactions and their reflection in the income statement and the bottom line. The accounting profession has also spawned a large number of rules which grant management considerable discretion in the timing and method for recording transactions on their books. . . all of which is perfectly legal. In order to clarify the ambiguities of corporate accounting for the union leadership, Locker/Abrecht Associates conducted two seminars for the bargaining committees of IAM District 100 and Flight Attendants Local 553 of the Transport Workers Union.

The seminars were conducted in September 1981 and May 1982. For two full days members of these bargaining committees took time off from their jobs to comb through and digest the complete financial statements of their company. This was no mere educational exercise. For four years they and other Eastern workers had lost part of their wages because management's reported figure for "net income" did not equal 2% of "total revenues." Through the Variable Earnings Program Eastern's management unintentionally prompted the union to take a closer look at its financial statements because its members' wages were directly tied to Eastern's accounting methods. The union now realized that there was more to "net income" than netting the opening and closing balance of a check book.

Generally Accepted Accounting Principles, or GAAP for short, are the recognized basis upon which all publicly-traded corporations must present their accounts. The name in itself is enough to raise

eyebrows. Our first task in the seminars was to explain these principles of corporate (accrual) accounting and erase common misunderstandings about income statements and balance sheets. Revenue recognition, the matching of revenues and expenses, depreciation and amortization, the determination of period income, the valuation of assets and liabilities, the going concern principle and others were all concepts which became building blocks to analysis of Eastern's financial condition.

Our intention in defining basic terminology and principles was threefold:

1. to provide each union leader and the membership with the necessary tools to evaluate Eastern's financial statements independently.

2. to clarify what conclusions can be drawn from information which is publicly available as opposed to conclusions which could only be reached by someone with privileged access to company records.

3. to communicate the ambiguities of accounting standards and the parameters within which management can choose between alternative accounting principles, can change accounting estimates and can time extraordinary events, all of which affect its financial statements and, most importantly for the workers, its "net income."

Management Discretion

Two items best exemplify the impact of management's discretion on the public record of its financial and operating condition: *depreciation* of flight equipment and *pension costs*.





In the case of *depreciation*, management estimates at the time a plane is acquired how many years it will remain in service and what value it will have after that period is completed. Two companies having identical fleets and the same operating revenues, but using different depreciation schedules, will report different net incomes. The shorter the depreciation schedule, the lower the net income. Thus Delta with a strong bottom line depreciates a Boeing 727 over 10 years whereas Pan American with substantial losses uses 19 years. As an airline's fortunes change, it is common for management to change the depreciable life of an aircraft. The seminar participants quickly realized that Eastern's management could arbitrarily affect its net income by altering the estimated life of its fleet.

The second item, *pension costs*, is also subject to an educated guess. In this area management draws on the obscure services of actuaries to predict life expectancy, employee turnover, salary levels and interest rates a decade or more into the future. Not surprisingly their recommendations vary considerably from company to company,

but appear directly correlated with a company's need to lower or raise costs at a particular moment. By raising its interest rate assumption, a company can lower its pension costs and raise its net income.

In the seminars, we examined each item in Eastern's financial statements line by line, working our way through the balance sheets, the income statement, the statement of changes in financial position and the explanatory notes. Key items were examined for trends over time and through standard financial ratios to assess the company's performance. These ratios were compared to Eastern's primary competitor, Delta Air Lines, to evaluate Eastern's performance within its industry and market. We noted, for example, that while in 1978 Eastern's labor costs were proportionately higher than Delta's—43% of total revenues versus 40.3%—by 1980 Eastern had cut its labor costs to 38.6%, reflecting the cutbacks at Eastern due to the Variable Earnings Program.

Another important thrust of our seminars was to place Eastern within the context of the corporate power structure which governs many decisions affecting operations and long-term strategy. Because of the size of Eastern's debt, its banks and other lenders were the major focus of our attention. By year-end 1982 Eastern's long-term debt had passed the \$2 billion mark, or 63.8% of its assets. Interest expense had risen to 4.7% of revenues, while Delta's was only 0.6%, a difference of \$155.9 million, more than double Eastern's net loss for 1982. Had Eastern's debt been as low as Delta's, EAL would have reported net income of \$81 million in that year.

The weight of the lenders in Eastern's financing made it clear that they held veto power over important decisions. Moreover, gains in Eastern's financial performance were being syphoned off by the lenders. The unions realized that they were bargaining with the banks. While management insisted on cutbacks in labor costs, no one dared suggest that the lenders take a cut in the rate of return on their loans to Eastern.

We also studied Eastern's major suppliers, particularly aircraft manufacturers. Not surprisingly Eastern's lead banks are also Boeing's. When Boeing was desperate for a large initial order of its new 757 plane, Eastern was the first to jump on the bandwagon. At year-end 1982 Eastern had received 2 new 757's, ordered 25 more and held options for another 24, a considerable number in the light of its heavy debt load.

This overview of Eastern's accounting methods, financial condition, operating performance and business environment was the starting point for the union's independent evaluation of Eastern's current health and long-term prospects.

Looking for Eastern's Crown Jewels

This analysis, however, was not sufficient to answer all the union's questions about the airline's financial condition. In fact many new questions were raised, some arising from the fact that figures reported to the SEC and CAB differ because the two agencies use different accounting principles and reporting requirements. More importantly the union now realized that many issues related to management productivity, labor costs, creditor relations, fuel and equipment-purchasing agreements, and financial projections could not be answered through publicly available information.

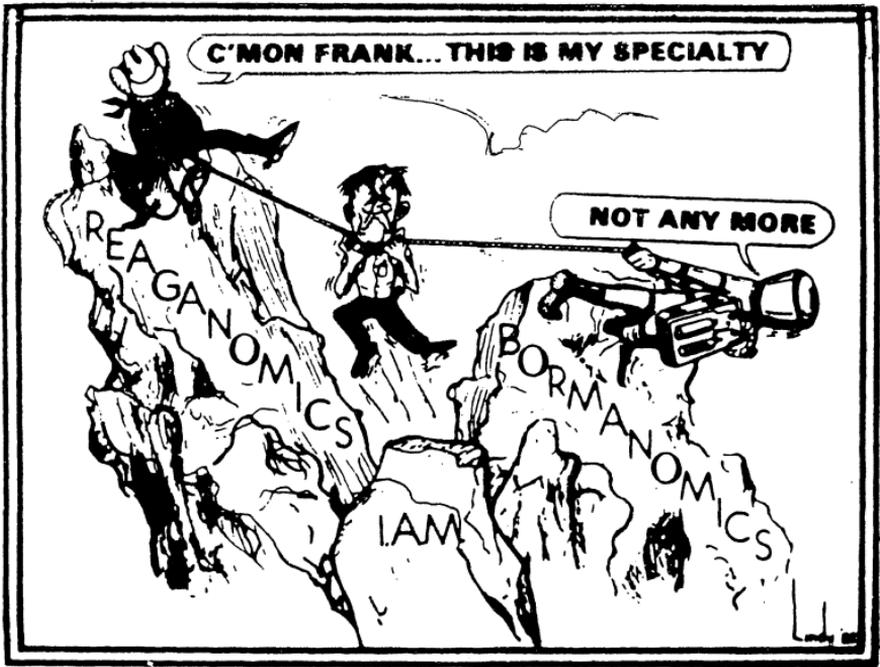
In the course of the next year and a half the union gradually broke through the barrier of public information and gained access to confidential documents about the company's operations. Traditionally employers open their books to a union only when they plead poverty. Eastern, however, had always maintained that its books were available to the union. This unusual policy had never been fully tested. The union's new access to inside information evolved in three steps:

1. Price Waterhouse. Following the first seminar, the company arranged for a meeting between its independent auditor, Price Waterhouse (PW), the union leadership and ourselves. This meeting helped to clarify certain issues, particularly with regards to discrepancies between SEC and CAB data. Answers to more substantive questions were promised by PW at a future date but were never received.

Subsequent research made the shortcomings of such an approach apparent. On the basis of SEC and CAB data, we often could only speculate about the real problem which underlay specific figures. If our questions were not phrased accurately or broadly enough, the auditor could easily evade the real problem.

In one specific case the union had noted a rapid increase in the inventory of spare parts. We asked PW whether their audit had found any problem with the inventory. Their answer was negative, but what they failed to disclose, and we only discovered a year and a half later, was that the board of directors had recently hired the consulting firm of Booze Allen & Hamilton to investigate how Eastern could reduce an excess of \$100 million in its spare parts inventory.

2. Bargaining with the Lenders. In December 1981, the IAM bargaining committee met for the first time with representatives of EAL's major lenders and underwriter. This meeting was important because it gave the union its first direct line of communication to parties which our research indicated possessed great influence over corporate affairs. Eastern favored the meeting for its own reason: it hoped to frighten union negotiators by demonstrating the banks'



power to cut off Eastern's financing. At this meeting, the unions received from the company the confidential "Financial presentation" which management prepares quarterly for its lenders. This document contains a wealth of information not readily available to the public. It largely focuses on *projections* as opposed to SEC and CAB public data which almost exclusively covers *past* activity. It also details all the liquidity and solvency ratios mandated by Eastern's loan agreements.

In March 1983 the projections showed substantial net income from 1983 through 1987. For the first time the union got a glimpse of management's optimism about the company's future and not just its pessimism about past losses. This bright picture was in sharp contrast to the gloom and doom to which the workers and the public were being subjected. This information proved to be an important asset to the union in its contract negotiations.

Borman Opens a Pandora's Box. The third step was the most critical to the union's bargaining position. In February 1983, only 4 weeks before the strike deadline, we received a call from Charlie Bryan, President of IAM District 100, with the surprising news that Frank

Borman would open all of Eastern's books to the union. This last minute offer, apparently aimed at heading off a strike and pressuring the Machinists into accepting its latest terms, was unprecedented.

By opening its books, EAL wanted to prove to the union simply that its SEC documents were accurate. The union had never suggested that this was not the case. But the union wanted access to additional information on the company which would indicate whether it could afford an industry standard wage. It also wanted to evaluate independently management's business plan and what it meant for the workforce.

As a result we drew up an extensive list of documents which we would examine at the company's headquarters over a period of three to five days. Because we had to confine our search to the time available, we included documents which would reflect the opinions of other parties close to the company, such as the auditor, creditors and members of the board of directors.

Our investigation was prefaced by a thorough review of reports on Eastern and the industry by Wall Street analysts. These gave us an independent assessment of Eastern's prospects. The optimistic projections in the latest and most extensive report were helpful in guiding our line of questioning.

The company came forward with the vast majority of the documents we requested, with two important exceptions. The auditor's working papers, the equivalent of a road map and diary of the audit, were considered the property of Price Waterhouse, which fell back on self-prescribed professional standards and its own firm policy to preclude our inspection of its contents. Data on the hierarchy and salary levels of EAL management and non-contract employees were also withheld because management felt the IAM would use it against them, presumably in an on-going attempt to organize non-union employees.

We were not permitted to photocopy some important documents we did inspect and we were unable to examine some material thoroughly because of its sheer volume. For the purposes of the task at hand, however, we were able to review the company's records sufficiently to draw important conclusions for the union and point to areas requiring additional investigation. We were assisted in this task by Randy Barber.

The report concluded that Eastern was entering a profitable period which could be sustained if management moderated its plane acquisitions program. At a meeting between the union leadership,



the company's top management, including the President, Frank Borman, and ourselves, Eastern executives were given the opportunity to comment on the report and refute the findings. Their observations were incorporated in the final document. Although management had originally required that the report remain confidential, they reversed their decision and authorized its release. The union quickly distributed copies to all shop stewards, who were instructed to inform the members of its findings.

Conclusions

Our research on Eastern Air Lines and our access to privileged documents led to the following conclusions:

A. In addition to their traditional activities, unions must carefully scrutinize the financial condition and bottom line of the companies they deal with. It is important that they do this on a regular basis in order to forestall impending disasters and dispel the crisis atmosphere fostered by management.

B. To bargain more effectively unions must have regular access to more detailed data on a company's performance than is generally found in publicly available documents. In effect unions must have the same standing as creditors in gaining access to inside information, a step which can be achieved through changes in federal labor law. For instance, SEC documents must be complemented by data which break down summary financial information into its component parts, much in the way management accounting permits corporate

executives to track the performance of divisions, products, profit centers, individual managers, etc. The union must also have access to projections, capital investment plans and financing programs which will affect the company's long-term competitive position, growth and employment levels.

C. A key factor in evaluating the true condition of a company is to follow the opinions of Wall Street analysts and informed reporters in the business and trade press. While obviously anti-labor, these sources offer a more probing and incisive analysis, which is often at odds with management's.

D. One method of gaining access to detailed insider information is to have a representative on the board of directors. From this position a union representative can also capture a sense of the debate among board members, the range of options considered on any particular matter, and the weight attributed to the opinions of different directors. Minutes of the meetings of the board of directors, to which we gained access at Eastern, provided only final resolutions and few insights.

E. Unions must develop a capability to digest this financial information either by developing internal expertise or hiring outside consultants. Without such expertise and without a cumulative knowledge of the company they are researching, they can't take advantage of an open books policy. If unions use outside consultants, the leadership must nevertheless become versed in the data and must disseminate the research findings to the membership in a regular and timely fashion through organized channels of communication.

F. In crisis situations, rapid access to and quick dissemination of financial information can play a major role in orienting the membership and swaying public opinion. □

