

This July, a jubilant Stone & Webster Inc. trumpeted news that a federal judge had dismissed a lawsuit by Lens Partners charging the architectural and engineering firm with fraudulent misrepresentation of its financial condition. Branding the charges "absurd" and "frivolous," the firm sounded as if it had just triumphed over a group of "Star Trek" fans who wanted it to report its results in the Klingon language. Lens had had the gall to urge Stone & Webster to trim overhead and shed noncore assets like languishing Florida real estate and 700,000 shares of Tenneco Inc. But the lawsuit went still further. It called for a candid restatement of reported earnings to show how noncash contributions from an overfunded pension plan have transformed net losses to net profits in recent years.

Frivolous? Absurd? Maybe so, in the context of general accounting and auditing standards that allow an income statement to ignore how such pension contributions boost

the bottom line—even if in Stone & Webster's case, the \$14 million contribution in 1993 amounted to 5 percent of the company's gross earnings. "This is clearly by the books," says a source at the usually circumspect Financial Accounting Standards Board.

FASB's official blessing and the court's ruling appear to leave a wide gap in GAAP. In a year when Stone & Webster earned less than \$2 million, the invisible pension fund credit manufactured more income than any item on the income statement except core engineering. Since 1987, when Stone & Webster started tapping this source, the income statement has buried \$101 million of pension credits as reductions in operating expenses. Without them, \$152 million in reported net income

TRUE LIES: HOW GAAP CONCEALS THE REAL STORY AT STONE & WEBSTER

boils down to less than \$87 million, net of federal income taxes.

If corporate raiders were still combing financial statements for undermanaged targets, suitors would have circled Stone & Webster by now. With its vast experience in nuclear power plant construction, the firm is well positioned to take advantage of the burgeoning market for power plants in the developing world. Instead, it is stumbling. Adrift in an unfamiliar environment, management has understandably put the best face on its financial condition.

OPENING VOLLEY

But accounting methods that pass muster with regulators caught the attention of Lens principal Robert A.G. Monks, who has bought about 1.5 percent of Stone & Webster's stock. No stranger to boardroom combat, Monks fought mighty Sears, Roebuck and Co. for three years and eventually prevailed. Now he is taking on Stone & Webster, and although his quarry is much smaller this time, it may prove more formidable—not because his purpose has less merit, but because employee benefit plans control 36 percent of Stone & Webster's stock, and participants tend to vote with management. To succeed, Monks must persuade these insiders to join his cause. And although Lens dismisses the July verdict as "just the

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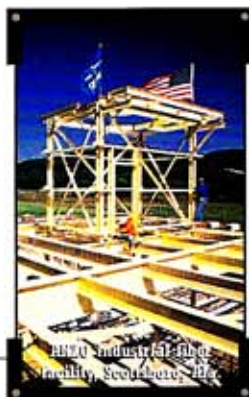


Nuclear power plant,
Limerick, Pa.

William Egan, CFO of Stone & Webster.



Advanced Recovery System,
Han Yang plant, Korea



HWI Industrial Fibre
Facility, Scotland, UK

BY S.L. MINTZ

opening volley," the loss of the lawsuit, which named directors and the pension trustee, The Chase Manhattan Bank, N.A., as defendants, is a clear setback.

Citing detailed notes to financial statements and entries for prepaid pension costs on cash flow statements, CFO William Egan insists that the pension reporting issue makes much ado about nothing. "We did everything on the level," Egan declares. Additional references to an overfunded pension appear on the balance sheet and in the discussion and analysis of financial condition, a fact the court noted in dismissing the lawsuit. Indeed, the pension credits seem to show up nearly everywhere except on the income statement, where they would have the most meaning.

It is certainly fair to say that Boston-based Stone & Webster is not the first company to prop up earnings with undisclosed pension contributions. To fend off critics, the firm researched the matter. Of 133 companies on the New York Stock Exchange that have these credits, it found, only 3 showed it on the face of their income statements. How often pension credits turned net losses into net profits did not fall within the survey's purview. "Most analysts look at this as a positive thing," Egan adds, inadvertently acknowledging the true picture. "Because once you return to profitability, you don't have an underfunding problem."

Therein lurks the larger problem, says Monks, a millionaire lawyer who ran the Labor Department's Pension and Welfare Benefits Administration under President Reagan. Monks questions whether Stone & Webster will ever be profitable again under current management. The court's decision notwithstanding, recent financial performance underscores Monks's fear that management has lost its grip. In the first half of 1994, Stone & Webster admitted losing nearly \$17 million as gross earnings slid 27 percent, to \$109.8 million, from \$151.1 million a year ago.

NOT THE GOOD OLD DAYS

Consistent with GAAP or not, as Monks sees it, Stone & Webster's income statement reflects a lack of accountability by ineffective, entrenched management. The pension fillip is just one symptom. There are others as well: bloated overhead, a balance sheet stuffed with Treasury securities and stock in another public company, and a fuzzy strategic focus. Together, they have persuaded Monks that Stone & Webster operates as if still in a bygone era, when shareholders clipped dividends and rubber-stamped proxies, and cost-plus contracts meant sure profits for contractors even if costs ran wild. Unless feet are held to the fire, Monks warns, Stone & Webster will continue to quan-

der its reputation and resources until little worth rescuing remains.

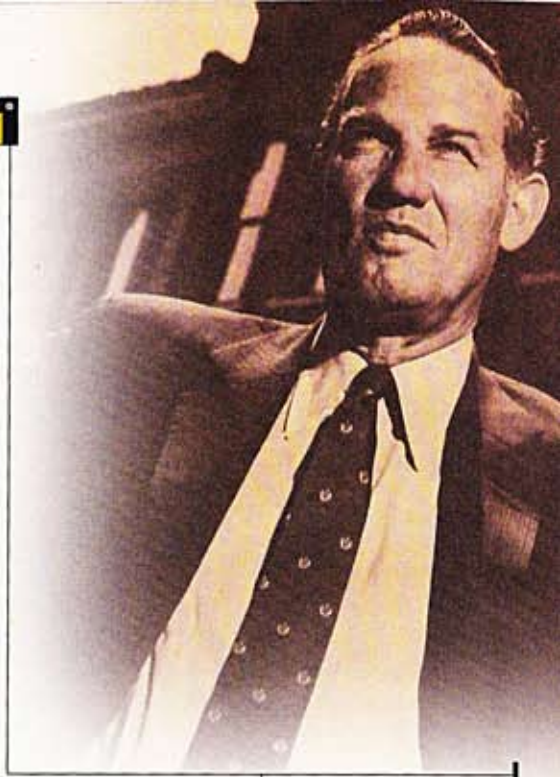
These are not the good old days for crusty Stone & Webster stalwarts like 75-year-old chairman Bill Allen, who relinquished the CEO post (but not the podium at the annual meeting) only a few months ago to president Bruce Coles, 50. Peter Grace, a director since 1945, is 80 years old. When Egan, 65, joined the company, in 1955, Dwight D. Eisenhower was President of the United States, and Stone

& Webster, fresh from its work on the atomic bomb-building Manhattan Project, was perfectly positioned for an era of unparalleled growth in the nation's infrastructure. Over the next two decades, thousands of Stone & Webster engineers designed and built highways, airports, dams, bridges, and electric power plants fueled by conventional and atomic energy. A partial list of the projects that bear their imprint includes Boston's Longfellow Bridge, the Washington, D.C., subway system, the Rock Island Dam, the New Jersey Turnpike, the Connecticut Yankee nuclear plant, New York's Aqueduct Raceway, a 140-meter radio telescope in West Virginia, and the Statue of Liberty restoration.

But as the commercial and industrial construction boom waned in the 1980s, Stone & Webster failed to make the transition to new activities capable of sustaining its own financial

IN A YEAR WHEN STONE & WEBSTER EARNED LESS THAN \$2 MILLION, THE INVISIBLE PENSION FUND CREDIT MANUFACTURED MORE INCOME THAN ANY ITEM ON THE INCOME STATEMENT EXCEPT CORE ENGINEERING.

structure. An illustrious past began to fade, obscured by developments the company was less equipped to handle than the design and construction of nuclear power plants. Forced by the government to divest financial interests in electric power producers, Stone & Webster found itself without a captive customer base. When demand for electric power leveled off in the United States, these former customers backed away from capital investment or shopped for the cheapest supplier. Hoping to



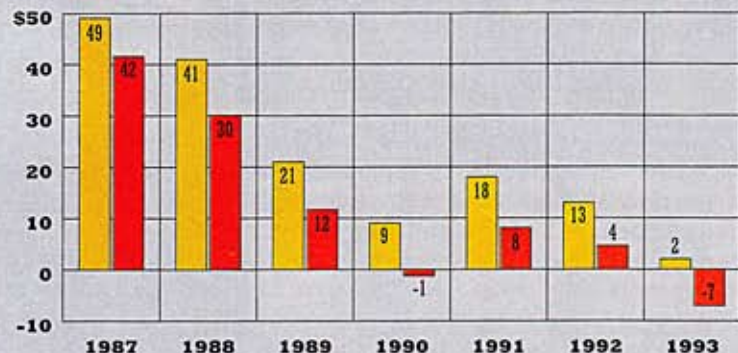
★ Lens principal Robert Monks: Stone & Webster's income statement reflects a pervasive lack of accountability by ineffective, entrenched management.

salvage these relationships, Stone & Webster elected not to form partnerships with upstart independent power companies that compete against an entrenched power industry. But in any event, newer customers police costs rigorously and don't sign cost-plus contracts that insulate suppliers from cost overruns. Meanwhile, the lucrative markets have moved away from the United States, where Stone & Webster is 9th among architectural and engineering contractors, according to a Smith Barney investment report. Internationally, the firm ranks only 19th in an increasingly competitive field.

Despite tough conditions, competitors have flourished as Stone & Webster has foundered. Since 1988, revenues at Fluor Corp., in Irvine, California, have increased by 58 percent, and net

THE TRUE PICTURE AT STONE & WEBSTER

(Figures in \$Millions)



■ Reported Net Income
 ■ Adjusted Net Income
 (reported net less pension credits, giving effect to federal income tax)

Source: Stone & Webster, CFO

earnings by 177 percent. Foster Wheeler Corp., in Clinton, New Jersey, grew revenues by 145 percent and net earnings by 88 percent. In the stock market, since 1988 issuers that make up the William O'Neill Heavy Construction Index have gained 55 percent, while an investment in Stone & Webster has lost 10 percent. Not surprisingly, Wall Street is disappointed. "You can't look at this performance and say this is one hell of a crew," observes securities analyst David Bartlett of Van Cleef & Partners in New York.

Dismal performance has not crimped growth in Stone & Webster's executive compensation, however. Despite mounting losses in the five years prior to year-end 1993, the chairman's base salary increased by 45 percent, and Egan's by 38 percent. The president, whose base salary grew by less than 4 percent, to \$349,000, did all right, also, thanks to an award of 2,000 shares of stock, worth about \$385,000 at the current stock price, to be granted over five years. All told, according to the lawsuit, base salaries of the company's five highest-paid executives increased 7.5 percent a year, while profits vanished. Overall, Lens calculated that Stone & Webster's general corporate expenses ballooned by 43 percent from 1989 through 1992 as net operating revenues fell by 31 percent.

In most cases, such a combination of results and executive compensation would have triggered a takeover, or at least a few resignations. But changing the culture or hiring a new crew is all but impossible when 22 percent of Stone & Webster's stock resides in an employee stock ownership plan, and an employee investment plan controls another 14 percent of the stock. With these shares effectively in management's pocket, Monks claims, Stone & Webster can behave as if it is not accountable to anyone, least of all other shareholders—especially when a compliant pension trustee is allied with management. While it is hard to prove that trustee Chase Manhattan Bank is indeed compliant, the relationship is certainly cozy. Board member John A. Hooper Jr., 72, a former vice chairman of Chase, chairs Stone & Webster's compensation committee.

"Some people might say it," Egan bristles, "but this management isn't stuck in cement." Far from moving too slowly to pare costs, set strategy, and shed noncore assets, he counters, Stone & Webster has been very responsive to a changed environment. After vigorously defending the old voting methods, for example, the company agreed recently to adopt confidential balloting. Next June, ESOP members will be able to oppose management without fear of personal repercussion. This should help erase a serious governance problem spawned by ESOPs: two classes of shareholders, insiders and outsiders, with different agendas. But it is not likely to go away entirely unless Stone & Webster regains its competitive footing or follows the example of Pasadena, California-based The Parsons Corp., where ESOP members eventually bought out other shareholders.

THAT'S ENTERTAINMENT

Taking a tiny step in that direction, Stone & Webster has announced plans to repurchase up to 1 million shares of common stock, or about 10 percent of the shares not held by employees. Meanwhile, a knife to overhead will eliminate more than 600 jobs this year, reducing head count to about 6,000 workers from a peak of 16,000 in 1984. Pension credits are their legacy. When the company was at peak employment, the labor cost component of many construction contracts fattened the pension fund. Workers who left the company before becoming fully vested took part of their benefits, but the balance remained in a fund with shrinking obligations. As of December 1993, Stone & Webster's pension assets exceeded projected liabilities by \$88 million. Investment returns on the plan's total assets supplied the pension credit.

Noncore assets are on the block, and have been for a long time, indicating a reluctance to

part with them. Management still harbors hopes of recovering an ailing investment in Sabal Corp., a real estate business near Tampa holding commercial and industrial properties for sale and lease. Commercial Cold Storage Inc. operates 21.1 million cubic feet of refrigerated distribution facilities in Georgia. Bids are welcome. "If you come down and say, 'Somebody is making an offer for this sub that isn't core,' we'd entertain it," Egan declares.

In new business chalked up since last January, Stone & Webster has signed agreements to codevelop projects at two existing oil refineries in Kuwait, perform upgrades on the Alaska Pipeline, and jointly develop and construct a \$60 million fiberboard manufacturing facility with Canadian investors. Meantime, Stone & Webster has announced plans to finance, build, and operate a \$65 million paper processing plant in Maine that will produce daily about 200 tons of so-called virgin pulp substitute (VPS) from office wastepaper. It will supply more than 90 percent of a \$25 million equity layer, while a consortium of banks headed by Bank of Tokyo will provide \$40 million of construction debt. Egan says that this investment offers lucrative synergies on its own merit, as well as a blueprint for further ventures by Stone & Webster as the North American licensee of VPS technology. These projects call for substantial investments of labor and capital up front, and profits depend in part on how long it takes to complete them. If they go awry, Stone & Webster can lose money.

LOSS LEADER

With an eye to improving its image at home and to exploring investment opportunities outside the United States, Stone & Webster has retained Goldman, Sachs & Co. as a financial consultant. "This is a consulting contract that we have with these characters to help us present our story better to the investing public," says Egan's operations-oriented colleague, executive vice president Jim White. That's high-priced investor relations, ordinarily, but Egan insists that the retainer is very modest. "These guys are marketing to us at this point; they're giving us a loss leader," he says. Moreover, Egan anticipates valuable synergies through new contacts. "They're looking in China to do work, we're looking in China. They know people we don't know, we know people they don't know." He also expects Goldman to make financing available for project development. "We really have not had an investment banking relationship, because we were *in* the [investment banking] business," he says. "Maybe it would be a good idea to meet some people."

Meeting the right people might perk up



demand for Stone & Webster's services in a world hungry for electric power. "If you look at developing countries, where a single light bulb in an abode is the extent of their electrification," Egan says, "then putting a toaster in or putting a TV in is doubling the demand." The strongest competitors should reap rich rewards. Between 1992 and 2020, the World Energy Council predicts that capital investment in technology will reach \$30 trillion, according to a recent survey in the *Economist*. Electric power, Stone & Webster's traditional bailiwick, will consume a third of this investment. In densely populated countries like China and India,

▲ Chairman Bill Allen (right) recently ceded the CEO post to Bruce Coles.

"YOU CAN'T LOOK AT THIS PERFORMANCE AND SAY THIS IS ONE HELL OF A CREW," OBSERVES SECURITIES ANALYST DAVID BARTLETT OF VAN CLEEF & PARTNERS.

demand for electricity will grow at three and four times the growth rate in the United States.

Egan and Monks appear to agree in one key respect: Stone & Webster has a promising shot at a lucrative future by doing what it has done well in the past. But they differ on how to make that happen. Egan appears willing to let Stone & Webster's future rest on factors beyond its control. When asked when the firm's performance will begin to reflect the world's pent-up demand for electricity, Egan's glib reply betrays a stunning lack of insight for someone who is

both CFO and a board member: "The answer to that kind of question," he says, "is as available to you as it is to us."

PILE O' CASH

Egan defends the composition of a balance sheet with \$54 million in U.S. Treasury securities, enough to retire all of the company's long-term debt and still leave \$6 million. "I don't like to hold Treasuries, because the yield is not that high," Egan says. It's on hand in case a job comes up that requires a lot of cash. "If you've got preferreds or something like that in your

information is foreign to Monks. "He doesn't quite understand what kind of business we're in," Egan complains. "In order to win work on many projects where the client is going to expect you to be around seven years from now, you've got to have a balance sheet to sustain that kind of thing." But Egan himself appears to mistake a cash pile for a strong balance sheet. Although he contends that Stone & Webster's financial structure is "absolutely, absolutely" in line with competitors, a comparison of current ratios suggests otherwise. At year-end 1993, Stone & Webster's current assets amounted to 2.5 times current liabilities, almost twice the ratio as at Fluor (1.4 times) and significantly more conservative than Foster Wheeler (1.5 times) or Morrison Knudsen Corp., in Boise, Idaho (1.7 times).

EGAN AND MONKS AGREE ON ONE POINT: STONE & WEBSTER HAS A PROMISING SHOT AT A LUCRATIVE FUTURE.

portfolio," he explains, "you may or may not be able to move it, or maybe move it at a loss."

At year-end 1993, cash, government bonds, and 700,000 shares of Tenneco worth \$41 million represented almost a quarter of Stone & Webster's \$680 million in total assets. Do shareholders pay management to make investments they can make themselves? "That's a comment we hear a lot," Egan admits. His muddled explanation suggests an unclear strategy. "Are you investing in Tenneco," he asks, "or holding the darn thing there to help you expand if you need it? If you don't need it, then sell it or move it into something else at the right time. We're not averse to selling Tenneco. We've sold Tenneco."

In Egan's defense, architectural and engineering firms are more chary than most about finances. They like low debt and lots of cash. Smart projects can absorb enormous amounts of capital up front, and one gone bad can suck out even larger sums. Egan gripes that this

Monks acknowledges some progress by Stone & Webster's management. "They're coming along a little," he says, "but it's nothing in terms of the real needs of this company." After restating earnings to reflect pension credits, Monks would attack the balance sheet by putting idle assets to work in the core engineering business. If proceeds can't reinvigorate the core business, then he would return them to shareholders to invest somewhere else. Analyst Bartlett of Van Cleef agrees that management needs a shot in the arm—or somewhere. "Stone & Webster has assets to exploit, but it hasn't done it," Bartlett says. "If I had \$50 million, I wouldn't wait for someone to invite me to dinner." Adds a critical portfolio manager whose stake ranked among the 10 largest until recently: "You've got to take some risks." He reports hearing complaints from Stone & Webster field engineers that the company is reluctant to exploit its bonding capacity.

Of the court's adverse ruling, Monks says the speed was more surprising than the conclusion that plaintiffs failed to show damages. "We knew it was an unusual approach," says his partner, attorney Nell Minow. "We went in knowing it would make new law if the court went along." Given such long odds, Monks concedes an ulterior motive beneath the raft of allegations. "One of the things I'm trying to do is develop a quiver of arrows [to promote] shareholder involvement," he says. If it wasn't clear before, he now admits that a lawsuit makes a clunky and unreliable arrow. Courts should be "damned reluctant" he declares, to insert themselves in matters of corporate governance and shareholder value. "With Stone & Webster, we thought we had one bad enough that we could make them do it." Unless Stone & Webster reverses course, Monks only has to wait and then try again. ■

✦ The late Robert Gallagher (left), who was treasurer, with CFO William Egan.



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