GREED AND CORPORATE FAILURE

The Lessons from Recent Disasters

Stewart Hamilton and Alicia Mickelthwait
GREED AND CORPORATE FAILURE
This page intentionally left blank
GREED AND CORPORATE FAILURE
The Lessons from Recent Disasters

Stewart Hamilton
and
Alicia Micklethwait
For Mairi, Iona, Eilidh and (Dr) Mairi
with much love – SH

In memory of my mother, Sheila Robson – AM
This page intentionally left blank
CONTENTS

Foreword xi
Preface xiii
Acknowledgements xv

Chapter 1 Introduction 1
Poor strategic decisions 2
Overexpansion 2
Dominant CEOs 3
Greed, hubris and a desire for power 4
Failure of internal controls 5
Ineffective boards 6
Other issues 7
The millennium meltdown 8
The recent past 9
The aftermath 11

Chapter 2 Barings and Allied Irish Bank: Lessons Ignored 13
A new dawn: Around-the-clock global trading 14
‘The sixth great power’ 16
Marrying the traditional and the entrepreneurial 18
The party is over 19
Confused reporting lines in a matrix management structure 19
Enter a ‘star performer’ – Nick Leeson 20
The Singapore business 22
The cover-up and creation of the 88888 account 23
Discovery and collapse 24
The fallout 25
‘Plus ça change, plus c’est la même chose’ 26
The unlearnt lessons 26
Memories are short 27
What went wrong and lessons to learn 28
Why Allied Irish repeated the mistakes of Barings and lessons to learn 29
## Chapter 3: Enron: Paper Profits, Cash Losses

- The earthquake 34
- The creation of Enron 35
- The Enron culture 36
- A changed environment creates new opportunities 37
- Changing the rules of the game 38
- 'Mark-to-market' accounting 39
- Increasingly adventurous trading operations 41
- Expanding the traditional business 41
- The broadband story 42
- Reporting spectacular financial performance 43
- Market and other pressures start to take their toll 44
- Being creative with off-balance-sheet transactions 44
- The impact of these deals 46
- Storm clouds gather 46
- The downfall 48
- The Powers committee post-mortem 49
- What went wrong and lessons to learn 50
- The consequences 56

## Chapter 4: WorldCom: Disconnected

- The genesis of WorldCom 60
- A tumultuous few years 61
- Some doubts surface 63
- Moving into new markets 64
- The tracker stock diversion 65
- A cosy relationship with investment banks 66
- Strained personal finances 67
- Accounting shenanigans 68
- No checks and balances 70
- Rumbled at last 72
- What went wrong and lessons to learn 73

## Chapter 5: Tyco: Greed, Hubris and the $6000 Shower Curtain

- Three decades of growth and profit 81
- Dennis Kozlowski – a man with persuasive powers 83
- Last vestiges of frugality disappear 85
- An acquisition a day … 86
- Extending the portfolio into telecoms and finance 87
- The share price on a downward trajectory 88
- The house of cards comes tumbling down 90
- Blurred boundaries 91
- The fallout 92
- What went wrong and lessons to learn 94

## Chapter 6: Marconi: Establishment to Wunderkind to Basketcase

- The man with the Midas touch 99
- Contrasting leadership styles 100
Chapter 10  Conclusions 173
What has been done? 174
A first priority: Improving boards and boardroom performance 175
Shareholder involvement 177
The need to realign executive compensation 177
Increase the involvement of the audit committee 179
Reform of the investment banks 179
Reform of the accounting profession 180
‘Profit is an opinion, cash is a fact’ 182
What next? 182

Epilogue 184
List of Abbreviations 186
Glossary 187
Index 199
The International Accounting Standards Board commenced operations in 2001. Shortly afterwards, the European Commission proposed that the consolidated accounts of all listed companies in the European Union should be drawn up using international financial reporting standards. Many of the 34 standards inherited by the board from its predecessor body, the International Accounting Standards Committee, had been severely criticised by securities regulators. The Board’s main objectives in its early days, therefore, were to improve some 17 standards which had been the subject of the regulators’ concern. At the same time, however, the board was aware of the growth in number of share options issued to senior executives and the alarm expressed in many countries throughout the world about the failure to reflect in the financial statements the worth of these options given by way of employee (especially management) compensation. Consequently, in its initial work programme the board included the expensing of share options, the standard being published in 2004.

This initial work occurred in the aftermath of Enron’s collapse. As this book discusses, the collapse of Enron was followed by those of other companies – several of whose management received massive grants of unexpensed share options. The shock to the financial markets in the United States was palpable. Despite the fact that initially many of these failures were attributed to ‘accounting standards’, later evidence revealed the root cause was a major failure of corporate governance – a theme running throughout this book.

The effects of these failures have been to hasten the global regulation of the world’s capital markets. The United States Financial Accounting Standards Board and the International Accounting Standards Board agreed, in October 2002, to remove the differences between their accounting standards and to work together on new projects. The aim was to converge to better quality global standards. This project is now accelerating as the two boards’ work programmes are aligned. Similarly, the passing of the
Sarbanes-Oxley Act has led to increased regulation of auditors and a greater emphasis on internal controls systems worldwide. While some may complain about the cost of the increased level of regulation, it has to be viewed in the light of the spectacular losses which occurred when the companies dealt with in this book collapsed.

Memories can be short and, as confidence returns and the markets recover, there is a danger that the lessons of the recent past begin to be forgotten. Hamilton and Micklethwait have done us all a service by reminding us of the consequences of the lack of strategic judgement, of greed and of the failure of corporate governance.

DAVID TWEEDIE

*International Accounting Standards Board, London*
It has been convenient for many to pass off the recent spate of corporate failures as accounting scandals and frauds. That way, politicians, analysts, reporters and other commentators can gloss over the problems, pass some hasty bits of legislation, call for better auditing, deplore greed, and move on. The media, in particular, have relished this source of juicy headlines and pictures of high-flying executives in handcuffs. Certainly fraud played a part in some of the more spectacular disasters (WorldCom, Parmalat, Barings, Enron) but not in others; the same can be said about the misuse of accounting (Enron, WorldCom) or of greed. The reality is more complex.

In this book we define ‘failure’ to include not only administration or liquidation but also the large-scale destruction of shareholder value in companies that do survive in a legal sense. This book is not intended as a definitive study of the myriad collapses that occurred in the dot-com meltdown of 2001, nor of the disastrous value destruction in the mega-mergers like that of AOL-Time Warner or DaimlerChrysler. Rather, by studying a small number of examples in detail, and alluding to others, we seek to show that the main causes of failure are relatively few and common across all types of industry and countries, in turbulent times and calm.

Here, we have selected case histories to identify the causes of failure, rather than adopting a thematic approach, with a list of reasons for failure being illustrated by cases. We have chosen, out of a vast number, what we believe are eight representative examples from different industries and in five countries. Most of the cases are well known by dint of having attracted widespread media coverage and, sometimes, legal action – both criminal and civil.

The chapters have been based in part on IMD case studies (and accompanying teaching notes).¹ In each one, we have relied primarily upon information in the public domain, using original sources wherever possible. We have been fortunate, through IMD’s position as a leading European business school, to have gained access to and interviewed some of the people involved – both internally and externally – to aid our under-
standing of what went wrong. Where they are happy to be identified, we do so; we also understand and respect the wishes of those who are not. While all the cases we examine are of large companies, the causes of failure we identify are also applicable to most small company collapses although the relative importance of individual factors will be different.

All of the stories are complex, and distilling the essentials of each into one chapter has been a major challenge. Most have been the subject of complete books (usually narrative rather than analytical) and, in the case of Enron, a whole bookshelf-full. We hope that we have provided enough detail to inform, but not so much as to overwhelm the reader. Our objective has been to make the stories, and the lessons to be learnt, accessible to a wide range of readers. To this end, there is a short glossary including some acronyms at the back of the book. For consistency, we have used the USA billion (one thousand million) throughout.

Note

1 For those who wish a longer and more detailed examination of each example, the cases are available through the European Case Clearing House or Harvard Business School Publishing.
We would like to thank Sir David Tweedie, an incredibly busy man in his role as chairman of the International Accounting Standards Board, for agreeing to write the foreword.

All books are inevitably the outcome of collaborative effort and much outside assistance. Ours is no different and we would like to publicly acknowledge the debts of gratitude that we owe.

First and foremost, to Sarah Hutton, our research associate at IMD whose contribution has been immense in many ways, including the preparation of the glossary and keeping the manuscript under control, and to IMD’s resident editor, Lindsay McTeague, who has been a tower of strength. We would like to give credit to IMD research associates, Ivan Moss and Inna Francis, who were involved in the writing of a number of the original case studies upon which the book has been based.

The manuscript was read in its entirety by IMD colleagues, Professor Sean Meehan and Dr Janet Shaner, whose suggestions were most helpful. Gordon Adler, IMD’s former senior writer and now director of PR and communications, deserves many thanks, not only for his careful reading of the manuscript and useful recommendations, but also for his encouragement of the project from its inception. Indeed, had it not been for his persistent, if intermittent, prodding over the years, it might well have never been undertaken.

Dr Peter Lorange, president of IMD, not only read the manuscript but has also been an enthusiastic encourager of the endeavour from its early stages, and has allowed us to make use of IMD resources, which has been invaluable.

John Evans, IMD’s resourceful librarian, and his team helped immensely in digging up information for us.

Michelle Perrinjaquet has patiently dealt with the tasks of correcting and formatting the manuscript. Nadine Kraehenbuehl, a calm and efficient secretary and administrator, did much to ease the strain of production in so many ways.
Many have contributed, but the ultimate responsibility for any errors or omissions lies with us. This we gladly accept.

Finally we owe heartfelt thanks to our families who, despite having to put up with our absences (mental and physical) over many months, have been immensely supportive of our endeavours. We hope they feel it has been worth it.

Stewart Hamilton
Lausanne/Edinburgh

Alicia Mickleton-Wait
London
A decision to save $20,000 a year by not subscribing for a second Reuters terminal ultimately cost Allied Irish Bank’s American subsidiary, Allfirst, some $690 million in 2002: possibly the worst bargain ever. Allied Irish was big enough to absorb the losses and did not suffer the same fate as Barings Bank, which had failed some seven years earlier after a ‘rogue trader’ ran up even greater losses. It was abundantly clear that Allied Irish had learnt nothing from that high-profile disaster. This was, sadly, only one of many such omissions that have led to history repeating itself so dramatically in the first years of the new century.

This book is not about stock market ‘bubbles’. Nor is it about accounting scandals and craven auditors. It does, nevertheless, identify why companies fail, and sets out what the prudent investor, board member or manager should be alert to but often is not. We believe that a thorough understanding of what has gone wrong, what the major causes of corporate failure are and where the responsibility lies is essential if we are not to continue to repeat the mistakes of the past.

We postulate that the reasons why companies fail are few, and common to most, and that this holds irrespective of industry or geography. We believe that the main causes of failure can be grouped into six categories: poor strategic decisions; overexpansion and ill-judged acquisitions; dominant CEOs; greed, hubris and the desire for power; failure of internal controls at all levels from the top downwards; and ineffectual or ineffecting boards. We look at these reasons in more detail as we study the individual stories of some of the better-known failures.
Poor strategic decisions

Our research has shown that companies often fail to understand the relevant business drivers when they expand into new products or geographical markets, leading to poor strategic decisions. For example, Marconi did not clearly understand where rapid technological change was driving the market. Similarly, Tyco did not understand how GE had made a success of GE Capital or, as with Enron and WorldCom, how growing overcapacity in fibre cables would impact its investment. The board of Barings did not understand how the derivatives market worked, and therefore did not comprehend the risks associated with it.

This lack of appreciation of risk covers a wide field. Risk management, or rather the lack of it, was a major contributor to Enron’s and Barings’ downfall. They both failed to understand – and control – the level of risk in their trading operations.

Marconi did not appreciate the technological risk associated with moving out of industries that it knew well, into telecoms, about which it knew little. Neither Ahold nor Parmalat (in South America) nor Enron (in India) really understood the country or the political and economic risks that they faced. When Swissair made a large minority investment in Sabena (Belgium), it failed to judge the difficulties associated with achieving change in a government-controlled company.

Often a lack of adequate due diligence, whether building a new plant or making an acquisition, exacerbates the problems. Tyco did not research the cable market adequately; Ahold failed to uncover fraud at USF; WorldCom blindly accepted its advisors’ overvaluation of Intermedia’s local network assets.

Overexpansion

Many companies, frustrated by their inability to grow organically sufficiently quickly, turn instead to acquisitions. Despite all the empirical academic studies which have shown that less than half of all acquisitions deliver the sought-after or promised returns, AOL and Time Warner being a prime example, this tendency shows little sign of abating. Very often, the desired synergies (possibly the most dangerous word in the business lexicon) are ephemeral, and the integration costs far exceed the anticipated benefits. Furthermore, cultural differences and lack of management capacity often add to the obvious problems. Think of Daimler and Chrysler or BMW and Rover.
Too often, a tendency to pay too high a price to secure the deal – perhaps as a result of hubris – adds to these difficulties. This is what happened with Enron and Wessex Water, and with WorldCom and Intermedia, for example.

Organic expansion can obviously fail, but it rarely brings down a large corporation. One notable exception was Rolls-Royce which invested heavily in developing the RB 211 engine to power the Lockheed Tristar. These costs were then capitalised which allowed Rolls-Royce to show profits and pay dividends, despite haemorrhaging cash, until the company collapsed. Enron’s growth was partly organic and partly new businesses (but mostly developed organically). Its overexpansion put intolerable pressure on its balance sheet and led in part to the deceptions used to disguise the difficulties.

In other cases, overexpansion, mostly by acquisition, is driven by the overweening goal of short-term growth. This is particularly true where companies are focused on headline revenues. As we shall see, this was very evident with Enron, WorldCom, Tyco, Ahold and Parmalat. Furthermore, such a strategy provided opportunities to manipulate short-term earnings and long-term forecasts through the use of purchase accounting adjustments, such as integration cost provisions, and proforma reporting.

While, obviously, acquisitions per se are not necessarily bad (although many do not add value in the end), when performed primarily to boost growth rates over a number of years, they have to become ever larger to achieve the same effect. As the pool of possible targets decreases, prices paid – and level of risk – rise quickly.

Dominant CEOs

These individuals usually emerge after a period of successful (or apparently successful) management. The company becomes packed with like-minded executives who owe their position to (usually) him and are reluctant to challenge his judgement. A complacent board, lulled by past achievements, stops scrutinising detailed performance indicators and falls into the habit of rubber-stamping the CEO’s decisions. His drive, commitment, (often) charisma and streak of ruthlessness have contributed to the previous success. But later, as we will see in the majority of our tales, they become a major contributor to the company’s downfall. With no challengers or critics within the company, the dominant CEO may begin, perhaps unconsciously, to behave as though it is his own creation and – as Kozlowski did at Tyco, Ebbers at WorldCom and Tanzi at Parmalat – use it
as his own piggy bank. Shareholders and the board become irrelevant. Seduced by the prospects of yet more power and wealth and with a strong belief in his own infallibility, he goes all out for growth.

**Greed, hubris and a desire for power**

People tend to be naturally greedy, rarely content with what they have achieved. High achievers, such as top executives, are particularly ambitious and eager for more power and wealth. Since there is a clear, positive correlation between size of corporation (measured by revenue or by capital employed) and executive pay and status, CEOs have every incentive to grow their companies. Since, as we have already argued, the quickest way to grow a company is often by acquisition, the greedy CEOs of WorldCom, Tyco, Ahold, Parmalat and others, needed little encouragement to embark on a spending spree.

An additional incentive to unrestrained growth during the last years of the bull market was the huge awards of share options to executives, particularly in the US (Enron, WorldCom and Tyco) but also elsewhere (Ahold and Marconi). As a reward scheme, share options are a one-way bet: recipients cannot lose if the share price falls; indeed, options have often been re-priced when prices fall in order to maintain the value of the incentive. Options tilted the risk–reward balance in favor of more risky ventures. For a time this paid off: investors rewarded high-growth companies with ever-higher share prices, and CEOs became the recipients of undreamed of wealth. In 2004, average CEO earnings in leading US corporations were $11.8 million or 431 times more than those of the average worker.¹

But it is not only CEOs who are driven by greed. Where bonuses are a high proportion of remuneration, and tied to short-term results, there will always be a temptation to massage the figures in order to raise pay. Successful City (Wall Street) traders are highly rewarded but their pay is heavily dependent on the trading profits that they personally make. Banks encourage a climate of competition between traders, pushing them to try to report the highest personal profits. Individual bonuses are widely known among traders; ‘star’ performers are lauded and, sometimes, maverick behaviour excused in order not to disturb the profit-making genius. Again, it is status as much as wealth that drives traders to excel and, in some cases – such as Barings, Allfirst and Enron – to cook the books.
Failure of internal controls

Internal controls can fall short in a number of ways, some of which we outline below. The deficiencies are often compounded by complex or unclear organisational structures.

Blurred reporting lines leave gaps in control systems, nowhere more obvious than in the case of Barings, where no one believed that they had overriding responsibility for the activities of rogue trader Leeson. Dispersed departments can add to the problems: it is more difficult to pool knowledge of goings on when departments do not work closely together. In WorldCom, where the finance and legal functions were scattered over several states, communications were poor and employees lacked support to question the CFO’s (Scott Sullivan’s) actions. This also led to biased decision-making, where Ebbers relied on a small clique of insiders (not all the most senior personnel) to discuss strategy.

Changing the organisational structure can often leave gaps in information flow and responsibilities until the new one matures. Vital data can be overlooked. At Marconi, the delegation of responsibility to division heads and the abandonment of Weinstock’s famous ratios and trend lines meant that the deterioration in the working capital position was not addressed early enough.

Remote operations, far from head office, are often difficult to manage since head office is heavily reliant on local management and cannot always judge whether correct and sufficient information has been transmitted. This is particularly a problem with new, or unfamiliar, operations such as in the cases of Barings and Ahold.

Under-resourced risk management departments (if indeed they exist) together with inadequate information systems can be a fatal weakness in a trading operation, as witnessed in both Barings and Enron.

A fundamental contributor to failure is a weak, or ineffective, internal audit function. Often this is regarded as an expensive and unnecessary overhead. As a result, in many companies, such as Barings and WorldCom, the function is understaffed, and has chosen, or been forced, to perform mostly operational audits with the objective of uncovering potential cost savings rather than financial audits with the objective of safeguarding company assets.

Traditionally, external auditors partially filled the gap with their financial, transaction-based audits. Today, ‘risk-based’ audits are more common, where the focus is on areas identified as being the most exposed. This has left gaps where internal controls are rarely, if ever, audited. The door is left wide open to fraud. Internal audit’s independence is further
undermined when it reports solely to the CEO or CFO or when the audit programme, findings and employee remuneration are dependent on the CEO or CFO, such as in the examples of WorldCom, Barings, Enron and Tyco.

A recurring feature is poor cash control: at Marconi the spiralling level of working capital was not detected and dealt with early enough; at WorldCom, revenue was more important than collecting debts; at Enron, profit over the life of a contract was more important than the fact that it made losses and consumed cash in its early years.

In many cases, inappropriate financial structures have played a part. Tanzi’s desire for Parmalat to remain a family-controlled company precluded the issue of new shares to fund acquisitions, and instead it relied upon bond issues. In the Enron case, it was a desire not to dilute earnings per share (EPS) – and thus the share price and value of executive options – which gave rise to the same tactic. Thereafter, both companies suffered under heavy debt burdens and manipulated their accounts to disguise the effects of this illogical behaviour, rather than produce true and fair statements.

We believe that a CFO without a professional accounting qualification (Fastow at Enron; Meurs at Ahold) is a significant additional risk factor. Bankers, or for that matter MBAs (even with a finance specialisation), do not have the broad range of skills to oversee the finances of a large company and certainly not ones as complex as Enron and Ahold.

**Ineffective boards**

The examples we have chosen underline the lack of genuinely independent directors. A board is supposed to provide a non-partisan judgement of senior management’s actions and strategic proposals and to look after the interests of shareholders. The directors may not do this effectively if they are financially beholden to the company (other than by way of proper compensation for work as a director), as their judgement might well be clouded. Many so-called independent directors may not have been so independent after all. At WorldCom, many of the directors came from companies it had acquired and who owed much of their wealth to Ebbers. At Tyco, some of the ‘independent’ directors either depended indirectly on Tyco for the bulk of their income or had benefited from the use of company assets at the discretion of the CEO, Kozlowski.

Another clear danger is combining the roles of chairman and CEO. One key task of the chairman should be to assess the CEO’s performance in running the company. This is impossible to do if he is the CEO himself, as
was the case at Tyco and Enron. WorldCom was different as it did have a separate chairman. However, he performed none of the duties normally expected of a chairman, effectively allowing Ebbers to assume both roles.

We believe that a competent audit committee is essential to ensure that the appropriate internal controls are in place and working adequately; to ensure that company financial statements give a true and fair view of the company’s affairs; and to appoint, oversee and, if necessary, remove external auditors. Many audit committee members have too little financial expertise, making it difficult for them to understand complex accounting matters. Instead, they have tended to go through the motions of reviewing controls rather than undertaking a much more detailed study which would involve posing challenging questions. Enron’s audit committee, despite being chaired by a distinguished academic accountant (if this is not an oxymoron), clearly failed in this regard, as did several others.

A background of rising share prices and earnings may have lulled boards into thinking that all was well, that management was doing its job and may explain, if not excuse, the ‘hands off’ approach that many took in the late 1990s. But once share prices started to fall and companies came under pressure, there was no excuse for directors to sit back. Many boards failed to question management; failed to assess their competence, especially in the case of Ebbers at WorldCom; rubber-stamped decisions; spent as little time as possible in board meetings; allowed executive compensation to spiral out of control; and accepted management figures and explanations without serious question. This was obviously what happened at WorldCom, Enron, Marconi, Ahold, Parmalat, Swissair and Tyco.

Other issues

While we explore these causes of failure, we will also seek to demolish some prevalent misconceptions. Many commentators – politicians, the media and some academics – have chosen to describe events in terms of ‘accounting scandals’, exhibiting an inability to understand the root causes of the disasters. Few of the failures were the result of accounting irregularities. Rather, the misuse of accounting enabled flawed or failed business strategies or decisions to be concealed for longer than should have been possible. This was, of course, exacerbated by the abject failure of public auditing firms to do their job properly. And it was not just Andersen with Enron – none of the major firms has clean hands. Deloitte with Parmalat; Ernst & Young with Skandia; PricewaterhouseCoopers with Tyco; KPMG with Xerox are just some of the other examples.
Equally, while fraud was an issue at Parmalat, Barings and Enron, it was more a symptom and a result of deeper underlying problems than the proximate cause of the failures. The real issue is more one of the failure of controls both internal and external.

Similarly, it is too simplistic to ascribe events to the ‘irrational exuberance’ of the raging bull market of the 1990s. While, in terms of the old adage, recessions (and stock market collapses) uncover what auditors do not, corporations fail in all economic climates. Rolls-Royce and Barings Bank are examples of companies that went down in periods of relative calm. What is true, however, is that in long bull markets there is a tendency for even the most rational individuals to get caught up in the excitement of the times and act less prudently than they might otherwise do. Similarly, companies face ever-increasing pressure to perform, quarter after quarter, in terms of reported earnings and growth and to maintain or increase their share price. Growth may be pursued at almost any price, often through aggressive acquisitions that raise the debt burden, thus putting further pressure on management. At the same time, if a company’s share price continues to rise, its board might find it harder to question and challenge senior management even if it has misgivings about the strategy being pursued.

We are critical of the role played by the major accounting firms, the rating agencies and the investment banks and their analysts, but do not believe that they actually caused the failures. Rather, they failed to identify, or report, the problems early enough for remedial action to be taken. In our concluding chapter, we describe how governments and regulators are trying to prevent such problems in the future. Nevertheless, we believe that although these new rules may reduce the number of future failures, given humanity’s ingenuity, they will not eliminate them. We suggest some additional steps which should be taken.

We also identify some ‘red lights’ that managers, investors, analysts and indeed board members should heed as warnings of companies that may be heading for trouble.

The millennium meltdown

When Enron, the seventh largest (by recorded revenues) corporation in the US, collapsed in December 2001, it caused a shock but was largely dismissed as an unfortunate aberration in the system, ‘the one bad apple’. Europeans, and others, looked on with a measure of Schadenfreude. This was to be short-lived. When WorldCom went down a few months later in
the biggest corporate bankruptcy the world had ever seen, and reports emerged of other – if smaller-scale – disasters in the UK, Switzerland, the Netherlands, Australia and elsewhere, it became clear that this was a global phenomenon.

As tales of trouble at ImClone, Adelphi, Tyco, Global Crossing and others continued apace, these were paralleled by the collapse of TXU Europe, followed by major problems at Marconi, both in the UK; the failure of Swissair; revelations of serious accounting fraud at Ahold, in Holland; the near collapse of Equitable Life, also in the UK; and the scandal of HIH in Australia among many others. Perhaps most spectacular of all was the implosion of the Italian food giant Parmalat in Europe’s biggest ever corporate failure.

Worldwide, there was something rotten at the core of corporate life. Politicians and financial commentators alike pronounced themselves to be aghast at the unfolding tale of excess, corporate wrongdoing, misled shareholders, shoddy accounting and supine boards. They should not have been. In his classic book, *A Short History of Financial Euphoria*, J. K. Galbraith commented:

> There can be few fields of human endeavor in which history counts for so little as in the world of finance.²

Yet again, Galbraith had been proved right.

**The recent past**

The recorded history of human enterprise has long been a tale of ‘boom and bust’. Think of the biblical story of the seven fat years followed by the seven lean ones. The past centuries, especially since the introduction of the principle of limited liability, have seen a regular pattern of success and failure, right back to the Dutch tulip mania of 1636–1637 and the British inspired ‘South Sea Bubble’ of 1720. The creation, and subsequent immolation, of dozens of canal companies and then railway companies were among the biggest scandals of the 19th century. The 20th century saw the Wall Street crash of 1929, the 1987 stock market crash and ‘junk bond revolution’, the South American debt defaults, the Japanese stock market collapse and, in Britain, major financial scandals such as Barlow Clowes, BCCI, Maxwell, Barings Bank and many others. Despite these traumatic events, stock markets around the world in the 1990s enjoyed the greatest bull run since the golden age of the twenties. Fuelled by the rapid development of
the Internet and strong growth in the world economy, there was a massive increase in share dealings. The NASDAQ, which had closed at 357 on 9 January 1991, reached a peak of 5049 on 10 March 2000. All indicators showed that prices were at an unsustainable level. Price/earnings ratios were at an all-time high, as was Tobin’s ‘Q’.

In the dot-com arena, companies that had never earned a penny were being valued at many times the worth of their more traditional counterparts. One of the most extreme examples was that of eToys, an online retailer competing with Toys ‘R’ Us. At the height of the dot-com boom, eToys, with sales of $117 million, 300 employees and losses of $126 million, had a market capitalisation of $5.6 billion compared with that of its ‘bricks and mortar’ competitor, which was valued at $3.9 billion and generated profits of $12 million on sales of $11.9 billion and had 70,000 employees worldwide.

There were some voices of caution. In his prescient book, *Irrational Exuberance*, published in 2000, before the crash, Robert Shiller, a professor of economics at Yale, expressed his concerns that:

> The present stock market displays the classic features of a speculative bubble: a situation in which temporarily high prices are sustained largely by investors’ enthusiasm rather than by consistent estimation of real value.

IMD finance professor James C. Ellert, and separately, one of the authors, in a major open enrolment programme in June 2000, voiced the same concerns, and were derided as doom-merchants. Most chose to ignore or dismiss such concerns.

Despite the fact that politicians and others claimed that this time things were different, that there had been a ‘paradigm shift’ and that boom and bust were a thing of the past, the stock market crash of 2000 proved the opposite, with the dot-com and telecom companies replacing the canals and railways of earlier eras. Company failures occurred across continents and industries, among small and large companies alike.

The cheerleaders this time around had been the investment banks and their conflicted analysts; the ‘tip sheets’ of the past had been replaced by CNBC and Bloomberg; and the unlikely valuations of these ‘new economy’ companies were justified by consultants such as McKinsey. We saw the emergence of ‘day traders’ whose activities were enabled by the technological revolution in which they were investing. We also witnessed

---

1. Tobin’s ‘Q’ is the ratio of the stock market value of a firm’s assets (as measured by the market value of its outstanding shares and debt) to the replacement cost of the firm’s assets.
2. A tip sheet was an unregulated document circulated by stockbrokers and others, encouraging investment in particular shares.
the phenomenon of ‘momentum’ investment strategies born of a fear of missing out and the suspension of rational thought by those who should have known better.

It seemed that, once again, the brutal rules of capitalism were being played out. New technology which promises a significant change in the way people live and work offers great rewards to those who can capitalise on it. Much money flows in the direction of the companies established to benefit from the change. Some will succeed, most will fail and consolidation among the survivors will result in relatively few players remaining to reap the rewards.

Some choose to criticise this mechanism, which results in a great deal of capital being directed into new technology in a very short time, allowing the development of that technology to happen much faster than in any planned economy, national or corporate. It can be no surprise that upstarts lead the way, being more nimble and able to make decisions unburdened by bureaucracy, even if it is often the dinosaurs that pick up the pieces and go on to reap the rewards. Think of the consolidation in the railroad industry, among automobile and computer manufacturers and, more recently, in telecommunications. Such a system inevitably creates winners and losers, but it works. Inevitably, however, those who lose out demand explanations, inquiries and greater protection. The concept of *caveat emptor* is often forgotten by the most strident protestors.

**The aftermath**

As the many companies tumbled to earth, various excesses and failings came to light. These included inadequate auditing (both internal and external); regulatory failure; gross excesses of executive remuneration; supine boards unable to monitor and control executives; accounting fraud; and the greed of executives, employees, auditors, lawyers, banks and, indeed, shareholders who blindly invested without any rational analysis or understanding of what they were getting into. Some of these added to the main causes of failure set out above.

After the crash came the post-mortems. The US Senate held its many public hearings; villains such as Fastow of Enron and Ebbers of WorldCom were identified and photographed doing the ‘perp walk’; demands were made for legislative reform. This was to manifest itself in the Sarbanes-Oxley Act of 2002, a knee-jerk response to events, which was rushed through Congress in a matter of four months. The Act was intended to make directors and officers more explicitly responsible for
their companies’ financial statements; to place an obligation upon them to tighten internal controls; to clarify the role of audit committees; and, controversially, to grant formal status to ‘whistleblowers’. We believe that these measures will have little effect in the long run as they do not address many of the causes of failure we have set out above.

In our concluding chapter, we will take a look into the future, consider the impact and likely effectiveness of what has been proposed or implemented, and suggest what more needs to be done.

Notes

In February 2002 Allied Irish Bank (AIB) announced that a trader at its Allfirst Baltimore-based subsidiary had lost $691 million in unauthorised trading. It soon became apparent that this had happened because of poor risk assessment and management control; a lack of management supervision; an ineffective internal audit process; and a short-sighted desire to reduce overheads without regard to the potential long-term consequences. History was repeating itself.

Seven years earlier, on the morning of Friday 24 February 1995, Peter Baring, chairman of Britain’s oldest established investment bank – Baring Brothers Bank (Barings) – had walked over to the Bank of England (the Bank) to explain that his bank was in deep trouble and needed to be bailed out. A ‘rogue trader’, Nick Leeson, in Singapore had run up massive losses in unauthorised derivatives trading which threatened to bring down the bank. That weekend, there was frantic activity at the Bank – some of it bordering on the farcical when those seeking anonymity tried to enter by a locked back door – as the heads of Britain’s major banks sat down to see if a rescue package could be put together. They failed. Although the banks came up with a package worth £600 million, enough to cover the losses at that time, they demanded a cap on further potential losses on the open-ended contracts. No public money was available, and time ran out before another backer could be found. Barings collapsed the following Monday with losses of £830 million. The bank, very small by international standards, had lost an amount equal to more than twice its capital base.

As many of the bankers summoned to assist had been lenders to Barings, the activity back at their offices was even more frantic as staff
tried to ascertain their bank’s exposure to Barings and find out if they, too, had a Leeson. While no similar cases were reported, some members of the rescue team discovered that their own systems were lacking – they had no way to determine quickly and accurately the extent of their counter-party exposure to the Barings group as a whole. With the Barings collapse, the term ‘rogue trader’ firmly entered the financial lexicon, as the UK Chancellor of the Exchequer, Kenneth Clarke, sought to reassure the world that there was no problem with the financial system as a whole. The problems were initially ascribed to the irrational or criminal behaviour of a single individual, operating alone – an attribution of blame that conveniently deflected attention from the failures of management and regulation. Nick Leeson, who had fled to Kuala Lumpur with his wife four days before the collapse, had been fingered as the fall guy and all could relax. In fact, at this stage one could almost feel sorry for Peter Baring.

A new dawn: Around-the-clock global trading

The early 1990s had seen an unprecedented number of high-profile financial scandals, including Metallgesellschaft, Sumitomo, Showa Shell and Morgan Grenfell Asset Management. Indeed, it seemed that hardly a month passed without another example – often involving the misuse of derivatives – of management appearing to have been caught flat-footed. At the same time, there had been spectacular growth in trading in derivatives as banks worldwide tried to find new ways of generating profits to offset the decline in income from traditional sources. Because of recession and intense competition (not only from traditional rivals) it was more difficult to earn advisory fees. The problem was compounded by narrower interest spreads: banks’ bigger clients (which often enjoyed higher credit ratings than the banks themselves) were now able to borrow more cheaply in the bond markets. As a result, the potential profits from derivatives trading looked highly attractive. Of course basic hedging instruments had been around a long time and were a normal and reasonable way to transfer risk from those averse to it to those willing to assume it, for an appropriate price. What had changed were the trading environment and the profile of employees. There was a proliferation of new and more exotic instruments, fuelled by faster computers, and the hiring of young maths and physics graduates to design and operate the new models required to price the risks inherent in these derivative products. These ‘rocket scientists’ were new to the banking world and had little or nothing in common with the traditional banker, who in turn had little understanding of what they did.
When banks pushed to find customers for these new and, they hoped, highly profitable products, they found open doors. Corporations, at least those with large cash balances, were looking for ways to improve their yields. The general downward trend in long-term interest rates meant that normal market returns were decreasing and so too was the overall return on capital. More and more companies, some envious of what GE and ABB had achieved by building up substantial and profitable financial services arms on the back of their main businesses, started to see the Treasury function as a profit centre, rather than a support operation, and encouraged the search for higher returns. As a result, rather than using derivatives to manage their risks as they had before, a number of them started to trade them on their own account in order to make profits. Unfortunately, this trading activity was not accompanied by a realistic assessment of the risks involved nor by the necessary controls, and few had the experience or knowledge to compete against the established players.

Another ingredient in this potentially explosive recipe was the fact that some ambitious exchanges (and governments) saw this new business as a means by which they could increase their importance in world markets. Nowhere was this more obvious than in Singapore, where the Singapore International Monetary Exchange (SIMEX) aggressively pushed for business at the expense of Tokyo and Osaka.

The prevailing climate was one of optimism that this was a game at which all could win. Initially, any expressions of concern about the dangers of derivatives were brushed aside as scaremongering. Indeed, a report by the G30\(^i\) in early 1993 and a Bank of England study published shortly thereafter concluded ‘that there are no fundamentally new or different risks in derivative products’.\(^1\)

But problems had already surfaced at Showa Shell, a Royal Dutch/Shell affiliate which declared paper losses of more than $1 billion in early 1993 as a result of unauthorised currency trading. In an article in BusinessWeek, the Money and Banking Editor, Kelley Holland, drew attention to the growth of the credit exposure of some of the major US banks, citing Citicorp, J. P. Morgan and Bankers Trust. She called on dealers to ‘discuss how they manage their derivatives business – what internal controls they use and what steps they take to ensure that top management really understands what’s going on’.\(^2\)

The financial world had been transformed by the new instruments and, even more, by the rapid development of communications technology and

---

\(^i\) The Group of Thirty (or G30) is an international body of leading financiers and academics. The aim of the group is to deepen understanding of global economic and financial issues.
computing power, which allowed 24-hour trading around the world. Consequently, the speed at which positions could be built up increased dramatically in what had become a truly global activity. The nature and extent of risk had fundamentally altered. Traders operating round the world and round the clock could commit their companies to massive transactions at the stroke of a computer key. Unfortunately, even within long-established financial institutions, the control systems and necessary management skills to oversee this new business had not always developed in line with the growing market. The consequences were inevitable.

In December 1993 Metallgesellschaft, the giant German conglomerate, announced substantial losses resulting from speculation in energy derivatives by its US-based trading subsidiary. It only escaped bankruptcy by the injection of a reported DM 3.4 billion ($1.99 billion) in a rescue organised by Deutsche Bank, a major creditor and shareholder.

In early 1994 problems emerged at Kidder Peabody, the New York-based investment bank owned by GE Capital. A highly regarded trader had allegedly built up, and concealed, losses of some $350 million, while reporting fictitious profits over a three-year period. Indeed, Joseph Jett, the trader in question, had reportedly been paid a bonus of some $9 million the previous year.

In the wake of these and similar problems, the US Congress’s General Accounting Office had called for new legislation to regulate derivatives dealers and for greater oversight by the SEC of companies using such instruments. However, in May 1994 Arthur Levitt, the SEC chairman, told Congress that he saw no case for new powers, and that he would prefer to educate the public about derivatives, and urge greater disclosure by firms using them.3

Perhaps the Barings collapse was an inevitable result of the upsurge in derivatives trading. The collapse grabbed the headlines worldwide, acres of newsprint were covered, books were written and, ultimately, a Hollywood film was made.

‘The sixth great power’

In 1818 the Duc de Richelieu, a French soldier and statesman, noted, ‘There are six great powers in Europe: England, France, Prussia, Austria, Russia and Baring Brothers’. Barings was founded in 1762 by the sons of a Protestant immigrant, originally from the Netherlands. Although the family business was based on the cloth trade, it soon branched out into investment banking. The bank made its early fortune from trade, linking up with the Amsterdam house of Hope & Co., at that time one of the
richest and most powerful in Europe.ii Barings expanded its lending activities to foreign governments, including arranging loans to France for reparations after the Battle of Waterloo. While influential in Europe, evidenced by Richelieu’s comment, Barings was also a significant force in the US.

Always ready to invest in far-flung places, the bank got its fingers burnt financing, *inter alia*, a water supply and drainage company in Argentina (the Pacific Rim of the day). At the time – the end of the 19th century – Barings was judged to be ‘the keystone of English commercial credit and its collapse would provoke terrible consequences for English trade in all parts of the world’. Barings was saved by the Bank of England at a cost of £17 million (equivalent to £450 million today). Within four years the debt was discharged and Barings was once again one of the most powerful banking houses in Europe.

A century later, at the beginning of the 1980s, Barings, although tiny compared with the British high street banks, still had a reputation as one of the world’s most pre-eminent financial institutions. Income was derived from corporate finance fees, corporate debt funding and asset management. There was a significant ‘blue chip’ client base and Queen Elizabeth II was among its private clients. The bank was majority owned by a charitable foundation but control lay in the one hundred voting shares held by the directors of Barings plc.

With financial deregulation – prime minister Margaret Thatcher’s ‘Big Bang’ – looming in the early 1980s, there was a frenzied scramble by both British and foreign banks to buy stock broking and jobbing firms. Many of these hasty partnerships turned out to be less rewarding than promised but it was the vogue. Barings was not exempt from marriage fever, and when its overtures to Cazenove, Britain’s most blue-blooded stockbrokers, were rejected, it ended up buying the much smaller Henderson Crosthwaite (Far East) for the modest sum of £6 million. An important part of the deal was the operational independence of Henderson Crosthwaite, now renamed Baring Securities Ltd (BSL), and its London-based managing director Christopher Heath. Many Big Bang marriages almost fell apart because of cultural incompatibility between the partners, as evidenced by the problems at Dresdner Kleinwort Benson. The Barings deal aimed to avoid this.

Heath had built up a significant securities trading operation, with offices in London and Japan. Through this acquisition, Barings had effectively diversified into a new market. It had a very different culture to Barings’ traditional business and a new range of products (derivatives), with which both senior management and the board were unfamiliar.

---

ii The current owner of Hope & Co. is ABN Amro.
Marrying the traditional and the entrepreneurial

Barings was an old-style merchant bank, gradually declining in relative importance as the world of corporate finance changed. It was conservative, risk averse and gained business mostly through exploiting existing relationships rather than using an aggressive, proactive approach. By contrast, Henderson Crosthwaite, in its new guise as BSL, was a free-wheeling, entrepreneurial enterprise. Their time frames were different. ‘Everything in the broker’s world is today and tomorrow … whereas when you talk to a corporate finance person, he is interested in what his clients are going to be doing next year.’ The atmosphere in a dealing room with its bustle, informality and overall impression of deals being concluded and money being made could not be further from the quiet, sober-suited corridors of Barings.

The employees came from very different backgrounds. While Barings people tended to be private school and Oxbridge educated, BSL employees came from every kind of social and educational background. BSL hiring criteria were personality, self-assurance and drive – or desire to make money. These qualities were judged to be more important than the education, professional experience or management expertise which Barings valued. The drive to make money was fed by the company’s extremely generous bonus scheme which allowed 50 per cent of BSL’s pre-tax profits, after a capital charge, to be paid out as bonuses. At director level, the ratio of bonus to base salary was typically around three to one.

If Barings was an example of merchant banking’s past, BSL was the face of the future. From 16 people in 1984, BSL grew to more than 2000 by 1992 with offices around the globe. The expansion was led by research and sales people, with back-office staff struggling to keep up as best they could. BSL was formed in the mould of Christopher Heath, a consummate salesman and charismatic personality who engendered a spirit of family loyalty and ran the company like a one-man band, taking all major decisions himself. Management and control systems did not keep up with the expansion. As one senior director who left in the early 1990s commented: ‘Management was second-rate at best … They had no concept of the words risk and management going together, for instance. The place was becoming unravelled.’

---

iii Oxbridge is the term for the elite British universities of Oxford and Cambridge.
iv The back office is the department of a financial institution responsible for the processing and settling of trades and other administrative work (as opposed to the front office which is directly involved with the trading/dealing operations).
The party is over

As long as BSL was making healthy profits, little attention was paid to how the company was being managed. However, in 1990 the Tokyo stock market crashed, and although BSL coped better than many of its rivals, the collapse of its most important market had serious long-term implications for the future of the company. While Heath’s expansionist, entrepreneurial approach had worked well during the long bull market, a different approach was required for what turned out to be a persistent bear market. Believing that the Japanese market would quickly recover, BSL continued to expand, but in 1992, as a result of rising overheads and falling revenues, the company posted its first loss (£26 million).

For Barings, which had for some time been searching for a way to integrate the securities side into the bank and which was increasingly concerned about the way the company was run, this was the opening it needed. Heath was pushed upstairs as chairman and would resign at Peter Baring’s request six months later, taking a number of senior executives with him. Peter Norris, a rising corporate finance executive fresh back in London from Barings’ Hong Kong office became chief operating officer (COO) of BSL in September 1992. Given the job of introducing new management disciplines to BSL, he wanted to replicate the control standards of Barings within BSL. Heath, who understood the business thoroughly, had been replaced by a traditional banker who did not. Heath’s departure with most of his team left Barings’ management bereft of anyone who really understood the derivatives business.

The way was open to integrate the two operations (Barings and BSL) into a new entity to be called Baring Investment Bank (BIB), but it was decided to do so slowly because of the cultural and management differences between the two companies. The plan was to complete the integration by the end of 1994 but it had not taken place by the time of the collapse.

Confused reporting lines in a matrix management structure

Barings operated under a matrix management system. Traders, for example, reported both to product managers, who had profit responsibility for their actions, and to the local manager on operational and administrative matters. Back-office staff, while reporting to the local manager, also had a ‘dotted line’ report to their functional head in London. Senior management control was exercised by a series of head office committees. One of the most important committees, in operational terms, was the asset
and liability committee (ALCO), whose responsibilities included the
review, assessment and monitoring of credit and market risk across the
whole Barings group. Eight senior managers, including Norris, were
members of this committee, which met daily.

The Treasury and Risk functions at BSL were upgraded but were
designed more to cope with agency business (deals made on behalf of a
client) than with proprietary business (deals made on Barings’ own
account). The accounting function was improved but there was still little
emphasis placed on control. For example, it took no responsibility for
analysing or questioning the composition of balance sheets and was unable
adequately to allocate the cost of funding to the different businesses.
BSL’s internal audit department had only three members to cover its entire
global operations. The bank had invested too little in the necessary infra-
structure and, trying to keep costs down, it had devoted insufficient
resources to control. For example, the software used in Singapore was
incompatible with that used in London. As a result, the system relied
totally on information generated in Singapore and then transmitted to
London, where the bank could neither duplicate it nor check it.

Enter a ‘star performer’ – Nick Leeson

Nick Leeson joined the settlements department of BSL in London in 1989,
at the age of 22, having done a similar job at Morgan Stanley. Son of a
self-employed plasterer from Watford, he came up through the state school
system and left with two A-levels. Leeson proved to be good at his job
and was sent as a ‘fire-fighter’ to Hong Kong and Jakarta where they
needed an experienced settlements officer to sort out their problems. Back-
office employees, however, were always regarded as second-class citizens
by their front-office colleagues and Leeson yearned for the recognition
and rewards of a trader.

In early 1992 Leeson applied for a post in Singapore to take charge of
the settlements and accounting departments of the newly established
Baring Futures (Singapore) Pte Limited (BFS), a subsidiary of BSL. Partly
as a reward for his success in the Jakarta exercise, Leeson’s request was
granted and he arrived in Singapore in April. His job also included heading
up BFS’s SIMEX trading floor operation thus giving him authority over
both front- and back-office operations. As soon as he arrived, he applied to
SIMEX to take the examinations for the license necessary to become a

v Advanced (A) level exams are the English exams usually taken at the age of 17 or 18.
trader. This he achieved soon after BFS started trading in July 1992. He failed, however, to mention to SIMEX that he had been turned down by the Securities and Futures Authority (SFA) in the UK because, in his application for a trading license, he had omitted to disclose an outstanding county court judgment against him for a personal debt. Barings also failed to mention this to SIMEX, although it was well aware of the problem. Managers in both Tokyo and London held Leeson in high regard.

Right from the start Leeson’s reporting lines were unclear and the problem was compounded by the frequent structural changes taking place while BIB was being formed. Leeson should have reported on a local operational basis to Simon Jones and James Bax, managers of BSL’s Singapore subsidiary, BSS, and both also directors of BFS. However, Bax was given the impression that Leeson would be mostly controlled from London, to which he objected. This was just one example of the tension between local managers and financial control in London. Jones, concentrating on BSS, limited his involvement in the new BFS to administrative issues. London meanwhile assumed that Jones was taking a more active interest in BFS.

The picture was equally confused on the product (range of derivatives) side. Leeson originally reported to Mike Killian in Japan, who managed the agency business of Baring Securities (Japan) Limited (BSJ) including BFS’s agency business. At the end of 1993, Norris decided to move the equity derivatives business (BFS traded in derivatives) out of BSL and into the Banking Group headed by George Maclean. In future, BFS would be part of the Financial Products Group (FPG) run by Ron Baker. Baker was new to Barings and had little experience of exchange-traded derivatives (BFS’s business). Leeson continued to report to Killian on agency business but to Baker for proprietary business. Killian, for his part, assumed that Jones, in Singapore, was taking a more active role in monitoring Leeson’s trades. Until the end of 1994, Leeson was reporting to two different product groups.

This confusion of responsibilities resulted in poor control, as each of those involved thought that someone else was ultimately responsible for Leeson’s activities. Prior to the collapse, Barings had had three organisational structures in three years. Each was a matrix system with individuals reporting to more than one person, often in a different geographical location. The lines of responsibility became blurred, and confusion resulted.

The situation was hardly better on the back-office side. With Singapore local management abdicating operational control, London’s involvement was vital. Tony Gamby, director of settlements, BIB, was responsible for futures and options settlements from the beginning of 1994. Every company’s settlements department reported to him apart from BFS. BFS did report details of its trades to various departments in London, including
Brenda Granger, manager of Futures and Options Settlements, at the nascent BIB. This highly confused situation was compounded by poor relations between several key players. The financial controller, Geoffrey Broadhurst, stated that his relationship with Singapore was ‘very, very poor’, especially with Jones, with whom he was barely on speaking terms. Norris claimed that Ian Hopkins, director of Group Treasury and Risk, BIB, had a poor relationship with several senior executives and certainly with him. When, after Leeson fled, Norris summoned senior executives to a meeting, Hopkins was excluded. Norris’s personal assistant said, ‘It was thought that Mr. Hopkins would not be able to contribute anything meaningful to resolve the problem’.

The Singapore business

BFS started trading on SIMEX, as a clearing member, on 1 July 1992. Its trading volume rapidly built up until, by the time of the collapse, BFS was the largest trader on SIMEX, accounting for around 10 per cent of daily trades. The basic business of BFS was equity derivatives trading on behalf of a few clients, including BSJ. The main external client was Banque Nationale de Paris (BNP). Trading was in three main types of derivatives: ten-year Japanese government bond futures (JGBs), Nikkei 225 futures and three-month Euroyen contracts. These were simple exchange-traded contracts, and dealings were conducted through the recognised exchanges, SIMEX, the Osaka Stock Exchange and the Tokyo Stock Exchange. ‘Over-the-counter’ dealing was not permitted. BFS was authorised to take certain intra-day positions but, at the close of trading, all open proprietary positions had to be matched or closed. In keeping with this low-risk philosophy, BFS was only permitted to buy and sell options on behalf of clients. In other words, Leeson had no authorisation to take bets as to which way the market would move (apart from that allowed by his intra-day limits).

A supposedly very profitable part of the business was the ‘switching’ activity booked through BSJ. This took advantage of arbitrage opportunities between the different exchanges. While SIMEX operated on ‘open outcry’, the Tokyo and Osaka exchanges were computer based, which gave some room for arbitrage because of differing market structures. This business was supposed to be very low risk, since a position taken on one exchange should have been almost simultaneously matched against an equal and opposite one on another exchange. The reported revenue generated from this business was over £30 million in 1994. This performance formed the justification for Leeson’s proposed bonus for 1994 of £450,000.
and gave him the reputation of a ‘star performer’, not to be upset in case he took his talents elsewhere. When asked why management never questioned this high profit level from a risk-free operation, Maclean said that a lot of people ‘found it very puzzling. But I have to say, equally, and maybe you will say naively, we accepted it.’

To achieve the extraordinary profit levels that he did, Leeson resorted to hidden activities. They were twofold. First, he increased reported profits by trading between genuine accounts and a hidden account 88888 at prices that would credit profit to the known account. Second, he was betting on which way the market would move by taking open positions. Further illicit actions were required to disguise his activities. By the end of 1994, his disguised losses were over £200 million.

Then catastrophe struck in the shape of the Kobe earthquake on 17 January 1995. At the time, Leeson had a small short position in Nikkei 225 futures contracts and a large number of outstanding options contracts. His options strategy (writing straddles) implied a belief that the Nikkei index would continue to trade within a narrow range. The reality proved to be that the Nikkei index tumbled while JGBs rose.

Leeson rapidly built up a large long position in Nikkei 225 futures and a short position in JGBs, perhaps because he was betting that the Nikkei 225 index would rise and that bond values would fall. Alternatively, he believed that his trades alone could influence the market and save him from disaster on the options contracts. In the event, losses on the Nikkei 225 and JGB contracts dwarfed losses on the options. By 23 February, Leeson’s position was so large that he was losing £20 million for every 100 points that the Nikkei index fell (the index fell over 2000 points between 17 January and 27 February, falling 645 points on 27 February alone). The total resulting loss for the first 58 days of 1995 amounted to £638 million, or £11 million a day.

The cover-up and creation of the 88888 account

Leeson had set up account 88888 in July 1992 and used it to disguise the true trading position. He claimed that this account was opened originally as an error account and only later misused. In fact, the volume of transactions passing through the account right from the start implies that he never actually intended it to be operated as a genuine error account.

Reports of trades sent daily to London included details of positions and margins. Account 88888 was included in the margin report sent to London, but because the account was not on the computer master list it was put into a suspense file. Items in this file were never properly investigated.
Month-end balances on 88888 were concealed with premiums from writing options contracts or by creating false journal entries. As Leeson’s open position on 88888 increased substantially during 1995, so did the margin calls from SIMEX. By creating false trades, Leeson was able to alter the position sheet sent to SIMEX which was used to calculate the margin call. As a result, BFS’s margin requirements were eased. All these activities required the involvement of traders and back-office staff. They did what their boss said and did not query his requests with anyone outside BFS.

Despite Leeson’s concealment of his true position from SIMEX, he still needed increasingly large amounts of cash to support his losses and to fund his position. Since BFS had only limited funding facilities in Singapore, it relied on funding from Barings entities in London and Japan. At the time of the collapse, cumulative funding of BFS was, at over £740 million, more than twice the reported capital of the whole Barings group. The situation had worsened considerably during the first two months of 1995, rising from £221 million outstanding funding at the end of 1994. London thought that the cash was for funding clients’ margin requirements, supposedly only temporarily until the cash was collected from clients. Treasury, Settlements and Credit failed to spot what was going on and continued to transmit cash to Singapore.

**Discovery and collapse**

By the end of January 1995 there were rumours in the market regarding the scale of Barings’ positions. The Bank of International Settlements even telephoned Barings over a rumour that Barings could not meet its margin calls. SIMEX wrote to Barings asking for reassurance that BFS had sufficient funds to meet its obligations. London did not investigate these rumours, thinking that the market was unaware of Barings’ supposed equal and opposite positions on the neighbouring exchange.

Eventually Treasury (Tony Hawes) and Settlements (Tony Railton) staff visited Singapore in order to resolve several issues, one being the lack of information sent to London to support the margin requests. Railton soon discovered that something was wrong but did not yet suspect fraud. He tried, but failed, to talk to Leeson to resolve the problems. On Thursday 23 February 1995, Leeson and his wife flew to Kuala Lumpur, from whence he faxed his resignation the following day, citing health reasons. Hawes discovered account 88888 on Thursday night and then heard that Leeson had left Singapore. It was only then that ‘the alarm bells started flashing’.

On Friday, having taken legal advice, the directors of Barings plc decided that the group could continue to trade for that day. Peter Baring
paid his visit to the Bank of England. When the rescue bid failed, Barings was put into administration. Just over a week later, the assets and liabilities of the Barings group were purchased by Internationale Nederlanden Groep N.V. (ING) for the sum of £1.

The fallout

The Barings collapse was followed by two formal inquiries, the first by the Bank of England’s own Board of Banking Supervision and the second by inspectors appointed by Singapore’s Minister for Finance.

In July 1995, four months after the collapse – quick by UK standards – the report of the Board of Banking Supervision was published. The Singapore authorities, furious that the Bank of England, Barings’ supervising authority, had failed to prevent the fraud, had declined to cooperate. Leeson, then in prison in Germany, having been arrested en route for the UK, refused to talk.

The report set out in great detail the nature of the unauthorised transactions and the methods of cover-up. It was critical all round, but the Bank of England escaped relatively unscathed.

Two months later, the report commissioned by the Singapore Minister for Finance was published. It was much more critical of all the involved parties and indicated the Singaporean authorities’ belief in some degree of collusion by some Barings senior managers. Despite having somewhat differing emphases, the two reports agreed that fundamental lapses in control and lack of understanding of the trading activities were key contributory factors in allowing Leeson to incur over £600 million of losses in just the two months prior to the collapse. The formal investigations in London and Singapore revealed a catalogue of errors and omissions: Leeson controlled both back and front offices; he was inadequately supervised; he had manipulated the accounting system by putting in false data; and had been able to conceal his losses over a long period of time.

Leeson was extradited to Singapore and after negotiation with the authorities, nine of the charges against him were ‘stood down’.vi He pleaded guilty to the remaining two charges of cheating and was sentenced to six and a half years in prison. Apart from Leeson, the main losers in the affair were Barings’ bondholders and the recipients of charitable donations from the Barings Foundation, the shareholder. There is no evidence that Leeson tried to embezzle money for himself, although he did stand to benefit from large annual bonuses directly related to the false profits he reported.

---

vi Charges ‘stood down’ are not proceeded with but are taken into consideration when sentencing.
Subsequently, it was generally agreed that the Barings collapse had done more to highlight the need to improve the standards of risk management and control within financial institutions than all the previous exhortations of the various regulators combined. After the publication of the Bank of England’s Board of Banking Supervision’s report on the events leading up to the collapse of Barings, most major institutions set in train thorough reviews of their own controls and procedures and made significant strides in introducing some variant of the Value at Risk (VaR) model to assess their overall exposure to derivatives trading.

Even before the publication of the report, Brian Quinn, then an executive director at the Bank of England, said, in a 1993 speech to a G30 seminar on derivative financial instruments, that ‘the primary responsibility for understanding these products lies with the management of the individual firm’. With the benefit of hindsight this turns out to have been little more than the expression of a pious hope. After it emerged in evidence given to the House of Commons Treasury Committee by Peter Norris, ex-CEO of BIB, that no members of the board of Barings plc were knowledgeable about derivatives trading, it also cast doubt on the effectiveness of the Bank’s regulatory enquiries, which had been dismissive of the risks of such trading. At a subsequent hearing before the same committee, Quinn’s successor, Michael Foot, struggled to justify the Bank’s failure to identify this weakness as ‘something that we put out as good practice, it was not a supervisory requirement as such’.

The unlearnt lessons

Virtually unnoticed in the shadow of the Enron bankruptcy (see Chapter 3) and the resulting media outpouring, almost seven years to the day after Barings Bank collapsed, Allied Irish Bank (AIB) announced on 5 February 2002 that its American subsidiary, Allfirst, had incurred losses of some $691 million. John Rusnak, a currency trader in the Baltimore office, had been conducting unauthorised trades in Japanese yen which had gone badly wrong but which he had managed to conceal for some time. Despite the worldwide publicity that the Barings collapse received, and the numerous inquiries that were carried out, lessons had not been learnt.

Fortunately for AIB, the losses, although making a considerable dent in its balance sheet, were not big enough to bring down the bank. A new name had joined the ranks of the ‘rogue traders’ and the post-mortems began.
The story is straightforward enough. In 1983 AIB, as part of a strategy of increasing the global diversification of its operations, acquired a substantial stake in Allfirst, then known as First Maryland Bancorp. In 1989 it became a wholly owned subsidiary, and the decision was made to allow it to operate more or less autonomously, with its own management team and board of directors. One area which AIB did want to control was the Treasury operation, where it believed that it had greater expertise. Accordingly, a senior AIB executive, David Cronin, was sent from Dublin to take over the role of treasurer. The insertion of an outsider was not entirely welcomed, and it took some time for him to be accepted. Cronin, in this role, had responsibility for both back and front offices. Although head office in Dublin, with which he remained in close contact, retained confidence in Cronin, management in Baltimore began to question his energy and commitment. A confused reporting system left this problem unresolved and perpetuated the lax control environment.

Two further factors contributed. AIB had a significant appetite for proprietary trading, rather than simply providing a service for clients, thus putting its own capital at risk. Moreover, John Rusnak was able to exercise considerable control over back-office staff through intimidation and threats of dismissal. Although a contrasting style to that of Nick Leeson, who used charm as a tool, it was equally effective in deflecting scrutiny or criticism.

AIB’s board ordered an internal inquiry headed by Eugene Ludwig, a former US comptroller of the currency, to investigate the circumstances surrounding the fraud and to make appropriate recommendations. Ludwig produced his report on 12 March 2002 and it was immediately posted on the AIB website.

The Ludwig report was compulsive reading for anyone who had followed the Leeson story. The parallels were uncanny. In addition to some special factors unique to Allfirst, at least nine problem areas were identified which mirrored those in the Barings case. The story was not complete, as the investigators interviewed neither Rusnak nor the auditors.

Memories are short

The Centre for the Study of Financial Innovation (CSFI), a non-profit think-tank, each year publishes a survey of the risks facing banks based on industry questionnaires. In the two years following the Barings collapse, 1996 and 1997, the ‘rogue trader’ came fourth and third respectively. By the following year, that risk had dropped out of the top ten, and in the 2002 survey it featured at number 24.
Perhaps a degree of complacency had crept in at AIB and its subsidiary, but obviously the Barings lessons had passed them by. Ludwig’s report lists a whole string of deficiencies in their trading and risk assessment and reporting procedures, which, together with inexperienced and ill-trained staff, made the fraud almost inevitable.

Despite a number of clear warning signals, and some earlier attempts to investigate Rusnak’s activities, Allfirst failed to pick up his fraud until it was too late. Subsequently, Rusnak was charged with bank fraud and false entry into bank records and sentenced to eight years in prison.

**What went wrong and lessons to learn**

It is instructive to look at the similarities between the Barings and AIB cases.

**Weak internal controls**

The fraud in both cases occurred in an operation remote from the head office, a risk factor highlighted by Howard Davies, the deputy governor of the Bank of England, in the aftermath of the Barings collapse. Like Barings, there was a matrix management structure in place at AIB and Allfirst. This meant that the Allfirst treasurer ‘had less consistent and reliable supervision than would otherwise have taken place’.14

A breach of a fundamental principle of internal control, that of ‘segregation of duties’, had occurred at AIB, with Rusnak able to alter the computer records of his outstanding trades. Leeson had done similar things in Singapore. This breach was compounded by a weak internal audit function and poor follow-up of recommendations made or problems identified. Allfirst’s internal audit department suffered from inadequate staffing, lack of experience and too little knowledge of the risks involved in trading. There is a clear suggestion that insufficient resources had been devoted to control procedures in an attempt to contain costs.

Although Rusnak was not highly paid by the then prevailing standards of Wall Street, his remuneration was directly linked to the profits from his trading book, on which he stood to earn a substantial bonus. The Bank of England, in relation to Barings, had emphasised the risks inherent in tying remuneration to trading profits: ‘If remuneration is linked to profitability, it is important that the control environment should be particularly rigorous’.15

The necessary controls were not in place at Allfirst. Again, echoes of Barings.
Ludwig concluded ‘at both the AIB Group and Allfirst levels, the Asset and Liability Committees, risk managers, senior management, and Allfirst internal auditors did not appreciate the risks associated with Rusnak’s … style of foreign exchange trading’.16

Of course, no two cases are ever exactly the same, and with Allfirst there were additional control issues that made detection of Rusnak’s activities more difficult.

First, Allfirst made use of a VaR system to measure its trading risk, which relied on information on market prices obtained from Reuters. In order to save $20,000 per annum, instead of having a separate price feed for the risk management team, it relied on information provided by Rusnak from his terminal thus allowing him to enter false data and thereby conceal the extent of his losses. The savings thus achieved, compared with the loss of $691 million, must rate as one of the worst bargains ever.

Second, and even more improbably, Rusnak was allowed to continue to trade even when on vacation, using remote computer access. Most organisations, if they have any sense, have mandatory holidays and rotation of personnel, as it is well known that frauds are often uncovered during the perpetrator’s absence.

Ignoring early warning signs

With both Leeson and Rusnak, the market was aware of the very large positions they had built up. In May 2001 AIB had been tipped off about Allfirst’s very heavy foreign exchange trading. Enquiries into the size of Rusnak’s transactions seemed to have been tentative at best and easily brushed off by Cronin.

Why Allied Irish repeated the mistakes of Barings and lessons to learn

Controls weakened by inadequate internal audit

The reasons are clear and worth examining in some detail. In many organisations, internal auditors are perceived as overheads and not as essential parts of an overall control structure. A survey of 186 of the top 500 UK companies, carried out by the accounting firm Ernst & Young in 1995, found that 40 per cent of the companies had no internal audit service, and concluded that company directors are ‘dangerously complacent’ over
internal control. And this was after the Barings collapse! In the Barings case, Ian Hopkins, former head of Group Treasury and Risk at BIB, claimed that insufficient resources were devoted to control matters in an attempt to keep costs down.

‘Star’ performers

A second issue is the demand for continually high levels of performance of dealers and fund managers. The cult of the individual and the high profiles and remuneration packages on offer must, in themselves, give cause for concern. The absolute level of bonuses paid, no matter how offensive in the eyes of ordinary mortals, is not, however, the main issue. Rather the question of what has been described as ‘asymmetric risk’ presents the potential for encouraging aberrant behaviour. If you are approaching the bonus assessment day and you have not quite reached your target, is it not tempting to take an additional risk to make sure that it is achieved? This point was addressed in a paper published by the Bank of England where it was argued that ‘a remuneration scheme which gives perverse rewards to risk taking behaviour may put the control system under great stress.’

Organisational risks

Matrix management systems carry special risks. Unless well designed, and supported by proper information systems, there is a real danger that things might fall through the gaps. Reporting lines need to be absolutely clear, which was anything but the case at Barings:

No one in management accepts responsibility for Leeson’s activities between October 1993 and 1 January 1995 …

And again:

… some members of management believed that the responsibility for certain activities (for example equity derivatives, BFS) rested with other managers, who deny they had such responsibility. This resulted in confusion …

These problems are exacerbated by distance.
Understanding of business drivers

Finally, a thorough understanding of the business is a necessary prerequisite of good management. This is especially true when venturing into new markets or products, as Barings did, where the absence of knowledge was profound: ‘Until the collapse, Barings management in London believed the trading conducted by Baring Futures Singapore to be essentially risk free and very profitable.’20 It is hard to believe that experienced bankers, of whatever hue, could have been quite so naive.

Such lack of understanding is one of the main reasons that so many acquisitions fail to produce the expected benefits.

The key messages are:

1. Cutting corners to reduce expenses is often a poor strategy. Sufficient resources must be devoted to accounting and reporting systems, and must be tailored to the particular risk profile of the organisation. This in turn requires that a comprehensive analysis of risk is undertaken and then regularly reviewed.

2. Out of sight must not be out of mind. The benefits of managing by walking around are often lost in operations far from head office and therefore sound alternatives like regular, but unannounced, visits are needed.

3. Proper segregation of duties is essential. This absolutely basic principle of internal control is ignored at one’s peril. Mandatory rotation of personnel and compulsory vacations are an essential part of that process.

4. Sufficient and adequately trained personnel are essential for an effective internal audit and control system.

5. If profits seem disproportionately high in relation to the perceived level of risk, then there is almost certainly something wrong which should be investigated.

Notes

1 Brian Quinn, Executive Director, Bank of England Quarterly Bulletin (November 1993).
4 Baron Alphonse writing to Lord Rothschild in 1890.
5 Andrew Tuckey, Chairman Baring Investment Bank.
9 Tony Gamby, Settlemnts Director BIB.
16 Ludwig Report, p. 2.
18 Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings (18 July 1995), section 7.9, p. 120.
The collapse of Enron in 2001 in the (then) biggest bankruptcy the world had ever seen has had profound consequences. It led to the demise of Arthur Andersen, perhaps the most prestigious of the major accounting firms, and to the biggest shake-up of US corporate regulation since the Securities Acts of 1933 and 1934 in the shape of Sarbanes-Oxley.

Unlike some other contemporaneous high-profile failures, this was not a simple ‘dot-bomb’ story. When the NASDAQ index was falling through the floor, Enron shares, for a time, had continued to outperform the market. Rather, it is a tale of how a group of individuals, driven by greed and ambition, pursued flawed and poorly executed strategies and recklessly expanded a company far beyond its capital base. To try to sustain the unsustainable, they were prepared to fraudulently conceal the extent of the problems they had created, meanwhile enriching themselves at the shareholders’ expense. As the story unfolded, it became clear that ill-judged acquisitions and moving outside core competences had added to the problems. It is also a tale of bitter rivalries, the relentless pursuit of revenue growth, and a willingness to use whatever means were necessary to meet analysts’ expectations for quarterly profits. This they were able to do in the absence of effective internal controls and because of inadequate auditing, both internal and external, carried out by Andersen. It is also a story of a complacent and supine board, stuffed with cronies and grossly overpaid while failing to exercise any meaningful oversight. The key players were Kenneth Lay, CEO and chairman; Jeff Skilling, COO (who succeeded Lay as CEO in February 2001); Andrew Fastow, CFO; and Rebecca Mark.
The earthquake

It is difficult to exaggerate the shock to the business world when Enron, the seventh largest company by reported revenues in the US, employing 25,000 people worldwide, filed for bankruptcy protection on 2 December 2001. How could this high-profile leader in the world of energy trading have failed? The employees, many of whom had a large part of their retirement and other savings tied up in Enron shares, were devastated. Not only were they likely to be out of a job but they also faced financial ruin.

The readers of *Fortune* magazine, over six consecutive years, had voted Enron one of the most innovative companies in the US. Its performance had been lauded in the media, and Harvard Business School case studies had been written holding it up as a glowing example of the transformation of a conservative, domestic energy company into a global player. Other, more traditional, energy companies had been criticised for not producing the performance that Enron had apparently achieved. The consulting firm McKinsey had frequently cited Enron in its *Quarterly* as an example of how innovative companies can outperform their more traditional rivals.

The speed of the collapse surprised many. After all, in the months before, the rating agencies had not signalled any credit risk problems and most financial analysts following the stock were still rating it a ‘buy’ or ‘hold’. Only six months earlier, David Fleischer, an analyst with Goldman Sachs, had described Enron as ‘a world-class company’, ‘the clear leader in the energy industry’. While acknowledging that Enron’s ‘transparency’ was ‘pretty low’ and that ‘[the company] had been indifferent to cash flow as it sought to build businesses’, his view was that ‘an investment in Enron shares right now represents one of the best risk/reward opportunities in the marketplace’. This was not untypical.

As details of massive undisclosed debt emerged, it became clear that Enron had many elements of a ‘Ponzi’ scheme. The drive to maintain reported earnings growth, and thus the share price, led to the extensive use of ‘aggressive’ accounting policies and practices to accelerate earnings with, at least, the tacit approval of Enron’s auditors, Arthur Andersen. Of these practices, the use of ‘special purpose entities’ (SPEs) to accelerate profits and hide debt initially attracted the most attention because of the financial involvement of Enron officers and employees. This in turn led to the widespread and erroneous conclusion that Enron had been brought down by accounting fraud. The reality, as we shall see, is much more complex.

---

1 A swindle, also known as a pyramid scheme, which involves ‘borrowing from Peter to pay Paul’. It is named after Charles Ponzi, who, in the 1920s, conned tens of thousands of people in Boston into investing in international postal reply coupons by offering to pay vast amounts of interest, which he did by using the later investments.
The creation of Enron

Energy deregulation began in the US in the late 1970s. It started by allowing open market prices for new natural gas discoveries and thus created the opportunity for energy trading in a big way.

Kenneth Lay – who at one point in his career had been an energy economist at the US Interior Department, rising to the rank of Under Secretary – formed Enron in 1985, from the merger of two traditional gas pipeline companies, InterNorth and Houston Natural Gas. This combination created the largest natural gas pipeline system in the US of some 37,000 miles, stretching from the borders of Canada to Mexico and from the Arizona–California border to Florida. It also had significant oil and gas exploration and production interests.

Lay knew that, as deregulation progressed, this would create commercial opportunities for the more far-sighted energy companies. He became chairman and CEO and, with the help of Richard Kinder as COO, set about building up the company through a series of new ventures and acquisitions, many financed by debt. Thereafter, managing the debt burden was to be one of Enron’s constant preoccupations.

Kinder, a lawyer by training, was a traditional oil and gas man who insisted on rigorous controls and who had a reputation for being a fair but tough manager. He was considered the perfect foil to Lay, the free-market visionary.

Another key member of the team was Rebecca Mark, who had joined Enron in 1985 and who had been sponsored by the company to do a Harvard MBA. As CEO of Enron International, she was responsible for international power and pipeline development and was instrumental in negotiating the Dabhol power project in India, which, at around $3 billion, was the largest foreign direct investment ever in that country.

In the mid-1980s, Jeffrey Skilling, a Harvard MBA and the partner in charge of McKinsey’s energy practice in Houston, had advised Lay on how to take advantage of gas deregulation. In particular, he had been responsible for establishing Enron’s ‘gas bank’, a mechanism to provide funding for smaller gas producers to enable them to invest more in exploration and development and, at the same time, provide Enron with reliable sources of natural gas to feed its system. In 1990 Lay appointed Skilling head of Enron Finance.

The same year, Skilling hired Andrew Fastow from Continental Illinois Bank. Fastow’s background was in asset securitisation and structured finance. His role would be to develop the company’s gas bank business and to obtain and manage the debt and equity capital to fund its third-party...
finance business. He would eventually become CFO in 1998. Although not a certified public accountant (CPA), Fastow would, in 1999, be voted by CFO magazine the ‘most creative financial officer of the year’ in the US.

‘It was all Bill Clinton’s fault.’3 This unusual explanation of Enron’s collapse was put forward by an Enron employee, a traditional Texan Republican who believed that, had Senator Bob Dole won the presidential election in November 1996, Ken Lay would have been offered a cabinet-level post in Washington. Instead, with Clinton safely back in the White House, Lay signed on for a further five years as CEO. Richard Kinder, unwilling to remain as number two for that length of time, resigned on 26 November, just weeks after the election, to form his own company. As a result, Skilling became president and COO of Enron and was thus free to pursue his vision. He believed that it was possible to make more money through an ‘asset light’ strategy, which involved concentrating on trading and disposing of traditional activities. What is certainly true is that most of Enron’s problems arose after Kinder had gone.

The Enron culture

The occupants of Enron’s head office at 1400 Smith Street, Houston regarded themselves as an elite. Enron had largely left behind the Texan ‘good ol’ boy’ culture – and certainly the culture of the regulated utility – and embraced Lay’s free-market vision. Encouraged by Skilling, a highly paid army of financially literate MBAs sought innovative ways to ‘translate any deal into a mathematical formula’ that could then be traded or sold on, often to SPEs set up for that purpose. By the end, Enron had in excess of 3000 subsidiaries and unconsolidated associates, including more than 400 registered in the Cayman Islands, a well-known tax haven.

Skilling introduced a rigorous employee performance assessment process that became known as ‘rank or yank’. Under this system the bottom 10 per cent in performance were shown the door. There was heavy pressure to meet targets, and remuneration was linked to the deals done and profits booked in the previous quarter. This was particularly acute at the quarter end and gave rise to the expression ‘Friday night specials’. These were deals put together at the last moment, and often inadequately documented, despite the efforts of the 200 or so in-house lawyers that Enron employed. The emphasis was on doing deals and not necessarily worrying about how they were to be managed in the future. Even internally it was recognised that project management was not a core competence.
Despite, or perhaps because of, all the pressure, Enron’s senior employees were loyal and well rewarded. In 2000 the top 200 employees shared remuneration packages of salaries, bonuses, stock options and restricted stock totalling $1.4 billion (compared with reported profits of $970 million), up from $193 million in 1998. The board also enjoyed handsome benefits well in excess of the normal levels of remuneration paid to non-executive directors of public companies in the US.

The belief that they were changing the world ran deep, even after the problems emerged. Following Skilling’s sudden resignation as CEO in August 2001, for reasons that were far from clear at the time, after only six months in the post, there were some lay-offs in the trading and risk management areas, and in at least one case an individual used a substantial proportion of his severance package to buy more Enron stock in the market. Another, after hearing expressions of sympathy for the redundant employees, said:

I would disagree on your view of the ‘poor employees’, however. When I was there it was pretty obvious that most employees knew what was going on and the fact that many people had an overly large exposure to Enron shares was based on greed and share price growth which had taken a disproportionate part of personal assets. … I fume when I see some of the VPs on US television complaining about their egregious treatment.

A changed environment creates new opportunities

Prior to energy deregulation, the industry was vertically integrated, from the sourcing of natural gas or the generation of electricity, to its transportation, distribution and sale into a captive market. Although low risk, it was capital intensive and heavily regulated. Success came through technical expertise and economies of scale, and the whole industry was characterised by slow trends requiring a long-term view.

The effect of deregulation was to ‘unbundle’ the industry value chain so that companies were free to choose in which parts to operate. In other words, it was not necessary to be a generator or a transporter in order to market and sell power to the end customer. One could source electricity from generators and rent transmission capacity or indeed trade it like any other commodity. Enron’s chosen strategy was to focus on the high value-added activities and optimise them independently of one another. In particular, Skilling decided to put the emphasis on trading.
Enron had been involved in buying and selling energy commodities since the early years, using its intimate knowledge of the market for natural gas gained from its pipeline operations. The piecemeal process of energy deregulation continued over a number of years, and Enron’s trading activities steadily increased in parallel. Initially confined to contracts for physical delivery, the trading ultimately extended to gas futures, long-term supply contracts and hedges. Recognising that this required new skills, in 1989 the company entered into a joint venture with Bankers Trust to set up a financial trading desk. This arrangement was short-lived, ending in 1991, but helped establish Enron as a major player. Thereafter, Enron hired its own traders from the investment banking and brokerage industries and, increasingly, newly graduated MBAs from high-ranking business schools. Over the next ten years, Enron was to transform itself from a domestic natural gas company into a global energy provider and trader.

The industry, led by Enron, had lobbied hard for exemption from the normal regulatory oversight of derivatives trading. Wendy Gramm, as outgoing chairman of the US Commodities and Futures Trading Commission (and the wife of the senior US senator for Texas), granted that exemption. Sometime afterwards, she joined Enron’s board as a non-executive director. In 1994 Enron extended its trading operations by buying and selling electricity after it had obtained exemption from regulation as a utility company.

**Changing the rules of the game**

A significant Enron innovation had been the development of ‘volumetric production payments’ (VPPs) in 1990. To get round the problem in the gas industry of the large number of small producers who lacked access to capital to improve their facilities and to search for new reserves, Enron provided liquidity by prepaying for long-term fixed-price gas supplies, with the payment secured on the gas itself and not on the assets of the producer. This reduced the risk of default to Enron which had first call on a proportion (usually half) of the gas from the field. This arrangement also meant that Enron had secure long-term natural gas supplies.

A major breakthrough came in December 1990 when Enron secured a 23-year, $1.3 billion supply contract for natural gas to the New York Power Authority (NYPA). The price was fixed for the first ten years and would thereafter be adjusted monthly to market rates. This in turn allowed the NYPA to finance the construction of a 150-megawatt power plant on Long Island. As a consequence, Enron would require the secure long-term sources of natural gas provided by the ‘gas bank’.
The possibility of being able to depend on long-term supplies of natural gas at predictable prices reduced the risk for electricity generators of building the very expensive but much cleaner, and more environmentally friendly, gas-fired power stations.

‘Mark-to-market’ accounting

The VPPs were contracts that had a predictable future cash flow and could be treated as ‘merchant assets’. Following this logic, Enron applied to the Securities and Exchange Commission (SEC) to be allowed to mark these assets to market. This permission was granted for 1991 on an exceptional basis and thus Enron became the first company outside the financial sector to adopt this method. Although the permission was supposed to be temporary, the SEC seems to have forgotten to revisit it, thus paving the way for Enron to make increasing use of this accounting treatment in the ensuing years. The effect of this method was to allow a company to take upfront most – if not all – of the anticipated profits on such contracts, with a requirement to recognise losses if their value diminished.

The basic methodology was simple. To ‘monetise’ a deal, the trader would forecast the future price curve for the product, calculate the future cash flows and apply a discount rate to compute the net present value (NPV) which could either be sold to an SPE created for that purpose or kept on Enron’s books as a merchant asset. For some products – for example gas futures – market prices could be obtained from NYMEX (the New York Mercantile Exchange) but usually for a limited time horizon, say four years. Enron extended the principle to much longer contracts for which it had to derive its own price curves and, as one trader put it, for some products where Enron was the only supplier, it was more a case of ‘marking to Enron’. In other words, Enron could determine its own profits based on a forecast price which it alone provided: a recipe ripe for manipulation.

Enron’s accounting policies led to some deals being struck that would be cash negative in the early years. In one example, Enron entered into a 12-year, fixed-price gas supply deal in the Far East at a price below the current ‘spot’, and as Enron did not have its own supply, it had to go into the market to purchase at the higher price. Nevertheless, the forecast price curve was such that it showed a positive NPV and a profit was booked to reflect that. The manager who had done the deal was subsequently approached by his boss towards the end of the quarter and told that, as they were not going to meet their budget, he should revisit the deal and ‘tweak the numbers’ to squeeze out a bit more. This he did (an action of
which he is now somewhat ashamed). The process was so common, he said, that it was known as ‘marking up the curve’.  

The accounting policies Enron adopted, and which Andersen sanctioned, were unusual for a non-financial company. As one employee recounted:

The issue, which was unnerving, was their focus on immediate earnings (accounting not cash). Whenever a transaction or business plan was presented, the focus was on how much earnings the deal would bring rather than if it made business sense or made cash. Another example is the way they conducted their trading business: Enron would create forward price curves on commodities, based in many cases on rather sketchy data or pricing points. Using these curves, Enron would enter into long-term transactions with counter parties (ten years was usual in illiquid markets like bandwidth). For Enron, it did not matter if they lost money in years 1–5 of a deal (that is, sold below current market values), as long as they recovered the investment and made a ‘profit’ on years 6–10. The reason was because Enron used ‘mark-to-market’ accounting and would take the NPV of the ten-year deal on day one, using the sketchy curves I mentioned before as price points for discounting and, therefore, making a ‘profit’. The fact that the company was bleeding cash in years 1–5 in exchange for potential gains in years 6–10 was usually not considered in these transactions. The only thing that mattered was ‘earnings’. 

Those who worked in Enron were reluctant to challenge such deals. One former employee described his experience:

From a cultural perspective, what shocked me was that no one could explain to me what the fundamentals of the business were. As a new person I have always been used to asking questions – many might seem dumb, but it is part of the learning process. In Enron, questions were not encouraged and saying things like ‘This doesn’t make sense’ was unofficially [punished]. Further, I got the impression that many people did not understand what was going on, so asking questions would show this lack of knowledge.

Enron had a large risk assessment and control group, headed by the chief risk officer, Rick Buy, who had been with Bankers Trust. The group was split into four departments: credit, underwriting, investment and valuation, and trading. The trading department was supposed to ensure that the traders’ pricing was appropriate for the risks being assumed. However, sometimes the level of activity was such that there was time to do little more than check the arithmetic rather than question the underlying
assumptions. Nevertheless, both Andersen and McKinsey hailed Enron’s risk management procedures as an example to all.

**Increasingly adventurous trading operations**

Enron’s trading portfolio was gradually extended to more exotic items including weather derivatives. The rationale was that an energy supplier concerned that the weather was going to be too warm – and that its customers would consequently consume less energy – would want to find a way of hedging this income shortfall. As markets for existing products matured and competition eroded margins, Enron had to find new and more innovative instruments to trade. These eventually included things as diverse as wood pulp futures and oil tanker freight rates. Ultimately, there were over 1200 separate trading ‘books’, including broadband capacity, which was to give rise to some special problems.

In late 1999 EnronOnline was launched, creating an electronic trading floor for oil and gas in the US and Canada. It quickly expanded to other products and countries. Although it was developed at the relatively low cost of $15 million, it required a large amount of working capital to fund the ‘book’. Enron used the short-term paper market for this – a market that was to dry up in the immediate aftermath of 11 September 2001, adding to liquidity problems.

**Expanding the traditional business**

In the early 1990s Enron substantially increased its foreign activities. In addition to the Dabhol investment in India, it bought energy plants in Brazil and Bolivia and an interest in an Argentinian pipeline system in its drive to become a global player. In 1993 Enron built a gas turbine power plant on Teesside in England, its first foray into the European energy markets. It was granted permission to do so by Lord Wakeham, a UK energy minister who subsequently joined Enron’s board. By 1994, Enron was operating power and pipeline projects in 15 countries and developing a number in several others.

In July 1998, as part of its strategy to build a worldwide water utility company, Enron purchased, for $2.2 billion, Wessex Water in the UK and formed a new company, Azurix, which it intended to float separately. The idea was to develop and operate water and wastewater assets, including distribution systems and treatment facilities and related infrastructures.
Azurix pursued such projects in Europe, Asia and Latin America. These large, long-term investments were to act as a cash drain on Enron and increase the debt burden even more, as the proposed flotation failed to take place.

**The broadband story**

Enron’s venture into broadband was more opportunistic than planned. In 1997 it had acquired Portland General Electric, an Oregon electricity generator and distributor that had laid some 1500 miles of fibre-optic cable along its transmission rights of way. Enron, through its subsidiary Enron Broadband Services (EBS), started to build its own network using its existing rights of way, adding 4000 miles in 1998 and a further 7000 the following year. The intention was to sell capacity to heavy data users on long-term contracts which could then be ‘marked to market’, and to trade bandwidth in a manner similar to gas or electricity.

Such was the speed with which this business developed that no fundamental supply and demand analysis was carried out and Enron found itself competing with the likes of WorldCom and Global Crossing for customers in a market which had huge overcapacity. Even more worrying was that technological improvements were exponentially increasing the amount of data that could be carried by existing cable. Getting the dark fibre lit\(^\text{ii}\) considerably increased overheads, and for 2000 EBS would report losses of $60 million on revenues of $415 million. Since the only way to make profits from cable is to get data flowing through it, EBS, in an attempt to generate traffic, announced in July 2000 that it had entered into a memorandum of understanding with Blockbuster Video to provide ‘video on demand’, whereby the former would provide the means of delivery and the latter the content. Small trials in four parts of the US proved that the technology worked and the service was rolled out with much fanfare in Seattle, Portland and Salt Lake City just before Christmas. However, it proved impossible to attract enough subscribers to make it pay. Fearful of the cannibalising effect of the project on its existing business if it were to work, Blockbuster walked away from the deal after a few months, leaving EBS to go it alone. This did not prevent Enron from booking a ‘mark-to-market’ profit, based on its predictions of the project’s future cash flows of $100 million. The spreadsheet model used went out to end-2010, and

\(^{\text{ii}}\) Dark fibre is fibre that has been installed but is not yet activated; once it is activated it is referred to as being ‘lit’.
assumed a massive increase from the existing 400 paying subscribers to some 8 million.\(^9\)

Despite this setback, by the end of the year broadband was being hailed as a major part of the company’s future and was being promoted as such to the financial markets. Lay commented in October 2000, ‘We are an energy and broadband company that also does a lot of other stuff.’\(^10\)

This was little more than wishful thinking. For Enron, the broadband exercise was a disaster, losing large amounts of money and consuming more cash than the company could afford.

After the collapse, a former employee posted his thoughts on his MBA class website:

> OK, now that it’s bust, I can tell you a little bit of what was going on – at least where I was. Imagine that you make a spreadsheet model of a business plan (in this case it was taking over the world). You discount it with Montecarlo simulations (more like Atlantic City, really), sensitize it to all possible shocks, but still make sure you obtain a huge NPV. Then you sell this ‘idea’ to a company that Enron does not consolidate and which finances the purchase with debt guaranteed by Enron’s liquid stock (remember no consolidation). You book all the NPV (or profit) UPFRONT.

**Reporting spectacular financial performance**

In the five years from 1996 to 2000, Enron reported consolidated net income rising from $580 million to $970 million, with a blip in 1997. This was in marked contrast to the tax losses of $3 billion declared to the Internal Revenue Service (IRS) for the four years to 1999.

Over the four years to December 2000, while revenues from the traditional physical asset, energy-generating business grew relatively slowly, reported revenues from trading grew exponentially to become 80 per cent of Enron’s turnover, which leapt from $40 billion in 1999 to $100 billion in 2000. Much of this increase was accounted for by ‘empty trades’ of broadband capacity with WorldCom and others. These swap deals had no cash effect but served to inflate the top line. At no stage does the board appear to have questioned this stellar growth, although one would have thought that its members might have been vaguely curious as to how this had been achieved if only to see if it was sustainable.

Despite earlier expressing some misgivings about the accounting policies being used by Enron, Andersen had signed off each year’s accounts without qualification.
Market and other pressures start to take their toll

Enron’s shares had significantly outperformed the market in the late 1990s. However, performing well on the stock market brings its own problems by raising market expectations.

Consequently, there was tremendous pressure on Enron to maintain quarterly earnings per share (EPS) growth, which in turn led to the need to find new sources of revenue and new sources of capital. The large investments in major capital projects needed cash. These were not expected to generate earnings or positive cash flow in the short term, placing immediate pressure on the balance sheet. Enron had always been highly leveraged, and funding new investments with debt was unattractive as these investments would not generate sufficient cash flow to service that debt and would put pressure on credit ratings.

Enron had never been a company awarded a ‘triple A’ by the ratings agencies, but its debt had to stay within investment grade. In order to do so, it had to keep its debt to equity ratio within acceptable bounds. Were it to lose this status, this would affect the company’s ability to issue further debt, trigger bank covenants and guarantees, and influence the perceptions of – and its credibility with – counter-parties in its trading operations. One answer might have been to issue new equity, but this was resisted as it would dilute EPS and in turn affect the share price.

This set the stage for Andrew Fastow to employ his financial engineering skills. Rather than try to manage market expectations, which might have reduced the pressure, or to rein in some of the capital expenditure, as any prudent CFO would have done, Fastow decided to manage the reported results.

The chosen solution was to get some of the assets and related debt off the balance sheet. This required finding outside investors willing to take some of the risk through equity participation in separate entities, which, in turn, could borrow from third parties (outside lenders). This would only work if these special purpose entities (SPEs) did not have to be consolidated in Enron’s results; otherwise it would defeat the objective. Finding truly independent investors proved difficult, so Enron turned to related parties.

Being creative with off-balance-sheet transactions

The first controversial deal using an SPE was Chewco. This Limited Liability Partnership (LLP) was formed in 1997 with the purpose of acquiring the California Public Employees Retirement Scheme’s (CalPERS)
interest in an earlier joint venture with Enron called the Joint Energy Development Investment (JEDI). CalPERS’ initial investment of $250 million in 1993 had been valued at $383 million, and Chewco was to borrow, on an unsecured basis, a like amount to buy out CalPERS’ investment. In a rather complicated deal, the loan would be guaranteed by Enron.

The debt was provided by BZW, a subsidiary of Barclays Bank in the UK. Enron charged Chewco a fee of $40 million for providing the guarantee and booked that sum as part of its profit for the quarter. A significant issue here was that the general partners in the SPE were Enron employees or associates, in particular Fastow’s assistant, Michael Kopper, and his partner, William Dodson. Fastow had wanted to do this deal himself but the Enron board would not allow that to happen, so Kopper, a graduate of the London School of Economics, who had joined Enron in 1994 from Toronto Dominion Bank and had become close to Fastow both professionally and privately, took his place. Kopper would later plead guilty to a number of criminal charges and agree to cooperate with the authorities in order to reduce a potential 15-year jail sentence.

The next significant event was the formation of LJM1 in June 1999, a Cayman Islands registered SPE. The name was derived from the first initials of Fastow’s wife and two children. Aware that Enron was anxious to get more debt off its balance sheet, Fastow had taken to the board a proposal to raise $15 million from two limited partners, through an SPE, which would purchase from Enron certain assets and associated liabilities that the company wished to remove from its balance sheet. Although the Enron code of ethics prohibited Enron from having any dealings with an officer of the company because of the potential for conflicts of interests, the board gave special permission for this to proceed subject to certain checks being put in place to protect the company’s interests. LJM1 then entered into a number of transactions with Enron.

A few months later, Fastow put a more ambitious proposal to the board that he would raise $200 million of institutional private equity in order to purchase assets that Enron wanted to syndicate. At that level, the leverage potential was huge. The board agreed that he should go ahead, and so LJM2 was formed in October 1999 as a Delaware limited partnership. Merrill Lynch prepared a private placement memorandum for a co-partnership with LJM2, which ultimately had some 50 limited partners, including some well-known financial institutions such as GE Capital, Citigroup, Deutsche Bank and J. P. Morgan. Enron was a significant purchaser of investment banking services, and Fastow was the gatekeeper who had made it clear that participation was a prerequisite for continuing banking business.
The memorandum clearly identified Andrew Fastow, together with Kopper and Ben Glisan, as the managers and, in an unusual twist, highlighted their use of inside information:

their access to Enron’s information pertaining to potential investments will contribute to superior returns.

Glisan had joined Enron three years earlier from Andersen and was described as being responsible for the deal structuring of the company’s ‘highly complex non-recourse or limited recourse joint venture and asset-based financings’.

Enron’s own disclosure was less frank. In a note to the 2000 Annual Report, on page 48, it simply said, ‘In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner’s managing member is a senior officer of Enron.’ The note then went on to outline some of the transactions.

**The impact of these deals**

At the end of the third and final quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2. Enron bought back five of the seven assets shortly after the close of the respective financial reporting periods. While the LJM partnerships made a profit on every transaction, the transactions generated Enron ‘earnings’ of $229 million in the second half of 1999 (out of a total $570 million for the same period).

In June 2000 Enron sold $100 million of dark fibre-optic cables to LJM, on which it booked a profit of $67 million. LJM sold on cable for $40 million to ‘industry participants’ and the remainder to another Enron-related partnership for $113 million in December. Between June and December, these deals suggested that the value of fibre had increased by 53 per cent, while the open market value had fallen 67 per cent in the same period. Fastow is reported to have profited to the extent of $45 million from these deals.\(^{11}\)

**Storm clouds gather**

On 31 December 2000 Enron’s share price stood at $83, some 70 times earnings and valuing the company in excess of $60 billion. However, in the course of 2000, a number of problems had emerged across Enron’s
global operations. The Dabhol power project in India had run into political difficulties and the Maharashtra state government was refusing to honour its obligations under the contract. Rebecca Mark, widely regarded as being responsible for the difficulties, resigned in August 2000 and the plant was shut down in 2001.

In Brazil, the issue had arisen of impaired asset values compounded by the devaluation of the local currency. The Azurix venture had already resulted in write-downs of $326 million relating to assets in Argentina, and the Wessex Water business in England was experiencing both financial and operational difficulties. At the end of the year, proposed write-offs for asset impairment were in the order of $7 billion against reported shareholders’ equity of $11.4 billion. Such a write-down would have greatly increased Enron’s debt/equity ratio and resulted in the loss of investment grade status. Were this to happen, the trading business would be destroyed. Somehow, Fastow persuaded Andersen to defer consideration of this until after the year end.

Furthermore, the broadband venture was losing money – with no short-term likelihood of generating profits – while continuing to suck up capital expenditure. To make matters worse, the fall in the value of Enron’s share price was likely to trigger its guarantee obligations in relation to many of the SPEs.

Against this background, some hedge funds had become short sellers of Enron stock. On 5 March 2001, in a Fortune article, Bethany McLean, who had been tipped off by a fund manager, questioned the stock market value of Enron. Her main thrust was that it was very difficult to ascertain how the company was making its profits, that these profits did not seem to be generating a commensurate amount of cash, and that there was a lack of transparency in Enron’s reporting and handling of media questions. In the meantime, Enron’s share price continued to slide.

A real blow came on 14 August 2001, when Skilling resigned after only six months as CEO citing ‘personal reasons’. Lay resumed the role of CEO. Subsequently, in an interview with BusinessWeek, Lay said, ‘There’s no other shoe to fall’, and went on to add, ‘There are absolutely no problems … There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues. The company is probably in the strongest and best shape that it has ever been in.’ Enron watchers, fearing there was more to the story, were not convinced and the share slide continued.

At the same time as seeking to reassure investors, Lay was cashing in his share options, netting himself more than $100 million in the process. As a rather jaundiced employee put it after the crash:
If the business works, super, if it doesn’t then you have to take a hit. Fun, hey? Meanwhile, as CEO, you take all your compensation in equity. You find out that as long as you keep making this paper money, the shares go up. Woohoo! But, oh shit! Something’s going on – maybe the world is pretty hard to take over. ‘I think I’ll sell my shares,’ says he. Of course, he keeps talking the stock up, while … selling his shirt as fast as possible.13

The downfall

On 15 August an Enron employee (and former ‘Anderoid’iii), Sherron Watkins, sent a memo to Ken Lay expressing fears over the company’s accounting practices and asking whether Enron had become a ‘risky place to work’. She expressed the view that ‘Skilling’s abrupt departure will raise suspicions of accounting improprieties and valuation issues’.

Lay, who briefly met with Watkins a few days later, passed her memo to Enron’s principal legal advisors, Vinson & Elkins. This well-respected Houston legal firm, which had advised on some of the transactions being questioned, concluded that there was no need to get a second opinion on the accounting policies.

Watkins also called someone she knew at Andersen and voiced her concerns. Andersen, Enron’s auditors since the group’s formation in 1985, had been uncomfortable for some time with the accounting practices that it had previously accepted. Revisiting some of the SPEs, it decided that, at least in the case of Chewco, there had been a breach and that Chewco would have to be consolidated, resulting in a restatement of Enron’s results. Accordingly, it advised Enron that the accounts would need to be restated.

On 16 October, in a conference call with analysts, Lay disclosed a $1.2 billion write-down of shareholders’ equity, focusing attention on the SPEs. Fastow was fired on 24 October and the SEC announced an investigation into Enron’s accounting practices and related party transactions.

Little over a week later, on 26 October, Enron’s board announced the establishment of a Special Investigation Committee chaired by the newly and specially appointed William Powers Jr., Dean of the University of Texas School of Law, with existing board members Raymond S. Troubh and Herbert S. Winoker. The committee was given a very limited remit, which was ‘to address transactions between Enron and investment partnerships created and managed by Andrew Fastow, Enron’s former Executive

---

iii A common nickname for Arthur Andersen employees.
Vice President and Chief Financial Officer, and by other Enron employees who worked with Fastow'.

Meanwhile, management was in frantic discussions with Enron’s many bankers – to try to win some breathing space – and with the rating agencies, trying to persuade them not to downgrade Enron’s stock; all the while desperately seeking a ‘White Knight’ to bail it out.

Enron’s great local Houston rival, the much smaller Dynergy Inc., announced a bid to acquire Enron but withdrew it on 28 November, having done some due diligence. Moody’s, the rating agency, downgraded Enron’s debt to ‘junk’ (Ca) on 29 November, with the inevitable result that Enron was forced to seek Chapter 11 protection from its creditors a few days later.

Ultimately, Enron’s examiner in bankruptcy, Neal Batson, would reveal that the undisclosed off-balance-sheet debts and other liabilities amounted to some $25 billion. This was much more than had originally been suspected and more than twice the amount of debt reported in Enron’s latest filings.

The Powers committee post-mortem

Working with commendable speed, the Powers committee team interviewed a number of the main Enron employees and examined numerous documents. The committee claimed that it was denied access to Andersen personnel and papers (an allegation strongly denied by Andersen), which limited its enquiries. Its report was published on 1 February 2002 and posted on the Internet. Contrary to many expectations, although restricted in scope and without access to some information that might have assisted, Powers and his colleagues produced a report that contained some damning criticisms of many involved, including the board itself. Their principal conclusion was that ‘many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bone fide economic objectives or to transfer risk’. They went on to say, ‘the LJM partnerships functioned as a vehicle to accommodate Enron in the management of its reported financial results’.

In their summary they said:

The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: A flawed idea, self-enrichment by employees, inadequately-designed controls, poor
implementation, inattentive oversight, simple (and not so simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits.18

In seeking to understand the plight of Enron, the Powers Report is a good starting point, but only that. Restricted in its remit to examining Fastow’s dealings with the company, the committee did not probe deeper into the underlying causes of the collapse.

What went wrong and lessons to learn

As is the case with most corporate failures, there was no single cause, nor was it the fault of any one individual. Instead the causes were complex and multiple, involving many people. However, it is possible to highlight some of the milestones along the path to ruin, as well as the contributions made internally and externally by some key players.

The consequences of poor strategic decisions

From the time of Skilling’s arrival, Enron pursued dual strategies: continuing to invest heavily in the traditional core activities of energy generation and pipelines, but increasingly outside the US; and developing a substantial energy trading business. Both strategies required a great deal of cash, something always in short supply.

Rebecca Mark’s strategy required substantial capital investment in projects that would take a long time to complete, and even longer to become cash positive, and also exposed Enron to substantial currency risk, especially in Latin America. When these currencies collapsed against the dollar in the late 1990s, Enron suffered substantial losses adding to the problems of having overpaid for the acquisitions. A double hit.

In India, the Dabhol project in Maharashtra State was bedevilled from the start; it was a vast undertaking in proportion to Enron’s capital base; and subject to serious political problems, especially after a change in the state government. The project was always going to be difficult. The World Bank had refused to fund it and it was only with considerable effort and much political lobbying that the finance was arranged with some US government assistance. It never came on stream and the whole exercise cost Enron something in the order of $3 billion, or more than three times the reported profits for 2000.
Many of these investments turned out badly, partly because Enron entered areas outside its core competences (for example the water industry) or in high-risk areas of the world (India and Latin America) with insufficient knowledge or due diligence. The Dabhol project was a prime example, but by no means the only one.

The trading side was initially profitable, but as more and more competitors joined in, margins decreased and Enron turned to increasingly exotic products in its search for profits. Some were in areas far removed from energy (pulp and paper futures, tanker freight rates), and in many cases Enron was the only market maker, placing great strains on its liquidity. The trading was largely financed by short-term commercial paper, making the retention of investment grade credit status all the more important.

Following dual strategies is not inherently wrong but it does put additional pressure on management, and requires careful and prudent financing. The seeds of Enron’s destruction were sown early on, with its reluctance to issue shares to finance acquisitions or investments. As Enron became more and more leveraged, this put immense pressure on its balance sheet.

This on its own would have been trouble enough, but Enron then added a third element with its venture into broadband. This was hardly a strategic decision as it got into it by chance when it acquired Portland General Electric which had laid fibre-optic cable along its power transmission right of way. Opportunistically, Enron jumped on the bandwagon with little or no due diligence and laid many more miles of cable in the hope that it could sell capacity on long-term contracts to heavy data users. No doubt it saw further opportunities to introduce mark-to-market profit recognition. However, there was already huge overcapacity in the market, with many existing specialist players including WorldCom and Global Crossing, and with technological advances enabling more and more data to be squeezed down existing cable. Despite Enron’s claim to be turning into an energy and communications company, a story much touted to the investment world, the reality was very different. Broadband lost money from its inception placing even greater strains on Enron’s highly precarious finances.

Greed and the ‘star system’

The deal-driven Enron culture added to the problems. Skilling’s desire to accelerate revenue, and thus, earnings, by using mark-to-market accounting, inevitably led to a ‘treadmill’ effect. If you took all the profit from a deal in one quarter, you were going to have to find another and
larger deal in the next. This inevitably put pressure on employees to do deals – often with little regard as to how they were to be managed – and to ‘make the quarter’ by whatever means necessary. There was also self-interest in this as an individual’s remuneration was based on deals done and profits recorded in the previous quarter. The focus on earnings rather than cash led to some crazy deals being done.

Poor risk management and control

In a deal-driven environment with a focus on quarterly earnings, a strong control system is necessary to prevent aberrant behaviour. This was not the case here. Although Enron claimed to have a strong risk management and control system, the reality was quite the reverse. Many of the deals being done and booked under mark-to-market accounting required complicated modelling and, sometimes, heroic assumptions about future prices and volumes, as with the ‘video on demand’ story. Enron’s risk managers were supposed to challenge and validate the assumptions upon which the calculations were based to ensure that they were reasonable, but often failed to do so. As one recounted, ‘at times we were so overwhelmed with work that we could do little more than check the arithmetic, and in any event, it was difficult to turn down deals that would directly affect a colleague’s remuneration’. On at least one occasion, a business unit bypassed internal risk management and cleared a major deal directly with Andersen.

Things were no better at a higher level. Within Enron after Kinder’s departure, there was conflict between, on the one hand, Rebecca Mark and, on the other, Jeff Skilling. Both were pretenders to succeed Kenneth Lay as CEO. In the clash of the Harvard MBAs, the resultant dual strategies led to competing demands for a scarce resource, cash. Cash allocation and control should normally fall within the orbit of the CFO and treasurer. Here, however, Fastow – who was not a qualified accountant – was not up to the task. It is doubtful if he had the skill set required of the CFO of a major corporation, let alone one as complex as Enron. In any event, he was Skilling’s protégé and thus unlikely to be effective as an arbitrator. Companies with cash flow problems need tight control. Enron did not have this. The result was that borrowing, spending and commitments spiralled out of control. After Fastow’s departure it became clear that no effective cash forecasting or control system was in place, and his successor could not even ascertain what debt was due to be rolled over in the immediate future.
In a clear display of leadership failure, Lay, meantime, had been content to let Skilling and Mark battle it out rather than exercise some control over their activities. He was far too busy embellishing his civic reputation in Houston as a philanthropist and patron of the arts.

Superficial internal oversight

Enron’s audit committee was chaired by Dr Robert Jaedicke, a distinguished academic accountant and former Dean of Stanford Business School, with Lord Wakeham, an English chartered accountant, as a fellow member. The committee met infrequently, perhaps four or five times a year, and the meetings were short thus allowing very little time to consider important issues. An example of this was the meeting on 12 February 2001. The agenda was, on the face of it, quite daunting. The committee was to consider a number of reports: on Enron’s GAAP compliance and internal controls; on adequacy of reserves and related party transactions; on disclosure of litigation risks; and on Enron’s 2000 financial statements. It was also to discuss revision of the audit and compliance committee charter; to review the 2001 internal audit control plan; to review the policy for communication with analysts; and to consider the impact of Regulation Fair Disclosure. All this was accomplished in under two hours. One must assume that the discussion was superficial at best. It is hard to believe that this audit committee played an effective role in providing any oversight of Enron’s finances and was thus unlikely to have been able to put a stop to the more outrageous practices.

An ineffective board

It was not just the audit committee that had been, at best, lax, or more likely, complacent and incompetent. The wide-ranging report of the Permanent Subcommittee on Investigations of the Committee on Government Affairs, published on 8 July 2002 and based on Senate committee hearings and the examination of tens of thousands of documents, was heavily critical of Enron’s board as a whole for its oversight failure. A main accusation was that the board knew and authorised high-risk accounting policies, despite warnings from Andersen as early as January 2001.
1999 (shortly after Fastow became CFO), that Enron’s policies ‘pushed
the limits’ and that another firm might take a different view. This was not
acted upon. The board also allowed excessive remuneration. It did not
follow its own code of ethics in allowing Fastow to transact with the
company, and it failed to ensure that sufficient controls were in place to
safeguard Enron’s interests in the deals with the special purpose entities.
The investigation identified 16 ‘red flags’ or warning signs in the period
from January 1999 until the collapse, which should have alerted the board
to the fundamental problems facing the company at a time when remedial
action might have been successful. Its lack of curiosity was underlined
when it failed to query how Enron had managed to increase reported
revenue from $40 billion in 1999 to a reported $100 billion in 2000.

Perhaps lulled by the rising share price, Enron’s highly flattering media
coverage and Skilling’s ‘poster boy’ status, the board seems to have been
reluctant to ask the hard questions. Alternatively, complacency and a high
level of personal remuneration made its members unwilling to rock the
boat. Either way, they failed and in January 2005, ten former directors
agreed to pay $13 million from their own pockets as part of a $168 million
settlement of a suit brought by shareholders who had seen their invest-
ments wiped out.

The failure of the external auditors

While the misuse of accounting permitted by compliant auditors did not
cause the collapse, it was certainly a contributory factor.

At Arthur Andersen, David Duncan was the client engagement partner
for Enron which, as one of Andersen’s largest clients, generated audit fees
of $25 million and additional consulting fees of $26 million for the firm
in 2000. A large team of Andersen staffers were based in Enron’s offices
and Enron had many employees who had joined from the audit firm.
Skilling was on record as saying that one of Andersen’s most useful
services was to provide a pool of accounting talent that Enron could tap.
How diligent are you going to be as a young audit assistant when you
know that gaining favour with Enron’s management could land you a
good job with all those stock options?

Additionally, and unusually, Enron had subcontracted its internal audit
function to Andersen. This was an obvious conflict of interest, which
removed one of the essential checks and balances that are necessary in a
robust system of internal control.
Within Andersen, Enron was known as difficult and demanding and was included in its ‘high risk’ category of client. Internal Andersen memos reveal concerns being expressed by technical partners as early as 1999, and one of them, Carl Bass, was removed from the engagement after Enron complained. These memos (and e-mails), released by the US House Committee on Energy and Commerce in April 2002, show that the local engagement partner and his team were able to override the advice of the specialists even though David Duncan was aware that ‘these … policies … push limits and have a high risk profile … others could have a different view’.

The Powers committee view of Andersen’s role was clear:

Andersen also failed to bring to the attention of Enron’s Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related party transactions.

Neal Batson, Enron’s court-appointed bankruptcy examiner, concluded that:

There is sufficient evidence … that Andersen … committed professional negligence in the rendering of accounting services to Enron.22

The pressure on Andersen partners to generate fees was intense. One has to suppose that the threat of losing a major client, and the impact that that would have on his career, led Duncan to suspend his professional judgment rather than risk the wrath of his senior partner. The consequence of that decision destroyed his firm.

Andersen failed in its public duties. A more robust approach might have prevented the misuse of accounting practices, thus making the extent of Enron’s problems clear at an earlier stage when action could have been taken to prevent the collapse.

In August 2002 Andersen, by then an empty shell, agreed to pay $60 million to settle a number of lawsuits relating to the collapse.

**Greedy bankers**

Again, while one cannot accuse the banks of bringing Enron down, they were substantial contributors. Many of Enron’s exotic schemes for concealing the extent of its indebtedness and accelerated earnings would have been impossible without the help of some of the major investment banks.23
The most significant involvement was in setting up the ‘pre-pay’ schemes which allowed Enron to hide billions of dollars of debt. The structures were straightforward enough. Enron, or an affiliate seeking a loan, would have the bank set up a conduit vehicle, usually in an offshore tax haven, which would be independent of Enron to avoid any question of consolidation. The bank would agree to pay a lump sum to the conduit in return for future deliveries of gas. The conduit in turn would enter into an identical agreement with the Enron party to pay a lump sum for future gas deliveries. The third step in these ‘unrelated’ transactions was for Enron to agree to pay the bank for future deliveries of gas at a rate which would repay the bank the outstanding debt and an appropriate rate of interest. The nature and complexity of the pre-pay schemes, coupled with the lack of adequate disclosure, made it difficult if not impossible, for outside observers to understand their impact and significance. When Neal Batson’s reports were released, there was shock and surprise about the sheer scale of the transactions.

After the collapse, a host of civil suits were launched against the banks and a number of criminal cases were threatened amid charges that the banks had helped the company’s former management to defraud shareholders and creditors. Many of the claims have now been settled for very large sums: Citigroup paid $2 billion; J. P. Morgan, $2.2 billion; Canadian Imperial Bank of Commerce, $2.4 billion; with others, more than $10 billion in total has been paid out.

The consequences

At the time of writing, a total of 34 Enron employees and others involved have been charged with criminal offences. Of these, 16 have pleaded guilty including Ben Glisan, Enron’s former treasurer who received a five-year prison sentence; Andrew Fastow, jailed for ten years; and Andersen’s David Duncan, yet to be sentenced. A further five were convicted after jury trials. Ken Lay and Jeff Skilling are scheduled to stand trial in January 2006 when Andrew Fastow is expected to be a key prosecution witness.
The key messages are:

1. Excessive remuneration based on short-term profit performance can lead to aberrant behaviour and must be rigorously controlled. Rewards should be aligned to long-term sustainable results rather than be in the form of stock options that can be exercised almost immediately. This puts too much focus on meeting market expectations at the expense of shareholders' longer term interests.

2. It is a fundamental error to mismatch long-term investments with short-term debt, such as commercial paper. Further, cash-financed rapid expansion is dangerous, particularly where, as for most organisations, cash is a scarce resource. The role of the CFO in managing this is crucial and should only be held by a suitably qualified and experienced accountant.

3. Ethics matter. Had Enron adhered to its ethical code, the board might have probed deeper; Fastow would never have been permitted to enter into the SPE transactions and the collapse might have been averted. Standards must be set by, and demonstrated from, the top, including intelligent inquiry and action where required.

4. In attempts to meet market expectations, accounting can be misused, which not only misleads investors but also perpetuates self-delusion. Core controls around accounting information and reporting are essential, including internal audit, which under no circumstances should be outsourced to the external auditor.

Notes

(A number of those who agreed to be interviewed by IMD did so on condition of anonymity.)

2 David N. Fleischer, Goldman Sachs, Enron Corp. conference call transcript (12 July 2001).
3 IMD interview.
4 IMD interview.
5 E-mail to the authors.
6 IMD interview.
7 E-mail to the authors.
8 IMD interview.
9 Copy seen by authors.
12 BusinessWeek Online (24 August 2001).
13 IMD interview.
14 BusinessWeek Online (24 August 2001).
16 Enron Special Committee Report (the Powers Report) (1 February 2002).
20 IMD interview.
CEOs around the world slept less easy after 13 July 2005 when Bernard J. Ebbers, founder and former chief executive of WorldCom, was sentenced to 25 years in prison for orchestrating the biggest corporate fraud in US history. For the 63-year-old Ebbers, a man in poor health, this – as the judge acknowledged – was effectively a life sentence. Coming hard on the heels of the tough sentences handed down to John Regas, the 80-year-old founder of Adelphi Communications (15 years), and his son Timothy (20 years) for the fraud in that company, it demonstrated clearly the US government’s determination to crack down on white-collar crime.

When it collapsed with debts of $41 billion in July 2002, WorldCom overtook Enron as the largest bankruptcy in history and the world at large was aghast. The telecoms giant had been the darling of investors and was valued at $180 billion at its peak in June 1999. Analysts touted it as the ‘single best idea in telecom’ and praised it to the sky: ‘there is no telecom company of any size anywhere in the world that possesses a better combination of assets, strategy, management, and valuation relative to growth within the entire global telecom sector’. With the collapse, many investors faced losing all their savings. They were not alone in their sufferings. As the United States’ second largest long-distance telecommunications provider, the largest competitive carrier of local telephone services, the largest carrier of international traffic and the world’s largest Internet carrier, WorldCom employed 80,000 people worldwide, all now facing the loss of their livelihood. ‘Another accounting scandal’, screamed the press headlines. Most media pundits took the line that this was, as with Enron, a case of fraudulent accounting bringing a great company to its knees.

As the dust settled, however, it became apparent that it was not accounting fraud that brought WorldCom down. Rather, the root causes lay in several areas: poor strategic decisions, driven by an all-consuming
drive for growth and a failure to see what was really happening in the industry; an incompetent and dominant CEO; a supine board which rubber-stamped Ebbers’ decisions; and a complete lack of other normal checks and balances. The complex accounting tricks, coupled with wholly inadequate external auditing and an impotent audit committee, allowed Ebbers and his right-hand man, Scott Sullivan, to conceal the many problems and overstate earnings in order to maintain WorldCom’s share price over an extended period of time. Sullivan, in an attempt to save his own skin, was to become the leading prosecution witness against Ebbers. The tactic appears to have worked as he, although recognised as the architect of the fraud, received a much more lenient sentence of five years in prison.

The genesis of WorldCom

Long Distance Discount Services (LDDS), the precursor of WorldCom, was established in 1983 on the back of the break-up of AT&T’s 95 per cent monopoly of the US telecommunications market. After years of fierce resistance, AT&T was finally forced to spin off its local service providers and to lease long-distance lines to its competitors at a steep discount. This allowed LDDS to obtain a licence to sell long-distance services to Mississippi businesses and residents. Murray Waldron, a telecoms salesman who was struck by the opportunities that would arise from the AT&T break-up, brought in Bernie Ebbers as a founding shareholder.

Ebbers was a Canadian who, after two unsuccessful stints at university in Canada, won a basketball scholarship to Mississippi College in the US. After obtaining a degree in physical education, he became a basketball coach but soon joined a clothing business and then, after a few years, bought his first motel. He grew the business into a chain of seven motels within ten years, following a business model which focused on tight cost control.

Initially, Ebbers’ role in LDDS was limited to that of a silent partner while he directed his energies towards the motel business. However, in 1985, as costs at LDDS spiralled out of control and debts mounted to $1.5 million, the board, realising the danger of collapse, asked him to become CEO.

Ebbers put in place his trademark cost control regime which was implemented down to the timing of the replacement of toner in the fax machine. Matters were soon brought back into line. This done, Ebbers then began to acquire small neighbouring resellers to benefit from economies of scale. With the aid of bank loans, Ebbers moved on to
ever-larger targets and eventually took LDDS public in 1989 via a reverse merger with Advantage Companies Inc. With stock now at his disposal, Ebbers’ shopping list grew.

The acquisition process was informal. Discussions were held with the original investors in LDDS rather than board members, and they were frequently finalised and signed before being fully approved by the board. Executives of acquired companies were also often appointed to the LDDS board, and staff at LDDS considered themselves part of a family. Takeovers had become a way of life. As Ebbers told journalists, ‘It’s actually a very, very enjoyable exercise. After you do enough of them, it kind of becomes part of your culture.’

By late 1992, having already swallowed 35 companies, LDDS was one of the largest regional long-distance companies in the US. One of the acquisitions, Advanced Telecommunications Corporation, brought with it Scott Sullivan, a certified public accountant who had qualified with KPMG. Sullivan moved to LDDS after the merger, becoming CFO in 1994 and joining the board in 1996.

As overcapacity in transmission facilities began squeezing margins at resellers in the 1990s, developments in fibre optics and digital technology allowed carriers with their own lines (rather than leased ones) to compete with AT&T. LDDS moved into this market via yet more acquisitions to become a national long-distance provider and reseller. With a comprehensive national network of fibre-optic cable and digital facilities – crucially giving LDDS control over much of its own line costs – the company’s next move was into the international market. It acquired IDB Communications Group Inc. and, a year later, in 1995, LDDS changed its name to WorldCom to reflect its new international status.

Ebbers by then had gained a reputation as a maverick with a fondness for blue jeans, cowboy boots, pick-up trucks and turquoise jewellery. He was a charismatic leader, inspiring deep personal loyalty. ‘When he enters a room, he is like a rock star’, said one key employee. ‘People wanted to touch him, shake his hand. He created tremendous wealth, at least on paper. People revered him.’ Sullivan, on the other hand, was an analytical type with supreme confidence in his knowledge and abilities. He and Ebbers became a close team totally dominating the company.

A tumultuous few years

The US telecoms market was thrown into turmoil by the Telecommunications Act of 1996 which further deregulated the market, removing the
enforced segregation between long-distance and local service providers. With another acquisition, MFS Communications Company, WorldCom made its entry into the local market. Along with MFS came an extensive European network, expanding WorldCom’s international presence, and also UUNet Technologies Inc., purchased by MFS earlier in 1996. UUNet was an Internet pioneer and by 1997 would become by far the largest Internet access company in the US. During 1995 and 1996, Internet traffic grew an astronomic ten times a year, the basis of the urban legend from the late 1990s that ‘Internet traffic was doubling every 100 days’. UUNet and WorldCom supported this myth in statements such as the one in September 2000 by Kevin Boyne, UUNet’s COO: ‘Over the past five years, Internet usage has doubled every three months.’ The myth came to be accepted as fact by industry and regulators alike and operators scrambled to build capacity as fast as possible. In reality, after 1996 growth slowed to a still fast, but more sustainable, 100 to 200 per cent per annum, a trend acknowledged by UUNet’s own engineers, although not in public statements.

Then came WorldCom’s boldest move yet – the bid for MCI Communications Corporation, one of the world’s top international carriers and more than three times WorldCom’s size. The bid was triggered by British Telecommunications plc (BT), the British ex-monopoly telecoms provider, which had made an agreed offer for MCI. However, after MCI forecast an $800 million loss in 1997 due to its newly acquired local network business in the US, BT dropped its offer price. WorldCom seized the initiative with an all-stock bid valuing MCI at $30 billion, nearly $9 billion more than BT’s offer. After GTE, a local telecoms provider, entered the auction, WorldCom raised its bid. By the time the deal closed 11 months later, it was worth a total of approximately $40 billion at WorldCom’s prevailing share price, such was the market’s infatuation with telecoms and with WorldCom in particular. WorldCom justified the purchase price by forecasting annual cost savings of $5.5 billion through the elimination of duplicated networks and systems. But the merger came with a sting in the tail: although most of the deal was paid for with WorldCom stock, BT had insisted on a cash deal for its large shareholding. The $7 billion cash cost added significantly to WorldCom’s debt burden.

Ebbers’ original plan to sell off MCI’s low margin residential business and to exploit its Internet and international networks was thwarted by the regulators, who insisted that the high-value Internet assets be sold to avoid over-concentration. ‘Essentially, Bernie took the low value end because, above anything else, he wanted to make the deal,’ said Discovery Institute’s John C. Wohlstetter. The merger, the largest in history at that time, made WorldCom a household name.
In the early days, WorldCom rapidly integrated its acquisitions, but as it became bigger and more complex so too did the integration process. Efforts focused on integrating physical networks. Other integration issues were ignored or forgotten in the race towards the next deal – sales forces were poorly integrated, if at all, and billing and accounting systems were largely ignored. WorldCom was evolving into a group of disparate entities rather than a seamless whole. Internal rivalry grew and made even simple problems more complicated. Customer dissatisfaction rose, and internal controls over the preparation and publication of financial results were dysfunctional at best. The numerous legacy financial systems operated by WorldCom units required significant manual processing to produce consolidated accounts. Weak controls permitted headquarters’ accounting staff to erase or create numbers simply by citing the wishes of Sullivan or Ebbers.

With the acquisition of MCI, the clash of two very different cultures made integration even more problematic: MCI was very marketing orientated, whereas WorldCom was more focused on cost control; WorldCom employees travelled economy class, in stark contrast to their counterparts at MCI who crossed the world on a fleet of corporate jets; MCI was innovation-led, whereas in WorldCom ‘if the idea didn’t come down from the top or one of the favoured people, it didn’t happen’. Rivalry between the two groups led to outright refusals to cooperate in eliminating redundant systems and achieving cost savings. Unable to agree how to manage network ordering and provisioning, executives closed the three centres MCI had set up to deal with this and opened 12 new ones.

To compound the problems, as WorldCom grew, its management became geographically dispersed. With Ebbers and the main finance department installed at corporate headquarters in Jackson, Mississippi and other finance functions based in Texas and Florida (where Sullivan lived), coherent decision-making became difficult. Network operations, public affairs, human resources and the legal department were equally spread out, with various offices for each function in Texas, Florida and Washington, DC.

Some doubts surface

In 1999 the world still accepted as gospel WorldCom’s forecast that Internet traffic was doubling every three months, and many analysts continued to push the stock. However, there was another school of thought whose proponents felt that WorldCom was weak in wireless
services; they were also concerned about falling prices for long-distance services. WorldCom responded with a $115 billion bid for Sprint Communications Inc., the third largest long-distance carrier in the US with a nationwide wireless network and Internet backbone. Although WorldCom agreed to sell off Sprint’s Internet division, US and EU regulators blocked the deal and it fell through in July 2000. Despite other smaller acquisitions in the wireless field, WorldCom failed to build up a significant presence in that area.

With continued high-growth forecasts in the late 1990s, money poured into the telecoms industry and capacity increased rapidly, partly as companies built their own networks and also as improved technology allowed greater volumes of traffic to pass through existing networks. As supply outstripped demand, rates for long-distance calls plummeted from 15 cents a minute to 2 cents a minute in the space of four years. At the same time, the local call market, with its high access charges, had become increasingly unprofitable for WorldCom.

Having peaked at $64.50 in June 1999, WorldCom’s share price steadily declined thereafter. When the dot-com bubble burst in early 2000 and many of WorldCom’s customers went under, the share price suffered further. However, it was the abandonment of the Sprint merger in July 2000 that drove the stock into freefall.

Moving into new markets

By mid-2000, with the Sprint deal looking increasingly unlikely, management decided to move into the Web-hosting business as part of a revised growth strategy. In June the board approved the initial proposal to do so via a virtually cost-free joint venture (codenamed Jaguar) with Andersen Consulting.

As the Jaguar negotiations were underway, Ebbers decided that an acquisition was the preferable means of entry, and Global Center – the Web-hosting division of telecoms carrier Global Crossing – was targeted. Negotiations began but, on 30 August 2000, Ebbers was furious to learn that Global Center was simultaneously pursuing Digex Inc., a leading provider of managed Web services. In what Sullivan later described as an ‘ego deal for Bernie’ because Ebbers did not want Global Center to win Digex, Ebbers retaliated by making a $6 billion offer the next day for Intermedia, Digex’s controlling investor. With pressure from Intermedia to close the deal almost immediately, Ebbers convened a brief telephonic board meeting to gain board approval.
The original plan was to sell Intermedia’s non-Digex assets (local networks), valued by advisors Chase Securities at up to $3.5 billion. (WorldCom’s own corporate development team had given a much lower estimate of $1.5 billion to Sullivan.) Despite a sharp fall in the value of local networks over the following months and several opportunities for WorldCom to opt out of the deal, Ebbers pressed on. Chase failed to find any buyers for the assets and revised the valuation to between $800 million and $1.8 billion. Nevertheless, WorldCom decided not to abandon the deal. Instead the price was reduced to just under $5 billion and the revised deal was executed on 14 February 2001. The board only rubber-stamped its approval a couple of weeks later. This was to be WorldCom’s last acquisition.

**The tracker stock diversion**

In September 2000, desperate to raise the share price, Ebbers initiated a boardroom discussion of the various restructuring options open to WorldCom. Although one option was the sale or spin-off of the MCI consumer business, it was clear that Ebbers favoured the creation of two separately traded tracker stocks. He told the directors that the tracker was ‘financial engineering’ and by putting poorly operating businesses into a separate tracker stock – MCI Group – high-growth operations such as data, Internet and international could be grouped together in a second, high-performing, tracker stock – WorldCom Group. No documentation was presented to the board concerning the different options, there were no external advisors present, and no decision or vote was taken at the meeting. By Ebbers’ own admission, the proposal to create tracker stocks had nothing to do with improving the operations of the company: it was all about the share price.

At an informal meeting on 31 October 2000, Ebbers informed the board that he had decided to create the tracker stocks. There was no vote and the formal announcement was released the next day. The October meeting was subsequently, and retrospectively, converted into a formal meeting containing the necessary resolutions to approve the decision and the minutes were retroactively approved by the board on 1 March 2001.

To the outside world, the tracker stocks were introduced in rather a different light, to ‘create greater shareholder value by providing shareholders with two distinct, clear and compelling investment opportunities’, with WorldCom Group holding the high-growth operations and MCI
Group emphasised as representing the low-growth but cash-generating mature businesses. But in overseeing the allocation of costs, revenues and balance sheet items between the two groups of stock, it has been claimed that Sullivan had a bias in favour of the WorldCom Group in virtually every significant decision that he made.\textsuperscript{i,15}

The tracker stocks were announced to the stock exchange on 1 November 2000. But any positive effect on the share price was negated by the news of WorldCom’s reduced revenue forecast for the fourth quarter 2000 and the whole of 2001 which was released that day too. The share price promptly fell 20 per cent in one day to close at $18.94.

Over the next year or so, WorldCom’s sufferings continued – as did the whole industry’s – and it was forced to implement cost-cutting measures including lay-offs. When Global Crossing announced in January 2002 that it was filing for protection under Chapter 11 – the largest telecoms bankruptcy so far – WorldCom’s stock took another dive to below $10 a share.

\section*{A cosy relationship with investment banks}

From the outset, WorldCom had been seen as a wunderkind by the analysts, among them Jack Grubman, Salomon Smith Barney’s (SSB) star telecoms analyst, who described WorldCom as ‘the “must-own” large-cap growth stock in anyone’s portfolio’.\textsuperscript{16} Grubman had a peculiarly symbiotic relationship with WorldCom. Compromising his role as an independent securities analyst, he attended several board meetings to discuss major transactions and even coached WorldCom staff for analyst conference calls. But his inside edge did not prevent him issuing consistently strong buy recommendations for WorldCom stock right up to April 2002. Other analysts were also touting WorldCom stock but Grubman stood out by almost always forecasting higher target share prices. It seemed that everyone was a winner. Salomon and its successor, SSB, won $106 million in underwriting fees from WorldCom between 1996 and 2002; Grubman personally earned $20 million a year from 1998 to 2001; Ebbers’ huge stockholding at one point was worth over $1.5 billion. The high share price also gave Ebbers crucial leverage to target acquisitions, allowing him to pay with shares rather than cash. It also enabled WorldCom to top up employees’ remuneration with valuable options, keeping the cash component at a lower level.

\textsuperscript{i} The tracker stocks did not create enough investor interest to improve share prices and the decision to abandon them was taken in July 2002.
As WorldCom’s deals grew in size, the interests of Ebbers and Citigroup (SSB’s parent) became more and more intertwined. SSB allocated Ebbers and other WorldCom directors highly profitable shares in initial public offerings (IPOs), making Ebbers $12 million profit.\(^{17}\) It seemed no coincidence that it was shortly after Ebbers received his first IPO allocation in 1996, that Salomon advised on its first merger deal for WorldCom, and the relationship continued over the next five years.

Ebbers also received personal and commercial loans from Citigroup units at highly favourable terms. But it was in late 2000, when Ebbers was in trouble with his lenders, that SSB really came to the rescue. In the opinion of the bankruptcy examiner, SSB offered Ebbers ‘extraordinary and unprecedented financial assistance’:\(^{18}\) SSB persuaded Citibank not to sell any of the stock that Ebbers had pledged to back his loan; and SSB also guaranteed Citibank that the bank would suffer no losses on a $53 million loan to Ebbers.

**Strained personal finances**

Not satisfied with running a huge global enterprise, Ebbers had built up a personal empire, buying, among other things, a cattle ranch in Canada, a timber farm and a luxury yacht-building company. To finance these purchases, Ebbers took on a huge volume of debt – estimated at between $500 million and $1 billion at its peak – using WorldCom stock as collateral.\(^{19}\) The loans were conditional on a minimum WorldCom share price, and as this tumbled in September 2000, Ebbers received repayment demands. Faced with possible forced liquidation of his holdings, Ebbers turned to his long-time associates on the WorldCom board for a short-term loan.\(^{ii}\) The compensation committee quickly agreed to a $50 million loan. It was only two months later that the terms were agreed and formalised, with Ebbers benefiting from interest charges at well below market rate.

By the end of September, however, Ebbers had already run short. This time, with no joy from either the banks or the compensation committee, he resorted to selling forward three million WorldCom shares. Announced a few days later to the stock exchange, it appeared to trigger a fall in the share price. Other telecoms shares fell at the same time but the directors used the assumed link between the sale and the price drop to justify a further loan in October. Neither loan was disclosed to the stock exchange or full board until November.

\(^{ii}\) There are conflicting accounts as to whether it was Ebbers who approached the committee or the committee who suggested the loan.
The precedent was set, and over the next 18 months Ebbers racked up a total of $408 million in loans and bank guarantees from WorldCom. Incredibly, he used some of the loans as working capital for his businesses. Instead of objecting, WorldCom accepted Ebbers’ reasoning that he used the money to maintain the value of his assets. For the first few loans, WorldCom did not even insist on any collateral, with the view that Ebbers’ stock would more than cover all his debts. However, as the share price spiralled downwards, WorldCom was without adequate security. Eventually, after pressure from the compensation committee, a written agreement was drawn up to take in some of Ebbers’ outside interests as collateral.

In line with numerous other investigations into the accounting practices of telecoms and other companies, in March 2002 the Securities and Exchange Commission (SEC) started an inquiry into WorldCom’s accounting policies and loans to directors. For the first time, worried non-executive directors met without management, angry at Ebbers’ attitude towards his loans. Ebbers was asked to resign, the blow softened with a very comfortable severance package, including an annual payment of $1.5 million for life. The loans were converted into a single five-year loan but still at a below-the-market interest rate which benefited Ebbers by as much as $30 million a year.20

**Accounting shenanigans**

WorldCom had embarked on a single-minded pursuit of revenue growth driven by Ebbers, who viewed this as by far the most important measure of business performance. As one employee said, the focus on revenue was ‘in every brick in every building’,21 and WorldCom responded by consistently outstripping the competition, reporting double-digit percentage revenue growth from 1999 to the third quarter of 2001. Unfortunately higher revenue was not always reflected in the bank balance, since actually getting paid had become a secondary issue.

A detailed monthly report, the ‘MonRev’ report, was used to monitor WorldCom’s revenue performance. Distribution of the report was limited and only a select few were allowed to see one schedule in particular, the Corporate Unallocated schedule. This contained items not attributable to any particular sales channel, such as those reflecting the impact of changes in an accounting policy. The Corporate Unallocated schedule was effectively used to carry entries which were often improper or at best highly questionable, most of them recorded after the month end in an attempt to plug the difference between the actual results and the revenue target for the month. This coordinated exercise, which kept a running tally of accounting
‘opportunities’ to increase revenue growth, came to be known as ‘Close the Gap’. If these ‘opportunities’ were stripped out of WorldCom’s overall revenue, the group’s performance would have been nowhere near as stellar.

One such ‘opportunity’ was the reclassification of customer credits, which would normally reduce revenue. In the second quarter of 2001, Sullivan decided to reclassify the credits as miscellaneous expense. There was a double benefit to this move: it both improved the revenue figures and, since miscellaneous expenses were not included in EBITDA, it improved this measure of earnings – one that analysts followed closely, since it was supposed to approximate cash flow.

Another measure analysts closely followed was the ratio of line costs to revenue (line cost E/R ratio). WorldCom frequently stressed that its series of acquisitions had created synergies that had kept a lid on line costs. Despite increasing competitive pressure, WorldCom managed to report a line cost E/R ratio which hovered consistently around 42 per cent from the end of 2000 to early 2002. This compared favourably with Sprint’s equivalent of 49 per cent. However, once a variety of irregular accounting entries are stripped out of line costs, WorldCom’s ratio was actually 51 per cent for most of 2001.

Sullivan was responsible for much of the manipulation of line costs. Like the revenue adjustments, the round-figure entries were generally made after the quarter close and rarely carried supporting documentation. The initial adjustments were accrual releases, some of which were genuine excess accruals but released after the period in which they were identified, contrary to approved accounting practice. In total, nearly $3.3 billion of accruals were improperly released against line costs from the second quarter of 1999 to the fourth quarter of 2000. One accounting group routinely carried excess accruals for the sole purpose of releasing them in order to smooth line costs. Although not uncommon, this ‘cookie jar’ process is not allowed under US Generally Accepted Accounting Principles (US GAAP). Alternatively, adjustments to line costs were made from accruals which were established for entirely different purposes such as tax or bad debts. Again, such entries are strictly forbidden by accounting rules.

If employees objected to an accrual release, they were told not to worry since the company was overaccrued on a consolidated basis. However, by the end of 2000, Sullivan and his team faced increasing resistance from employees to further accrual releases. They had to find another way to decrease line costs.

WorldCom, like many other telecoms companies in the late 1990s, had estimated a huge growth in demand which never materialised. Concerned at the time over possible shortages in capacity, WorldCom had entered into
long-term fixed-rate leases for network capacity. As demand and revenues started to level off, the underlying line cost E/R ratio started to climb.

A certified public accountant (CPA) called Tony Minert, who worked in General Accounting, first came up with the idea of capitalising line costs in July 2000. He suggested that the cost of unused capacity be transferred to fixed assets until traffic increased and the capacity could be used. The idea was quickly dismissed as not permissible under US GAAP and Minert left WorldCom shortly afterwards. However, less than a year later, the first entries to capitalise line costs appeared. There was no documentation to support the entries which, in any event, were far greater than the amount of unused capacity identified earlier. In all, $3.5 billion of line costs were capitalised as ‘pre-paid capacity’ between the first quarter of 2001 and the first quarter of 2002. Arthur Andersen, WorldCom’s external auditors, were not asked to approve this change in accounting policy, nor was it disclosed in public filings.

The process of booking the capitalised costs required the coordination of several different accounting groups which were not necessarily aware of the nature of the entries, at first referred to as ‘non-cash adjustments’. However, it did not take people long to suspect what was really going on, at which point some refused point blank to make the entries and started looking for new jobs.

In August 2001 Andersen, as part of the normal audit test work, asked to review one of the accounts which contained the capitalised line costs. The costs were quickly transferred to various different asset accounts. The sheer size of the ‘pre-paid capacity’ items were drawing attention as they now began to dominate WorldCom’s capital expenditure, accounting for half of the 2002 capital expenditure budget. But when the Operations group, which accounted for most of the remaining budget and whose own budget had been slashed, asked Sullivan about these Corporate items, he replied that they were non-cash items and that Operations should concentrate on cash.

At the same time, the heavy capitalisation of line costs meant that reported line costs were actually starting to come in below budget. This would have been evident at board level and might have led to probing questions, given the immense pressure by management to reduce line costs at that time. To avoid this, the line cost budget for 2001 was retroactively reduced.

**No checks and balances**

Both internal and external auditors can exert considerable control over a company’s reporting systems. In WorldCom’s case, the weak internal audit
department was ineffective and the external auditors missed several clear warnings of possible trouble.

Arthur Andersen had a long-standing relationship with WorldCom, stretching back to 1986 and were WorldCom’s external auditors from 1989. The combined fee income for audit, tax and consulting work, totalling over $64 million between 1999 and 2001,iii easily made WorldCom one of Andersen’s top 20 clients worldwide. The fee split was roughly one-third audit and two-thirds non-audit.

As pressure on audit fees increased in the 1990s, Andersen revised its audit approach from one of heavy, detailed testing to a risk-based model (which required fewer audit hours). Although WorldCom was in fact assessed as a ‘maximum risk’ client, for some reason the risk of fraud was assessed as only moderate. This is perhaps even more surprising given that WorldCom denied Andersen access to the general ledger.22 Extraordinarily, Andersen was willing to rely heavily on management’s own explanations, without, it seems, much hard questioning.

WorldCom’s internal audit department was only established in 1993. Ebbers himself saw little value in the function and, as a result, in an effort to gain the respect of senior management, internal audit focused its energies on areas aimed at reducing costs and increasing efficiencies. Risk-based audits and internal control reviews therefore featured lower on the list of internal audit priorities. Furthermore, internal audit resources were inadequate for the size of WorldCom, and access to financial information, including the general ledger, was limited.

Internal audit initially reported to the head of corporate development, then from February 2000 directly to Sullivan, who oversaw personnel issues as well as providing input on audit conclusions. There was little communication between internal audit and Andersen, which did not appear to rely on internal audit’s work to any extent. Given the limited scope of internal audit’s reviews, however, that was perhaps not surprising.

Although the board of WorldCom formed its own audit committee, to which internal audit reported, as well as to Sullivan, the committee’s contribution to the internal or external audit process was negligible. Of its four members, only two had any formal financial training. The audit committee spent as little as three to six hours a year23 overseeing WorldCom’s activities. In contrast, the compensation committee met as many as 17 times a year. During the meetings, presentations to the committee were made by internal audit, Sullivan and Andersen.24 Discussion of issues arising was

---

iii Many of the non-audit services that Andersen provided WorldCom are now restricted or prohibited for US companies by the 2002 Sarbanes-Oxley Act and the SEC’s rule enhancing auditor independence.
minimal, however, and the views of Sullivan and Andersen generally went unchallenged. Andersen itself neglected to tell the audit committee that it no longer had access to WorldCom’s general ledger. Nor, after 1997, did it show the committee its annual management comment letter, identifying areas of concern, and the committee, in turn, does not appear to have asked to see it.

**Rumbled at last**

It was, eventually, internal audit which triggered WorldCom’s downfall. An audit of capital expenditures at the end of May 2002 quickly uncovered the ‘pre-paid capacity’ entries, which were immediately reported to KPMG (which had replaced Andersen as auditors in April 2002) and the audit committee. Despite Sullivan’s protestations, they persisted with the audit. Sullivan tried in vain to justify the entries to KPMG and the audit committee on the basis that they enabled WorldCom to match costs to revenue. But KPMG was insistent that the capitalisations were not permitted under US GAAP. Sullivan was promptly fired.

The following day, on 25 June 2002, the $3.8 billion accounting fraud was announced to the stock exchange. WorldCom’s share price fell through the floor until the stock was suspended the next day at 9 cents. Bonds, already downgraded to junk bond status, were trading at 12 to 15 cents in the dollar. Technically in default of its bank loans, WorldCom filed for bankruptcy protection under Chapter 11 on 21 July 2002.

Lawyers had a field day. Lawsuits were slapped on WorldCom or its officers by the Federal government, the SEC, Oklahoma State, AT&T and others. WorldCom settled the SEC securities fraud suit for $750 million, including $250 million to be distributed to WorldCom’s shareholders and bondholders. In the first agreement of its kind, WorldCom also agreed that the court-appointed Corporate Monitor, Richard Breeden, should review WorldCom’s internal controls and oversee the implementation of his new blueprint for corporate governance. By mid-2003, it was estimated that income for previous years would have to be reduced by nearly $11 billion because of fraudulent and inaccurate accounting. In October 2003 WorldCom finally reached an agreement with its creditors and bondholders which would allow it to emerge from bankruptcy. Creditors wrote off $36 billion, leaving a debt of about $5.5 billion. A record $77 billion asset write-down left WorldCom with only $27 billion of assets: three-quarters of supposedly solid assets had been so much accounting hot air. WorldCom finally emerged from Chapter 11 on 20 April 2004 under the name of MCI.
Bondholders received some stake in the revived company, but shareholders were wiped out and left to mourn a loss of over $180 billion. Only a year later, the local telecoms company Verizon Communications, bought MCI for $8.4 billion.

**What went wrong and lessons to learn**

Ultimately, WorldCom collapsed because of Ebbers’ orgy of acquisitions. Not only was the pace of growth excessive, outrunning WorldCom’s capacity to integrate its acquisitions, but also, many of the purchases were ill-judged on strategic or cost grounds. The company became unwieldy and inefficient. The excessive costs and heavy loan burden incurred during the acquisition spree meant that WorldCom was unable to ride the shock of the downturn in the telecoms market. The fraud did not cause WorldCom’s downfall; it occurred in order to cover up the deficiencies in Ebbers’ management, and was allowed to occur because of the total failure of internal, and external, controls.

**Strategic failures**

Initially, the strategy was driven by the need to achieve economies of scale through the acquisition of neighbouring resellers. Later, declining margins and spiralling line costs led to the acquisition of facilities-based carriers. The deregulation of local markets created the opportunity to acquire a number of carriers with local networks. It all seemed to make sense. But many of the acquisitions were ad hoc and opportunistic, rather than part of a well-thought-out, long-term plan. The acquisition of UUNet was a lucky accident. MCI, on the other hand, was bought at a hugely inflated price, justified by potential synergies which were mostly never realised. What was worse was that WorldCom was forced to dispose of MCI’s high-growth Internet assets and kept instead the loss-making local networks which had scared BT into reducing its original offer. Intermedia was another disastrous acquisition where Ebbers’ ego, rather than commercial logic, dictated the deal.

If Ebbers had resourced his corporate development department more heavily, and respected its analysis, he would have been able to make more informed strategic choices. The Intermedia deal, for example, would probably not have gone ahead if Ebbers had accepted the department’s original valuation of the local network assets. The WorldCom board itself should have reined in Ebbers and stopped some of the excesses.
Growth for growth’s sake

Fairly early on in WorldCom’s evolution, the strategy changed to one of growth for growth’s sake rather than the maximisation of shareholder value over the long term. Ebbers had become addicted to the buzz of the ‘deal’ and preferred the instant high of an acquisition to the slog of organic growth. As WorldCom grew, it needed to make larger and larger acquisitions to achieve the same growth effect. Disaster struck when the Sprint merger was disallowed by regulators: WorldCom could not easily replace it. The party was over and the share price took the hit.

Although in its early days the company had a good reputation for quickly and smoothly integrating smaller newcomers into the group, a lack of detailed and thorough post-deal integration planning caused problems when it came to larger deals. This was particularly true when it tried to link the billing and accounting systems of larger, facilities-based carriers, to the extent that many of the purported synergy benefits were never captured. All in all, Ebbers made so many acquisitions (some 60 over 15 years) that it became impossible to sort out all the problems before the next target came along. Consequently many were never resolved.

Bernie Ebbers – hero to villain

Ebbers was a small-town boy with little formal business education and no knowledge or experience of telecoms when he entered the business. His entrepreneurial skills and attention to detail helped him to rescue LDDS from near disaster but he failed to develop the skills necessary to run a large multinational like WorldCom. Ebbers was a micromanager par excellence, as evidenced by his attempts to reduce costs by banning free coffee and arranging for the water coolers to be filled with tap water. He did not have a firm handle on the operations of the company as a whole. As Richard Breeden, the court-appointed Corporate Monitor for WorldCom commented: ‘Bernie Ebbers was as incompetent and unqualified to be a CEO as anyone who has ever held that post.’

The failure or – to be more accurate – the complete lack of any of the normal checks and balances against excessive power at WorldCom allowed Ebbers imperial reign over the affairs of the company. Ebbers ran WorldCom like his own private fiefdom, decreeing virtually everything that happened within the company and tapping it for loans when he ran short of cash.
He controlled compensation decisions throughout the company, as senior employees were only too aware. Although, nominally, the compensation committee controlled pay and option awards to all employees, in practice Ebbers had the final say on all compensation awards apart from his own.

In May 2000, faced with fierce competition for human talent from the wave of high-tech start-ups, Ebbers awarded over 500 key employees a total of $240 million in cash retention bonuses plus share options. Ebbers was given sole discretion by the board’s compensation committee to decide which employees were to benefit from the scheme and by how much. Despite the professed intention of the scheme being to retain key staff, Ebbers did not attach any condition of continued employment to the bonuses granted – the chosen employees were free to take the cash and walk. Ebbers and Sullivan themselves did not go empty-handed, receiving a $10 million cash retention bonus each. This was in addition to the $77 million and $49 million compensation they received respectively for the three years to December 2001. Interestingly, Sullivan shared part of his bonus with seven of his closest subordinates and their wives. Four of them later pleaded guilty to accounting fraud charges. The retention bonuses had become, in effect, a slush fund, there to reward personal loyalty towards Ebbers and Sullivan.

Unlike Kozlowski (Tyco) and Skilling and Lay (Enron), Ebbers did not make a fortune from WorldCom options or shares. He preferred to keep his stake (apart from a $23 million profit on realising options in 2000) and financed his lifestyle through loans rather than stock sales: the incentive to raise the share price was just as great in order to provide collateral for his loans. When the share price did fall, rather than sell his businesses, he got WorldCom to finance them. It became an overwhelming priority for Ebbers to support the share price, and hence the fraud began.

Today WorldCom would not be allowed to give Ebbers loans. The Sarbanes-Oxley Act specifically forbids loans to company officials, although not all countries have this prohibition.

Ripples of greed

Maintaining a high share price was essential for Ebbers to finance WorldCom’s acquisitive appetite (and to increase the value of his shares and stock options). To this end, he was greatly assisted by a number of investment banks and their analysts, including, as we have seen, Grubman of SSB. There can be little doubt that Grubman’s closeness to the company
and the fact that Citigroup received large fees from WorldCom encouraged him in continuing to promote the shares long after sensible analysis should have led to a different result. In the aftermath of the collapse, Grubman’s activities were investigated by Eliot Spritzer, the New York Attorney General, although none of the final charges related directly to WorldCom. He agreed to a ‘no guilt’ deal involving a fine of $15 million and a lifetime ban from working in the securities industry, rather than face the court. In 2004, Citigroup paid $2.65 billion in compensation to WorldCom investors in an out-of-court settlement of a claim that the bank had taken part in a financial fraud. Other banks followed suit, paying out an additional $3 billion to WorldCom shareholders.

A complacent board

On the face of it, with 9 outside directors on the 13-strong board, WorldCom would have satisfied the New York Stock Exchange’s new rule, introduced in 2003, for a board majority of independent directors. But many of these ‘independent’ directors were independent in name only as they were connected in some way or other to companies acquired by WorldCom and some owed most of their wealth to Ebbers’ actions. Although never chairman of the board, Ebbers controlled its agenda, discussions and decisions.28 As one former director said, ‘we were not there to second-guess our leaders [Messrs. Ebbers and Sullivan]’.29 WorldCom’s strategy was also largely dictated by Ebbers and Sullivan, who between them identified acquisition targets or areas for corporate development on an informal ad hoc basis. The small corporate development department was responsible for due diligence on smaller deals but, quite incredibly, in assessing the impact on WorldCom’s existing business it was not allowed access to WorldCom’s internal financial data. Despite WorldCom’s size and rapid growth, the board did not form its own strategy or risk committee and its involvement in approving strategic decisions was limited – increasingly so after 1997. Management presentations to the board were brief, for some acquisitions a mere 15 minutes,30 and, apart from major transactions, the level of data received by the board gradually diminished over time. It was a remarkably supine board that allowed this state of affairs to develop.

Ebbers’ entrepreneurial streak was evident in his drive to create his own personal private empire. The outside directors claim not to have been aware of Ebbers’ businesses before the loan requests began, but it is very strange that the board allowed Ebbers to continue them since these
activities provided no conceivable advantage to WorldCom shareholders and could only have been having an adverse effect on Ebbers’ performance. At the very least, Ebbers must have been diverted from WorldCom business, spending time managing his outside interests and negotiating his loans; at worst, from mid-2000 onwards, as the share price fell, he must have been tempted to make any move which would increase the share price in the short term.

WorldCom did have a few excellent and experienced directors who would never have tolerated even marginal accounting practices, let alone fraud, had they known about them. But the board only met, on average, quarterly and the meetings largely involved formal presentations from management rather than detailed discussions. With weak internal controls, ineffective external auditors and a laissez-faire audit committee, outside directors had little chance of detecting the fraud. It is also possible that the board may have been blinded by the philosophy that a rising share price was proof that all was well, although from mid-2000 onwards, as the share price headed downwards, this could no longer be an excuse. At best, the WorldCom board can be described as complacent and spineless: no director said ‘no’ to Ebbers’ loans; no director insisted that Ebbers sell his external assets to reduce his loans; no director said ‘no’ to the $240 million employee retention programme; and no director appears to have questioned Ebbers’ competence to run WorldCom until disaster was unavoidable.

In the aftermath of the WorldCom implosion, its board did not escape scrutiny. Shareholders brought a class-action law suit against the directors, charging them with lying about the company’s finances before a large bond issue. The directors eventually settled the case for a $60 million payment, $25 million paid by the directors personally, the remainder by insurers.

Weak internal controls

The list of WorldCom’s control failings is a long one: a diffuse accounting department, spread over several locations; numerous legacy accounting and billing systems which required much manual intervention to perform consolidations; an under-resourced and ineffective internal audit department; an under-sized corporate development department which could not conduct thorough due diligence or risk analysis; and a small clique of insiders who made the key decisions, isolated from impartial advice. All of these contributed to the poor decision-making and allowed the fraud to happen.
Another Andersen debacle

No doubt Arthur Andersen’s task was made more difficult by the complexity of WorldCom’s operations, compounded by the frequent acquisitions and subsequent failure to integrate accounting systems. Nevertheless, by any comparison it fell far short of the standards one is entitled to expect from a professional accounting firm. Andersen’s willingness to sign off on a set of accounts when denied access to the company’s general ledger beggars belief. That it did not draw this restriction to the attention of the audit committee is even more difficult to comprehend. One can only assume that, as WorldCom was a major client paying high fees for both audit and consulting services, Andersen did not want to lose the job and was willing to compromise its integrity in order to avoid doing so.

Even ignoring such egregious behaviour, and at a more mundane level, it is difficult to understand how Andersen missed a number of clear warning signals that all could not be well. It did not query how WorldCom’s revenue growth and line cost E/R ratio was significantly outperforming its competitors’; it did not follow up on reserve reallocation problems brought to its attention by a finance manager; and, despite regarding WorldCom as a high-risk client, did not work with internal audit to identify and investigate potential areas of weakness.

Like the other players in the debacle, Andersen was sued in a class-action shareholder lawsuit for failing to detect the accounting fraud at WorldCom. The defunct shell of Andersen, after its own collapse, finally settled the action out of court for $65 million but continued to deny any wrongdoing.

Andersen’s failings did not cause WorldCom’s collapse. It had no duty to dictate Ebbers’ strategy or stop his acquisitions. It could have detected the fraud earlier and perhaps investors would have lost less money, but the damage had already been done by the date Sullivan’s cover-up activities began.

Fraud

It should be clear by now that fraud was not the cause of WorldCom’s downfall. The accounting fraud occurred because it was too hard to admit that the entire WorldCom edifice was built on straw; because Ebbers, and others, had grown to appreciate the standard of living which the high share price had brought them. Earnings had deteriorated not only due to the downturn in telecoms but also because the collection of companies that Ebbers had built up had never been fully integrated; because WorldCom
had come to believe its own words about Internet growth and had incurred additional line costs; because Ebbers had paid too much for some of his acquisitions and WorldCom was struggling under its burden of debt. For these, and many other reasons, WorldCom went under.

The key messages are:

1. Growth for growth’s sake almost invariably ends up in disaster. Aggressive acquisition programmes have many potential pitfalls: poor strategic fit; excessive purchase costs; increased operational and financial risk; insufficient time and resources to integrate fully, which reduces potential synergies.

2. Like governments, large companies require checks and balances to keep them honest: a strong, independent board and audit committee; an effective internal audit team to perform financial audits; and a set of external auditors determined to get to the truth.

3. What no legislation can provide for, and what company boards need above all, is a curmudgeonly director to hold management to account.

4. Entrepreneurs are rarely successful in developing and running large corporations. Non-executive directors must therefore play an important role in assessing the competence of a CEO and replacing him, or her, when necessary.

Notes


2. Thomas Catan, Stephanie Kirchgaessner, Peter Thal Larsen, and Juliana Ratner. ‘Bernie Ebbers – Before the Fall’, Financial Times (18 December 2002).


16 SSB research report (16 November 1998), p. 3.
20 Richard C. Breeden ibid.
21 Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom Inc. (March 2003).
23 Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom Inc. (March 2003).
24 Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom Inc. (March 2003).
28 Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom Inc. (March 2003).
Chapter 5

Tyco: Greed, Hubris and the $6000 Shower Curtain

The Tyco story is not, strictly speaking, one of a company that failed. It is the tale of an ambitious and greedy man: a man who, blinded by previous success and spurred by the prospects of fabulous wealth, went on a $60 billion acquisition spree; a man who took his company into new, and risky, markets; a man who, quite blatantly, looted his company of millions of dollars.

In May 2002 graduating students from St Anselm College in New Hampshire gathered to listen to a speech by Dennis Kozlowski, Tyco’s CEO. He told the students, ‘You will be confronted with questions every day that test your morals. Think carefully, and for your sake do the right thing, not the easy thing.’ Less than a month later Kozlowski was standing in court charged with tax evasion.

With 2001 revenues of $38 billion and 240,000 employees worldwide, Tyco was one of America’s largest conglomerates. But when the new ventures failed and the excesses were uncovered, its $28 billion debt mountain brought the company to the brink of bankruptcy. Shareholders lost over $90 billion, more than 80 per cent of Tyco’s peak market value, and the bosses were jailed for a minimum of seven years for grand larceny and fraud. Yet the company somehow survived, albeit in a somewhat shrunken state.

Three decades of growth and profit

Tyco Laboratories\(^i\) was founded in 1960 to perform experimental research work for the US government. Having gone public in 1964, Tyco quickly

\(^i\) Tyco Laboratories changed its name to Tyco International Ltd in 1993.
expanded, mainly by acquisition, to exploit the commercial applications of its work. Joseph Gaziano, Tyco’s CEO during the 1970s, bought up yet more companies and, by his death in 1982, Tyco had reached $500 million in revenues. In 1975, in what turned out to be a pivotal moment for Tyco, Gaziano met Dennis Kozlowski and persuaded him to join the company as an assistant controller. Kozlowski was fascinated by Gaziano, an imposing figure who appreciated the high life and whose collection of company perks included a jet, a helicopter and three luxury apartments.

Born in 1946, Kozlowski came from a blue-collar background, the son of a Newark policeman. Dennis himself was an easygoing young man. He worked his way through college, graduating in 1968 with a major in accounting, and even found the time to earn himself a single-engine pilot’s licence. In 1970 he began working as an auditor for the conglomerate SCM Corporation and later became director of audit and analysis for Nashua Corporation, a manufacturer of specialty imaging products based in New Hampshire. At Tyco, his ambitions led him to start night classes at the local college where he claimed to have earned his MBA, although in fact he only completed three classes.2

When Gaziano died in 1982, he was replaced by 41-year-old John Fort, his opposite in nearly every way. A coolly analytical, abstemious man, Fort changed Tyco’s focus from growth to profits. He streamlined Gaziano’s collection of acquisitions into three main divisions – fire protection, electronics and packaging – and sold off unprofitable businesses. At head office, perks were cut right back – jets were grounded and company cars and even country club memberships were banned. In 1985, as further proof that Tyco was walking the straight and narrow, Robert A. G. Monks, shareholder activist and champion of corporate governance reform, was appointed to the board. (Before he left the board, in 1994, Monks reformed Tyco’s long-term compensation scheme for top executives. The share award scheme was changed so that the shares would vest only if Tyco met specified performance targets.)

Fort appointed Kozlowski president of Tyco’s largest division, Grinnell Fire Protection Systems Co. Kozlowski implemented Fort’s programme with a vengeance, cutting corporate staff from 200 to 30 and restructuring the compensation system. Having refocused the division, Kozlowski turned his attention to buying out competitors. While Fort was involved in the negotiations, it was Kozlowski who ‘got the deals executed … It was very clear these deals were value-adding … What was startling was the speed with which acquisitions were integrated into Tyco’.3 Kozlowski was appointed to Tyco’s board in 1987 and named president and COO two years later.
Dennis Kozlowski – a man with persuasive powers

Tyco suffered badly in the 1991 recession, partly because of the poor performance of one of its fire protection businesses, Wormald International, bought for $360 million the previous year in Tyco’s biggest acquisition to date. Fort called a halt to further acquisitions but Kozlowski thought that Tyco had merely encountered a minor setback and should continue its growth strategy. As the dispute intensified, Kozlowski engineered a boardroom coup to become CEO in 1992 and chairman in 1993. But, in a tribute to his political skills, he persuaded Fort to remain on the board.

Tyco had grown substantially under Fort’s leadership and by 1992 its revenues had reached $3.1 billion. But although it appeared diversified, nearly 80 per cent of its business was heavily dependent on the volatile commercial construction industry. Kozlowski’s solution was to diversify into disposable medical supplies with the acquisition of Kendall International. Kendall did not, at first glance, appear an attractive target. It had emerged from Chapter 11 bankruptcy only two years before and its revenues were growing at a lacklustre 3 per cent per annum. But Kozlowski’s powers of persuasion convinced the board and shareholders that he could turn Kendall around, and in 1994 Tyco bought Kendall for nearly $1 billion. It was a great success and became the core of Tyco’s new healthcare division, which then grew, mostly by acquisition, to become America’s second largest producer of medical devices.

Mark Swartz came to Kozlowski’s attention while working on the Kendall deal and soon after it closed Kozlowski appointed him CFO. Swartz was a typical Kozlowski protégé: ‘smart, poor and want[s] to be rich’.4 Like Kozlowski, Swartz was a self-made man, who had worked his way to the top without the benefit of an Ivy League degree or an MBA. He had joined Tyco in 1991 after qualifying as an auditor (CPA) with Deloitte & Touche. More polished than Kozlowski, Swartz took the lead in Tyco’s relations with Wall Street. He soon developed a very close working relationship with Kozlowski, becoming Tyco’s second most powerful executive.

In mid-1995, shortly after Swartz’s promotion to CFO, Kozlowski persuaded the board to move the corporate suite from its modest Exeter, New Hampshire head office to lavish new premises in Manhattan. A standard relocation programme, applicable at all levels of the organisation, was approved by the board’s compensation committee. However, in practice, the plan was superseded by a much more generous programme, ‘tailored to each individual’s circumstances’. Apparently this package was not even seen, let alone approved, by the committee.5 Limited to
five or six executives, the additional cost was initially negligible. But then, in 1997, Tyco bought the security services company ADT and spending rocketed.

To rescue ADT from a hostile bid, Tyco had stepped in as a white knight with a $5.4 billion offer. The reverse merger allowed Tyco to assume ADT’s registration in Bermuda’s tax haven, through which Tyco could avoid US tax on overseas earnings. Excited by the money-saving opportunities of tax planning, Kozlowski set up finance subsidiaries in other offshore centres and used them to slash Tyco’s effective tax rate from 36 per cent in 1996 to 23 per cent in 2001.

Contrary to practice in its prior acquisitions, Tyco appointed Michael Ashcroft, ADT’s CEO, and two of his colleagues to the Tyco board. Describing himself as ‘one of life’s buccaneers’, Ashcroft was a charming, if ruthless, Englishman and a self-made millionaire. Apart from managing ADT, he was an Ambassador Extraordinary for the small Central American country of Belize and 65 per cent owner of its largest company. He cultivated a high social profile and lavish lifestyle, using his yacht, Atlantic Goose, as a travelling office. Kozlowski was impressed not only by Ashcroft’s lifestyle but also by the more than £200 million profit he made from the Tyco merger by cashing in his share options.

Prior to the ADT merger, Tyco had banned share options, using restricted share awards as its long-term compensation scheme. As late as April 1997, Kozlowski was extolling the virtues of Tyco’s restricted share scheme to the Wall Street Journal. He described share options as ‘a free ride’ and ‘a way to earn the megabucks in a bull market with a hot company’. But it seems that Kozlowski was attracted to the ‘megabucks’, since shortly after the acquisition Tyco’s board adopted ADT’s share option scheme and awarded Kozlowski six million (adjusted for a later share split) options to vest over three years. Tyco also continued with its restricted share scheme and, in addition, introduced a ‘reload’ share option scheme. This scheme awarded participants replacement options, at market price, whenever they exercised any options or sold restricted shares. Unlike the main option scheme, these options vested immediately and could be exercised after only three months. In effect, this permitted participants to cash in their option gains at any point while still benefiting from future price rises. As Tyco’s share price rose to new heights, Kozlowski pocketed profits by selling shares and options as soon as they could be exercised. This negated the main purpose of the share scheme which was to encourage key officers to identify with shareholders by maintaining a stake in Tyco. It would appear that Tyco’s board had not thought through the potential consequences of the ‘reload’ scheme. Since, unlike shares,
Kozlowski’s ‘reload’ options had no downside price risk, there was now every incentive to take risks to improve the short-term share price by, for example, making frequent acquisitions accompanied by aggressive accounting techniques, as we shall see in the next few pages.

Share options avoided one disadvantage of the restricted share scheme which was to trigger a personal tax liability when the shares vested, forcing employees to sell shares to pay the tax. To encourage employees to keep their shares under the restricted share scheme, Tyco had set up the Key Employee Loan Program (KELP) which allowed employees to borrow from Tyco to cover the tax due. This was too good an opportunity for Kozlowski to miss. He used the programme as a private bank, borrowing $245 million between 1997 and 2002 for spending on items far removed from tax, such as Impressionist paintings and a racing yacht.

Kozlowski’s compensation in 1996, pre-ADT, was a fairly modest $9 million. Two years later his compensation, including stock grants and the value of realised options, had shot up to $66 million and in 1999 it rose to a staggering $170 million. In addition, from 1998, Tyco paid into an executive retirement scheme for Kozlowski and Swartz which, by 2001, guaranteed Kozlowski an annual income of over $4 million after he retired.8

Last vestiges of frugality disappear

In 1998, in a final departure from Fort’s frugal policies, Kozlowski relocated 44 employees from Tyco’s Exeter office to ADT’s operating headquarters in Boca Raton, Florida. Two relocation programmes were set up, similar to the New York ones, stating that they had the same 1995 board approval. Kozlowski himself borrowed $29 million under the programme to purchase land and build a property in Boca Raton. Tyco’s general counsel, Mark Belnick, appointed in 1998, was another executive to benefit from the plans, receiving nearly $14 million in interest-free loans to finance the purchase of a home in Utah and an apartment in Manhattan. (The loans were later forgiven.) The loans were not disclosed in company filings despite the recommendation of the auditors, PricewaterhouseCoopers (PwC), to do so.9 The auditors should have mentioned this to the audit committee, but failed to do so.

In Boca Raton, executives could order breakfast to be delivered to their desks on china plates, and on Fridays a masseur came around to soothe away stresses. But Tyco still registered the spartan Exeter office as its US operating headquarters and Kozlowski often cited it as an example of Tyco’s thrift. In one interview Kozlowski said, ‘If you build an elaborate
headquarters, people are tempted to spend a lot of time there and it becomes really unproductive.\textsuperscript{10}

Even before the Boca Raton relocation, Kozlowski had built up over $28 million of interest-free relocation loans. Brazen-faced, Kozlowski then told Swartz to write off $25 million of his loans (and $12.5 million of Swartz’s own loans). Kozlowski later claimed that the lead director, Philip Hampton, had approved the write-off but there was no written record of any such request and no other director recollected any mention of it. Hampton died of cancer in 2001 so could not corroborate Kozlowski’s statement. The loan forgiveness was left off both the annual proxy filings and Kozlowski’s and Swartz’s 1999 income tax declarations, an omission that, extraordinarily, they both claimed not to have noticed.

An acquisition a day …

Kozlowski continued his expansion programme after the ADT merger. While some large acquisitions such as AMP, a maker of electronic connectors, bought for $11.3 billion in 1998, made the headlines, the majority were small and passed almost unnoticed. Between 1999 and 2001, Tyco spent $8 billion on more than 700 acquisitions, which it said were not material and thus did not need to be disclosed separately in public filings.

Kozlowski was a past master at the acquisition game. Immediately after acquiring a target, Tyco rolled into action. Overheads were cut to the bone, unprofitable lines scrapped and efficiencies introduced. These actions, plus pre-closure or acquisition write-offs, produced an immediate, but one-off, growth spurt. The following period, more – and bigger – acquisitions were required to produce the same percentage growth. The market rewarded the high growth rate by marking up the share price and thus allowing future takeovers to be financed mostly by shares. The constant flow of acquisitions made it impossible to calculate the true organic growth (growth excluding takeovers) from the published accounts so it was unclear how much Tyco depended on acquisitions to boost its growth rate.

The acquisition train stopped for a period from October 1999 after Albert Meyer, an analyst at David W. Tice & Associates, accused Tyco of consistently booking excessively large acquisition-related charges which could later be released to increase profits.\textsuperscript{11} Other worries emerged concerning instances where target acquisitions had slowed down revenue growth or written off assets just before the deals closed. For example, just before Tyco’s $3.17 billion takeover of US Surgical Corp. in 1998, the
medical products maker took $322 million in one-time charges. This process, known as spring loading, artificially boosted the post-acquisition growth rate.

Prompted by Meyer’s report, in December 1999 the US Securities and Exchange Commission (SEC) began an investigation into Tyco’s handling of more than 120 of its acquisitions during the previous six years. The share price nosedived and was now more than 40 per cent lower than before Meyer’s original report. But Kozlowski’s ‘willingness to test the limit of acceptable accounting and tax strategies’, as described in a later interview with BusinessWeek, paid off. The following summer the SEC sent a letter informing Tyco that it was taking no action.

Meanwhile, with its share price suffering, Tyco sold some non-core assets in order to finance more acquisitions. In January 2000 it sold ADT Automotive, its wholesale automobile auction unit, for $1 billion, making a profit of around $300 million on the sale.

**Extending the portfolio into telecoms and finance**

Later that month, greedy to cash in on the telecoms boom, Tyco announced it would build and operate its own undersea fibre-optic network. Its subsidiary, TyCom, the global leader in installing and maintaining undersea cables, would build the network, partially funded by an initial public offering (IPO). Ignoring hints of overcapacity in undersea cables that began to emerge in 2000, Tyco raised $2.1 billion selling 14 per cent of TyCom in July 2000 at $32 a share.

In congratulatory mode, the board awarded a bonus to key executives for the successful implementation of the IPO. But Kozlowski added a new element to the bonus: forgiveness of relocation loans, grossed up to compensate for income tax. This cost the company nearly $96 million, with Kozlowski personally benefiting by $33 million. According to Tyco, the compensation committee knew nothing about the loan forgiveness and Kozlowski ensured that it would remain that way by putting confidentiality agreements in place with recipients. PwC was aware of the bonuses but was told by management that they were not material and therefore did not require disclosure.

Two months later, Kozlowski authorised another bonus programme, again without the board’s knowledge. This time it was for the successful completion of the ADT Automotive sale. The total cost to the company was $56 million, of which $25 million went to Kozlowski. Neither of these bonuses was reported in Tyco’s proxy filings.
By 2001 Tyco was a huge conglomerate, with operating earnings of $3.7 billion on 2000 sales of $29 billion. But Kozlowski had bigger ambitions. He wanted Tyco to ‘become the next General Electric (GE)’ and to be a $100 billion company (by revenue) by the time he reached 60. Kozlowski hoped to copy GE’s success with its finance arm GE Capital and had been hunting for a suitable finance acquisition for some time. This was a risky strategy, since GE was the exception to the rule that had seen a long trail of companies with failed finance arms (ITT, Westinghouse and so on). Then, in January 2001, Frank Walsh, Tyco’s lead director, proposed to the board that Tyco approach CIT Group with a view to a merger. Walsh was friendly with CIT’s CEO, Albert Gamper, and offered to introduce him to Kozlowski. As one of the top three US asset-based lenders, CIT had over $50 billion in managed assets but was suffering from a poorly managed acquisition the previous year. Kozlowski anticipated synergies from providing vendor finance to increase sales and by exploiting its database of home-security consumers. But vendor finance could be a slippery slope, as others, such as Lucent Technologies, had found out when they became lender of last resort and ended up with a pile of bad loans. GE Capital, on the other hand, financed only 2 per cent of its parent’s industrial sales. Despite all the risks, in March 2001 Tyco announced a $10.2 billion shares and cash offer, a 54 per cent premium on the CIT share price (and nearly three times its price the previous autumn). Living up to his reputation as America’s ‘most aggressive CEO’, Kozlowski encouraged CIT to make pre-closure downward adjustments to its results. The adjustments totalled at least $220 million and resulted in a loss of $78.8 million for the two months before closure. Then, the following month, CIT, now owned by Tyco, reported a profit of $71 million: shareholders saw an apparently impressive turnaround.

After the deal was agreed Walsh negotiated a finder’s fee of $20 million, which he and Kozlowski agreed not to disclose to the board. According to Tyco, the board only discovered the payment when they read the draft annual proxy statement in January 2002. Furious, the directors demanded that Walsh repay it. Walsh refused and, when asked for an explanation, Kozlowski could only say that he had ‘screwed up’. The board then initiated legal proceedings to recover the money.

The share price on a downward trajectory

In October 2001, following the sharp fall in the TyCom share price – in line with other telecoms stocks – Tyco bought back the public stock for
$15.42 a share in Tyco stock. There was a widely acknowledged bandwidth glut and some cable owners had already gone bankrupt but Kozlowski thought that Tyco could ride out the dip, saying: ‘We are the last man standing.’17 Six months later, he had to acknowledge that the dip was actually a slump and wrote off the whole of TyCom’s network in service, at a cost of $2.2 billion. The TyCom venture was always doomed to failure. Granted, many others also failed to foresee the imminent telecoms crash, but it was clear to almost everybody by mid-2000 that the market had reached its peak and that there was serious overcapacity in bandwidth. Kozlowski was blinded by other companies’ past profits into investing in his own network at the top of the market.

By November 2001, Tyco’s share price had recovered to the pre-SEC investigation level, but the shine had rubbed off. With a price earnings (PE) ratio of only 19 (based on 2001 earnings) compared with 33 in 1999, the share price had lost its premium. Then rumours surfaced in early January 2002 that the SEC was about to mount a fresh investigation into Tyco’s accounting practices. In a jittery market, still stunned by Enron’s collapse, Tyco’s share price tumbled.

The share price must have dominated Kozlowski’s thoughts. His 2001 compensation had dropped to ‘only’ $40 million, including $30 million of restricted stock. This was well below the previous year’s $125 million. Towards the end of 2001, in a bid to raise the share price, Kozlowski announced a plan to split Tyco into four separate businesses (one being CIT). He argued that Tyco’s share price did not reflect its true valuation and the planned split could increase shareholder value by as much as 50 per cent. The estimated $11 billion proceeds would be used to pay down debt. But investors were taken aback at the sudden change in strategy. Amid suspicions of Kozlowski’s reasons for the break-up and fears of revelations of accounting shenanigans, the share price fell. It dropped even further when Tyco reduced its profit forecast for the second quarter 2002 and revealed the bonus payment to Frank Walsh.

In early February 2002 liquidity issues began to spook the market. Tyco’s free cash flow was falling; debt had more than doubled over the past year; and there was $12 billion of long-term debt due for repayment in 2003. To ensure liquidity, Tyco decided to draw down on its expensive credit facility, triggered by its imminent expiry. By drawing down on the whole $3.9 billion facility, Tyco was able to extend it for another year. But this action produced the very result that Tyco feared – one of the major debt ratings agencies, Standard & Poor’s (S&P), downgraded Tyco’s long-term debt from A to BBB (just two notches above junk status) and its short-term debt from A-1 to A-3. CIT’s debt was similarly downgraded,
effectively barring it from the (cheap) commercial paper market and thereby seriously reducing its profit margins. The share price nosedived. It had now lost nearly 50 per cent of its value since December.

At the end of April, with no recovery in the share price in sight, Kozlowski abandoned his plans to break up the company but pushed forward with the IPO for CIT, optimistically estimated to raise $7.15 billion. Tyco announced second quarter results the same day, posting a net loss of $1.9 billion following a $2.2 billion (pre-tax) write-down of TyCom and other provisions. It also reduced forecasts for the full year saying that future growth would be lower and that thereafter it would concentrate on increasing returns on capital rather than earnings per share. Kozlowski apologised to shareholders, admitting that management had let them down. But Kozlowski had lost credibility with the markets: the U-turn failed to reassure shareholders and the share price dropped a further 20 per cent.

The house of cards comes tumbling down

On 2 June Tyco dropped another bombshell: about to be indicted on charges of tax evasion, Kozlowski had resigned as chairman and CEO. The indictment, issued two days later, accused Kozlowski of avoiding $1 million of New York sales taxes by claiming that paintings he had bought, worth more than $13 million, had first been sent to New Hampshire rather than to New York, where they now hung on the walls of his apartment. Kozlowski had received his first subpoena a month before, but he and Belnick together agreed not to tell the board. This was part of a pattern of concealment, according to Tyco, which frustrated the board’s internal review of compensation and corporate governance matters, launched after it discovered the Walsh payment in January 2002. On 10 June Belnick was caught moving confidential company papers out of the New York office. He was promptly fired and, or so Tyco claimed, the investigation started to make headway.

Swartz resigned at the beginning of August, just days after the appointment of Tyco’s new CEO, Edward Breen, the former president and COO of Motorola. Breen appointed the legal firm Boies, Schiller & Flexner (Boies) to perform an ‘in-depth review into the company’s accounting practices’ in addition to the ongoing inquiry into executive compensation. One month later, both Kozlowski and Swartz were indicted on charges of grand larceny, fraud and enterprise corruption, a term more commonly heard in Mafia prosecutions. The SEC filed charges of looting
and reporting violations against Kozlowski, Swartz and Belnick. Then Tyco filed civil charges against Kozlowski, Swartz and Belnick to recover over $600 million.

The State charged Kozlowski and Swartz with stealing a total of $600 million from Tyco through schemes such as unauthorised bonuses, loan forgiveness programmes and the manipulation of stock sales. As Stephen Cutler, the SEC’s director of enforcement, said, ‘[these men] treated Tyco as their private bank, taking out hundreds of millions of dollars of loans and compensation without ever telling investors’. The first trial ended in a mistrial but a second one began in January 2005 with prosecutors accusing Kozlowski and Swartz of running a criminal enterprise within Tyco. With its clients facing 30-year jail terms, the defence claimed that they had every right to take the money and that the board was fully aware of their actions.

The board claimed ignorance and that as soon as it was aware of illicit activities it had investigated them. The defence failed to convince jurors and both men were found guilty on 22 counts including grand larceny and fraud. Both received sentences of 8 to 25 years, and fines and compensation orders of $240 million – an ignominious end to their glittering careers.

Many remained unhappy about the role of the board. Only 4 of the 11 directors were classified as completely independent by the Institutional Shareholder Services (ISS) and most of the non-executives were long-serving members. The board was almost certainly also hampered by lack of information. As chairman as well as CEO, Kozlowski controlled the board’s agenda, and information was channelled through Kozlowski and Swartz since internal audit reported directly to Kozlowski, instead of to the audit committee, and it was Swartz, rather than the legal department, who submitted SEC filings. In October 2002 New Hampshire’s securities regulator accused the Tyco board of ‘failing to adequately exercise its fiduciary responsibilities’ to supervise top officers including Kozlowski. Tyco settled the case for $5 million, without admitting any guilt.

**Blurred boundaries**

Investors wanted to know where the $600 million had gone. Since the late 1990s, Kozlowski had bought ever-more sumptuous residences in Manhattan, Boca Raton, Nantucket and New Hampshire. After Kozlowski gave his Manhattan apartment to his ex-wife in 2000, Tyco spent a total of $31 million on a new apartment for him on Fifth Avenue, including extravagances such as a $6000 shower curtain. As time went on, the lines
separating Kozlowski and Tyco became increasingly blurred. A yachting enthusiast, Kozlowski got Tyco to hire a yachting expert to help him build a 130-foot racing yacht. Other people Kozlowski used such as his maid, doctor, fitness trainer and a chef that he liked, were also put on Tyco’s payroll. The Boca Raton restaurant partly owned by his wife also benefited: when he dined there, Kozlowski frequently put 50 per cent tips on company credit cards. His most notorious expenditure was $2.1 million on a party extravaganza on the Mediterranean island of Sardinia for his new wife’s 40th birthday, including a life-sized ice sculpture of Michelangelo’s David with vodka flowing from its penis. Kozlowski charged $1 million of the party’s costs to Tyco, claiming that the expense was justified by the number of Tyco employees present and the TyCom board meeting he attended in Sardinia that same week. He was also famous for his charitable donations, many of which were in fact funded by Tyco itself. Unlike in many other companies, there was no board committee to oversee donations. All the ‘decisions were ultimately made by … Kozlowski’ himself. One donation, of $1.3 million, made to the Nantucket Conservation Foundation, was allegedly used to buy up land adjacent to Kozlowski’s own Nantucket estate to prevent further development of the area. Another donation of $4.5 million to the Whitney Museum of American Art, New York’s most socially prestigious institution, supported Kozlowski’s newly won position on the board of trustees and his rising social standing. Kozlowski seemed to have forgotten that he was not the sole owner of Tyco and was not entitled to take whatever he wanted from the company.

The fallout

Tyco’s auditors, PwC, did not escape unscathed. Tyco was a key client of PwC, bringing in $19.6 million in audit fees and $31.5 million in consulting fees in 2001. In August 2003 Richard Scalzo, the engagement partner at PwC who had overseen Tyco’s audits since 1997, was given a lifetime ban from auditing public companies. In addition to allowing various accounting irregularities, it was clear that Scalzo knew of the TyCom and ADT Automotive bonuses and Walsh’s finder’s fee, but had failed to re-evaluate audit risk and so change the audit methodology.

ii Unlike in the UK, American companies are not required to disclose charitable donations unless they are material to an investor’s understanding of the financial statements or unless there is potential for a conflict of interest.
Banks were also sucked into the scandal. The investment bank Merrill Lynch had been Tyco’s lead underwriter and had also advised on many of its acquisitions ($15.1 billion in 1998). In 1999 Kozlowski complained to Merrill Lynch’s CEO about its investment research on Tyco. Shortly afterwards, the analyst concerned was replaced by Phua Young, who had covered Tyco for Lehman Brothers and with whom Kozlowski had a good relationship. In 2003 securities regulators charged Young with issuing misleading research, saying that his relationship with Tyco was too close and that some of his bullish reports did not reflect his private doubts about the company.

Other key players faced various charges. In July 2004 Belnick was acquitted of grand larceny. Walsh, on the other hand, pleaded guilty to felony charges and agreed to repay Tyco the whole $20 million finder’s fee; to pay a fine of $2.5 million; and never to serve as a director or officer of a public company again.

In December 2002 the Boies inquiry commissioned by Breen reported that Tyco had ‘pursued a pattern of aggressive accounting … to increase current earnings’ but did not uncover any systematic fraud. Six months later, however, further accounting issues were uncovered which reduced profits by $1.5 billion. Worse, the SEC demanded that previous years’ accounts be restated to reflect these charges. The restatement left both the company and its auditors open to charges of negligence, or worse.

Breen performed an almost clean sweep of management in his efforts to put Tyco on the straight and narrow. All board members who had served under Kozlowski had resigned by early 2003, and 220 of the 250 top managers were replaced. CIT had already been sold in July 2002 for $4.6 billion, less than half the purchase price one year before. Breen then sold Kozlowski’s other big mistake, TyCom, for $130 million, a small price for the more than $4 billion investment. He also moved the plush New York headquarters to more modest offices in Princeton, New Jersey.

Tyco’s 2002 results were hit hard by its disastrous forays into financing and fibre-optic networks and by a sharp decline in margins in the electronics division. A $6.6 billion write-down of goodwill for CIT and a $3.6 billion write-down of TyCom contributed to the full-year loss of $9.4 billion. Fortunately, the healthcare division held up well and the company generated cash of $4.3 billion after capital expenditure but before acquisitions and disposals. The company had survived, but shareholders continued to suffer. The share price began to recover but by September 2005 had only reached $28, half its value in December 2001 ($58.90).

---

iii The $3.6 billion 2002 write-down for TyCom includes $2.218 billion asset impairment taken in the second quarter; another $363 million asset impairment taken in the last quarter and $1.025 billion write-down of goodwill taken in the third and fourth quarters.
What went wrong and lessons to learn

The Tyco story is one of excess: of an acquisition drive that spent $60 billion on more than 1000 companies over 10 years; of executives, enriched beyond their dreams, spending the company’s money on extravagant lifestyles.

Disastrous strategies

Kozlowski made some major strategic errors when he ventured into uncharted waters with the TyCom and CIT investments. Tyco ignored signs of impending collapse in telecoms and sank billions of dollars into its submarine cable network. Because it failed to understand the key success factors behind GE Capital, GE’s finance arm which it was attempting to emulate, Tyco wildly overestimated CIT’s valuation and the synergies it could achieve. As a result, it grossly overpaid for CIT. The disastrous ventures ended up costing Tyco (and its shareholders) more than $9 billion and almost drove the company into administration.

Non-stop acquisitions

Not only was Kozlowski an acquisition junkie, but he also paid top whack for his fix. Tyco offered, on average, a 52 per cent premium to the market value of its target company the day before its offer, compared with an average 25 to 35 per cent acquisition premium paid for US companies over a similar period. Tyco found itself caught up in an ever-widening spiral: of acquisitions to inflate profits; of growth lifting the share price; of high share prices financing bigger acquisitions to maintain the growth rate. The share price was supported by the high growth rate and so bigger and bigger targets had to be acquired each year just to stand still. The end was inevitable. Overextended due to its expensive TyCom and CIT ventures, Tyco began to experience cash flow problems. The market saw this, lost faith in Kozlowski and the share price plummeted.

Hubris and greed

There can be no doubt that Kozlowski was once a successful businessman, but somewhere along the way he forgot that he was only an employee, and a fallible one at that. In an interview with *BusinessWeek* he described
himself as an amalgam of GE’s Jack Welch and the billionaire investor Warren Buffet. Humility was conspicuously absent. Blinded by hubris and greed and having lost touch with all but the top level of management, Kozlowski committed Tyco to the ruinous TyCom and CIT investments.

Board failings

Relying on Kozlowski’s past success, Tyco’s board failed to question his judgement and put brakes on the expansion programme. The judgement of some non-executive directors was probably also clouded by their business links with Tyco – Walsh’s finder’s fee for the CIT deal being the most obvious example. Although the board was not aware of many of Kozlowski’s schemes for enriching himself, it did approve the share option and ‘reload’ option plans. Both of these encouraged risk-taking in order to raise the share price. With a domineering CEO, also combining the role of chairman, Tyco badly needed a strong and independent board prepared to confront management and call a halt to questionable strategies. Unfortunately Tyco’s board, while not breaking the letter of the law, failed to act as a check to Kozlowski’s activities.

Weak internal controls

Tyco had other weaknesses in its internal controls: internal audit reported directly to Kozlowski rather than to the audit committee; Swartz, rather than the legal department, submitted SEC filings (failure to segregate duties); and there was insufficient risk assessment of acquisitions. As has already been discussed, Tyco’s accounting was aggressive, at best, and positively misleading in some respects. A company which seeks to camouflage its true financial situation risks inculcating a culture which disdains the truth. It will eventually lose the trust of the investment community and trust once lost is not easily rewon.

The key messages are:

1. It is very difficult to judge the true health of the underlying business of serial acquirers like Tyco. Almost inevitably, financial statements fail to separate out fully the effects of acquisitions on growth, while
accounting techniques, such as purchase accounting, relegate many of the costs to a footnote. Investing in such companies can be a leap of faith.

2. Strong and charismatic CEOs often create wealth – and perhaps a certain degree of ruthlessness is necessary to run a successful company – but all too often they grow arrogant and success is followed by a fall.

3. Some aspects of compensation schemes may have unforeseen adverse consequences. Share option schemes, with their limited downside potential, should be avoided.

Notes

5 Tyco’s Form 8-K filed with the SEC on 10 September 2002.
8 Tyco’s annual proxy statements filed with the SEC.
16 Tyco’s Form 8-K filed with the SEC on 10 September 2002.
18 Tyco Form 8-K filed on 10 September 2002.
22 Tyco’s proxy statement filed with the SEC on 28 January 2002.
23 Tyco’s Form 8-K filed with the SEC on 30 December 2002.
24 Thomson Financial Securities Data Company.
On the morning of 4 July 2001, shares of the pre-eminent British industrial group Marconi were suspended. Four months later, with losses mounting and haemorrhaging cash, Marconi entered into urgent negotiations with its bankers. Shareholders looked on aghast as shares, worth £12.50 at their peak in September 2000, fell to almost zero. £35 billion of wealth had vanished into thin air.

The collapse was all the more tragic as six years earlier, Marconi, then known as GEC\(^i\) had been an £11 billion turnover military and electrical company with pre-tax profits of nearly £1 billion, a cash pile of over £1 billion and 83,000 employees spread throughout the globe. Lord Weinstock, GEC’s managing director (CEO) for the previous 33 years, had made GEC his life’s work, turning it from a slowly declining, medium-sized electrical enterprise into one of Britain’s largest companies. Finally, in September 1996, Weinstock, then aged 72, handed over to George Simpson who became the new managing director.

Simpson reinvented GEC – renaming it Marconi\(^ii\) – and turned it into a high-tech telecommunications equipment company, taking on £4.4 billion of debt in the process. From a solid, staid, diversified company, throwing off cash, and with a share price supported by a high dividend payout, Marconi had become almost wholly devoted to the volatile telecoms industry, a new organisation had been put in place and, after the dividend payout was slashed, the share price was driven by expectations of growth.

\(^i\) GEC is not related to the similarly named American company, General Electric Co (GE).

\(^ii\) Guglielmo Marconi invented wireless transmissions, sending the world’s first wireless message in 1896. Marconi’s Wireless Telegraph Company was taken over by English Electric in 1946 that then merged with GEC in 1967/68.
But Simpson had changed too much too quickly. Within six short and tumultuous years, Simpson was gone and Weinstock was dead, heartbroken at the destruction of the company he had created.

In its bid to become a leading player in the telecoms equipment market, and under considerable pressure from the financial markets to invest its cash pile, Marconi had spent £5.4 billion on acquiring apparently leading-edge technology companies. Bought close to the market peak, the acquisitions had come at too high a price and, worse, the technologies had failed to live up to their promise. At a more basic level, the new organisational structure put in place to match this brave new world of high-tech had gaps in its controls. When the telecoms market collapsed in 2000/01, control systems allowed early warning signs to slip past unnoticed and with them, the opportunity to take corrective action.

The man with the Midas touch

GEC’s roots stretched as far back as 1886, when it was established to sell electrical goods. Although it grew over the next 60 years to become one of Britain’s largest electrical companies, by the late 1950s complacency and poor management had led to falling profits and mounting debts. Salvation came in the form of Arnold Weinstock, who arrived on the scene in 1961 through GEC’s acquisition of Radio and Allied Industries Ltd. With his drive and attention to financial detail, he transformed GEC after taking over as managing director in 1963.

Layers of management and bureaucracy were stripped away. Divisions were split into units with specific product responsibilities. Strict budgets and financial controls were introduced, with close monitoring of cash expenditure and working capital. Having conducted a benchmarking exercise with key US electrical companies such as General Electric Co. (GE), Weinstock devised a set of 7 financial ratios and 12 trend lines.¹ They provided him with enough data to create an up-to-date picture of the operational and financial performance of every subsidiary and Weinstock studied them in detail throughout his reign at GEC. Combined with Weinstock’s personal commands to rectify any problems they had revealed, the ratios and trend lines were a very effective method of control.

Rewarded with a sharp increase in profits and a rising share price, and backed by the then Labour government, Weinstock merged GEC with its two main British rivals in 1967/68. Of the combined 171 major locations, just 29 survived Weinstock’s subsequent rationalisation programme. Profits rose nearly fivefold during this period and cash came pouring in.
By the mid-1980s Weinstock had built up a £1.5 billion cash balance and was ready to make a major acquisition. In 1985 GEC’s bid for Plessey, its leading competitor in telecoms and defence, was blocked by the Monopolies Commission, the UK government’s competition watchdog. Changing tactics, GEC made a joint bid for Plessey with Siemens, the German electrical giant, in 1988, and, after an acrimonious battle, the bid succeeded. Plessey’s defence interests were split between the two companies and Siemens took a 40 per cent stake in the merged telecoms interests, GEC Plessey Communications (GPT). Following the same formula for broadening GEC’s geographical spread and erecting barriers to takeover, Weinstock formed two further joint ventures. One was with GE’s European domestic appliance operations and the other with the power generation and train-building interests of Alcatel Alsthom (Alcatel), to create GEC-Alsthom. The result was that a substantial part of GEC’s business was tied up in joint ventures.

Growing the defence business through the 1990s, Weinstock made further acquisitions in the UK and the US. Ignoring criticisms from the City,iii which thought that GEC should invest in research and development (R&D) or in major acquisitions, Weinstock continued to build up cash. R&D spend was kept to a mere 4 per cent compared with the industry average of close to double that percentage. Perhaps inevitably, therefore, GEC failed to keep up with developments in some of its main industries such as semiconductors, computers and, most importantly, mobile tele- coms. Competitors, including ABB, Siemens, GE and Alcatel, leapt ahead during the 1980s and 1990s.

By 1996, GEC was made up of ten divisions. Three divisions – defence, power systems and telecommunications – accounted for 71 per cent of group turnover and 75 per cent of operating profit. The remaining businesses were a mixed bag, both in terms of industry and performance.

**Contrasting leadership styles**

Weinstock ran a tight ship with a strong culture of cost control and efficiency. He firmly believed in a decentralised management structure where managers took personal responsibility for their unit’s results but at the same time those results were closely monitored. Each of the hundreds of individual units reported directly to Weinstock. The set of financial ratios he had devised was applied relentlessly, and if an individual unit

---

iii The UK’s leading financial district (the equivalent of Wall Street).
fell short of expectations, Weinstock pulled up the manager concerned personally. The penalties were at times severe. As one 1970s executive said, ‘He is capable of sustaining invective at a higher level for longer than most people I have ever met.’ Problems such as growing inventory were soon corrected: no manager wanted to expose himself to repeated harangues from Weinstock! But this approach did have some adverse consequences as GEC became an increasingly risk-averse organisation, preferring tried and tested strategies to radical change. Furthermore, in such a rigid vertical structure, the opportunities for cross-fertilisation and development of synergies, even within a division such as defence, were limited.

Lord Weinstock finally retired in 1996 and handed over to George Simpson. Born in 1942 and qualified as an accountant, Simpson’s background was in the UK motor industry with a career in selling companies. He joined British Leyland and, as CEO of its volume car division, Rover, managed the sale to British Aerospace (BAe) in 1988. Simpson moved across with Rover and became deputy CEO of BAe. In 1994 he was once again charged with disposing of the beleaguered Rover, this time to BMW. He was then hired to revitalise Lucas Industries, a car components company. After some rationalisation moves, he decided that Lucas was too small to succeed on its own and arranged a merger with competitor Varity Corporation.

In taking on GEC, Simpson inherited a large, diverse company with generally strong market positions but in markets which, in many cases, were in long-term gradual decline. Financially, GEC was sound, with a stash of over £1 billion in cash. However, investors were becoming impatient and the underperforming share price, compared with competitors’ prices, reflected this. Recognising the need for a major strategic rethink, Simpson reorganised the company into five divisions: defence, power, telecoms, US industrials and other industrials (companies to be sold or restructured). The five divisional managing directors now reported to the centre on behalf of their units and had considerable autonomy over investment decisions within their divisions. Simpson also appointed functional directors at head office level, in charge of personnel and strategic planning, for example.

Conscious of the need for full board support for any radical change, Simpson encouraged the injection of new blood. Many of Weinstock’s key supporters left, including Lord Prior, the chairman, and by the end of 1998, only 5 members of the 14-strong board had served during Weinstock’s time. Perhaps the most momentous change occurred when Simpson forced Weinstock’s long-serving CFO to resign, replacing him
with John Mayo. Although originally trained as an accountant, Mayo was primarily a deal maker, an ex-investment banker who had executed the demerger of Zeneca, the pharmaceutical company, from giant chemical company ICI in 1994. He then joined Zeneca as CFO before being head-hunted to join GEC. Mayo was an abrasive character who did not suffer fools gladly. He was frequently short-tempered with his staff, in direct contrast to Simpson, who had a laid-back approach.

Mayo dropped many of Weinstock’s controls, including his famous seven ratios, and introduced a new measure of performance evaluation – real, post-tax cash flow return on investment. It was a measure that reflected one of GEC’s strategic goals but was complicated to calculate, requiring assistance from outside consultants, and was influenced by too many variables to be useful in day-to-day management. The combination of dropping many of Weinstock’s financial controls and devolving management responsibility to divisional levels meant that Simpson and Mayo had much less detailed management information on a regular basis and relied heavily on divisional managers for day-to-day control. Although it is generally considered beneficial to devolve responsibility down the chain of command, in GEC’s case this was an about-turn in terms of culture and control. It would take time for the new structure to operate effectively. In addition, units identified as strong performers were encouraged to invest significant sums to grow their business. Here, managers who had previously been kept on a tight leash with little space for independent action were suddenly given the freedom to spend money without the close supervision that they were accustomed to. Simpson also spruced up GEC’s image by moving it from its notoriously scruffy headquarters to glossy new offices in Mayfair.

**A new strategic vision**

Nearly a year after taking over, in July 1997, Simpson announced his strategic vision for GEC. The company was to be streamlined, focusing on fewer, high-growth, high-margin businesses: defence, telecommunications and the three US industrial businesses. Cash surpluses, and more, would be spent on acquisitions to build up global leadership positions, while the dross of poorly performing companies would be sold. Simpson also earmarked some cash for share buy-backs (some £659 million over the next two years).

GEC’s joint ventures were also targeted; Simpson disliked the lack of strategic control. The largest one, GEC-Alsthom, which was seen to be not
pulling in sufficient operating profits, was floated in June 1998, raising £1.2 billion for GEC.\textsuperscript{iv}

The US industrials division, which Simpson wanted to grow, made up 12 per cent of GEC’s sales in 1997/98. Its largest company, Picker International, was number four globally in the medical imaging market which was expected to grow between 5 per cent and 8 per cent annually for the next three years. GEC wanted to expand the business and, in November 1998, bought the CT scanner division of Elscint for $275 million. However, competition was intense and operating margins (estimated at only 6 per cent in 1998/99) were kept down by pricing pressure in the US.

Another major US industrial, Gilbarco, was the world leader in petrol dispensing systems and vending equipment. Environmental legislation in Europe and the US had helped to boost sales but the number of petrol sites was declining in its mature markets, which would limit future sales growth.

The third US business was Videojet, the world’s leading producer of state-of-the-art industrial marking and coding products. Although small, it was highly profitable, with estimated operating margins of 33 per cent.

Telecommunications made up only about 10 per cent of GEC’s revenues in 1997 but its 14 per cent profit margins were excellent – considerably better than those of most of its competitors. The majority of the business was GPT, the 60 per cent owned joint venture with Siemens. GPT was heavily dependent on sales of old-generation circuit switches to BT (the UK’s dominant telecoms provider) but the product was incompatible with other networks, and sales were in decline. More promisingly, GPT claimed European leadership in new-generation fibre-optics transmission systems. Unfortunately the European technical standard, SDH,\textsuperscript{v} was incompatible with the US standard, SONET,\textsuperscript{vi} leaving GPT unable to compete in the world’s largest telecoms market. Given GPT’s size and its reliance on Siemens for R&D, most analysts expected Siemens to buy out GEC’s share.

Simpson, however, saw opportunities in merging GPT with Marconi SpA, a defence division company but with a significant civil telecoms business, to create a communications division. The new division made sales of £1.86 billion in 1998/99 and operating profits of £295 million, but was in 11th place globally, trailing behind giants like Lucent, Nortel, Ericsson and Alcatel.

\textsuperscript{iv} GEC had to retain a 21 per cent stake in the company for at least one year. GEC and Alcatel reduced their stakes in Alstom to 5.67 per cent in February 2001, raising a further £650 million each.

\textsuperscript{v} Synchronous Digital Hierarchy.

\textsuperscript{vi} Synchronous Optical NETworking.
The division’s largest business was public networks, which supplied circuit switching, optical transmission and some access products to telecoms carriers. There was a growing business in private networks, including some private mobile networks, but the division had virtually no presence in the public mobile networks market. GEC’s main strength was in optical networks, where it claimed a 33 per cent global share of the SDH market. However, it could not offer a full product offering to its telecoms carrier customers since it had no presence in the fast-growing markets of broadband switching or broadband access.

But as the digital revolution gathered speed, GEC found itself falling behind. Its core portfolio of SDH products was threatened by the new dense wave division multiplexers (DWDM), which GEC had been late to develop. The other problem was the geographical spread: 50 per cent of sales were in the UK or Italy and only 4 per cent of sales were in the US.

Defence – weighing up the options

The defence division was GEC’s largest business. It was the second largest defence equipment supplier in the UK (after BAe) and the second largest defence electronics company in Europe (after Thomson CSF). It had the capability to be prime contractor for marine platforms (submarines and surface ships) and had European joint ventures in space projects and sonar.

The end of the Cold War and consequent decline in defence spending had caused a huge upheaval in the industry. By 1998, the US was dominated by three huge companies. Europe, in contrast, was still peppered with nationalised companies and most governments were reluctant, at best, to relinquish control.

Simpson’s initial move was to try and expand in Europe. When his bid for Siemens’ defence business was unsuccessful, he went down the joint venture route instead – despite his previous misgivings – and joined forces with the Italian company Finmeccanica, which specialised in missile and naval systems. Then GEC made inroads into the US market with a major acquisition, Tracor, to become the sixth largest defence company in the US. The company’s software-based combat systems and electronic warfare business complemented GEC’s portfolio. The price tag of £800 million was expensive, at 24 times 1997 earnings and 1.1 times sales, but it followed the trend of rising prices.

By late 1998, GEC’s strategic alternatives for the defence sector had narrowed down to three: merge its defence interests with the French company Thomson CSF; merge them with the British BAe; or merge the
whole company with the US defence giant Lockheed Martin. Talks with Thomson proved unfruitful as negotiators struggled to find a formula which was both fair to GEC’s shareholders and also acceptable to the French government. In the US, GEC entered into serious negotiations with Lockheed Martin about a full-scale merger of both companies. But talks with Lockheed’s management did not go well either and there was a big question mark over whether a large transatlantic merger would be permitted by the US government.

The third possibility was to merge GEC’s defence interests with BAe to create a huge, vertically integrated defence company. BAe was then deep in merger negotiations with DASA, the aerospace subsidiary of Daimler-Benz. When Simpson gave BAe an ultimatum – either table a bid or GEC will do a deal elsewhere – BAe opted for the all-British deal over the pan-European merger. GEC shareholders did well out of the transaction, as BAe paid a 30 per cent premium to gain control of the business; at the same time, however, they were deprived of one of GEC’s oldest and most stable businesses. The demerger gave GEC shareholders shares and loan stock in BAe, while GEC received £1.5 billion in cash by way of injecting debt into the demerged company.

With GEC’s coffers once again overflowing, speculation was rife about Simpson’s next move. Would he finish breaking up GEC and return the cash to shareholders? Or expand the telecoms business to compete with Lucent and Nortel?

**Jumping on the telecoms bandwagon**

By 1999, the global telecommunications equipment market was worth an annual $200–$250 billion with growth forecast at 13 per cent per year for the next three years. The stock market technology bubble of the late 1990s and feverish competition to buy up the best companies had driven the prices of potential targets through the roof. Lucent’s offer of $20 billion for data networking company Ascend in January 1999 represented 13 times 1998 sales and 81 times 1998 earnings (excluding acquisition charges).

GEC wanted a piece of the action too, likening the Internet boom to ‘a high-tech gold rush, a latter day Klondike of bits and bandwidth’. During the gold rush, some prospectors made fortunes while others lost everything. But the people who consistently made money were the suppliers of equipment to the miners. GEC wanted to make itself into a supplier of picks and shovels ‘to harness the power of bandwidth and information’.
What Simpson did not consider was the fate of such companies when the
gold rush ground to a halt.

With a net cash balance of £484 million, the promise of a further £1.5
billion when the defence division was demerged and additional available
funds of £3 billion from established loan facilities, GEC’s potential war
chest at the end of March 1999 was close to £5 billion. Within a year,
Simpson and Mayo had spent most of this on acquiring telecoms equip-
ment companies. ‘Cash in the bank offers a very low return and it does not
say much about being a dynamic company … I spent the cash as fast as I
could’, said Simpson.

Reltec Corporation was the first trophy of any size collected by GEC –
in April 1999 – although, at £1.2 billion (including Reltec’s debt), the
acquisition still did not make a significant dent in the cash balance.
GEC’s target was Reltec’s portfolio of access products (linking local
phone networks to subscribers’ phones), which accounted for 33 per cent
of Reltec’s revenues. The company also had 15 per cent of the US market
for next-generation digital loop carrier (NGDLC) systems, which allowed
local carriers to provide more subscriber lines and services. Apart from its
access product range, Reltec’s attraction to GEC lay in its blue chip
customer list of local carriers such as Bell South and GTE. Reltec had
floated in March 1998 but the share price had subsequently fallen sharply
as sales and earnings growth failed to meet market expectations. GEC’s
offer price was at a 36 per cent premium and represented 2 times annual
sales and 70 times 1998 earnings (before exceptionals).vii

The City had hoped for a much larger acquisition, and Simpson did not
disappoint the second time round when, in June 1999, he spent £2.7 billion
(net of cash balances acquired) on another American company, FORE
Systems. FORE’s products were in high-growth broadband switching
markets, expected to grow at an annual rate of 24 per cent over the
following five years. FORE’s primary market consisted of ATM switches
used in company data networks (the enterprise sector), but they were
facing fierce competition from cheaper IP Ethernet switches. Trying to
move towards the higher margin carrier network sector, the company had
recently sold high-capacity switches to the carrier and service provider
sectors too.

Poor results reported in October 1998 had caused FORE’s share price to
drop to $10 per share, down from $25 three months earlier. Merger specu-
lagation drove the share price right back up again but GEC’s offer of $35 per
share still represented a premium of more than 40 per cent. This valued

vii Reltec reported a $36 million loss for 1998 after acquisition and litigation costs.
FORE at more than 6 times sales and 85 times historical earnings (before acquisition costs). But Mayo could congratulate himself on clinching the deal, given that FORE’s management had rejected an even higher, stock offer for the company in favour of GEC’s all-cash bid. GEC’s agreement to buy out all existing stock options, whether vested or not, may have proved too tempting for FORE’s top executives to turn down. The more normal practice was to convert unvested options in the target company to options in the purchasing company. This particular clause was to have far-reaching consequences.

FORE was a young company, full of entrepreneurial spirit. Culture clashes with staid old GEC were inevitable. GEC managed to retain the two founders for two years on a consultancy basis to help the merger process. Not so for the rest of the management team, including seven of the top executives (known as ‘the Magnificent Seven’), who cashed in their options and resigned to set up companies of their own. Cultural issues apart, FORE represented a completely new market for GEC in terms of both product and also customers (large telecoms users rather than carriers). The failure to retain existing management with its market knowledge and technical expertise was nothing less than disastrous.

GEC had been forced to offer cash instead of shares for these two US acquisitions. Because it was not compliant with the US Foreign Corrupt Practices Act, GEC was prohibited from listing in the US and therefore had no US-listed shares to offer as payment. Buying a company using shares spreads the risk among all shareholders: those of the acquired company and the purchaser. If there is a market downturn and the share price falls, both sets of shareholders suffer rather than just those of the purchaser. This is a particularly important issue when the market is artificially inflated, which (for telecoms shares at least) it clearly was in 1999.

The £4.1 billion spent on Reltec and FORE, plus a few bolt-on acquisitions, had virtually emptied the war chest by March 2000. Only £200 million of this was represented by net assets; the vast bulk, £3.9 billion, comprised goodwill.

In November 1999 Simpson completed GEC’s transformation by changing its name to Marconi plc. To reflect Marconi’s new status as a technology company and its need to invest heavily in R&D, Mayo reduced the dividend payout from 55 per cent of earnings (before goodwill amortisation

---

viii In 1982, Ruston Gas Turbines, a US subsidiary of GEC, pleaded guilty to the charge of bribing officials of Pemex, the Mexican national oil company. Ruston was fined US$750,000 for violation of the Foreign Corrupt Practices Act.

ix With more than 40 per cent of group revenues coming from the US, Marconi eventually listed on the NASDAQ in October 2000.
and exceptional items) in 1996 to 31 per cent in 2000. Although this was in line with Marconi’s adopted industry, it was a divergence from Marconi’s historical policy and, given the higher inherent risk in the new strategy, it may well have been out of sync with shareholder expectations. Also in line with its adopted industry, Marconi started to issue an increasing number of share options.

By February 2000, it was time to review Marconi’s future strategy. Mayo, aware that Marconi’s shares were probably artificially inflated due to the technology boom, proposed that Marconi should look for a merger partner. A merger could offer the double benefit of releasing money back to shareholders and also giving Marconi the critical mass to compete with its largest competitors. The other board members, none of whom had any particular expertise in the telecoms equipment industry, rejected the proposal and the spending spree continued.

Marconi spent a further £1.3 billion in 2000/01 on acquisitions but this time only £368 million was paid in cash, the remainder was represented by stock, loan notes and deferred compensation. Like its larger competitors, Cisco and Lucent, Marconi also invested in some new technology start-up companies. The share price continued to rise, reaching its peak in September 2000 at £12.50, valuing the company at nearly £35 billion.

The tide turns

The technology bubble burst, in the US at least, in March 2000. In the wake of the downfall of their dot-com customers, telecoms carriers began to downgrade their forecasts for 2001 and equipment companies followed suit. Despite this, telecoms-related capital expenditure in the US continued to climb, reaching over 30 per cent of sales in 2000, a clearly unsustainable figure. Finally, towards the end of 2000, capital markets dried up and the new, loss-making carriers – now starved of funds – began to go bust.

The ripples spread across to Europe, where the slowdown was initially less dramatic, as telecoms companies had not overindulged so much in the 1990s. However, the recent auctions of the radio spectrum for 3G mobile networks had cost telecoms companies dearly. There was an inevitable spill-over effect on fixed network capital expenditure. Meanwhile, equipment companies which had extended significant vendor financing experienced the fallout from their clients’ bankruptcies. Loss-making new carriers had struggled to raise capital during 2000 and had looked to equipment suppliers to finance their capital spending. Marconi was in
better shape: 80 per cent of its telecoms clients were incumbent carriers which did not demand much vendor financing. It had only £170 million of vendor financing commitments at the end of March 2001.6

Even so, while Marconi’s main rivals such as Nortel, Cisco and Alcatel were warning of a severe slowdown in the US, Marconi itself was conspicuously silent. It did acknowledge some slowdown in 2001 but was convinced that sales would pick up in early 2002. In March 2001 Marconi even launched its own optical components venture, despite the well-publicised slump in demand reported by established companies.

Confident that all was well, Simpson prepared his succession plans. Mayo was appointed deputy CEO in April 2001 in preparation for taking over as CEO in July, when Simpson would become chairman.

However, the first signs of trouble were already apparent to sharp-eyed observers. While the optical networks business increased its like-for-like sales by 40 per cent year on year, broadband switching (essentially the FORE business) declined by 16 per cent, as Marconi had been forced to exit much of the enterprise market in the face of competition from cheaper Ethernet switches. With management adopting an ‘ostrich’ policy, Marconi’s inventory began to pile up. Shortages in optical components the previous year had led to a decision to build up stocks in 2001. This accounted for nearly half of a £764 million inventory increase reported for the year to the end of March 2001. Higher finished goods inventories compounded the problem which was forcing debt up to record levels. There was disquiet at the factories as orders started drying up in January and by April 2001 one plant was operating at below 50 per cent capacity.7 But Marconi, confident that sales would recover later that year, did not write down goodwill or inventory, unlike some of its larger competitors.

Despite Marconi’s acquisition binge, it was still a minnow in the telecoms equipment market. Its 2000/01 sales of £6.9 billion were dwarfed by those of Nortel, Cisco, Alcatel and Lucent, which reported revenues of $30.1, $23.7, €32.7 and $24.9 billion, respectively. It had not managed to build up a dominant position in any sector of the market. Although Marconi claimed to be the leader in the SDH market, it had almost no presence in the equivalent North American (SONET) market. Also, this core sector was threatened by new developments in DWDM, where Marconi had fallen behind. In the access market, the digital subscriber line (DSL) solution was proving to be the winning technology. Unfortunately, Marconi’s access division, based on Reltec, was still developing its own DSL product, well behind the market leader, Alcatel. Its focus, prior to acquisition, had been on the much less flexible product, Fibre-To-The-
Curb (FTTC). In the broadband switching market, FORE’s products were losing share to next-generation technologies. At the time of FORE’s acquisition, new IP Ethernet switches were already supplanting FORE’s ATM switches for low capacity applications and it was a distinct probability that they would increasingly encroach on the higher end of the market. FORE did develop its own IP switches but it was always playing catch-up and suffered accordingly. The much hyped cross-selling opportunities of the US acquisitions had also failed to materialise and the telecommunications division’s US sales were only 28 per cent of the total. In 2000, this turned out to be more of a strength than a weakness as the European market seemed to be holding up better.

When they made the two core US acquisitions, Simpson and Mayo took a gamble (whether they realised it or not) as to which technologies would be in the forefront of future development. They lost the bet and Marconi, instead of leapfrogging its rivals, trailed further behind.

Despite management optimism, Marconi’s share price fell sharply in 2001 and by June it was 70 per cent below its September 2000 peak. When the June results revealed that new orders had virtually dried up, Simpson finally acknowledged the market downturn. On 4 July 2001 Marconi issued a statement halving 2001/02 forecast profits and announcing 4000 redundancies. The reaction to the announcement was compounded by the fact that the shares had been suspended early that morning before a statement was issued that the medical division had been sold, albeit at a lower price than the market had hoped for. The unprecedented day-long suspension was aimed at avoiding a false market in Marconi shares between the two announcements. But stunned traders feared the worst and wild rumours circulated of collapsing sales and mounting losses. When trading resumed the following day, traders reacted to the bad news by knocking more than 50 per cent off the share price. Responding to shareholder wrath, the board forced Mayo to resign. He left with £2.3 million for the three months that he had worked that year. Simpson survived until September, by which time debt had increased by a further £900 million to £4.4 billion.

With seemingly eternal optimism, hoping for a quick recovery in the markets, Marconi tried to negotiate a refinancing agreement with its banks. But as the telecoms recession deepened, and Marconi reported an operating loss of £474 million for the year to March 2002, the refinancing was abandoned and restructuring talks began. Full year results showed pre-tax losses of £6.3 billion, of which £5.2 billion was exceptional items. These

---

*x He received a further £800,000 in 2003 in an out of court settlement.
included £3.8 billion of goodwill impairment, a £700 million inventory write-down and £563 million of restructuring costs. All non-telecoms assets had been sold the previous year and now core telecoms assets were on the block. Marconi continued to reduce costs but revenues were falling too and there seemed no end in sight.

Costs were slashed to try and raise margins, and by March 2003, Marconi was able to report two consecutive quarters of positive cash generation. Restructuring talks were long, convoluted and at times heated. Eventually the creditors agreed to swap £4 billion of debt for 99.5 per cent of Marconi’s equity, £788 million of new bonds and £435 million of cash. In May 2003 the deal was finalised and the company was relisted as Marconi Corporation plc. The day it was listed it was worth £590 million. Shareholders were virtually wiped out: a £10,000 shareholding bought at Marconi’s peak in September 2000 was now worth 86 pence.

Epilogue

Marconi’s new CEO, Mike Parton (previously head of the telecoms division), reduced debt by selling the Reltec unit and the private mobile network business. As the telecoms market slowly recovered, so did Marconi’s fortunes. By late 2004, with its market capitalisation doubled and bondholders repaid, Marconi’s executives earned the right to large option awards, which they sold as soon as possible, netting them a total of £17 million (£8 million for Parton alone). But six months later, in May 2005, Marconi lost its bid to be one of the main suppliers to BT’s £10 billion next-generation network. The loss was not on technological grounds (Marconi’s purchase of FORE and high R&D investment had eventually resulted in the development of some leading edge products), but because the price was too high. The blow was devastating. In the new, slimmed down Marconi, 26 per cent of its sales were to BT (similar to the situation before 1999), and the loss of this major contract meant serious redundancies. Marconi now stood little chance of selling these cutting-edge products to foreign carriers. Too small to survive on its own, Marconi put itself on the block.

Simpson himself fared better than Marconi in the longer term. The penance prescribed by the rest of the corporate world does not seem to have been too severe. He was still considered a valued non-executive director of Nestlé, one of the world’s largest and most powerful companies, until his term expired in 2004.
What went wrong and lessons to learn

At the root of Marconi’s downfall was its headstrong rush into new and rapidly changing markets at a time of overinflated prices and unsustainable demand. In its haste to become a world-class telecoms giant, Marconi tried to change too much, too quickly.

Overexpansion

Once the defence business had been demerged, Simpson and Mayo were left with two alternatives: finish the break-up of GEC (which incidentally would leave them without a job) or grow the telecoms business to catch up with the market leaders. They took the gamble, going all out for growth, and launched Marconi on the path which was to lead to its eventual destruction. Simpson and Mayo wanted to cash in on the telecoms boom and shareholders cheered them on. Once the decision had been taken to expand the telecoms business, fund managers, major shareholders of GEC, pressed for the cash to be invested as fast as possible in order to achieve a higher short-term return. Fund managers have a potential conflict of interest: they have a duty to their many investors who are looking for long-term growth, to fund their pensions for example, but fund managers’ own compensation is largely tied to the short-term performance of their funds.

With cash burning a hole in his pocket, Simpson went on a shopping spree. Rather than take the slower route of building on existing expertise by expanding into either new geographies or a new technology, Marconi did both – and it did not restrict itself to just one new technology, but several. An additional layer of complexity was added with the FORE acquisition, with which Marconi inherited an entirely new type of customer: non-telecoms companies, with completely different purchasing priorities and procedures to its historical carrier customers.

With the telecoms equipment market rapidly consolidating, and although prices were already clearly overinflated, Simpson and Mayo must have thought that it was now or never. Marconi heavily overpaid for its American acquisitions, as evidenced by the write-off of all acquired goodwill in 2001, at a cost of £3.8 billion. It was probably impossible to acquire FORE for any less at that period as another company had already bid a higher price. The real question is whether Marconi should have bought FORE at all, given its technological weaknesses.

In addition to its overambitious strategy, Marconi’s due diligence process was weak. In the case of FORE, Marconi’s technical and market reviews
were an example of optimism triumphing over reality. FORE was fast losing sales to IP products and although it had started to develop carrier class ATM products, Marconi should have been only too aware from its own experience, with BT and others, that it took years to bring new products to market given the extensive customer testing required. Where was the cash flow to support the business going to come from in the meantime?

The problems of overexpansion and inadequate due diligence were reinforced by poor implementation. Marconi’s existing management did not have sufficient knowledge or expertise to run these new acquisitions and it then compounded the problem by failing to retain FORE’s top management. Perhaps Marconi only clinched the deal by buying out all management options, but it needed to provide greater incentives for the newly enriched executives to remain at FORE. Cultural and organisational issues were in the spotlight as Marconi tried to integrate the brash, freewheeling FORE into its own large, bureaucratic organisation. Many of FORE’s more entrepreneurial employees could not support the changes and resigned.

Strategic decisions based on insufficient knowledge

Marconi’s strategic decision to expand into the broadband switching and access markets was not necessarily wrong per se. Problems arose primarily because the expansion was too fast but also because Marconi did not know enough about the markets it was entering or the technological risks it was incurring. With Reltec, Marconi had bought a niche player whose focus on developing FTTC technology did not address the core market demand for products to connect consumers fully to the broadband network. When Reltec eventually brought out a DSL product it was far too late; Marconi had become an also-ran in the broadband access market. In the case of FORE, Marconi failed to appreciate the speed with which the technology it had bought would be superseded.

Marconi’s strategic errors in buying also-ran technologies at prices close to the top of the market were compounded by its failure to find a merger partner when prices were high. By 2000, it had become clear that Marconi could not catch up with the major players in the equipment market by organic growth. Marconi was then a mid-sized company with no particular technological leadership, but with what was acknowledged to be an over-inflated market value due to the telecoms boom. With more than a hint of hubris, Marconi’s board rejected Mayo’s suggestion to sell up with one director saying: ‘We didn’t give up on the beaches of Dunkirk,
and we are not going to give up now.’ Marconi’s objectives should not have included the requirement to stay independent at all costs. If shareholders would have been better served (that is, received a higher return for their investment in the long-term) by a merger then that option should have been pursued. Although any likely merger partner for Marconi would also have suffered during the telecoms downturn, total losses would almost certainly have been less.

Failure of internal controls

Simpson’s laudable intention was to change the old GEC culture in order to make the new Marconi into a rapidly responsive and innovative company. Devolving responsibility down the organisation was one of the actions he took to achieve this aim. The problem with this decision was that at the same time management information reaching top executives had been reduced as a result of dropping Weinstock’s ratios and trend lines. Shortly afterwards, before the new structure had bedded down, the major acquisitions occurred and there were yet more organisational changes to integrate the new subsidiaries. Different monitoring and accounting systems proliferated and it would be some time before they could all be unified. Unfortunately, Marconi had run out of time. The market downturn began but Marconi’s top management remained oblivious to the dangers. Marconi’s new reporting and organisational system meant that Mayo was not only slow to realise the gravity of its growing inventory pile and concomitant cash outflow, but was also powerless to deal with the problem, since operational authority had been delegated to the divisions.

Ignoring the warning signs

In late 2000, when the telecoms crash began, Simpson and Mayo were blind to mounting evidence of a slowdown. Operational units were aware of a growing slump long before top management, which relied on market research rather than internal signals to support its view that Europe would not go into freefall. Management failed to appreciate the potentially disastrous effects of the wildly expensive 3G auctions on the telecoms equipment market. It dismissed the warnings of other equipment companies and failed to improve cash flow.
The key messages are:

1. Radical organisational changes are likely to throw up some teething problems. It is often a wise move to retain some of the now redundant controls until the changes have bedded in and any weaknesses have been identified. This is especially important if other significant changes are occurring simultaneously.

2. When investing in new areas that are poorly understood it is vital to carry out thorough due diligence, not only of the financials, but also of the business drivers such as technology advances and customer demands.

3. The impatience of institutional investors to achieve short-term performance in their own funds may lead them to put undue pressure on management to make use of cash surpluses earlier, or less appropriately, than is prudent.

Notes

The collapse of Swissair illustrates that even a company with – on the face of it – a board of strong non-executive directors with outstanding personal track records, can get things wrong. It is a story of poor strategic decisions, a failure to properly assess risk and the dangers of over-reliance on external consultants. It also shows that even a renowned brand is not invulnerable.

Switzerland was stunned, shocked and outraged when, on 2 October 2001, Swissair, a national icon and source of pride, grounded its fleet, unable to afford to keep its planes in the air. The company had been struggling under a huge debt burden in the economic downturn which had impacted the entire airline industry. The terrorist attacks in New York on 11 September 2001 were the last straw, having a disastrous and immediate effect on the company’s liquidity as passenger numbers plummeted. Swissair was grievously wounded, and when it went into receivership shortly afterwards, banks and bondholders were left with claims of over SFr 6 billion.

All of Switzerland wanted to know how this could have happened to a company that was overseen by a board comprised of the great and good of Swiss industry, commerce and finance.

Swissair takes off

Formed in 1931 by the merger of two regional Swiss airlines and listed on the Zurich stock exchange in 1947, Swissair grew from an operating base of just 13 aircraft and 64 employees to establish itself as a quality global airline, albeit small in comparison with the likes of Lufthansa and British Airways (BA). And this was despite the limitations of a small domestic market – in terms of both population and geographical size – which was already extremely well served by rail and road transport.
Capitalising on the Swiss reputation for precision timing and reliability, Swissair became synonymous with first-class service, winning numerous travel awards in the process. Also a reflection of Swiss culture and its diversity, although with a less positive effect, was a seemingly constant battle between Zurich and Geneva to gain the status of Swissair’s main hub. Zurich eventually won the war, much to the disgruntlement of the French-speaking population.

**Airline industry deregulation in Europe**

Until 1987, European airlines were largely state-owned and controlled. They enjoyed high levels of subsidy and protectionism to prevent them – as largely loss-making enterprises – from going under. Most were highly integrated, including a whole range of airline-related activities. Many were subject to high levels of unionisation, which gave rise to frequent strikes. Switzerland was the exception.

Airlines tended to dominate departure and arrival slots at their designated national hubs and often had a monopoly on services, such as in-flight catering, baggage handling and check-in facilities, provided to other airlines. By negotiation between the respective governments, bilateral reciprocal agreements were reached for airlines to operate out of foreign hubs.

In 1987 the European Commission introduced a three-phase ten-year reform of the industry, ultimately enabling European Union airlines to operate on any route in the EU, including flights wholly within another country. By January 1993, the international skies across the EU were effectively already open to any EU airline.

A new breed of airline rose out of the newly liberalised environment, and competition intensified as low-cost carriers such as Ryanair, easyJet and Virgin Express successfully set up shop. With national flag carriers still dominating the main hubs, and the allocation of slots a hotly disputed issue at times, access to airports became more important. Swissair was forced to watch from the sidelines of the EU and to continue negotiating bilateral agreements with the individual governments.

**An alliance is proposed**

In 1989 Swissair had joined forces with the US carrier Delta and Singapore Airlines in what was known as the Global Excellence Network (GEN). The aim was to provide a truly global alliance, offering an
unparalleled level of service and number of flights. However, in light of the Swiss ‘no’ vote on EU membership in 1992, Delta and Singapore began to question the contribution of their European partner to the alliance. The pressure was mounting on Swissair to find a way to break into the EU.

Alcazar was to be the solution. In April 1993, Scandinavian Airline Systems (SAS), KLM Royal Dutch Airlines, Swissair and Austrian Airlines announced plans to set up a joint venture company, Alcazar, under which the four airlines would merge their respective operations. This would enable them to compete with the major European players and ultimately even the US ‘mega carriers’. Alcazar’s prospects were sufficiently strong that the Lufthansa CEO at the time, Jurgen Weber, openly admitted that the outlook for Lufthansa was bleak in the face of such competition.

It was too good to be true – Alcazar never made it off the runway. In what was a significant turning point for Swissair, negotiations faltered and were eventually abandoned at the end of 1993. The stumbling block was the existing alliances between the partner airlines and their respective US partners. Politics and egos clashed as neither KLM nor Swissair wanted to relinquish its existing US partnership in favour of one which would require it to fly via another European hub. In particular, KLM wanted to build on its Northwest Airlines shareholding, whereas the other airlines favoured Swissair’s partner, Delta, which was thought to be more financially sound and to have a more comprehensive US network. Furthermore, popular support for the Alcazar project in Switzerland was weak amid concerns over lay-offs and the loss of a symbol of national identity. The failure of the project was perhaps also a reflection of the Swiss reputation for being aloof, making it difficult for Swissair to form lasting alliances.

Alain Bandle, who joined Swissair in 1993 from Hewlett-Packard (HP) as vice president in charge of the core marketing functions, product development, distribution, revenue management, communication and frequent flyer programme, commented:

It was an ambitious, visionary strategy and we got really close. The failure of the Alcazar talks demonstrated the difficulties that major airlines faced in putting politics and egos aside.¹

This failure, along with Swissair’s exclusion from the EU market, led the airline to turn to management consultants, McKinsey, to find a solution to its problems.
McKinsey’s vision for Swissair

McKinsey proposed a dual strategy for the airline. It consisted of acquiring minority stakes in foreign airlines – to strengthen the airline business and build up a critical mass in the EU market – and implementing horizontal integration into airline-related activities in an attempt to diversify the portfolio.

Over the following decade, Swissair became the major account for McKinsey in Switzerland – by a wide margin.

According to Bandle, McKinsey’s influence on Swissair was powerful:

We got overwhelmed with so-called analysis. McKinsey people have very sharp analytical minds and their job is to concentrate exclusively on their project. Other managers still had their day-to-day jobs. Their reports were often left unchallenged and their word was taken for granted. It was actually incredible that the whole strategic function was almost entirely outsourced to the consultants.

Lukas Mühlemann – an ex-McKinsey partner – was a heavy promoter of all this in his capacity as a Swissair board member. He was well connected to the McKinsey network and well briefed by his former McKinsey colleagues. He had access to the executive committee of the board and the CEO, Otto Loepfe.

The overall effect of this outsourcing of strategic control – with McKinsey at times almost bulldozing the organisation into following its advice – was that, bit by bit, Swissair lost its own internal ability to carry out strategic thinking.

The McKinsey proposal was a three-pronged approach: revenue enhancement, cost reduction and reduction of asset intensity. McKinsey predicted that in the future airlines would fall into one of three categories – network managers, capacity providers and service providers – and that the network managers would rake in the lion’s share of the profits. These airlines would act as the integrator for networks, product design, scheduling, pricing, brand management and sales. Key success criteria would be access to a sufficiently large market to supply the global network, together with strong marketing and cost management competences within the organisation. In McKinsey’s view, Swissair fitted the bill.

[Airlines like] Swissair, which operate out of hubs that are parts of global networks with more capacity than their local market can support, can also perform as network managers by continuously importing traffic from other
markets. Airlines that have limited intercontinental or even Europe-wide routes but dominate their national markets will have to ally with network managers that are interested in exploiting the market potentials these carriers control.²

On the cost side, Swissair was paying a heavy price for its stable industrial relations compared with its European neighbours – Swissair crew costs were one-third higher than BA’s. The disparities had to be addressed, but in doing so Swissair would also need to develop new, more sophisticated skills to manage employee relations across the entire network.

According to McKinsey, Swissair would have to hone its brand management skills to cover not only its own operations but also those of its future capacity providers. The trick would be to develop a brand concept across the network but at the same time avoid dilution of the Swissair brand.

In 1995 Swissair, in close consultation with McKinsey, restructured its organisation into a holding group. Under the new structure, Swissair Group headed up four divisions – SAirLines, SAirLogistics, SAirServices and SAirRelations – each with operations around the world related to the travel industry. By 1997 the non-passenger-related businesses accounted for over 60 per cent of the Group’s total turnover of US$7.6 billion, compared with 24 per cent in 1990.

During the mid to late 1990s, as competition in the global airline industry intensified, more and more cross-continental alliances developed. In 1996 BA, American Airlines, Cathay Pacific and Qantas announced the formation of a new global alliance – Oneworld. In 1997 two others followed, Skyteam (led by Air France) and Star Alliance (initially comprising United, Lufthansa and SAS). Swissair followed suit in early 1998 with the Qualiflyer Group, initially consisting of six member airlines: Swissair, Sabena, Austrian Airlines, TAP of Portugal, Turkish Airlines and AOM of France.

Meanwhile, in an attempt to gain control over capacity providers, Swissair had started to buy equity stakes in regional European airlines. According to McKinsey:

Equity stakes are advisable … Even so, it is useful under such circumstances to examine the specific reasons for taking an equity stake. One valid reason is to pre-empt competitors establishing a threatening position … In addition, an equity stake can, at times, earn an attractive return for the network manager as a straight financial investment.³
Spreading its wings into Europe

Acting on McKinsey’s strategic proposal to become a network manager, in May 1995 Swissair bought a 49.5 per cent minority stake in the Belgian national airline, Sabena. Founded in 1923, Sabena had grown over the years so that, prior to the deal with Swissair, it was operating flights to Africa, North America and the Far East but with 80 per cent of its traffic still within Europe.

Sabena was not in great shape, however. Having shown a profit only once in its life, the state-owned airline was dogged by poor labour relations. The Belgian government had been casting about for a suitor for some time and a collective sigh of relief came with the offer from Swissair. In view of Sabena’s poor financial position, the response from analysts was less than effusive.

Bandle, who was charged with negotiating the deal and then leading the integration process, recalls:

I will never forget my discussions with Sabena’s CEO Pierre Godfroid – he almost fainted when, with the help of my Credit Suisse First Boston people, we showed him that Sabena’s value was ‘zero’. What we bought at the time was not Sabena airline. Through the acquisition of a stake in Sabena, we gained access to a well-established, modern hub in the heart of Europe. There were no constraints attached as the planes could fly in and out 24 hours a day. It had expansion possibilities. It carried over 4 million passengers and had a high potential to grow in a market of 40 to 50 million people.

Despite the elaborate demonstration of zero value, Swissair paid SFr 240 million cash and SFr 20 million in participating certificates. In addition, the Belgian state received SFr 159 million of 6.5 per cent interest-bearing loan warrants to pay off Sabena’s previous partner, Air France. Swissair was granted an option on a majority shareholding of 62 per cent, later increased to 85 per cent.

For Swissair, one of the implicit assumptions in the financial benefits of the deal was the realisation of substantial synergies on integrating the two airlines. Bandle reflected on the whole experience:

We wanted to have the best possible – and from the EU perspective totally acceptable – integration of these two airlines. We had far-reaching plans to have their entire revenue management system and their entire IT infrastructure running on Swissair’s IT platforms like we did with Austrian Airlines. We hoped
to be granted antitrust immunity, a step that would allow us to more closely coordinate timetables, fares and destinations and to offer a first-class product in terms of connections, through check-in and other services. McKinsey had done a great job in helping me to identify where we could get synergies. But at the end of the day it was not McKinsey who was going to make the synergies happen – it was the people that were in charge of parts of the business.

Meanwhile, deteriorating group financial performance, mainly due to poor results in the airline division, put the CEO, Otto Loepfe, under strain. He started to come under fire from the board who decided, in September 1995, that Philippe Bruggisser, a long-time airline industry man and officer at Swissair, would gradually assume full responsibility for the Group.

Bruggisser turned round the associated companies in a very aggressive manner, particularly the catering. He is very tough and not wedded to the airline industry like Loepfe. He is looking at every part of the business. Nothing is sacred.4

In 1996, Bruggisser became president and CEO of the Group. Paul Reutlinger, executive vice president marketing and ground services, was nominated as Bruggisser’s deputy. Described by his colleagues as a hugely charismatic, creative individual, a formidable marketer, excellent people manager and a good leader for a service-oriented organisation, he had aspired to be Loepfe’s successor and was frustrated at having to work under Bruggisser instead. A year later, Jeffrey Katz, a US citizen recruited from American Airlines, was appointed CEO of the airline division.

Despite Bandle’s best efforts at the outset in identifying and validating synergies with management on both sides of the business, the integration process did not go well and the situation was becoming untenable.

The dispute between former management and the Sabena unions was increasingly becoming one of personalities rather than issues. It jeopardised both the further development of the company and the confidence of its customers.5

The board decided to take action and placed Reutlinger in charge of Sabena. As Bandle noted:

Reutlinger finally got an airline to run and he was now less interested in integrating anything into Swissair.
Of the 12 synergy initiatives initially identified, only 2 or 3 survived. Sabena’s losses in 1996 amounted to €220 million and the passenger load factor had decreased to an average of 59 per cent – the lowest in Europe.

Against this backdrop, in November 1996, the CEO of Swissair – Bruggisser – announced that the investment in Sabena would be written off at once in Swissair’s books. Bruggisser, who was known to have opposed Swissair’s acquisition of the stake in Sabena, announced that Swissair should have probably paid less for its stake in Sabena.6

Swissair’s share price plummeted. Over the next 12 months, the struggle to achieve the promised synergies, and their cost savings, continued. Then in November 1997 Sabena placed an order for 34 new aircraft (up from the originally intended 17) with Airbus, at a cost of $1 billion – five times the company’s entire capital at the time.7 In addition to the huge acquisition costs, 650 Sabena pilots – who were used to flying Boeings – had to be retrained at a cost of €17 million. The actual financing for this investment was never disclosed in detail. But in 1998 Sabena announced a profit – for only the second time in its 75-year history.

At the end of 1999, it transpired that the 1998 result was a blip and an accounting one at that. The profit was only generated by including the sale of the old Boeing fleet. By 1999, the flight activity made an operational loss of €39.6 million and the cash position had shrunk from €223 million in the 1998 books to €124 million a year later. To make matters worse, four more A340-300 aircraft from Airbus had been ordered to be delivered in 2001 and 2002, creating a funding requirement of €513.5 million.

The Belgian government, still in possession of the majority stake, became increasingly worried. As Sabena’s debt mounted to €2.3 billion, the government’s position was far from enviable and the obvious solution was to persuade Swissair to take up its option on the 85 per cent shareholding. As 2001 approached, the government asked several investment banks to assess the financial situation at Swissair but little information was available. Moreover, it was clear that no other European airline was in the market for a partner, let alone one with Sabena’s financial record and a strategy which was completely aligned with that of its minority stakeholder.

Hunting for potential partners

In late 1997, on the back of Swissair’s Sabena acquisition, McKinsey came up with a new multi-partnership strategy, known as the ‘hunter’
strategy. The premise was that by creating cross-equity shareholdings with European national airlines, Swissair could bypass the need to negotiate bilateral traffic rights with the individual EU markets.

The focus of the hunter strategy was markets with growth potential (namely Belgium, Austria, Finland, Hungary, Portugal and Ireland) as opposed to the more mature European markets of France, Germany and the UK. Regional carriers landing at the now massively expanded Zurich hub were intended to be used as feeders to Swissair’s intercontinental flights. According to McKinsey, an increase in capacity and passenger frequency would make Swissair an attractive partner for a large American airline and make it into ‘the fourth power in Europe’.8

International expansion looked like a bold but reasonable idea to Bruggisser. Following McKinsey’s advice, Swissair started to invest in its new Qualiflyer partners and purchased a 10 per cent stake in Austrian Airlines and a 5 per cent stake in Delta in addition to its Sabena shareholding. Between 1998 and 1999 interests were also acquired in three French airlines: AOM, Air Liberté, and Air Littoral, and in the Volare Group, LOT (Polish airlines) and South African Airways (SAA) for a total investment cost of SFr 4.1 billion. All the acquisitions were approved by the board, based on management recommendations. With the exception of LOT, all the acquired companies were in a poor financial state and none were in the target markets previously identified by McKinsey.

Bandle (who became a member of the supervisory board of Austrian Airlines in spring 2001) gave his take on events at the time:

Bruggisser’s vision was that in the long run the alliances would not be a stable form of cooperation. It was clear to him that the alliance agreement structure had an expiry date, particularly once cross-country mergers were allowed – which he felt would happen sooner rather than later. Bruggisser’s idea was to build a portfolio of airlines, so once the cross-country mergers were allowed he would be in a position to consolidate his stakes in minority holdings.

After a series of expensive investments, including the 49 per cent of Sabena, and expansion into airline catering, airline maintenance, and cargo and ground services, Swissair should have been, in theory, closer to realising its objective. But as oil prices rocketed in 1999/2000, the airline industry, including ancillary services, suffered. This factor, together with the poor performance of Swissair’s investments, led the board to question the company’s ability to finance the underlying strategy.
A distinguished, but ineffective, board

Proposals to the board were signed and presented for approval by the CEO. The holding structure of the Swissair Group was highly complex, with the net result that it was virtually impossible for the board to get a clear view of the group’s overall financial position at any moment in time. Of significance also is the fact that the CFO, Georges Schorderet, who came on board in 1995, was not part of the Group’s mergers and acquisitions team.

Between 1995 and 1999, the number of board members was reduced from a very top-heavy 20 to a much more manageable 9. The list of the remaining members read as a roll call of the great and good of the Swiss business world, including Lukas Mühlemann, who was chairman and CEO of Credit Suisse (Swissair’s principal bank) and the former CEO of McKinsey Switzerland; Eric Honegger, a powerful political figure, former finance minister for the canton of Zurich and chairman of the Swissair board; and Mario Corti, CFO of Nestlé. Being asked to join the board of Swissair was a ‘certification that one had arrived in the corridors of power …’ said one of the members, Bénédict Hentsch (managing partner in the private bank Darier, Hentsch & Cie), in an interview. None of the nine board members had a background in the airline industry. Honegger, quite astonishingly, believed this was undoubtedly an asset:

I am not a friend of the notion that at the board level one should in a way duplicate the management requirements. Management has the know-how to lead the airline. The board has other tasks, it must especially carry out the monitoring function.

Direct remuneration of board members was almost negligible, with fees of SFr 800 per meeting and the equivalent of approximately SFr 15,000 in shares. However, a seat on the board entitled members and their families to seats in first class on unlimited Swissair flights around the world. Board meetings themselves were reputedly preceded by gastronomic extravaganzas, which may well have had an impact on the quality of the ensuing discussion. Bandle commented on his experiences with the board during the Sabena negotiations:

I was reporting to the board on a monthly basis during these five months. There were tons of issues we had to address in terms of unions, cost cuts, fleet
integration but very, very few questions were asked and there was very little discussion at the board level … I was not impressed by the discussion or the decision-making process.

Bandle talked about Bruggisser and his role as CEO:

Bruggisser always impressed me as a manager who did his homework, who was meticulous about due diligence … He was a very sharp dealmaker and a tough negotiator. He worked from 6 in the morning till 10 at night. He was a loner.

And suddenly, the same Philippe Bruggisser goes off and buys a 49.9 per cent stake in LTU – a German tour operator and charter carrier – for SFr 894 million in September 1998. I was in Düsseldorf at the time … and people, knowing that LTU was in such a big trouble, were asking me why Swissair wanted to buy it. It was not even part of the hunter strategy!

By 2000 LTU was showing a loss of SFr 390 million. The same year, clashes of opinion developed between Katz, CEO of the airline business, and other senior management, over both Katz’s personal ambitions and the strategic direction of the airline division. Katz eventually gave up and left. The board decided the role should be transferred to Bruggisser, in addition to his existing responsibilities. But Bruggisser was beginning to lose the confidence of his closest colleagues on the management committee. Communication between the CEO and the management team started to break down, to the extent that Bruggisser relied on an external consultant for due diligence work on a merger with Alitalia, Italy’s national airline. The board fully endorsed his pursuit of the project despite Alitalia’s financial and operational problems, second only to those of Sabena in severity.

**Reality dawns**

To meet EU requirements about ownership of airlines, acquisitions of minority interests under the hunter strategy were invariably accounted for in complex financial structures (special purpose vehicles – SPVs) which ensured they remained only as a minority shareholding in the consolidated financial statements. This was despite Swissair having, in some cases, effective operational control over the entities, a situation which would normally require the group to fully consolidate the interests as subsidiaries. The additional financial commitments required for these SPVs were putting
increasing pressure on the company. McKinsey performed a review of the financing requirements in August 2000 which resulted in estimates of between SFr 3.25 billion and SFr 4.45 billion. With no slack in the balance sheet, the board was left with little choice but to abandon the hunter strategy:

The Board realised that the depth of the resources required to implement the chosen strategy, in terms of time, capital and management capacity, was greater than the Group could provide. The lack of ample financial resources to pursue additional acquisitions and to carry out the required refinancing plans in Germany, Belgium and France forced the abandonment of this strategy.11

Simultaneously, Bruggisser’s 22-year career at Swissair was terminated and Honegger, the chairman, became the Group’s interim CEO, effective from 23 January 2001. Two months later, nine of the company’s ten directors announced their resignations to take effect over 13 months. This caused a great outcry in Zurich and Geneva at the directors’ ‘[refusal] to assume responsibility for their own strategy’.12

Mario Corti, by then chairman of Swissair, was appointed Group CEO in March 2001, in the hope that he could rescue the ailing airline. An MBA from Harvard, his banking background, together with his tenure as Nestlé’s CFO, made Corti one of Switzerland’s most respected business figures.

At his first press briefing in April 2001, Corti broke the bad news that in 2000 Swissair had sustained its biggest ever loss of SFr 2.9 billion, despite a 24.8 per cent increase in turnover. By mid-2001, the Group’s balance sheet was only 5 per cent equity and 95 per cent debt, which had escalated to SFr 17 billion. The CFO, Schorderet, immediately came under fire from shareholders demanding to know why his indication of a SFr 200 million profit less than six months previously was so extraordinarily far off the mark. Corti rapidly replaced him, appointing Jackie Fouse from Nestlé to take over in June 2001. In a similarly swift action, PwC was replaced as external auditors by KPMG, which was given the mandate ‘to go through the whole business and discover whether there are any skeletons left in the closet’.13

As a result, the Group restated its balance sheet as at 31 December 2000, cutting its equity from SFr 1.2 billion to SFr 716 million. Corti did not shy away from tough decisions and took an axe to Swissair’s non-core businesses:

Our main priority is to reorganise the Group’s airline sector, the first pillar of our dual strategy, and restore it to a sound financial condition … From where we stand today, it will be impossible to ignore broad restructuring measures.14
The full cost of Swissair’s expansion strategy was revealed to have been heavy indeed. Although operating profit fell only 11 per cent to SFr 603 million in 2000, exceptional costs and losses from investments totalled SFr 3.2 billion. The equity value on most of Swissair’s airline investments, including Sabena, LTU, AOM, Air Littoral, Volare, LOT and SAA, was written down if not written off entirely. Provisions were also made for Swissair’s share of the losses on investments in the same airlines. In all, 72 per cent of Swissair’s shareholder equity was wiped out.

The disposal plan was stepped up in order to counter the steadily growing debt, although many transactions required further cash outlays in order to stem the losses. The company reneged on its agreement to increase its stake in Sabena to 85 per cent and inject more funds, but the Belgians sued. An agreement was eventually reached in August 2001, with Swissair Group and the Belgian government providing Sabena with cash funds of €258 million and €172 million respectively. Swissair was allowed to walk away without taking up the further stake in Sabena.

Swissair also managed to rid itself of its French airline interests. A total of SFr200 million was contributed to the relaunch of AOM-Air Liberté by a former Air France pilot. SFr200 million was committed to a restructuring plan for Air Littoral, which was taken over by the airline’s former CEO.

The eight-month struggle to get Swissair back on its feet was futile, however. The unforeseen events of 11 September 2001 had a disastrous and immediate effect on the entire airline industry as people were reluctant to fly. Swissair was no exception. Its aircraft were grounded on 2 October 2001 and shortly afterwards the airline went into receivership.

Swissair Group collapsed with net liabilities of SFr 1 billion. But of its SFr 7.8 billion of assets, SFr 7.3 billion were either loans to Group companies or equity investments in subsidiaries, most of them worthless. The final cost to banks and bondholders topped SFr 6 billion.

Aftermath

Switzerland’s economic and political elite scrambled to save not just the airline but also – and more importantly to them – the nation’s image. Project Phoenix was conceived to give rise to a new flag carrier for Switzerland out of the ashes of Swissair. After much arm-twisting, a total of SFr 2.7 billion was pledged from both government and corporate sources, among them the cantonal authorities in Zurich and the Swiss banks UBS AG and Credit Suisse Group. Other corporate investors included Novartis, Roche, SwissRe and Nestlé, which poured millions into
the project in what was billed as a ‘triumph of corporatism’ but held few apparent benefits for their own shareholders.

Under Phoenix, the regional carrier Crossair obtained leases on planes from Swissair’s fleet and took over the slots for the majority of Swissair’s domestic destinations. However, transfer of the international slots could not be registered before March 2002 so a further SFr 1.5 billion was sunk into Swissair to keep it aloft until then, when Swiss International Air Lines (Swiss) was finally born.

The rebranded Swiss got off to a shaky start and immediately began the first of many rounds of restructuring, each involving further redundancies and aircraft disposals. A loss of nearly SFr 1 billion was posted in the first year of operations, 2002. This was narrowed to SFr 687 million for 2003 but by this time the airline was considered to be the ‘dead man walking’ among European airlines. Suffering from a high cost base with soaring fuel costs, an extremely tight market in the wake of both the war in Iraq and the SARS virus, and voracious competition from the low-cost carriers, Swiss was doomed almost from the outset. And strong airline alliances such as Oneworld and Star Alliance, which might have been capable of helping Swiss shoulder the burden, were shunning any of Swiss’ efforts to woo them.

Eventually, after an aborted attempt to hook up with BA, rumours began to circulate of a potential deal with Lufthansa, heightened by the appointment of an ex-Lufthansa manager, Christoph Franz, as CEO of Swiss in April 2004. The proposed takeover was announced in March 2005 with Lufthansa set to pay an estimated total of €310 million for the outstanding shares of Swiss. Lufthansa gained access to the Zurich hub and a highly sought-after business-class and first-class travel customer base. Swiss, for its part, was assured of its precious independence and continued operation of Zurich airport as an intercontinental hub, thereby guaranteeing jobs as well as sustaining the tourism industry and business sector. Despite initial opposition and continued misgivings over the sale of the national flag carrier, opinion polls eventually tilted in favour of the deal. And somewhat ironically, in finally gaining full access to the EU market, the Swiss national airline ultimately scored the goal it had been seeking for well over a decade.

What went wrong and lessons to learn

McKinsey had proposed an ambitious strategy with its concept of network managers. It probably underplayed the difficulties of achieving
this position, given the political issues with the status of national carriers; the tricky industrial relations; and the need to protect the Swissair brand. This was particularly true with Sabena. The strategy was then poorly implemented and was the root cause of Swissair’s downfall. Had there been more effective management control and board oversight, the strategic errors might well have been avoided or, at least, identified earlier and rectified in time to save the pride of Swiss industry. They were not, and over the course of five years, the airline relentlessly pursued an acquisition and investment policy which drained resources and gradually eroded shareholders’ equity until it was too late.

The dangers of outsourcing strategy

One of Swissair’s fundamental errors was effectively to delegate its strategic decision-making to McKinsey. Unsurprisingly, the strategy devised was one that ensured Swissair’s continued reliance on McKinsey through the ensuing series of acquisitions of minority stakes, so much so that the McKinsey consultants became almost indispensable to Swissair and a de facto part of the operations. In parallel, Swissair’s own internal capacity for strategic thinking diminished to the extent that McKinsey’s proposals, assumptions and predictions were rarely questioned or challenged, by either management or the board.

The need to protect the brand was sidelined

Historically, Swissair’s strongest asset had been its reputation for first-class service, which set it apart from many of the global players which dwarfed it. McKinsey’s hunter strategy underplayed the need to safeguard Swissair’s quality reputation when taking minority equity stakes in airlines where it would be unable to dictate quality standards and therefore put its brand at risk.

Poor implementation issues

The hunter strategy prescribed the acquisition of minority equity stakes of between 10 per cent and 30 per cent but this was not adhered to and with the exception of SAA, all of Swissair’s other investments were in excess of 30 per cent, many of them 49 per cent. This effectively exposed
Swissair to greater financial risks but without the benefit of full control to mitigate them. It also bought stakes in airlines outside the proposed target markets.

And the financial risks were not small. While McKinsey’s earlier advice was that the acquisitions should be attractive as straight financial investments as well as for strategic purposes, most were in a poor financial state. Swissair ended up paying over the odds for the minority interests while not having the power to turn around the operations and claw back some of the investment, since most of the companies continued to be run independently of Swissair.

The pitfalls of large minority investments

The Sabena investment provides a prime example of the dangers involved in large minority investments. Despite knowing that, in purely financial terms, Sabena was worth nothing, Swissair paid SFr 240 million in cash for 49.5 per cent of the equity. As control of the airline remained in the hands of the Belgian government, the anticipated synergies, particularly regarding employee costs, were never realised. Sabena turned into a black hole, into which Swissair poured more and more cash, including financing the purchase of a fleet of new aircraft.

Even after the investment in Sabena had been written off in 1996, which should have served as a warning sign for the board, management and external stakeholders, the acquisitive strategy continued and the same mistakes were repeated.

As well as acquiring a raft of minority stakes in smaller airlines, Swissair diversified into other areas, many of which were far removed from its core competences. While some of these (such as Gate Gourmet) proved to be a success, with others the potential rewards were less evident and another drain on Swissair’s limited resources.

The drawbacks of an ornamental board

Membership of the Swissair board was much sought after, offering as it did, entry to an elite club and public affirmation that one had reached the pinnacle of one’s career. None of the directors had any airline experience to speak of, and given the degree of cross-directorships between Swissair and companies such as Credit Suisse, Nestlé, UBS and Darier, Hentsch & Cie, it was effectively an ‘old boys’ network. Until 1999 there were some
20 members, making it an unwieldy forum which generally accepted, without much questioning or challenge, the acquisition and other strategy decisions. There was also an element of complacency that came from Swissair’s successful past and brand reputation, which perhaps led the board to think ‘it couldn’t possibly happen to us’.

The dominant CEO again

Although not as directly responsible for the downfall of Swissair, as were the CEOs of WorldCom, Parmalat and Tyco, the highly ambitious and power-hungry Bruggisser must shoulder some of the blame. His judgement became increasingly questionable, as evidenced by his unilateral decision to acquire 49 per cent of the problem-riddled LTU, which did not even fall in the scope of the hunter strategy. Furthermore, the clash between Bruggisser and the equally ambitious Katz, confused the lines of operational control and affected the orderly running of the group as this conflict percolated down through the organisation.

Lack of internal controls and clear financial information

There was a general lack of strong financial management within the Swissair Group, exacerbated by poor information systems. The fact that the Group CFO did not figure in Swissair’s mergers and acquisitions processes underlines this deficiency.

Within Swissair itself, the Group holding structure became increasingly complex and each acquisition only added to the problems. Combined with inadequate forecasting and poor financial reporting, the result was that even those responsible for Swissair’s day-to-day management did not have a clear picture of the overall position until it was too late. This was exemplified by the 2000 forecast profit of SFr 200 million turning into a loss of SFr 2.9 billion. Consequently, the time to take effective remedial action had already passed before the full extent of the problems was realised. By then it was too little and too late.

The auditors, PwC, were replaced by KPMG on Corti’s arrival, and immediately questions were asked as to why PwC had not raised warnings about asset impairment given the subsequent write-down of nearly three-quarters of shareholders’ equity. Similarly, the rating agencies did not recognise the true state of the Group’s financial position in sufficient time and reacted only when Swissair itself identified and announced problems.
Refusal to relinquish control

In contrast to some of the other collapses, where excessive executive compensation played a significant part in influencing management decisions, this was not the case at Swissair. However, an overriding objective for the board and management alike was to retain the airline under the national banner and Swiss control. This desire to preserve the autonomy and power of Swissair manifested itself at an early stage with the collapse of the Alcazar alliance, and from then on in the unwillingness of Swissair to take a secondary role in any other partnership. This was not helped by the refusal of the Swiss electorate to join the EU, thereby handicapping Swissair’s ability to compete within the open-skies policy.

The key messages are:

1. Overreliance on outside consultants can be dangerous. If consultants are dictating strategy, it is a good idea to ensure that they also carry a degree of responsibility for its implementation, perhaps by structuring the fee arrangements accordingly.

2. Board members need to bring expertise as well as prestige to the table. They should not have potential conflicts of interest if they are to fulfil their main function of ensuring that the company is well run and respects corporate governance best practice.

3. Efficient management information systems are essential to ensure that management and directors have the data quickly and accurately enough to enable correct and timely decisions to be made.

4. Hubris (or national pride) can get in the way of making the right decisions. The refusal to contemplate Switzerland without a flag carrier was ultimately to the detriment of shareholders and other stakeholders alike.

Notes

1 This quote and all others from Alain Bandle came from interviews with IMD research associate Inna Francis.

4 Airline Business (1 February 1996).
5 Sabena’s official statement (from the Sabena website).
6 Reuters (3 November 1996).
8 Results of Ernst & Young’s investigation regarding Swissair; January 24, 2003.
9 Interview with the Institutional Investor, 36(2) (2002).
10 Neue Zürcher Zeitung (10 March 2001).
12 Time (7 May 2001).
14 Shareholders’ meeting (April 2001).
It was 24 February 2003 and the Dutch nation was in shock. Royal (Koninklijke) Ahold, a household name and one of the pillars of the Dutch establishment, had just announced the discovery of a $500 million accounting fraud. The auditors were refusing to sign the accounts and Ahold had had to negotiate emergency financing with its banks to avoid immediate bankruptcy.

Over the previous year, Europeans had watched in horror as various titans of American industry tumbled in the dust, but were convinced that nothing of the sort could happen to them. But now European investors looked on nervously as Dutch headlines screamed: ‘Is Ahold Europe’s Enron?’ A year later the CEO, Cees van der Hoeven, and three other directors were under indictment for criminal fraud in the Netherlands. In the US, other officials also faced charges.

Ahold was a global food retailer with over 9000 stores (including joint ventures) and 278,000 employees (full-time equivalents) in four continents. The company had announced sales of €72 billion for 2002, up from €66 billion in 2001, although earnings were expected to drop because of a whole raft of exceptional items. The newly discovered fraudulent accounting in its overseas operations could not have happened at a worse time. Seven years of acquisitions, costing €20 billion, had left Ahold overextended, with outstanding loans of €13 billion. Ahold’s expansion drive had not only taken it into several developing countries, now in economic crisis, but also into a new business area, supplying restaurants. It was in this new activity that the first signs of fraud emerged. The breakneck expansion, driven by van der Hoeven, had allowed little time to assess likely risks; effective internal control systems had been left far behind; local managements retained most of their powers. The decentralisation and loose controls made problems inevitable. Only the scale was a surprise.
The first century – from small local shop to international group

In 1887 22-year-old Albert Heijn took over his father’s small grocery store, near Zaandam in west Holland, which sold a wide variety of products, from groceries to dredging nets. But young Albert had wider ambitions than his father and, by 1907, he had built up a 23-strong chain of stores. Heijn also branched out into own-brand products, baking his own biscuits in a neighbour’s house. His manufacturing company, Marvelo, developed from these small beginnings, and was eventually producing products such as tea, coffee and peanut butter, as well as bottling wine. The company went public on the Amsterdam stock exchange in 1948 and shortly afterwards made its first acquisition with the Van Amerongen chain of stores. Always innovative, the Albert Heijn chain opened its first self-service supermarket in 1955 and over the next 15 years continued its rapid growth.

The 1970s marked a new period of expansion. The holding company, Ahold NV, was formed in 1973 accompanied by the acquisition of Ahold’s first specialty stores: the liquor chain Alberto, and the health and beauty chain Etos. In the mid-1970s, politics drove the Heijn family to invest abroad. The oil crisis and ensuing economic turmoil put a socialist government into power in the Netherlands. Fearing the consequences, and seeking to protect its assets, Ahold sought to expand abroad, buying the Spanish supermarket chain Cadadia in 1976. A year later the company made its first US acquisition, buying the BI-LO supermarket chain based in the Carolinas and Georgia.

Expansion in the US continued in the 1980s with the acquisition of Pennsylvania-based Giant Food Stores and the Ohioan chain, First National Supermarkets (Finast). In the Netherlands, Ahold bought several small food service companies becoming the market leader in a very fragmented market supplying institutions such as schools and hospitals. In 1987 Ahold joined the country’s corporate elite when Queen Beatrix of the Netherlands marked its 100th anniversary by awarding Ahold the designation ‘Koninklijke’ (‘Royal’). Two years later, Ab Heijn – Albert Heijn’s grandson and the last family member to run Ahold – retired after 27 years and was succeeded as president and chief executive officer (CEO) by Pierre Everaert who had joined Ahold in 1985 and had served as its executive vice president, US retail operations.

Ahold continued to expand in the US under Everaert’s stewardship, buying the northeastern Tops Markets Inc. in 1991. It also started a

---

i The venture proved unsuccessful and was sold in 1985.
supermarket chain in the former Czechoslovakia and bought into the Portuguese market via a joint venture with Jeronimo Martins, owner of Pingo Doce, Portugal’s third largest supermarket chain. Everaert left Ahold in March 1993 to join the management board of the troubled Dutch firm Philips Electronics NV. He was succeeded by Cees van der Hoeven.

**New team at the top**

Born in 1947, van der Hoeven graduated in economics before joining the Anglo-Dutch oil company, Royal Dutch/Shell. He performed several roles there including that of finance director at the Shell/ExxonMobil joint venture, Nederlandse Aardolie Maatschappij, despite – as he admitted in a 1994 interview¹ – only having a slight knowledge of accounting. In 1985 van der Hoeven was headhunted to join Ahold’s executive board as CFO. He was disappointed not to get the top job when Heijn retired but eventually received his reward when Everaert left in 1993. Van der Hoeven, now president and CEO, controversially continued in his role as CFO until 1997 when he appointed Michiel Meurs to the post.² Meurs was a graduate in business studies and economics from the universities of Bogotá and Rotterdam. He became a banker, working for ABN Amro, one of the Netherlands’ leading banks, for 16 years before joining Ahold in 1992 as director of finance. When van der Hoeven became president, Meurs was promoted to senior vice president and also took on responsibility for business development. In 1997 he became a member of the executive board.³

In 1992, just before van der Hoeven took over as CEO, Ahold generated earnings of €138 million on sales of €10.1 billion. Ahold was dominant in the Netherlands where, together with its wholesale arm, Schuitema,³ it controlled 36 per cent of the food retailing market. Its other European ventures enjoyed mixed results. The recent joint venture in Portugal was proving profitable but the Czech chain, with 27 stores by the end of 1992, was still operating at a loss. Ahold was now heavily dependent on the US, since its five supermarket chains in America’s eastern states contributed 50 per cent of total turnover, making Ahold one of the top ten food retailers in a fragmented US market.

Van der Hoeven’s first full year results were disappointing. Recession and increased competition in America reduced profits there. Although

---

¹ In the Netherlands, as in other continental European countries, public companies have a two-tier board system: an executive board responsible for running the company; and a supervisory board, whose members are the equivalent of Anglo-Saxon non-executive directors.

² Ahold increased its stake in Schuitema to 73 per cent in 1992.

³ Ahold increased its stake in Schuitema to 73 per cent in 1992.
group profits grew overall, a rights issue earlier in the year to strengthen the balance sheet meant that earnings per share (EPS) were flat. But, in a hint of things to come, Ahold listed on the New York Stock Exchange in 1993, a move that would allow it to issue shares in the US to fund future acquisitions.

Ambitious plans for rapid expansion

Van der Hoeven was not discouraged by the poor results. In 1994 he unveiled ambitious growth targets for the company: sales and net profit were to double every five years, implying 15 per cent compound annual growth. This could only be achieved by making substantial acquisitions, although van der Hoeven claimed that two-thirds of the growth would come from organic expansion, financed out of cash flow. EPS had a target of at least 10 per cent annual growth. Given Ahold’s limited opportunities for expansion in the Netherlands, analysts expected most growth to come from acquisitions in the US, where the market was very fragmented, and southern and eastern Europe where supermarkets were much less dominant.

Van der Hoeven started his acquisition drive by buying two supermarket chains in the eastern US (Red Food Stores and Mayfair) and setting up a joint venture in Poland. But Ahold’s major expansion effort began in 1996 with the acquisition of the US Stop & Shop chain for $2.9 billion (including debt assumed) which made it the fifth largest food retailer in the US. Then it branched out into new territory, buying 50 per cent of Bompreço, the leading supermarket chain in northeastern Brazil. Expanding into yet more new countries, Ahold negotiated joint ventures with companies in Spain and Southeast Asia to develop retail operations.\textsuperscript{iv} A noted feature of Ahold’s joint venture agreements was its insistence on having operational control even when it did not have majority ownership. This allowed Ahold to consolidate the ventures fully and add 100 per cent of their sales to its own, flattering its reported sales growth.

Embarking on a major spending spree

Ahold made acquisitions every year from 1994 to 2002, spending over €20 billion during that time. But the rate of acquisitions speeded up considerably from 1999. At one point that year, van der Hoeven was in

\textsuperscript{iv} The Spanish joint venture again proved unsuccessful and Ahold withdrew in 1998.
simultaneous acquisition talks involving ten supermarket groups on three different continents.

In general, apart from a few hypermarkets in Eastern Europe and Portugal, Ahold bought large and medium-sized neighbourhood supermarkets which provided a wide range of branded and own-brand (branded with the name of the supermarket) goods. Most acquisitions were well-regarded, often family-owned, regional chains. Ahold had a poor record on turning failing operations round: one of its early acquisitions, the Finast chain, always struggled to produce decent profits and underwent several reorganisations without much improvement.

Once they were part of Ahold, large chains continued trading under their own name and branding, while small chains or groups of stores were integrated with larger ones. Ahold had a reputation for keeping management intact, which smoothed the acquisition process considerably as managers knew that their jobs were not at risk. It also meant that Ahold could benefit from local knowledge of consumer buying habits and pricing levels but, on the negative side, it was sometimes difficult to implement major changes to existing practices. The store groups retained considerable autonomy over local operations while Ahold tried to achieve economies of scale in areas such as central purchasing. Technology and know-how transfer in the form of logistics systems and loyalty cards provided further opportunities to increase profits.

In 1998 Ahold bought the US chain Giant Food Inc., which allowed it to maintain fifth place in the US food retail market, given the consolidation in the industry since 1996. The same year, Ahold and Velox Retail Holdings\(^v\) of Argentina, set up a 50/50 joint venture, Disco Holdings Ltd (Disco). As usual, Ahold insisted on operational control of the venture. Disco owned just over 50 per cent of Argentina’s largest – eponymous – supermarket chain and 37 per cent of Santa Isabel, the second largest supermarket chain in Chile and Peru. After the joint venture had purchased a further 14 per cent of Santa Isabel, Ahold fully consolidated the two companies. This meant that although Ahold took credit for 100 per cent of the South American companies’ sales and operating profits, it only owned a quarter of the underlying retail chains. The 75 per cent of earnings to which it was not entitled were deducted as a one line item: minority holdings.

As Ahold expanded, so did van der Hoeven’s ambitions. He repeatedly stated that he intended Ahold to overtake Carrefour to become the world’s number two food retailer, after Wal-Mart, by 2002.\(^3\) However, some

\(^v\) Velox Retail Holdings was a member of Velox Investment Group, an Argentinian banking and finance company owned by the Periano family.
investors were voicing doubts as to whether Ahold could become a truly global force given its relatively weak position in Europe, and its share price started to suffer. These murmurs gained strength after Carrefour merged with its French rival, Promodès, to become Europe’s largest food retailer. In contrast, Ahold ranked only 18th in Europe (by 1997 turnover).⁴

In response – and contrary to its previous policy of eschewing acquisitions in the developed markets of Europe – in 1999 Ahold bought a 50 per cent stake in ICA Group, Scandinavia’s leading food retailer, for $1.8 billion. ICA held 35 per cent of the Swedish market and 27 per cent of the Norwegian market, and the joint venture gave Ahold the opportunity to realise some economies of scale in Europe. Ahold also acquired some 150 supermarkets from seven companies in Spain that year in its third attempt to crack the Spanish market.

In Asia, Ahold acknowledged that its formula of buying existing supermarkets had not been as successful as its competitors’ solution of building hypermarkets. It decided to cut its losses by divesting operations in China and Singapore.

**Food service industry points to new growth opportunities**

In 1999 Ahold’s turnover and pre-tax profit in the US represented 57 per cent and 67 per cent, respectively, of the total. But that year, the Federal Trade Commission called a halt to Ahold’s northeastern acquisitions by blocking its takeover of Pathmark, a leading supermarket chain in New York. Cheated of his prey, and desperate for a big acquisition to sustain high growth rates, van der Hoeven changed tack and, in March 2000, bought America’s second largest food supply company, US Foodservice (USF), for $3.6 billion.

The food service industry supplies food to restaurants and institutional clients such as hospitals and schools. In 2000 the industry in America was much more fragmented than the supermarket industry, with the top two companies, Sysco Corp. and USF, holding less than 20 per cent of the $160 billion restaurant business, the industry’s largest segment. Ahold was attracted by its 5 per cent annual growth rate – almost twice the rate of the grocery trade – which was driven by people’s changing lifestyles (more eating out and take-aways).⁵

Ahold justified the purchase by claiming that it could make savings from increased purchasing power and by combining some back-office operations with the retail operations. But the supermarket and food service sectors were poles apart when it came to purchasing. They might be buying the
same end product, but for supermarkets it was packaged in small containers with fancy labels, whereas products sold by the food service industry tended to be delivered in bulk containers. The pricing structure was different; the salesmen were different, as were their incentives. Achieving cost reductions would not be as easy as Ahold made out. Ahold did have some experience of the food service sector through its Dutch operations, but this was tiny compared with USF. However, most investors took Ahold’s promises at face value and the share price started to recover.

USF’s CEO, Jim Miller, had built his career in the food service industry, first working for Sysco before joining PYA/Monarch. Together with other top managers, Miller had organised a leveraged buy-out of PYA/Monarch’s northeastern and Midwest branches in 1989. After the company floated in 1995, under the name JP Foodservice, it grew rapidly, swallowing several small firms before merging with the country’s fourth largest food service company, Rykoff-Sexton, in 1997 in a $1.4 billion deal. The company changed its name to US Foodservice (USF). Miller’s ambition now was to overtake Sysco, the well-regarded industry leader. But in 1999 USF was still only a third of the size of Sysco (based on 1999 sales) and generated lower margins, although underlying performance was difficult to gauge, given its numerous acquisitions over the past few years. Being acquired by Ahold would give USF the financial might to pursue further dramatic growth (and make Miller some $32 million from selling his stake). Miller continued as CEO of USF after its acquisition by Ahold and, in September 2001, became a member of Ahold’s executive board.

Over the next 18 months, Ahold snapped up a further five food supply companies in the US, including PYA/Monarch for $1.7 billion and Alliant for $2.2 billion, and merged them with USF. At the same time, Ahold continued its acquisition spree, at the rate of almost one a month, including US convenience stores and the online grocery retailer Peapod. In September 2001 it also bought the Alabama-based chain ‘Bruno’s Supermarkets’ for $500 million. In Spain, it bought the 341-store supermarket chain Superdiplo to add to its collection of stores purchased over the previous couple of years. But Ahold’s expansion efforts in Spain cost more than the company had expected. As Paul Draaijer, a former business development manager for Ahold in Spain, explained: ‘We were reading in the paper that Ahold was adding strong race horses to their stable, but on the ground we saw that they were crippled donkeys.’ He added: ‘The company realised often too late that it had to pay twice as much just to keep stores running.’

The year 2001 started well for Ahold, which announced a 48 per cent rise in net earnings for 2000 to €1.1 billion and a 56 per cent increase in sales.
to €52.5 billion. It now claimed to be ‘recession-proof’ in the US. This theory was based on the premise that although food service sales might suffer in a recession as more people ate at home than in restaurants, this switch must mean that retail food sales would increase. Ahold seemed to have forgotten the lessons of the recession in the early 1990s when, far from increasing, supermarket sales growth fell and margins suffered as customers switched to cheaper foods. Then the company was hit by several events: currency devaluations in Brazil and Argentina and the consequent fall in euro earnings; and the New York terrorist attacks of 11 September 2001 which hit the food service business as people bunkered down at home.

**Massaging the figures**

At USF, times were tough. Managers were working hard to make earnings targets – especially important due to the link with employee bonuses. The opportunities presented by vendor allowances, a common feature of wholesaling or retailing businesses, became increasingly important. A large proportion of USF’s earnings was derived from these allowances. In fact, during 2001 and 2002, the company made almost no profit from straightforward sales to customers. It all came from vendor allowances. USF received volume allowances from its vendors where purchase invoices were reduced (or vendors billed) dependent on the quantities sold on. Allowances were only supposed to be booked when the related products were sold on to customers (provided that target volumes looked achievable).

USF purchasing managers had become notorious for their tough negotiating stance, particularly after the Rykoff-Sexton acquisition. They began to demand bigger and bigger vendor allowances as a condition for doing business. USF sometimes negotiated bigger rebates per case if it hit aggressive sales targets. According to the former food broker Trey Gaiennie, USF would claim that it would make the sales increase and demand the higher rebate straightaway. If it then failed to hit target sales, manufacturers often struggled to get a refund.8

At USF, there was no comprehensive, automated system for tracking amounts owed under vendor allowance programmes and the situation was further complicated by the different methods used by USF’s various acquisitions. Instead, USF estimated an overall ‘allowance rate’, according to vendor agreements in place, and booked accruals accordingly. From 1999 onwards, employees in the purchasing and marketing departments began reporting fictitious allowances, which then prompted the finance
department to increase the estimated ‘allowance rate’. Finance then ‘booked to budget’, effectively recording non-existent allowances and thus improving profits. To support the fiction, suppliers were persuaded to sign confirmation letters sent to them by USF stating that they owed USF much more than was actually the case. The suppliers then sent them directly to Ahold’s auditors, Deloitte & Touche.

Both Ahold and Merrill Lynch failed to spot what was going on during their due diligence process on USF but later investigations by accountants PricewaterhouseCoopers (PwC) found that net assets acquired by Ahold had been overstated by €100 million due to fictitious vendor allowances. When USF’s CFO left in May 2001 after only five months in the job, he wrote to Meurs stating that he had grave concerns about the accounting for vendor allowances. Meurs sent internal auditors to investigate but they failed to spot the fraud. Despite this early warning sign of control issues, Meurs failed to speed up the implementation of an effective tracking system for vendor allowances.

The engine begins to falter

In December 2001 Ahold won the American Mass Retailer of the Year Award and was riding high. But only a few weeks later the first of a series of bad news was announced: integration costs for Alliant had increased from $70 million to $220 million; and fourth quarter US like-for-like store sales had declined by 0.4 per cent instead of increasing by 1 to 2 per cent, as predicted. Then, in February 2002, the share price dropped by nearly 7 per cent as rumours spread that Ahold’s US subsidiaries had misreported their numbers. Ahold vigorously denied the rumours but in the new, sceptical post-Enron era analysts had growing doubts about Ahold’s true underlying profitability and demanded more detailed information on organic growth and integration costs. Ahold responded by publishing its organic growth rates by division, but since these figures included small acquisitions and excluded food service sales accounts that had been deliberately shed, they hardly gave the clear-cut picture that investors needed. Ahold finally dismissed their concerns: ‘We’re grocers, not accountants or bankers’, snapped one board member.

When the 2001 results were finally released, they showed earnings flat compared to 2000, although sales – swollen by acquisitions – had increased by 29 per cent to €66.5 billion. But when exceptional costs were

---

vi Where the acquired company’s sales were less than 5 per cent of the sales of the acquiring company.
stripped out, including a €356 million exchange loss on Disco’s debt, adjusted EPS showed only 17 per cent growth compared with 30 per cent the previous year. Optimistically, despite slowing retail sales in the US, Ahold forecast a similar growth rate for 2002.

A few weeks later, when Ahold published its 2001 annual report, it seemed that investors’ fears had been realised. A footnote showed that earnings calculated according to US Generally Accepted Accounting Principles (US GAAP) were some 90 per cent lower than the Dutch ones. Furious that these figures had not been announced earlier, investors started selling and the share price fell 10 per cent. There had always been some difference between the two sets of accounts due to the different treatment of goodwill, but this year the issue was compounded by large profits on interest rate swaps (€76 million) and property transactions (€137 million). Once these gains had been deducted from earnings, the EPS growth slowed to a pedestrian 8 per cent. It had become clear that non-retail gains were now an increasingly important part of Ahold’s earnings (3 per cent in 1999, 6 per cent in 2000 and 13 per cent in 2001), but could they be maintained?

The Argentinian problem

Ahold’s forecasts were soon brought into question as the situation in Argentina worsened and its Spanish operations continued to struggle. In July 2002 Ahold’s Argentinian partner, Velox, defaulted on its debts and triggered a put option which required Ahold to pay around €490 million for Velox’s stake in Disco and to take on Disco’s full debt. Since the price was well above Disco’s current market value, it forced Ahold to take a €410 million exceptional charge. The put option, part of the original joint venture agreement, had first been disclosed in the 2001 accounts. Investors were understandably annoyed that it had not been disclosed as a contingent liability when Disco was acquired. The charge drove Ahold into a €197 million quarterly loss, its first for more than 25 years. Although Ahold cut its full-year EPS growth target from 15 per cent to 5–8 per cent, it still claimed that organic operating earnings would grow by 15 per cent with the growth skewed towards the second half of the year.

From mutteredings of trouble to full-blown crisis

In November 2002 things went from bad to worse. Third quarter earnings declined by 15 per cent year on year and van der Hoeven cut the full-year
Royal Ahold: Shopped Till He Dropped

forecast a second time, announcing that 2002 earnings were now expected to *decline* by 6–8 per cent over 2001. The market was shocked by the results and by the news that Ahold expected to take a $910 million charge in the last quarter due to problems in Spain, Brazil and Asia. The continued slowdown in the US was illustrated by a 0.2 per cent decline in like-for-like store sales in the third quarter, compared to a 3.4 per cent increase the year before. Currency devaluations in South America had virtually wiped out the profit from that region and the Velox debacle had contributed to higher interest charges. The July forecast had clearly been completely unrealistic.

In a pure flash of hubris, van der Hoeven dismissed calls to resign: ‘I am here to stay, whether you like it or not’,10 he crowed. Apparently he had offered his resignation to the supervisory board earlier that year but had been asked to stay on until his retirement in five to seven years’ time. He said that he took ‘responsibility for what [had] happened to the company … but would not call that a personal failure’.11 He announced a three-year programme to increase organic sales, reduce costs and improve cash flow in order to reduce debt. Non-core operations such as production and financial services would be divested. How investors were supposed to judge the programme’s progress was unclear, since Ahold refused to reveal detailed targets.

Preliminary results, announced in January 2003, adhered to the November forecast. Overall sales were up by 9 per cent year on year to €72 billion (although only up 0.3 per cent in the last quarter) and EPS was still expected to decline by 6–8 per cent. The earnings drop had raised cash flow worries and Ahold’s share price fell when Moody’s credit rating agency downgraded Ahold’s long-term debt rating to Baa1, only one level above junk status.

A few weeks later, Ahold’s auditors, Deloitte, discovered a $500 million accounting fraud at Ahold’s USF division during their annual audit. Furthermore, fraud was suspected at Ahold’s Argentinian operations. Realising that the loss would cause the company to breach its loan covenants, Ahold rapidly negotiated a €3.1 billion emergency loan package over the weekend before announcing the discovery to the markets on Monday, 24 February. The banks imposed stiff conditions but an immediate crisis was averted.

**Heads must roll**

Anticipating shareholders’ calls for scalps, the board announced the resignations of van der Hoeven and Meurs. As the Dutch nation reeled in shock, the share price fell by 70 per cent to reach just 10 per cent of its value a year earlier and Ahold’s debt was downgraded to junk status. The
US Securities and Exchange Commission (SEC) and Justice Department announced investigations into Ahold’s activities and Dutch authorities started an inquiry into alleged insider trading.

PwC performed the accountancy investigation which identified 470 accounting anomalies and over 275 issues concerning internal controls. The investigation proved more complex than anticipated, and Ahold missed three deadlines for publishing its 2002 results before they were eventually announced in October 2003. The year 2002 showed a loss of €1.2 billion after a €1.3 billion write-down of goodwill. The accounts also revealed that 2001 and 2000 earnings had been overstated by €363 million and €196 million respectively; non-existent vendor allowances were responsible for the majority of this. In all, 39 executives and managers were dismissed, including Miller, the CEO of USF, and four other USF employees were indicted on charges of fraud by both the Federal authorities and the SEC. The four men were accused of conspiring to overstate earnings by at least $700 million during 2001 and 2002. Two of the four pleaded guilty to Federal charges and paid a $300,000 fine to the SEC. At the time of writing, the remaining two are still awaiting trial. In January 2004 the SEC also charged employees from nine of USF’s suppliers with fraud. The indictments contended that the employees had signed confirmation letters from USF’s auditors stating the amounts owed by their employers to USF, despite knowing that these amounts were seriously overstated.

For van der Hoeven and Meurs, the most serious discovery was of documentation proving that most of Ahold’s joint ventures should never have been consolidated. Ahold’s claims to exercise management control over its joint ventures such as ICA and Disco had been supported by control letters which had been copied to Deloitte. However, side letters to the contracts, drawn up as little as three days after the control letters (and withheld from the auditors), denied operational control. Without operational control, Ahold should not have consolidated the joint ventures, and as a result sales had been overstated by as much as $30 billion over three years. Four Ahold executives, including van der Hoeven and Meurs, were charged with criminal fraud by the Dutch authorities. Earnings were barely affected by the deconsolidation but Ahold had trumpeted its sales growth record which now proved to be, at best, misleading. Van der Hoeven laid the blame on Meurs as the person responsible for consolidation issues. In his turn, Meurs claimed that he had not disclosed the letters because he considered them ‘not important’. Ahold itself paid $9.9 million to avoid criminal prosecution in the Netherlands and avoided similar charges brought by the SEC because of its ‘extensive cooperation’ with the regulator. The American authorities left it to the Dutch to prosecute van der
Hoeven and Meurs for criminal fraud although it did ban them for life from serving as directors of any American company. The case had not been heard at the time of writing. The Dutch Enterprise Chambervii also ordered a limited inquiry into events at Ahold despite a vigorous defence mounted by the company. Other class-action lawsuits were filed in the US by Ahold shareholders against the company and its executives.

**Ahold after van der Hoeven**

Despite poor operating results in 2003 (the third quarter showed a €122 million net loss compared with a €159 million profit the year before), Ahold successfully raised €3 billion in a rights issue in December that year. It also announced a €2.5 billion divestment programme. It was to sell all its operations in Asia, Central and South America, and Spain; its convenience stores and service stations in the US; most of its non-grocery operations in the Netherlands; its hypermarkets in Poland; and its Bruno’s and BI-LO supermarket chains based in America’s southeast. One year later the divestment programme was almost complete. The core Dutch and US retail operations had stabilised, but Central Europe still showed a loss and the US food service division reported a €74 million operating loss on sales of €15 billion for 2004. The share price had recovered, but was still more than 80 per cent down on its June 2001 peak. The army of small private investors (more than seven in ten Dutch private investors had bought Ahold shares) were the chief sufferers, having seen most of their savings disappear.

**What went wrong and lessons to learn**

Ahold’s tale is essentially a simple one, of a company that overexpanded into new countries and new markets. Having failed to exercise tight control over these far-flung operations, it paid the price: fraud and economic failure in some of Ahold’s countries of operation brought the company to near collapse.

**Failed strategy**

In expanding so rapidly into new markets, Ahold made some very poor strategic decisions. In Southeast Asia, where supermarkets had only a toehold in the food retail market, Ahold failed to understand the market

---

vii A special Chamber of the Court of Justice in Amsterdam.
dynamics: its acquisition strategy was ill thought out and far inferior to its competitors’ strategy of building new hypermarkets. In the more developed Central and South American markets, Ahold’s piecemeal acquisitions made it the second largest supermarket chain in Central and South America after Carrefour. But competition was intense and Ahold was in a much weaker position than Carrefour which was twice the size (sales of $10.8 billion) while operating in half as many countries (four) with the same number of stores (about 560).\textsuperscript{14} Ahold seemed overstretched and then the economies themselves imploded after major currency devaluations. Country risk had proved fatal and exposed the flaw in the contract with Velox – the fixed-price put option – which was to cost Ahold dear. Ahold’s collection of stores was spread over many countries which made achieving economies of scale more difficult. It seemed to be following the opposite strategy to its more successful one in the US where it had increased its concentration of stores in a relatively small area. Ahold’s strategy in South America was muddled and did not include proper quantification and monitoring of risks, especially exchange risk. Velox’s fixed-price put option seems to imply an unwarranted confidence that there would be no significant currency devaluation and that Disco’s US dollar value would not fall.

In the US, van der Hoeven was seduced by the faster growth prospects of the food service industry. He justified the diversification by outlining the synergies he expected to achieve, most of which did not materialise judging by the continuing losses at USF in 2003 and 2004. Equally disastrously, Ahold and its advisor Merrill Lynch failed to perform a sufficiently thorough due diligence process, which should have identified the problem with vendor allowances.

Overexpansion diverted resources

Ahold operated in essentially a low-margin, low-growth industry. In order for van der Hoeven to reach his goal of doubling sales and profits every five years, he had to make large acquisitions. With little room for manoeuvre in the Netherlands, and limited opportunities in neighbouring countries, he had to move in on the US or even further afield. The rapid-fire acquisition programme disguised the true performance of underlying operations and allowed – or forced (due to lack of time) – management to ignore looming problems. The acquisition programme also drained cash from existing operations in the Netherlands and US which were given ever-higher earnings targets. These were achieved by increasing prices and delaying capital expenditure: organic growth began to suffer.
Greed and ambition

Van der Hoeven was arrogant and highly ambitious. Becoming CEO of Ahold was only the first step; he had to stamp his own impression on the company. After a dull first year, he took the path which seemed to promise the quickest results: acquisitions. Widely admired within the business community and elected Dutch Businessman of the Year several times, van der Hoeven began to believe in his own infallibility. His domineering style, combined with Ahold’s hierarchical structure, discouraged questions or criticism. He was known for his comment of ‘no surprises’ during budget meetings: targets had to be met, whatever the cost. Although not particularly highly paid compared with his American counterparts, he was extremely well remunerated in comparison with his European peers, and rewards increased substantially during his tenure. Including the proceeds from exercising share options, total executive board compensation nearly doubled between 1999 and 2001. Shareholders, on the other hand, saw a total 7 per cent return on their investment over those two years. Compensation had become detached from reality.

Remote operations are difficult to control

The fraud discovered in Disco, USF and other American operations clearly exposed the weaknesses in Ahold’s internal controls. Allowing existing local management to run a new acquisition has its advantages, but not in the area of financial controls. The computer systems monitoring USF’s vendor allowances were completely ineffective, a situation that head office should have been aware of and therefore monitored closely. Other systems in developing operations such as Disco could not keep up with the pace of acquisitions, and controls suffered accordingly. Remote operations are hard to control effectively in the best of circumstances because of the lack of face-to-face daily contact and (often) time zone differences, both of which make communication difficult. In Ahold’s case, van der Hoeven and Meurs were too busy looking for the next deal to devote sufficient time to manage their new acquisitions properly.

Corporate governance issues

As might have been expected, Ahold’s supervisory board was criticised by investors for not restraining van der Hoeven’s activities. However, only the
chairman of the board accepted any responsibility for the scandal by resigning. The remaining directors acknowledged the need for a new board but staggered their resignations over two years. The board members were mostly the great and good within the Dutch business community. Most were directors of several other prestigious Dutch companies and had limited time and attention to spend on Ahold’s affairs. For example, Ahold’s chairman, Henny de Ruiter, was on the supervisory board of 17 other companies while another director, Roelof J. Nelissen, held 18 other directorships. Nelissen had another conflict of interest as the ex-CEO of ABN-Amro and then as a member of its supervisory board. ABN-Amro was Ahold’s main lending bank and participated in many of Ahold’s share and debt offerings to finance its acquisitions, contracts which netted the bank considerable fees.

In line with common practice in the Netherlands, Ahold had several measures in place to restrict the power of shareholders. A ‘poison pill’ allowing Ahold to issue preference shares with preferential voting rights to a foundation appointed by itself gave Ahold protection against hostile takeovers. Van der Hoeven also began issuing a new class of share – cumulative preferred financing shares – which had a disproportionate share of voting rights. Those voting rights were then transferred to a foundation set up by management. Ordinary shareholders already had limited voting powers since it required a two-third majority vote to reject any nomination to the supervisory or executive board, an even less likely event after the cumulative preferred financing shares had been introduced.

The supervisory board members claimed to have had intense, detailed meetings to discuss Ahold’s affairs. They must have been aware of some of van der Hoeven’s more questionable premises such as the potential synergies at USF, but perhaps they were over-persuaded by his domineering style and apparent past success to approve the deal. It is quite extraordinary that the supervisory board allowed van der Hoeven to combine the roles of CEO and CFO. This is a direct breach of the principle of segregation of duties. The dual role is an indication of how van der Hoeven was able to persuade the board to accept his decisions. At the very least, the supervisory board should be criticised for not accepting van der Hoeven’s resignation in the spring of 2002 when it should already have been clear that his strategy was in trouble. Ahold did adopt most of the measures proposed in the Netherlands’ new code for corporate governance, the Tabaksblat Code, introduced in the wake of the Ahold affair, to improve the independence of the supervisory board and increase shareholder power, among other things. The ‘poison pill’ remains but Ahold intends to convert its cumulative preferred financing shares into ordinary shares which will increase shareholder power.
Fraud was not Ahold’s worst problem

Although it was the discovery of accounting fraud at USF that triggered Ahold’s near collapse, as we have seen, Ahold’s problems ran far deeper. Ahold had several opportunities to detect the fraud at an earlier stage, either during the original due diligence process or as part of the internal audit investigation in 2001. Considering the importance of vendor allowances to USF’s profit margin, Ahold should have made it an overriding priority to implement an effective system to monitor them. Such a system would have stopped the fraud.

Has Ahold really changed?

Whether Ahold has fully acknowledged the causes of its near collapse remains open to doubt. While internal controls have undergone a complete overhaul – including centralisation of the internal audit department – and corporate governance has improved, there remains the question of what Ahold will do with its cash mountain of over €3 billion, built up through its divestment program. The company has made one small acquisition in the Czech Republic despite, or perhaps because of, continuing losses in Central Europe. Suspicions remain that more large acquisitions will be made. We can only hope that the targets will be better chosen; that a fair price will be paid; that risk will be properly assessed; and that sufficient time and resources will be devoted to integration, of control systems in particular.

The key messages are:

1. Large-scale expansion programmes often have the undesired effect of diverting management time or other resources away from existing operations. Care should be taken to ensure that these businesses do not deteriorate as a result.

2. Remote operations, especially those not well-integrated into the overall company structure, need strong internal control systems with frequent monitoring and review by head office.

3. Post-acquisition reviews are essential to discover whether cost savings and synergies, identified before the acquisition, have actually been achieved. If not, corrective action can then be taken and lessons learnt to apply to future acquisitions.
Notes

4 Paribas, European Equity Research.
5 Deborah Orr, ‘Changing Appetites …’, Forbes (2 October 2000).
8 Steve Stecklow, Anita Raghavan and Deborah Ball, ‘Ahold Unit’s “Initiative” Appears to be at Centre of Accounting Probe’, Wall Street Journal Europe (6 March 2003).
12 Ahold’s Form 20-F filed with the SEC on 29 December 2002.
13 Decision of Amsterdam Court of Appeal, Enterprise Section, in the case brought by Ahold shareholders against Koninklijke Ahold NV, 6 January 2005.
15 Interview with ex-Ahold employee.
17 Based on final dividend declared (from annual reports) plus increase in average share price divided by average share price in 1999. (Average share prices taken from article by Abe de Jong, Douglas V. DeJong, Gerard Mertens and Peter Roosenboom, ‘Royal Ahold: A Failure of Corporate Governance and an Accounting Scandal’, table 13, ECGI – Finance Working Paper No. 67/2005 (February 2005)).
The spectacular downfall of Parmalat caused a shockwave throughout Italy and indeed the rest of the European Union. There quickly unfolded a tale of excessive ambition, fraud, incompetent auditing, gullible or greedy bankers, and inept regulatory supervision. Once again, the rating agencies had been caught flat-footed. It soon emerged that the story was, in many ways, not unlike that of Enron, with the same problems of rapid overseas expansion, extravagant borrowing, a compliant board and inadequate analysis by outside observers.

On Christmas Eve 2003 Parmalat SpA collapsed into unexpected bankruptcy with undisclosed debts of €14.3 billion. It was later found to have been falsifying its accounts for more than ten years.

A global dairy company with 36,000 employees and 139 business units in 30 countries, Parmalat had become one of the icons of Italian industry. Its demise dispelled for all time any thoughts that corporate failure and accounting fraud were purely an American phenomenon.

Five days after the collapse, Calisto Tanzi, founder, chairman and CEO of the company, was in San Vittore prison, facing hours of interrogation and wondering how to explain where Parmalat’s problems had begun. Tanzi, along with his long-term associate and confidant Fausto Tonna, and Parmalat stood accused of the biggest accounting fraud in European corporate history. Around the world, bondholders found themselves facing substantial losses. They had known Tanzi was in the milk business. They had just never realised that he was not only milking cows, he had milked them too.

Following the Parmalat story requires some understanding of Italian corporate culture, which is illuminated by the behaviour of private family companies, and not by a listed, regulated market environment such as is found in the US and UK, among other places. Italian industry is dominated
by large and medium-sized private family companies, which choose to remain independent. This means that there are a relatively small number of listed companies on the Italian stock exchange, given the size of the economy, and an even smaller number of companies with credit ratings. The banks have been the traditional providers of capital and, consequently, there is much less public scrutiny of company results than in many other countries. Many of the characteristics displayed by Parmalat are usual, not unusual, in Italy, for example private family interests, strong central control, lack of transparency with the markets, and minority shareholders treated with contempt.

An additional element relates to the Italian banking industry, where political influence has long been important. Bank support for a company is not necessarily solely dependent on economic logic or financial performance. This may well explain how building political relationships in the early years enabled Tanzi to raise the funds for his expansion and how later he was able to prop up bad business.

**From local Italian milk company to international dairy giant**

After inheriting a small local Parma ham business in 1961, Tanzi founded Parmalat and grew it into first an Italian – and then a global – giant in the milk and dairy products industry. At its peak in 2002 it had a market capitalisation of €3.2 billion.

In its early years, Parmalat was a genuinely innovative company. As an ambitious young man, not content to remain a small, local ham producer, Tanzi sought new opportunities. His first successes were built on a move into the milk business, when he opened a milk pasteurising factory and launched Parmalat as the first branded milk produced in Italy. In 1964 he introduced Parmalat Vita C (pasteurised milk enriched with vitamin C) and, a year later, started selling milk certified to be tuberculosis-free, a major contribution to public health.

The following year Tanzi brought to Italy Tetra Pak’s new technology for packaging milk in cardboard cartons. The process, called ultra-high-temperature pasteurisation, created Parmalat’s cornerstone product – UHT ‘milk in a box’, able to be stored without refrigeration for six months. The innovation enabled Parmalat to charge a premium for what had been a commodity product, and by seizing the first mover advantage, which would not last for long, Tanzi was able to build up the resources to exploit the 1970 change in Italian law which permitted the sale of whole milk in grocery stores instead of only in licensed milk shops. When, in 1973, the
courts broke up the monopoly of the Centrali del Latte (municipal milk distribution centres), an important limitation on the spread of Parmalat’s products into other provinces across Italy was removed. At the end of the 1970s, Parmalat moved into new markets with the production of cheese, butter and a variety of desserts. International expansion began, with acquisitions in Brazil (1977), Germany (1977) and France (1979).

**Home, church and factory**

Tanzi embodied the values of many hard-working entrepreneurs in northern Italy, who are little known overseas and whose lifestyles are described in Italy as ‘casa, chiesa e fabbrica’ or ‘home, church and factory’. Despite the international spread of his business, Tanzi’s life remained focused on his hometown of Parma – the city of parmigiano (parmesan cheese) and the eponymous ham – with a population of 170,000. He was reputed to be in bed at 10.30 every night, at the office by 7 in the morning, at work six days a week, and at mass every Sunday.

Through Parmalat’s success, Tanzi was in the process of creating one of the giants of Italian industry. Yet outside of Italy and the milk industry, Parmalat and Tanzi had a much lower profile than most other big Italian family companies. The Benettons built a Formula One race car team, Fiat’s Agnelli family befriended presidents and married royalty, and Berlusconi used his Fininvest empire to propel himself to political power. In contrast, Tanzi lived a more modest lifestyle. But he did develop ties with Italy’s great and good – especially in the Catholic Church in Parma. Bankrolled by the success of Parmalat, he became a major patron of the Church and was active in social issues, sport and political parties.

In Italy the Catholic Church is not only a religion but also a political force, and this power was even greater in the 1960s, 70s and 80s. Explicitly it had moral authority over politicians and the public, and privately, it wielded influence through the connections and status of senior churchmen in society. Tanzi’s generous support of the Church was part of his strategy to build political influence in Italy, which in turn would foster his relationships with the banking community.

Parmalat’s sports sponsorship, which started with the ski world cup, was also innovative. No company had ever before demanded so much television exposure in return, which led to Parmalat becoming a world-recognised brand. This was followed by the sponsorship in Formula One of Niki Lauda, who always wore a Parmalat hat. This success led Tanzi into the world of football. Parmalat bought the small local team, Parma AC, in
1991. Over the following decade, backed by Parmalat’s cash, Tanzi’s son Stefan, as manager, turned Parma AC into one of the bigger names in European football, winning two UEFA Cups and one European Cup Winners’ Cup. Parma AC was a ‘vanity’ acquisition by the Tanzi family – to the detriment of minority shareholders, who receive scant protection under Italian law. It was a drain on Parmalat resources, since building Parma AC into a winning team was an expensive business, with heavy cash outflow to buy key players, and substantial operating losses (estimated at €100 million per year by Italians close to Parma AC).

Perhaps a measure of the company’s growing success was the takeover approach by Kraft Foods in 1988. This was dismissed by Tanzi but three years later, after 30 years as a family company, Parmalat listed on the Milan stock exchange. Tanzi, through his family company Coloniale, merged Parmalat with a publicly traded company, Finanziaria Centro Nord (FCN), which he controlled. (FCN subsequently changed its name to Parmalat Finanziaria SpA and became the parent company of Parmalat SpA, the main operating company.) This move enabled Parmalat to raise money through a share issue, selling stock to repay reported debts of 520 billion lire (€268 million), but with Tanzi’s family retaining 52 per cent ownership. Rumours circulating at the time that Parmalat had created offshore finance companies in the Dutch Antilles to hide the true level of its debt were never substantiated.

However, by wishing to remain a de facto family company Parmalat had sown the seeds of its own destruction. In order for Tanzi to avoid losing control, henceforth all acquisitions would have to be funded by borrowing rather than shares, placing great strain on the balance sheet.

**Explosive growth**

Parmalat’s rate of growth was little short of phenomenal. In 1991 it had annual sales of 1.3 trillion lire (€685 million), production facilities in six countries and 4800 employees. Over the next decade, Parmalat aggressively expanded overseas to become a global giant in dairy products. Parmalat went into 30 countries throughout South America, North America, Australasia and southern Africa, and in 1993 alone, it acquired 17 companies.

To finance its post-flotation acquisitions, Parmalat raised more than $8 billion in bonds. Over a ten-year period the company made over 30 bond issues, increasingly using non-Italian banks (especially Citigroup and

---

i Parmalat’s accounts do not report any other company or individual holding more than 3 per cent of the company’s shares during the period 1991 to 2003.
Bank of America) as a source of finance. But Tanzi’s relationships with Italian bankers were still strong – Luciano Silingardi, former chairman of a local Parma bank, had been on the Parmalat board since before 1988.

Some have interpreted Parmalat’s shift to dealing with international banks for its bond issues as reflecting a lack of competitiveness from the Italian banks for Parmalat’s business. Others have suggested that this indicated that Italian banks, which probably had access to more information on Parmalat – better local contacts, networks, possibly a more complete picture on the Tanzi family cash flows – had a different risk assessment for Parmalat than the international banks did. The Italian banks would also have been well aware of earlier concerns about Parmalat and the behaviour of Tanzi and Tonna. In 1993 four members of the Italian parliament asked the government to investigate the close links between Parmalat and its two main bankers, fearing conflicts of interest and possible illegality. After considerable delay, the Parma prosecutors’ office commissioned a report (delivered in May 1997) by an independent accountant, who concluded that by 1996 Parmalat was already in financial difficulties. The prosecutor, Judge Adriano Padula, declined to launch an investigation. In a separate matter, a year later, the same judge found Tanzi and Tonna not guilty of false accounting involving SATA, one of Parmalat’s financial holdings.ii

As a result, the local banks were less willing or able to provide further loans or to back bond issues for Parmalat.

A force to be reckoned with

Fausto Tonna, Parmalat’s long-time CFO and Tanzi’s right-hand man, had a fierce reputation within the financial community. He was prone to berating analysts who wrote critical reports on Parmalat and created tough competition among international banks for Parmalat’s business. This reputation actually gained him respect. He was seen as intolerant of fools, driving a hard bargain for his business and tough on analysts if they did not understand his business. Tonna was also feared inside Parmalat – employees would prefer to risk making mistakes than ask his advice.1

He was a difficult man to press with questions regarding the financing of the business as many analysts and bankers discovered, and most likely intimidated the auditors.2 He had built a strong power base within Parmalat, had a central hold on information and decisions and, at the same time, restricted the information flow to external parties. He was aided in

ii Since the collapse, reports have emerged that Padula had received free trips from a travel company controlled by Tanzi (Associated Press, 25 June 2005).
this by the wholly inadequate state of Italian accounting standards and disclosure requirements. Nevertheless, Tonna and Parmalat were seen as a source of much potential business by many banks, which were therefore willing to tolerate his behaviour.

**Going for broke**

Parmalat’s dominance in its home market continued to increase. In 1999 Tanzi bought the Italian milk-processing business, Eurolat, with operations in Argentina and the US, for €400 million (a very full price) from Italian entrepreneur Sergio Cragnotti’s Cirio group. Concerned by the possible effects of the acquisition on competition in the fresh milk market in Italy, the Italian Competition Authority authorised the acquisition only on condition that Parmalat disposed of a number of brands and production facilities. (This condition had not been fulfilled by the time of the collapse.) Parmalat’s many overseas acquisitions radically reduced its dependence on the Italian market, which in 1991 had accounted for 83 per cent of net sales. By the end of 2001, the whole of Europe accounted for only 33 per cent of sales.

Meanwhile, the privately held Tanzi family companies were expanding. In the late 1990s Parmatour, the family-owned tourism firm, acquired a series of other tour operators and hotels around the world. There had even been a brief and unprofitable foray into the media with the acquisition of Odeon TV. Odeon operated about a dozen stations but found it impossible to buy rights to popular programmes, losing out to Silvio Berlusconi, the media mogul who later became the prime minister of Italy. Tanzi sold the business in 1989, but reportedly $108 million of debt to suppliers stayed on the books of a Tanzi family holding company, SATA. Odeon filed for bankruptcy later that year.

The continued existence of these companies as separate entities (particularly the complex holding company structures) provided an environment, a framework and the opportunity for Tanzi to confuse the boundaries between the interests of the family and those of the outside shareholders. Parmalat lent money to the family companies and recorded this as investments; Parmalat provided guarantees to third parties on behalf of the family companies, and paid monies to family members disguised as fees or expenses.

On the surface at least, Parmalat approached the new millennium with confidence. In 2000 European sales exceeded €2 billion for the first time. The group held a leading market position in Italy and a strong market presence in Spain, Portugal, Hungary and Romania. South American sales also
reached the €2 billion mark, with a presence established throughout the continent and market leader positions in Brazil and Venezuela. North American sales jumped as well, from €1.9 billion to €2.4 billion. Parmalat had 50 per cent of the New York dairy market and a significant position in dairy products in the southeastern United States.

Although following further acquisitions in 2000, Parmalat had declared its expansion programme complete it still remained acquisitive. In October 2001 the company purchased the Brazilian assets of Kraft Foods’ dairy business, including the Gloria and Avare brands and some manufacturing operations. And the acquisitions continued – in mid-2003 the firm acquired Unilever’s South African cheese units.

**Things turn sour**

In January 2003 Parmalat was promoted to Milan’s blue chip Mib30 stock index from the mid-cap Midex. However, it received a lukewarm welcome, with its shares closing down 0.7 per cent on the first day’s trading, despite the fact that entry to the Mib30 typically boosted a stock, reflecting the needs of ‘index’ funds.

Market sentiment was undoubtedly affected by mixed analyst reports. Schroders Salomon Smith Barney (owned by Citigroup, one of the largest lenders and bond underwriters to Parmalat) gave an ‘outperform’ rating on the stock, UBS Warburg considered it a ‘buy’ and Merrill Lynch reiterated its ‘sell’ rating. Merrill Lynch had downgraded Parmalat to ‘sell’ from ‘buy’ in December 2002, citing its increasing cost of capital (due to exposure to rising inflation and exchange rates in Latin America), a lack of transparency on its cash flow, and the default of fellow food group Cirio.iii

Centrosim, an Italian brokerage firm, while rating Parmalat as ‘outperform’, estimated Parmalat’s net indebtedness as understated by at least €800 million and commented:

> Getting in-depth details about Parmalat debt’s structure is really hard work: this is why the stock has often been penalised.³

By January 2003, Parmalat shares were off 40 per cent from the high point in April 2002. Only a month later it withdrew a $360 million to $600 million Eurobond offer, citing unfavourable conditions in the bond and equity markets as well as ‘unhelpful’ market speculation.
At the end of March 2003 Parmalat announced its 2002 results. Year on year, turnover had slipped from €7.8 billion to €7.6 billion, but profits had increased from €218 million to €252 million (or some 15 per cent). In his presentation to investors, Tanzi described the period as ‘one of the darkest twelve months in the economic and political history of the last 20 years’. He cited particular adverse factors including the devaluation of every South American currency against the dollar and the euro, and no signs of economic recovery in the US and Europe. One enduring mystery remained. How did Parmalat consistently achieve higher margins than its competitors in a commodity business? This question had never been answered satisfactorily.

Tanzi also took the opportunity to revise Parmalat’s targets downwards for the next three years, forecasting a slowdown in organic growth to 3 per cent per year, a reduction in gearing and an increase in the EBITDA margin from 12 per cent to 13 per cent over the period. He remained confident, however, arguing that Parmalat’s sales and margins growth continued to prove that, in the right markets and with the right brands, good returns could be achieved for a company dominated by commodity products.

For reasons that remain unexplained, Tonna then resigned as CFO but, perhaps surprisingly, remained on the board as a non-executive director. Alberto Ferraris, a non-executive director since 1998 and Parmalat’s former account manager at Citibank, became CFO until November 2003, when Luciano Del Soldato replaced him. Many have expressed doubts as to Tonna’s role and the extent to which he continued to exercise influence over Parmalat’s accounts.

The decline continues

In September 2003 Parmalat reported its earnings for the first six months of 2003. Profits had fallen by 37 per cent to €120 million, due primarily to an extraordinary charge of €44 million for ‘company restructuring costs and other losses’. The balance sheet showed net debt of €1.8 billion: bank debt, bonds and debenture loans of €5.2 billion offset by cash and cash equivalents of €3.4 billion – a picture largely consistent with Parmalat’s previously reported 2002 half-year and year-end positions but, nevertheless, an improbable financial position.

This alone should have alerted the analysts in general and those of Standard & Poor’s (S&P) who rated Parmalat’s bonds, in particular, that there was something amiss with the accounts. At least one would have expected much more detailed questioning, especially against the background of
Parmalat’s reputation for being opaque. However, all that happened was for S&P to cut Parmalat’s credit rating outlook from ‘positive’ to ‘stable’.\textsuperscript{iv}

On 10 November, in response to market rumours and press speculation, Parmalat disclosed that in October 2003 Consob, the Italian market regulator, at the request of the Parma prosecutor, had asked Parmalat for clarification of some balance sheet items before it published its third-quarter results. Consob had raised questions about the accounting treatment of Parmalat’s current asset investments, debenture loans and the nature of its inter-company financing agreements. In reply, Parmalat had revealed details surrounding some of its Cayman Islands subsidiaries, in particular a financing vehicle called Bonlat. (Parmalat’s Cayman operations had been established in 1999, although Parmalat had had offshore financial subsidiaries in the Dutch Antilles, Luxembourg and Malta since the early 1990s.)

Parmalat claimed that it held current asset investments, through its Bonlat subsidiary, of €496 million in a Cayman Islands-based mutual investment fund called the Epicurum Fund, together with €1.5 billion in A-rated bond investments and promissory notes of €570 million. At the same time, Parmalat reported having recently bought back €550 million of bonds, bringing the total value of its own bonds that it had repurchased from the market, but not cancelled, to €2.9 billion.

**The Epicurum Fund**

The existence of the Epicurum Fund was news to most investors, and market speculation prompted Parmalat to issue further details of this investment the following day. This press release also reminded investors that Parmalat’s half-year financial statements were, in line with general practice, subject to an audit review, but not a full audit. In particular, Deloitte, the group’s auditors, noted:

Deloitte does not express an opinion on the book value of shares in the overseas mutual investment fund, Epicurum, recorded at subscription price, while awaiting publication of the fund’s first balance sheet as of December 31, 2003;

Deloitte is not, while awaiting the results of an independent appraisal commissioned by Deloitte itself, in a position to confirm the fairness of the recorded

\textsuperscript{iv} The credit rating outlook indicates S&P’s assessment of the possible direction in which a credit rating may move over the next six months to two years. Outlooks can be ‘positive’, ‘stable’ (unlikely to change), ‘negative’ or ‘developing’ (may be raised or lowered).
value of the amount collected by Parmalat within the context of a foreign exchange swap contract, which Parmalat believes has been fairly accounted for in that based on an expert appraisal carried out by the auditing firm, Grant Thornton SpA.  

A day later, on 12 November, Parmalat announced that it had decided to liquidate its investment in the Epicurum Fund and would receive approximately $600 million (€520 million) within 15 days. It explained that this decision was taken on the advice of the Epicurum Fund, because of the impact on the fund’s reputation of market and press speculation and rumours.

On 27 November Parmalat reported that the $600 million was to be repaid on 4 December, the Epicurum Fund having approved Parmalat’s liquidation of its investment. In the midst of all this, on 14 November, Parmalat’s board had released the third-quarter results for 2003. For the nine months to 30 September, Parmalat reported underlying sales growth of 4.1 per cent offset by negative exchange rate effects of 11.2 per cent, resulting in a net decline in consolidated sales revenues of 7.1 per cent. However, although profits declined in absolute terms, margins had risen, and were reported as being ahead of the same quarter of the previous year. In the balance sheet, Parmalat’s net debt position remained largely unchanged at €1.8 billion, but the value of cash and cash equivalents and bank debt and debenture loans had both risen by approximately €0.7 billion.

On 8 December Parmalat announced that the Epicurum Fund had failed to pay over the $600 million. The explanation given was that concurrent requests for liquidation received from the majority of the fund’s investors had led Epicurum to decide to proceed with the total liquidation of all the fund’s activities. The ensuing complexity made it impossible to meet the deadline previously agreed with Parmalat.

It was the final straw. Against this background, and unable to obtain short-term financing, Parmalat was forced to delay repayment of €150 million of bonds maturing on 8 December 2003 until the last possible deadline of 15 December 2003. Trading in Parmalat shares was suspended immediately pending clarification of the group’s finances.

The momentum was gathering. The next day Parmalat announced that it had engaged 69-year-old Enrico Bondi, a turnaround specialist, as a consultant to draw up an industrial and financial restructuring plan for the

---

Bondi, like Tanzi, had a reputation for austerity, reportedly getting to work at 6.30 a.m. every day and rarely giving interviews to journalists. While at Telecom Italia, he refused to have a chauffeur, preferring to drive himself in a Fiat Punto. He was described in the press as ‘a representative of a modernising faction within Italian business and finance’.
group. Bondi had built his reputation in the 1990s, when he saved the Italian industrial conglomerate Montedison from bankruptcy. His appointment was widely believed to be a condition of the banks’ continuing support of Parmalat.

**A sinking ship**

On Friday 12 December Parmalat announced that it had fully repaid the €150 million of bonds, enabling Parmalat shares to resume trading on Monday 15 December. Simultaneously, Parmalat announced the resignation of Luciano Del Soldato as CFO. Two more directors, Fausto Tonna, the former CFO, and Mario Brughera, chairman of the audit committee, resigned the following day.

Of the remaining five executive and five non-executive directors on Parmalat’s board, only two did not have family and/or employment ties to Tanzi – and both of those individuals had served as non-executive directors for over a decade. In fact, there had been no independent scrutiny of Parmalat over the years and that, combined with a large degree of complacency on the part of the board, had been a major contributory factor in the downfall.

At a board meeting on 15 December, Tanzi resigned as chairman and chief executive and from the board, as did his brother, Giovanni. A new three-member executive committee was appointed to run the company, led by Bondi and with two external turnaround experts he had appointed – a CFO and a legal specialist. Lazard and Mediobanca were retained as advisors. The following day, PricewaterhouseCoopers (PwC) was instructed to review the financial assets and liabilities of the Parmalat group – including derivative contracts and commitments – and particularly those of its financial subsidiaries.

On 17 December, Citigroup’s Smith Barney issued an analyst’s report reaffirming a hold rating, stating:

> Our broad conclusion is that an interim financing package will be finalised shortly, which should prevent liquidation, providing that substantial fraud is not discovered.\(^8\)

When asked the question, ‘Where is the cash?’ Citigroup responded:

> Our inability to reconcile the operating cash flow with the reduction of net debt has yet to be fully explained to our satisfaction by the company.\(^8\)
That same day, Bank of America’s New York branch informed Grant Thornton, auditors of Parmalat’s Bonlat subsidiary in the Cayman Islands, that it did not have ‘an account’ in the name of Bonlat. In doing so, Bank of America denied the authenticity of a document dated 6 March 2003, which the auditors had received via the company rather than directly from the bank. This document certified the existence of securities and liquidity amounting to €3.95 billion as at 31 December 2002 relating to Bonlat; it had been the basis for Grant Thornton’s signing-off on Bonlat’s 2002 accounts.

Grant Thornton immediately informed Consob, the Italian financial market regulator, which, in turn, informed Bondi. Parmalat shares were again suspended before trading opened on 19 December – this time indefinitely.

Then, on 19 December, after an extraordinary board meeting, Parmalat told an astonished world about the missing €3.9 billion. The board instructed Bondi to inform the judicial authorities, to cooperate with any criminal investigations and to draw up as quickly as possible a plan of action to protect Parmalat’s ongoing business.

Meanwhile, the Italian cabinet met and approved a new urgent legislative decree on measures to allow for the restructuring of major companies. Announcing the decree, Italian Industry Minister Antonio Marzano said that the objective of the updated rules for large companies, such as protection from creditors for two years, was ‘not to safeguard shareholders or managers but employment, the company, the company’s Italian nature and suppliers’. The decree created an extraordinary administration procedure enabling insolvent major companies to continue trading while undergoing economic and financial restructuring. In many ways, the new rules mirrored the Chapter 11 law in the US. This decree was subsequently approved by the Italian parliament in February 2004 and became the Marzano law, popularly referred to as the ‘Parmalat law’.

The decree was widely seen as made-to-measure for Parmalat. A parliamentary commission soon afterwards tabled a proposed reduction in jail time for crimes associated with bankruptcy. Companies accepted into extraordinary administration were given 180 days to prepare a financial and industrial restructuring plan approved by the Minister of Productive Activities (‘the Minister’). Creditors’ interests were protected by the Extraordinary Commissioner (Bondi), the Minister and his advisors, and by the ‘procedural aspects and judicial resources’ of the extraordinary administration. Under Italian law, however, there was no role for any formal creditors’ committee as would be the case in, for example, the UK.

On 24 December 2003, Parmalat SpA was placed under the new extraordinary administration procedure and on 27 December it was declared insolvent by the Court of Parma. By 30 December, Parmalat Finanziaria
SpA (Parmalat SpA’s parent company) and the Eurolat SpA and Lactis SpA subsidiaries were all under extraordinary administration, with Bondi appointed Extraordinary Commissioner for the companies. In the following days, Bondi took the Tanzi family’s private companies into extraordinary administration, most notably the Parmatour and Coloniale groups. Bondi suddenly found himself president of a major league football team – Parma AC had fallen under his extraordinary administration.

Criminal investigations

While Bondi was busy controlling the implosion of Parmalat’s business and trying to secure the company’s future, others were more interested in the past. Criminal investigations were launched in Italy within days of Parmalat’s collapse, leading to numerous searches and arrests. It was a race against time; prosecutors rushed to raid offices before incriminating documents could be shredded. Rumours circulated of desperate Parmalat employees smashing computer hard drives with hammers in an attempt to destroy evidence. Calisto Tanzi and his wife, meanwhile, were on holiday, visiting a Catholic shrine in Portugal and then off to Ecuador before returning to Italy, where he was arrested on 27 December.

As the scandal unfolded, Parmalat employees reportedly had money to hide as well. Investigators discovered details of bank transfers and withdrawals by Parmalat executives in the weeks leading up to the collapse. In January Tonna’s wife was arrested, accused of improperly withdrawing €0.8 million in cash from a Parmalat bank account.

Later in January, one of Tonna’s former assistants, Alessandro Bassi, committed suicide by jumping from a bridge after being questioned by investigators. Police ruled out the possibility that he had received threats.

A month after Parmalat’s implosion, Bondi gave the world a picture of the scale of Parmalat’s problems with the publication of the interim findings of the PwC investigation. PwC had established fairly quickly the full extent of Parmalat’s debts – €4.2 billion of bank loans, €9.4 billion of outstanding bonds and €1.2 billion of other liabilities, offset by only €0.5 billion of liquid assets. Questions of where the money had gone were less easy to answer.

Furthermore, 2002 revenues had been overstated by €1.5 billion (€6.2 billion vs. €7.7 billion reported); EBITDA by €0.6 billion (€0.3 billion vs. €0.9 billion reported); net debt had been understated by €12.5 billion. Parmalat’s real indebtedness was €14.3 billion, as opposed to the €1.8 billion net debt it had reported at 30 September 2003 and in its 2002 and 2001 accounts.
In the following weeks, Parmalat’s Brazilian subsidiaries entered into bankruptcy procedures, its US operations applied for Chapter 11 protection, and its subsidiaries based in the Netherlands and Luxembourg were taken into extraordinary administration. Meanwhile, the former head of Parmalat’s operations in Venezuela, Giovanni Bonici, was questioned by investigators following the discovery of the purported sale of hundreds of millions of dollars’ worth of non-existent powdered milk to Cuba through a Singapore-based holding company.

Throughout April and May 2004 additional Parmalat-related companies were admitted to Bondi’s extraordinary administration, and some of the overseas subsidiaries were sold. Among the first to go was Parmalat Thailand, followed by Parmalat Chile.

Parmalat had raised much of its capital through private placements and publicly tradable bonds, spreading the risk – and pain – of Parmalat’s collapse across the world’s financial institutions and investors. There were so many creditors for Bondi to deal with that the Court of Parma had to open a call centre and a website to assist creditors in registering their claims. Everyone who was anyone had a claim on Parmalat debt, from Citi- group ($689 million) to individual Italian bond investors to the local dairy farmers, unpaid since August 2003 and owed more than €100 million.

How did Parmalat do it?

Quite how Parmalat had disguised its true level of debt was as yet far from clear. Nevertheless, from the US Securities and Exchange Commission (SEC) lawsuit against Parmalat, as well as Italian investigators’ allegations leaked to the press, and other sources, it was possible to indulge in a bit of intelligent guesswork. At the end of the third quarter of 2003, Parmalat had reported net debt of €1.8 billion – €4.2 billion of cash and cash equivalents offset by €6.0 billion of bank debt and debenture loans. As Bondi and PwC later reported, true net debt appears to have been €14.3 billion, with some of the difference accounted for by the non-existent €3.95 billion Bank of America account; Parmalat had not bought back €2.9 billion of its own bonds, as it had reported earlier in 2003. It appeared that the bonds were still in circulation and held by third parties. It is unlikely that the cash (€496 million) in the Epicurum Fund had ever existed and there are similar doubts about the €1.5 billion in bonds and €570 million of promissory notes and commercial paper disclosed in Parmalat’s third-quarter 2003 accounts. Also questionable was the $819 million (€640 million), which Parmalat had claimed to be held by
various banks under ‘participation agreement’ transactions to finance group companies in other countries. Uncertainty also surrounded the conditions under which Parmalat had factored €611.7 million of invoices and the full extent of the exposure of Parmalat’s foreign exchange hedging contracts.

Bondi’s investigations found that the debt had been spread widely through Parmalat’s structure of operating and holding companies, propped up by guarantees which all led back to Parmalat SpA (the primary operating company) or Parmalat Finanziaria SpA (Parmalat SpA’s parent company).

Alleged confessions or admissions from Fausto Tonna, the former CFO, indicated that much of the €14 billion had been used to hide losses dating back to the early 1990s. Tonna was also reported to have claimed that annual losses ran at between $420 million and $540 million from 1995 to 2001, caused by inefficient factories, poorly managed inventory and costly acquisitions.10

The behaviour of the international banks requires some explanation. The Italian market is relatively small, with not so many suitable clients to compete for, and where strong relationships exist. An incomer would have to be fairly aggressive to get the business and might have to accept a higher degree of risk. On the face of it, Parmalat was an attractive client. It had a good ‘name’, and all the evidence was in place: audited accounts, a stock exchange listing and an S&P rating, albeit a lowish one. Most of the debt was in the form of bonds, which meant less credit risk on the banks’ own balance sheets. Parmalat had a record of meeting its interest and bond payments on time; it paid good fees and commissions and generated a high volume of business paying above average interest rates. Against this background, the banks focused on their own positions, not Parmalat’s total exposure, and doubtless took comfort from the others with bigger exposures who continued to lend. This became a vicious and dangerous circle of self-reinforcing mutual reliance.

The investigations into Parmalat’s hidden debts brought out of the shadows and into the limelight another interesting character alleged to be implicated in the scandal. Gianpaolo Zini, the head of Zini and Associates, was arrested and a number of his employees were subpoenaed by the US SEC.

Zini had established the New York office of Pavia e Ansaldo, one of Italy’s largest independent law firms, in the 1990s. In 2001 Zini left Pavia to set up his own firm, taking the Parmalat account, virtually his only client, with him. With offices in New York and Milan, he employed 4 junior partners and approximately 25 lawyers. Zini was regarded as a temperamental and unpredictable character with a long-standing close – and closely guarded –
relationship with Tonna. For all practical purposes, he was Parmalat’s de facto in-house counsel. Zini’s involvement came under scrutiny in part because of his firm’s role in establishing and administering a number of Parmalat’s Cayman Islands off-balance-sheet vehicles, including the Bonlat subsidiary, which held the mysterious Epicurum Fund investment. Zini would subsequently receive a two-year sentence for his part in the scandal.

Bondi had dismissed Parmalat’s external auditors, Deloitte & Touche, within days of taking charge. Deloitte & Touche had been the Parmalat auditors since 1999, when Italian law had forced the company to rotate its auditors, replacing Grant Thornton. The press soon discovered that in 2001 and 2002 a partner in Deloitte & Touche’s Brazilian firm had communicated concerns to partners in Italy about transactions related to Parmalat’s Bonlat subsidiary. Documents leaked to the Wall Street Journal purported to show that an Italian partner had written to the US head of Deloitte’s international network warning that questions raised by the Brazilian auditor could result in the loss of its multimillion-dollar worldwide engagement with Parmalat. In the light of that warning, and under pressure from New York, Deloitte Brazil had not qualified the 2002 accounts of Parmalat’s Brazilian subsidiary. Instead the auditors’ opinion included a note emphasising that the inter-company transactions at issue could have resulted in a different outcome if undertaken with companies not associated with the Parmalat group. These disclosures were never mentioned in the consolidated reports of Parmalat itself and, of course, had much less effect than a qualified audit report would have had.

Grant Thornton had been Parmalat’s main auditors from 1996 to 1999, but in reality, had been Parmalat’s auditors for much longer. Hodgson Landau Brands, an Italian division of the HLB International accounting group, had joined the Grant Thornton network in 1996, bringing with it the Parmalat account which it had held for some years. From 1999 to 2003, Grant Thornton had retained the audit of several Parmalat subsidiaries – including Bonlat. It too was dismissed by Bondi. Initially, subsidiaries holding 22 per cent of the Parmalat group assets were examined by auditors other than Deloitte, increasing to 49 per cent by 2003. Shortly after the Parmalat scandal broke, Grant Thornton International expelled its Italian unit from the accounting firm’s global network, whereupon it renamed itself Italaudit. This would not solve the auditors’ problems.

It soon emerged that Grant Thornton had been instrumental in setting up a series of offshore investment vehicles for Parmalat in the Dutch Antilles, many of which were later closed down and replaced with the Cayman

---

vi Italian law, requiring regular audit firm rotation, is stricter than the US SEC in this respect, which only requires rotation of audit partners within firms.
Islands subsidiaries – including Bonlat. In addition, the former Hodgson Landau partner who had signed off Parmalat’s accounts from 1990 to 1992 had become the managing director of a number of Parmalat’s Dutch Antilles companies. Deloitte & Touche and Grant Thornton went straight onto the hit lists of investigators and litigants. Both also became embroiled in an investigation of Parmalat by Italian tax authorities and in Consob’s challenge to Parmalat’s 2002 accounts.

The importance of tax laws and their evasion lies in the impact they have on Italian accounting and banking. It is common practice in Italy for family businesses to create a complex web of bank accounts and holding companies – both within the country and in offshore havens – which undoubtedly occurred with Parmalat. This meant that Parmalat was already a complex and non-transparent business even before it gained a stock exchange listing. It had a legacy of complexity which made it easier for Tanzi and Tonna to hide losses and debts. But the complexity in Parmalat’s treasury management structures (Dutch Antilles, Luxembourg, Malta, Cayman Islands) is not unusual within the Italian context.

S&P was also among those embarrassed by the fall-out from Parmalat’s collapse. Police searched the agency’s Milan office, in the course of investigating how much the various financial institutions knew about Parmalat’s problems before its collapse and trying to find out if S&P had been given false information. S&P subsequently claimed to have been the victim of deception and fraud.

Bank of America’s Milan office was one of the first places to be raided. The search warrants were issued on the suspicion that Bank of America employees had known about the true condition of Parmalat’s finances when working on bond issues. A major advisor to Parmalat, Bank of America quickly wrote off $134 million of Parmalat loans and derivatives. It had issued nearly €1 billion of private placements of Parmalat securities from 1997 to 2003.

In March 2004 prosecutors formally filed applications for indictments. Calisto Tanzi and Fausto Tonna headed the list, accompanied by the Parmalat board, internal auditors and senior executives. Charges primarily related to misleading markets about Parmalat’s finances. The crimes carry a maximum penalty of five years in jail. After a bit of plea bargaining on Tonna’s part, he was sentenced to two and a half years’ imprisonment in June 2005. Tanzi’s attempt at plea bargaining was rejected, the authorities being adamant that he should stand trial. Three months later, Milan prosecutors requested indictments for Citigroup, Deutsche Bank and Morgan Stanley for alleged securities violations.
In passing, it is worth noting the unusual speed with which the Italian authorities brought prosecutions and secured convictions. A very different story to that of Enron!

**What went wrong and lessons to learn**

Parmalat grew rapidly outside its Italian home base, particularly in the Americas, through a series of expensive acquisitions. As these acquisitions were paid for in cash, Parmalat was required to issue more and more bonds which placed great strain on its balance sheet. The difficulty of managing from a distance, and the lack of an adequate control system, together with the collapse of the South American currencies, compounded the problems.

**Fraud was a contributing factor**

In order to disguise cash problems and poor operating results, Parmalat used highly dubious accounting practices dating back to the early 1990s. That these were accepted by first Grant Thornton and later Deloitte & Touche allowed Parmalat’s problems to remain hidden for much longer than should have been possible. Furthermore, Tanzi was able to continue to fund his losses and to pay for his ambitious expansion plans because of the willingness of the banks, Italian and foreign, to continue to lend on a ‘name’ basis, without adequate due diligence.

Had the banks not been provided with fraudulent accounts from the early 1990s, they would not have lent Parmalat the monies to fund its rapid expansion; Parmalat would not have been able to become so over-extended; and the banks would not have been so exposed. Similarly, if the auditors had been effective in spotting the more glaring examples of fraud, like the fictitious Bank of America account, bondholder losses might have been less, despite S&P’s failure to accurately track Parmalat’s bond issues.

**The consequences of retaining family control**

The determination that Parmalat remain a family-controlled company severely restricted its financing options. This was compounded by Tanzi’s inability to distinguish between company and family funds, and his diversion of funds from the main business to prop up failing family businesses was another drain on cash. His ‘vanity’ investments in football with Parma AC, and television with Odeon, further bled cash. The board, consisting as
it did of relatives and friends, exercised no control over Tanzi or Tonna, and did little, if anything, to act as a restraining influence. This, together with the Tanzi family’s desire to retain voting control, effectively prevented Parmalat from being run as a normal public company, with an appropriate capital structure. The high debt alternative was unsustainable and directly contributed to the downfall.

The Italian effect

The strong control exerted by both Tanzi and Tonna over dealings with analysts and the press, coupled with the general lack of transparency in Italian accounting and the less than effective external scrutiny by both Consob and the Bank of Italy helped Parmalat to conceal its problems. One suspects that the foreign banks did not take sufficient account of the very different business culture in Italy when making their lending decisions.

The perils of overexpansion

Parmalat’s much admired dramatic growth in the 1990s, primarily through overseas acquisitions and financed by issuing bonds rather than shares, was a proximate cause of its collapse. History has shown that such expansion is often a way to destroy value and even cause companies to fail.

Furthermore, such expansion can place intolerable strains on management capacity and jeopardise the chances of achieving synergies or successfully integrating the acquisitions. Leaving local management in charge, without adequate supervision or controls, can be a recipe for disaster. Parmalat made the same mistakes as Ahold, with even more dire consequences.

The key messages are:

1. Shareholders investing in family-controlled companies run additional risks as the interests of the family will always come first.
2. Mandatory rotation of auditing firms will not necessarily resolve problems with the misuse of accounting and fraudulent financial statements.
3. It is dangerous to assume that others have done the necessary due diligence. Better to do your own, and be wary of investing in companies where even the analysts have difficulty understanding the accounts.

4. Departures from core activities, especially into glamorous fields like football clubs and television stations should flash warning signs about the motivations of management.

Notes

1 IMD research associate interview with insiders.
2 IMD research associate interview with insiders.
5 IMD research associate interview with insiders.
In the preceding chapters we have tried to demonstrate that the causes of corporate failure are, as we postulated at the outset, surprisingly few and common to most cases. We have also tried to separate symptoms from causes; to dispel the myth that the problem lies in accounting per se; and to highlight what really matters.

The recurring themes are poor strategic decisions; overexpansion, especially through often ill-judged acquisitions; the dominant CEO or ‘one man band’; the greed, hubris and lust for power of CEOs and other ‘star’ performers; poor risk management and weak internal controls, particularly with regard to cash; and ineffective boards and their audit committees.

We reiterate that fraud is rarely the underlying cause of a company’s downfall. Where it occurs, either the fraud was possible as a result of lax or non-existent controls, or it was deliberately perpetrated in order to cover up management failings. In the case of Barings, the size of the fraud was sufficient to wipe out the bank’s capital and much more, but the real problem was the lack of internal controls which allowed it to happen and to last for so long. This was compounded by the staggering ineptitude and stupidity of those who, without question, continued to send the margin call money to Singapore.

In the other cases, the accounting fraud was either a sometimes desperate attempt to conceal the extent of the company’s self-induced problems or an attempt to match stock market analysts’ expectations (Enron, WorldCom, Parmalat). Either way, auditors should have provided early warning but failed to do so.

In our increasingly complex business world, it is necessary to provide safeguards for investors, creditors and, indeed, society as a whole. Some of these tasks have been delegated to the auditing profession, and to a
Poor auditing allows problems to remain hidden, thus preventing those who rely on certified numbers to make their investment or lending decisions from reaching a properly formed judgment. One example was Arthur Andersen, whose craven behaviour, in its desire to keep a profitable client, undoubtedly enabled Enron to fool the market for much longer than should have been possible.

The rating agencies have also failed to provide early warning of troubles ahead. In none of the cases we looked at were they ahead of the game. Under the present arrangements, where those rated pay for the privilege, the agencies have a conflict of interests. We wonder how long the US authorities, specifically the Securities and Exchange Commission (SEC), can allow this oligopoly (which they in fact created) to continue unregulated. Surely the time has come for a major rethink.

Investment banks and their analysts are not free from blame as they whipped up investors’ hysteria during the last years of the bull market by issuing misleading research reports praising companies which, in some cases, they knew were worthless. The resultant share price bubble, combined with huge option packages, increased CEOs’ incentives to meet analysts’ expectations and thus support the share price. Fund managers became overly sensitive to the tiniest fluctuations in earnings with even a small shortfall having a drastic effect on a share price. But companies’ earnings are by nature volatile. To achieve the appearance of even growth requires the manipulation of the accounts. From such small beginnings as ‘cookie jar’ accounting, for some it is but a short step to more pernicious forms of misleading or fraudulent accounting.

**What has been done?**

In 2002, in response to public outcry, the US Congress passed the Sarbanes-Oxley Act (SOX) in the biggest shake-up of corporate regulation since the 1930s. The Act has four main thrusts: the implementation or improvement of internal controls (the, by now, infamous section 404);¹ the strengthening of the role of the audit committee; the independence of non-executive directors; and the requirement that directors explicitly recognise their responsibility for the company’s financial statements. There is also a

¹ Section 404 requires an annual internal controls report in which management state their responsibility for establishing and maintaining adequate internal controls and procedures for financial reporting, and at the end of the year give an assessment of the effectiveness of the internal control structure and procedures.
requirement to provide support for ‘whistle-blowing’ for concerned (or, as we fear, disgruntled) employees. In addition, SOX prohibits auditing firms from providing many other services to their audit clients in order to prevent conflicts of interest, a provision we endorse.

In the UK, the ‘Combined Code’, which came into being in the wake of a number of major financial scandals in the 1980s and early 1990s, has been updated to take account of the Higgs committee on the role of non-executive directors and the Smith report on the functions of audit committees. Adherence to the code is voluntary, but if listed companies do not follow it they must explain why not. In the European Union, a draft directive on the auditing of company accounts has been issued, and another, on non-executive directors, promised. Similar initiatives, like the Tabaksblat Code in the Netherlands – also voluntary – have been seen around the globe. Even the tiny island of Mauritius has its own code. All seek to deal with the issues we have outlined.

Predictably, these various codes and requirements, especially SOX, have received widespread criticism. Many companies are finding compliance to be expensive and onerous and doubt the effectiveness of it all. The problems are being compounded by the leading accounting firms, which, no doubt trying to make up for fees lost in other areas, are, in our opinion, behaving badly by exaggerating the difficulties of SOX compliance and offering extensive and expensive consulting time to assist. It is all rather reminiscent of the Y2K saga, when IT consultants – and hardware and software vendors alike – made a fortune, but the world did not come to an end as even those who declined to be duped suffered few difficulties. While some requirements amount to little more than ‘box ticking’ (or ensuring that procedures are adequately documented), the general thrust of these codes, by encouraging greater director independence and better all round controls, has validity.

However, we believe that they are unlikely to do much to prevent future failures and scandals, as they do not (and we believe cannot) address the fundamental causes we have set out. Certainly, they should prevent some of the more outrageous behaviour evident in the cases we have examined, but will not, on their own, be sufficient. We therefore outline what more needs to be done by companies and by external agencies.

**A first priority: Improving boards and boardroom performance**

Recent events have put the spotlight on corporate governance as never before. In each of the examples we have used, the board has failed in its
responsibilities to shareholders and other stakeholders. The director ‘gene pool’ has been too small. Too often cronyism has been evident; the directors have not had the necessary knowledge or specific industry experience required to make an effective contribution (Swissair, Ahold and Marconi); and, in most cases, have allowed themselves to be dominated by the CEO. This must be wrong. The CEO should be the servant of the shareholders and board, and not the other way round. Perhaps the settlements paid by Enron’s and WorldCom’s directors, or the personal liability suits outstanding in other cases, will improve board behaviour. More likely, it will frighten off suitable talent, especially in light of the SOX provisions.

A fundamental question is whether one can define and legislate for the independence of non-executive directors that most of the new codes require. In our view, the answer is no – independence is a state of mind, the willingness to ask tough questions and get answers, and to walk away if not satisfied. If this became the norm, then board behaviour would take a turn for the better. Trying to explain the sudden departure of a board member causes problems for companies which then might think twice about ignoring the concerns of the non-execs. There is a fine line between having a docile board which falls in line behind the management and a confrontational board which impedes the smooth running of the company. Maybe the answer, which cannot be legislated for, despite perhaps being the most effective solution, would be for each board to have at least one director who is a stickler for keeping the rest on the straight and narrow.

However, there are some simple things that could be done at little cost or inconvenience: limit the number of board directorships that any individual may hold (already the case in some countries); limit their period of service to no more than ten years; require that independent directors meet on regular occasions without the company’s executives being present; and pay them properly to compensate for the additional time that will be required to carry out their obligations under the new regimes.

As part of a necessary system of checks and balances, we believe that the roles of chairman and CEO should be separate in all cases. Each has a separate and distinct contribution to make. We further believe that a retiring CEO should not step up to the chairman’s position as that risks emasculating or at least overshadowing the new incumbent.

At a practical level, the chairman should set the agenda for board meetings, in consultation with the CEO, and appropriate papers should be sent out to directors in good time so that they can properly prepare for the meeting, which would make for a more constructive use of time. An effec-
tive board which reviews strategy plans and questions management thoroughly should act, at the very least, as a brake on poor decision-making and at best, be a positive force, using its wider vision and experience to direct the company onto the most profitable path.

Shareholder involvement

There is a clear need for more shareholder participation. We believe that all directors should stand for election at the same time, preferably annually, rather than have staggered elections (or re-elections) which may mean that it takes years to change the full board. It should also be made easier for shareholders to nominate directors, unlike the present arrangements in the US. Instead of shareholders voting on an advisory basis, their approval should be required for the full compensation packages of directors, including cash bonuses, options and pension contributions.

We believe that separate classes of shares with different voting rights, which are generally designed to limit ordinary shareholders’ influence, are no longer acceptable and should be outlawed. In the Ahold case, preferred shares were issued at par value rather than market value which meant that they had a disproportionate weighting, with 19 per cent of votes compared with 6 per cent of market value. These shares were transferred to a foundation set up by management, which was thus able to control the votes. Such behaviour is at odds with the concept of shareholder democracy.

Institutional investors must reconsider their role in corporate governance. In the past, if they did not like what was happening in a company, they sold up and invested elsewhere. In most countries, institutions are now the largest category of shareholders and, as such, they should exercise the voting powers that they have to influence events. This is especially important with regard to board composition and executive compensation. Their former passive stance is no longer acceptable.

We believe that there are special risks for shareholders in companies that remain under family control (Parmalat), as the directors will almost invariably put the family’s interest first. In such cases the need for strong independent directors and auditors becomes even greater.

The need to realign executive compensation

Executive compensation packages should be designed to encourage long-term thinking and focus on long-term achievement with some penalty for
poor performance. The granting of share options, which are just a one-way bet, should be avoided. If share options are used, they should be expensed immediately. A better incentive scheme would involve restrictive shares whose value can go down as well as up. Awards based, partially at least, on relative performance – say, on how the share price moves relative to an index of its peers – would avoid the problem of excessive, or negligible, rewards because of generally improving, or deteriorating, market conditions. Any share awards should be conditional on their being held for a minimum of a year after the beneficiary (CEO or other senior executive) has left the company (apart from any sale necessary to pay tax on the award) or, if still with the company, until a suitable period, perhaps three years, has elapsed. Guaranteed bonuses, which are simply salary by another name, should be banned, and all executives should be on no more than an annual rolling contract except in very special circumstances such as inducing individuals to assist a company to emerge from Chapter 11. Company perks such as the private use of aeroplanes should be disclosed in annual reports at their pre-tax value. Company-funded charitable donations have been abused in the past with CEOs like Kozlowski taking the personal credit while seeking to boost their own status in the community. We believe that all company-funded charitable contributions should be in the name of the company and not of individual directors and should be listed in the annual report, subject to a de minimus level. Board approval should be required for donations over, say, $100,000 and for all political donations. All executive outside interests must be disclosed to the shareholders.

In some countries executive pay has spiralled out of control. The multiple of executive pay to average production worker earnings in the US has gone from 180 to 431 in the nine years from 1995. Compensation consultants have contributed by encouraging companies to pay their executives within a specific quartile of executive pay. This means that pay rates are continually ratcheted upwards as successive companies increase pay awards to keep them in the desired quartile. Non-executive directors, who are often senior executives themselves, have little incentive to restrict this upward movement. Perhaps compensation committees should have a majority of members who are either retired company executives or who are established in different areas such as academia or the legal profession. However, it seems unlikely that the absolute level of executive pay will be reduced as it would require a concerted effort across all companies. While impossible, and indeed not desirable, to entirely remove greed and the desire for power from CEOs’ ambitions, by insisting on compensation packages that focus on long-term performance, it should reduce their
incentive to increase short-term earnings at the expense of the long-term health of the company. This might act as a curb on making reckless acquisitions, as all such would need to deliver the promised benefits before the CEO received his own reward.

**Increase the involvement of the audit committee**

An effective audit committee will ensure that both internal and external auditors keep it informed of any control problems and any issues with regard to the financial statements. It should be backed up by a competent internal audit department, reporting directly to it, with a well-thought-out audit programme able to identify problems before they become critical. The committee should see that audit recommendations (both internal and external) are followed up and implemented where appropriate. As directors, members of the audit committee are able to put strong pressure on management to implement changes. They can thus help to restore shareholders’ confidence by insisting that the company’s financial statements show a true and fair view of the company’s financial position.

**Reform of the investment banks**

Investment banks and their analysts have been urged by judges and regulators alike to erect stronger barriers between banking services and research, especially on the ‘sell side’ where analysts in the past have assisted the bank to secure new business by implicitly promising favourable reviews. Doubtless this will work for a while but temptation will eventually prove too much. The late Jimmy Gammellii used to say that he had never seen a Chinese wall that did not have a grapevine growing over it.

More effective would be to curtail or prohibit banks from accelerating their earnings as they presently do. Huge deal and arrangement fees are booked upfront contributing to large bonus pools which are then quickly distributed to the deal makers. Thus, as with Enron, they have an incentive to conclude any deal, even when they may be doubtful about its particular merits. It also leads banks to tout (often unsuitable) takeover targets to their corporate clients in order to generate more fees.

Were banks required to recognise such fees over the period that they had the continuing loan (or other) exposure, or make fees dependent on the

---

ii J. G. S. Gammell, CA, former senior partner of Ivory & Syme, a leading Edinburgh investment house in the 1970s and 1980s; non-executive director of Pennzoil, Bank of Scotland, and so on.
satisfactory achievement of the deal’s objectives, we might rediscover a more prudent approach to lending or deal-making. Where banks are merely conduits, for example in selling clients’ bonds to the public, they should have more prudential responsibility and be liable to sanction if they fail in that regard. This should not just be potential monetary penalties, since it would appear that many banks, particularly in the US, regard these as merely costs of doing business. The threat of corporate or individual banking licences being revoked would be much more effective.

Anything that can be done to encourage responsible behaviour by the investment banking community should be done, as it was their greed that led to the provision of the monies that allowed Parmalat, Enron and others to behave as they did.

Reform of the accounting profession

The current problem of the public accounting profession needs to be addressed. In almost all the cases we have looked at, some fault lies with the auditors. And there can be no excuse as the concerns are not new. Forty years ago, Leonard Spacek, Arthur Andersen’s successor as senior partner of the firm he had founded, was a vigorous advocate of auditors facing up to the challenges of the day. A collection of his articles and speeches over a 15-year period to 1969 had titles that are as relevant today as they were then: ‘Accounting has failed to prevent major misrepresentations’; ‘The elusive truth of business profits’; ‘Professional accountants and their public responsibility’; ‘Unrealistic profits and the stock market’; ‘Accounting is being challenged – do we have the solution?’; ‘The auditor is also accountable for his work’; and many more in the same vein. His efforts and drive to meet these challenges led to Andersen being regarded as the epitome of probity and the gold standard of auditing. Yet, three decades or so later, it became the first, but possibly not the last, of the major accounting firms to come to grief. A dispassionate observer might wonder how it had come to this. The answer is all too simple – greed overcame the profession. In the 1980s, in a desire to win new clients (and with the new found freedom to advertise), firms engaged in the practice of ‘low balling’. In other words, they pitched audit fees at a low level in the hope that, once the audit had been secured, they could then sell their more lucrative consulting and advisory services to a now captive client. As a strategy, this might have been fine initially, but soon the rationale for low audit fees was forgotten. The audit partners were put under pressure by their consulting counterparts to generate higher fees or, at least, earn higher
profits. This could only be achieved in one or more of three ways: by over-leveraging partners’ time (in other words, increasing the number of audits they supervised); by de-skilling the audit team (using more junior, therefore less expensive, personnel); and, although not publicly admitted, by ‘cutting corners’ and doing less work than necessary to form a proper opinion. The inevitable outcome was a decline in the standard of audits.

Despite the fact that the auditing profession has never been held in less regard, there is little sign of its leaders facing up to this. Instead, we see a profession in denial, pleading to have future damages claims capped and to have the restrictions on performing non-audit work eased. But there is little evidence of *mea culpa*. If the profession is to regain public confidence – and that will not come easily – as a minimum it must accept some responsibility for what has happened.

There should also be a clear statement of intent to put the house in order; a drive to improve international auditing standards and their enforcement; and, crucially, the consistent application of standards in the international firms.

Initial signs are not encouraging. SOX provided for the establishment of the Public Company Accounting Oversight Board (PCAOB) to oversee the work of the accounting firms. In its report on a review of KPMG, published in October 2005, it found serious deficiencies in about a quarter of the audits examined. It appears that some have not yet learned the lessons from the recent scandals.

It remains a mystery why the relevant competition authorities ever allowed the huge accounting firm mergers of the 1980s and 1990s which reduced eight to five. Now, some partners in the remaining firms believe that, with Andersen gone, they have a measure of protection against prosecution or other government action because no one wishes a further reduction. They point to the relatively lenient treatment of KPMG in the tax shelter scandal in 2005 as proof of this. Such an attitude is not conducive to thorough self-examination and reform. Therefore, we believe that a further radical step is necessary. The remaining ‘big four’ firms should be broken up, perhaps by reversing the earlier mergers or, if not that, then in some other way. Only when we have enough firms to allow clients a real choice, and where none can feel any complacent sense of immunity, will we see real reform.

The problem of opaque accounts has also been driven, at least partially, by auditors. Americans were the first exponents of the ‘true and fair’ principle in presenting accounts, which continues to be the overarching principle in other jurisdictions such as the UK. In the US, however, fear of

---

*iii In August 2005, KPMG reached a settlement agreement with the US Government, acknowledging wrongdoing, agreeing to pay a $456 million penalty and to limit the scope of its tax practice.*
costly litigation forced the accounting standards body to issue more and more prescriptive, and detailed, rules. The purpose being that if auditors can prove that – in very separate decisions – they have followed the relevant standard to the letter, they cannot be sued. The fact that, as with Andersen and Enron, the sum of all these decisions can result in a picture that is far from ‘true and fair’ has apparently become irrelevant. We advocate the reinstatement of the overriding principle to produce accounts that present an accurate picture of the corporation as a whole.

‘Profit is an opinion, cash is a fact’

The old adage has never been as true as in the recent past. Any astute analyst of Enron, Parmalat or WorldCom should not have failed to realise that there was a distinct mismatch between reported profits and the cash generated from operations. In each case, rapid expansion, often using debt to finance acquisitions, was putting an intolerable strain on cash flows. At Enron, it led to the concealment of debt; at Parmalat, the fraudulent claims of having bought back bonds; and at WorldCom the improper capitalisation of expenses. Perhaps one reason that this mismatch is often overlooked is a continuing focus on EBITDA, still frequently used in bank covenant requirements and described by some as a proxy for cash flow. This totally mistaken idea may prevent some analysts from undertaking the necessary detailed study of companies’ cash flow statements.

Companies do not go bust in the long-run. Rather they fail when they run out of cash (or credit lines), which was certainly the case with Rolls-Royce in the 1970s. Prudent non-executive directors spend a lot of time and effort making sure that senior management is properly managing cash and that they, as board members, can reconcile reported profits with reported cash flows. Those investors wishing to avoid becoming victims of over-ambitious CEOs would do well to follow suit. Always follow the cash.

What next?

We think that the next round of major scandals may be centred on hedge funds, especially ‘funds of funds’. Despite the major problems at Long-Term Capital Management (LTCM), where even Alan Greenspan feared a systemic risk to world banking, there has been a mushrooming of this activity, with an estimated 8000 such funds worldwide. These are largely unregulated and free to engage in highly leveraged speculation in shares and derivatives, with concomitant levels of risk. The portents are not good. The
first half of 2005 saw a number of problems emerge, and growing demands on both sides of the Atlantic for regulation. Hedge fund involvement in takeovers and leveraged buy-outs has also been the subject of criticism as these funds’ activities are essentially free from public scrutiny. Alternatively, it may be among the highly leveraged and secretive private equity funds which have been involved in a large number of high profile acquisitions.

As we have seen, anytime in the past when there has been a frantic scramble to be part of the new ‘get rich quick’ activity, there has eventually been grief. This time, we suspect that it will be no different. These firms have billions of dollars under management and possibly too few opportunities to invest wisely. Inevitably this leads to their taking ever-more speculative positions, with substantially increased risk.

We do not expect that our recommendations will change the world. There will be another stock market speculative bubble and there will continue to be corporate failures – most of them small, but a few spectacular. Greed, overweening ambition and a desire for power will continue to drive many, in and out of the corporate world. Companies will still choose to follow poor strategies, make inappropriate acquisitions and overreach themselves on the project too far. However, if a few, by reading this, become more aware of the pitfalls and avoid some of the mistakes of the past, our task will have been accomplished.

Notes

1 A voluntary code of corporate governance practice that UK listed companies are expected to adhere to, published and maintained by the Financial Reporting Council, current edition July 2003.
2 Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors (London: The Department of Trade and Industry, January 2003).
4 EU draft directive updating the rules on the audit of company accounts (7677/04 and 12617/05), Luxembourg (11 October 2005).
5 Report on Corporate Governance for Mauritius (Port Louis, Mauritius: Ministry for Industry, Financial Services and Corporate Affairs, April 2004).
10 See, for example, ‘Hedge-Funds Crisis Breaks into the Open’, Executive Intelligence Review (17 June 2005).
Not all of the stories related in this book are as yet finally resolved. In some cases, it might be many more years before a line can be drawn underneath them.

**Enron**

On 28 December 2005, Richard Causey, Enron’s former Chief Accounting Officer, pleaded guilty to securities fraud in a bargain with prosecutors and was expected to be a key witness in the trial of Ken Lay and Jeff Skilling, which started on 30 January 2006.

**WorldCom**

Bernie Ebbers appealed against his twenty-five year jail sentence, seeking a retrial. At a Federal appeals panel hearing on 30 January 2006, his lawyers claimed that he had been denied a fair trial as three potential witnesses were denied immunity from prosecution making them reluctant to testify for the defence. Meantime, Ebbers’ punishment remained stayed, pending the outcome of the appeal.

**Tyco**

In January 2006, the board of Tyco International approved a plan to split the once mighty conglomerate into three publicly traded companies: Tyco Healthcare; Tyco Electronics and Tyco Fire & Security.
Marconi

Ericsson, the Swedish telecoms equipment giant, acquired the majority of the assets of Marconi for £1.2 billion in October 2005 bringing to an end the life of a British icon. The rump, renamed Telent, will continue as an independent company concentrating on its UK services business.

Royal Ahold

On 9 January 2006, the company announced that it had preliminary court approval to settle with the lead plaintiffs in a securities class action suit raised in the US, for $1.1 billion, the compensation to be distributed to Ahold shareholders worldwide. Given the settlement in the US class action case, the VEB (Dutch Investors’ Association) agreed that no further legal action would be taken against Ahold or its officers (including former directors) in return for payment of its expenses. However, the VEB has insisted that the inquiry before the Amsterdam Enterprise Chamber must be completed and the results made available to the VEB and investors.

Parmalat

Calisto Tanzi, on trial in Milan for his role in Italy’s biggest ever bankruptcy, on 12 January 2006, offered, for a second time, to plead guilty in exchange for a sentence of two and a half years, which would enable him to request community service rather than incarceration. His offer was refused and the trial, adjourned until March 2006, will proceed with charges against him of market manipulation, false communication and obstructing the stock market regulator, Consob.
LIST OF ABBREVIATIONS

CA Chartered Accountant
CEO Chief Executive Officer
CFO Chief Financial Officer
COO Chief Operating Officer
CPA Certified Public Accountant
EBITDA Earnings Before Interest, Tax, Depreciation and Amortisation
EPS Earnings Per Share
FASB Financial Accounting Standards Board (in the US)
GAAP Generally Accepted Accounting Principles
IASB International Accounting Standards Board
IPO Initial Public Offering
LLP Limited Liability Partnership
MBA Master of Business Administration
NASDAQ National Association of Securities Dealers Automated Quotation System
NPV Net Present Value
NYMEX New York Mercantile Exchange
R&D Research and Development
SEC Securities and Exchange Commission (in the US)
SIMEX Singapore International Monetary Exchange
SOX Sarbanes-Oxley Act of 2002 (US)
SPE/SPV Special Purpose Entity/Special Purpose Vehicle
SSAP Statement of Standard Accounting Practice (now replaced by the Financial Reporting Standard (FRS) in the UK)
VPP Volumetric Production Payment
Accruals concept: Accounting method whereby revenues and expense items are recognised in the period that they are earned and incurred (respectively) even though they may not have been billed or paid for in cash.

Accrual releases: (see above) the process by which the final settled amount is matched against the recorded accrual, and any excess or shortfall is released or charged to the profit and loss account.

Acquisition charges: Future costs relating to the target company (such as restructuring costs) identified during the acquisition process and provided or accrued for by the acquiring company. Provisions or accruals for acquisition charges should later be reviewed against actual costs incurred and released as appropriate.

Arbitrage: The process of taking advantage of price differences in the same or similar instruments between one market and another. It is usually effected by the simultaneous purchase and sale of similar financial instruments in different markets in order to profit from distortions from usual price relationships. Arbitrage can occur in and across most financial instruments including foreign exchange, securities, commodities, futures and swap deals.

‘Asset light’: Refers to a strategy adopted with the aim of generating profits from a small fixed asset base. Certain industries, such as banking and financial services, are by nature asset light.

Asset securitisation: Process whereby debt instruments (such as loan paper or accounts receivable originated by banks or credit card companies) are aggregated in a pool and new securities then issued backed by the pool.

Bank covenants: A restriction on a borrower imposed by the lending bank. For example, it could be a requirement placed on a company to achieve and maintain specified targets such as levels of cash flow and/or
balance sheet ratios and/or specified capital expenditure levels in order to retain financing facilities.

**Bank of International Settlements (BIS):** The BIS is an international organisation which fosters cooperation between central banks and other agencies in pursuit of monetary and financial stability. Its banking services are provided exclusively to central banks and international organisations.

**Bear market:** A market in which prices are generally falling (cf. bull market).

**Brokers’ loans:** Money lent to brokers by banks for financing the underwriting of new issues, financing customer margin accounts, and other purposes.

**Bull market:** A market in which prices are generally rising (cf. bear market).

**Capital base:** Another term for the total net assets or equity of a company.

**Capitalised line costs:** In the telecoms industry, line costs are the costs of carrying voice or data traffic from its start point to its end point. They primarily consist of access charges to other carriers’ networks. Capitalising the costs involves treating the unused element of a fixed-rate long-term lease on access to third-party networks as an asset as opposed to an expense. The procedure is not permitted under most generally accepted accounting principles.

**Cash equivalents:** Instruments or investments of such high liquidity and safety that they are virtually as good as cash. Examples are a money market fund and a treasury bill.

**Chapter 11 bankruptcy:** In the US, bankruptcy is the state of insolvency of an individual or an organisation. Under US law, Chapter 11 provides that, unless the court rules otherwise, the debtor remains in possession of the business and in control of its operation. It also makes possible the negotiation of payment schedules, the restructuring of debt and even the granting of loans by the creditors to the debtor. (The UK equivalent term is ‘administration’.)

**Commercial paper:** Short-term obligations with maturities ranging from 2 to 270 days issued by banks, corporations and other borrowers to investors with temporarily idle cash.

**Contingent liability:** A potential financial liability that may exist in the future dependent on a past event. Disclosure is required in most countries but the liability is not provided for unless it is probable.
Counter-party exposure: The risk borne by one party involved in a transaction in the event the other party is unable to fulfil its side of the contract/agreement/transaction.

Credit ratings: see Ratings.

Debenture loans: (i) (US/Canada) Unsecured bonds with no particular assets pledged as security. The term usually implies an unsecured obligation. (ii) (UK) A security issued by a company acknowledging indebtedness in a specified sum at a fixed date with interest thereon, normally – but not necessarily – constituting a charge on assets.

Debt capital: The capital raised by the issuance of debt securities, usually bonds.

Delaware limited partnership or limited liability company: The state of Delaware offers attractive conditions for companies or partnerships wishing to register as such in the US. Costs of incorporation are among the lowest in the US, there are no state residency requirements for directors, corporation tax is low and directors are shielded from responsibility regarding their actions as directors of the company.

Derivatives: A derivative instrument is a contract that derives its value from the price of an underlying asset, an interest rate or an index. Examples of derivatives are forward contracts, futures contracts and options. Derivatives usually cost a fraction of the underlying asset, making them highly geared. Equity derivatives are based on the underlying value of equities.

Due diligence: (i) The obligation on a securities firm contemplating a new issue of securities to explain the new issue to prospective investors. (ii) In mergers and acquisitions, the process of reviewing the condition of a company in detail.

EBIT: Earnings before interest and tax. A financial performance measurement and also often used in valuing a company (price paid expressed as a multiple of EBIT).

EBITDA: Earnings before interest, taxes, depreciation and amortisation. A measure which is used as an approximation to operating cash flow.

Earnings per share (EPS): Total profits of the company after tax divided by the number of issued shares.

Equity capital: Any issued share capital entitled to a share in both the distribution of dividends on capital and proceeds on wind-up of a company.
But it usually means ordinary shares only, so that the ‘equity interest’ is that part of the business which belongs to the ordinary shareholders.

**Error account:** Error accounts occur frequently in futures trading operations. If a trade is miscommunicated, incorrectly executed or for some other reason not agreed to by the client, then it is booked into an error account. Such error positions are usually closed out immediately and the resulting loss or gain included in the overall figures of the booking operation.

**Euroyen:** A yen-denominated financial instrument traded outside the formal control of the Japanese monetary authorities. The three-month Euroyen futures contract is a standardised contract with settlement days every quarter.

**Exceptional items:** An item in the annual accounts of a company which, while lying within the ordinary scope of the business of the company, is exceptional by virtue of its size.

**Forward contracts:** In forward contracts, the parties agree to exchange assets in the future. The contract specifies the assets to be exchanged, the date of the exchange and a price. The terms of the contract are tailored to the needs of the counter-parties.

**Free cash flow:** Cash generated from operations less capital expenditure.

**Futures contracts:** Highly standardised forward contracts traded on organised exchanges. Financial futures mainly relate to bonds, exchange rates and equity market indices. The size of traded units is standardised, as are the dates of exchange.

**Gearing:** see Leverage.

**General ledger:** Contains the detailed accounts which make up the entity’s financial statements. Separate accounts exist for individual assets, liabilities, stockholders’ equity, revenue and expenses.

**Goodwill:** The excess of going-concern value of a business over net asset value, generally understood to represent the value of a well-respected business name, good customer relations, high employee morale, and other such factors expected to translate into greater than normal earning power.

**Hedging:** Action taken to offset or reduce possible adverse changes in the value of assets or the cost of liabilities currently held or expected to be held at some future date.
Index funds: A portfolio of investments that are weighted the same as a stock exchange index in order to mirror its performance.

Initial public offering (IPO): A corporation’s first offering of shares (stock) to the public.

Insider trading: Dealing in shares on the stock market by those wishing to take advantage of their inside knowledge of a company’s affairs. The degree to which this is a crime varies from country to country but in general covers those who are party to privileged information directly and deal themselves; those who encourage someone else to do so; and those who pass the information to someone else who can make profitable use thereof.

Interest spread: The difference between the interest rate applied by an institution on assets (that is, interest income) and the interest rate applied to the institution’s liabilities and capital (that is, interest expense).

Intra-day trading limit: Limit imposed, by management, on the level of open positions permitted within a trading day. Gross trading limits permit open positions to be carried overnight.

Investment grade: Securities rated Baa or above by Moody’s or BBB or above by Standard & Poor’s (S&P) are known as investment grade (see Ratings).

Joint stock company: Another term for a limited liability company, where shareholders’ liability is restricted to their investment. (Under US law, a joint stock company is a form of business organisation that combines features of a corporation and a partnership, whereby the companies are recognised as corporations but with unlimited liability for their stockholders.)

Junk bond: Bond with a credit rating of BB or lower by rating agencies. Issued by companies without long track records of sales and earnings, or by those with questionable credit strength. Popular means of financing takeovers. Since they are more volatile and pay higher yields than investment grade bonds, many risk-oriented investors specialise in trading them.

Lead director: Initially created as an interim crisis role, this position has evolved over recent years, although responsibilities are interpreted differently by different companies. In general, the lead director is an independent non-executive board member who coordinates the activities of the independent directors, including convening meetings of non-executive directors and acting as a liaison between non-executive directors and management.
**Leverage:** The proportion of a company’s long-term debt and preference share capital to its ordinary equity share capital. High leverage means that prior charges and/or debt capital are high in proportion to ordinary shares. Low leverage means the reverse. High leverage can enable ordinary shareholders to benefit from higher than average levels of profitability through the use of loan stock, but it works to a company’s disadvantage during times of declining profitability as fixed-interest costs must be met in full regardless of profits. (The UK equivalent term is ‘gearing’.)

**Limited liability partnership (LLP):** A legal entity structure often used as a fixed-life investment vehicle. It consists of a general partner (the management firm, which has unlimited liability) and limited partners (the investors, who have limited liability and are not involved with the day-to-day operations). A partnership agreement covers terms, fees, structures and other items between the limited partners and the general partner.

**Limited recourse:** Where there is some recourse to the assets of the borrower other than those charged, and sometimes limited recourse to other companies in the borrower’s group. The latter may take the form of a parent company guarantee (see also Non-recourse).

**Loan warrants:** A certificate, often attached to a debt security, giving the holder the right but not the obligation to buy a specified amount of certain debt (such as bonds) at a specified price for a given period of time. Warrants are invariably detachable and may be traded independently of the debt security.

**Long position:** see Position.

**Margin:** The good-faith deposit that a client must lodge with a broker, and the broker with the exchange, when buying or selling a contract in order to cover any potential losses on his position. As the value of the underlying asset moves, then the exchange can demand that the client puts up more money to cover margin requirements. This is known as a margin call.

**Margin trading:** The use of borrowed money to buy securities with the aim of magnifying profits.

**Mark-to-market accounting:** The adjustment of the price of a security or other position to reflect its market value, a process which gives rise to unrealised profits or losses.

**Marzano law:** New Italian law introduced in December 2003, in the wake of the Parmalat collapse, with the aim of accelerating and facilitating the financial and operational restructuring of insolvent enterprises.
**Merchant assets**: Assets purchased for investment purposes but considered to be held for later sale by a company rather than longer-term investment. The asset is generally held at fair value or market value rather than historical cost.

**Minority stakes/interest**: (i) The part of a subsidiary company’s shareholders’ funds that is not attributable to the holding company. (ii) Shares in a subsidiary company held by others than the holding company.

**Monte Carlo simulation**: A type of spreadsheet simulation which randomly and repeatedly generates values for uncertain variables to simulate a real-life model.

**Mutual fund**: A fund operated by an investment company that continually offers new shares and buys existing shares back at the request of the shareholder and uses its capital to invest in diversified securities. Management and administrative fees are charged to shareholders, who share equally in the gains and losses generated by the fund. (The UK equivalent term is ‘unit trust’.)

**Net present value (NPV)**: The value of a future income stream discounted – using an appropriate interest rate – to take account of the time value of money.

**Nikkei 225**: An index based on the 225 leading Japanese stocks traded on the Tokyo Stock Exchange. It is composed of representative blue chip companies and is a price-weighted index. This forms the basis for the Nikkei 225 futures contract.

**Nominal value**: The value stated on the face of a security. This is not necessarily the value at which it was first issued which may have been at a premium.

**Non-recourse**: Where the lender has no recourse to any party or any assets other than the assets over which the lender has specifically taken security and/or the single purpose vehicle which owns the assets.

**Off-balance-sheet**: Financing which results in neither the debt nor the asset appearing on the company’s balance sheet. Under such financing, the financial ratios which may be used to determine borrowing capacity are not affected.

**Open outcry**: A trading method whereby trading takes place in a designated area of the exchange known as the pit, within an agreed timeframe. The term derives from the fact that traders must shout out their buy and
sell offers. When a trader shouts that he wants to sell at a certain price and someone else shouts that he wants to buy at that price, the two traders have made a contract that will be recorded by completing a ticket afterwards.

**Open position:** A position that is not yet closed, that is, the deal has not been completed and ownership transferred.

**Operating profit/loss:** Calculated as operating revenues less cost of goods sold and operating expenses. The measure relates only to the normal business activities of the entity.

**Option:** The right, but not the obligation, to buy or sell an underlying instrument at a specified price – the strike price – in the future. The holder of a *call option* has the right to buy, the holder of a *put option*, the right to sell. The cost of this right is called the premium.

**Over the counter:** A market which is outside a formal stock exchange, where transactions are completed directly by dealers acting as principals rather than agents, using the telephone, telex or by computer.

**Participating certificates:** Certificate representing participation capital, a separate class of share capital, which usually carries economic rights similar to ordinary shares but without voting rights.

**Position:** An investor’s stake in a particular security or market. A long position equals the number of financial instruments owned. A short position equals the number of financial instruments owed.

**Pre-emption rights:** A contractual right of a party to have the first option to purchase a specified asset in the event that its owner should elect to divest it. In respect of shareholder rights, it refers to the statutory right of a shareholder to subscribe at the price determined, in proportion to his existing shareholding, for any new equity.

**Price earnings ratio (PE):** Calculated as the price of a stock divided by the earnings per share. The measure is often used to give investors an idea of how much they are paying for a company’s earning power; a high PE ratio indicates expected future earnings growth to be high and vice versa.

**Private equity:** Equity securities of unlisted companies.

**Private placement:** The direct sale of securities to a small number of investors.
**Promissory note:** A written and signed promise to pay unconditionally to the payee a fixed sum of money, either on demand or at some definite future time (in other words, an IOU).

**Proxy filing:** A document which is intended to provide shareholders with the information necessary to enable them to vote in an informed manner at shareholders’ meetings. Such information may include significant share ownership, board composition and executive remuneration.

**Ratings:** An evaluation of the creditworthiness of a specific securities issue or borrower, made by an agency in the US such as Standard & Poor’s Corporation or Moody’s Investors Service. The gradings are assigned from AAA for the most creditworthy to DDD for the least. Ratings change as the borrower’s financial position changes.

**Related party transactions:** Interaction between two parties, one of whom can exercise control or significant influence over the operating policies of the other. As the parties may apparently act independently, in most countries listed companies are required to make certain disclosures concerning related parties and any transactions between them.

**Reverse takeover:** (i) When a private company acquires a public company, effectively bypassing the usually lengthy and complex process of going public (also referred to as a *reverse merger*). (ii) When a smaller company buys out a larger company. (iii) When a target company takes over the prospective bidder instead of the opposite.

**Sarbanes-Oxley:** The Sarbanes-Oxley Act (commonly referred to as SOX) came into effect in the US in July 2002. Considered the most significant change to Federal securities laws in the US in recent years, it was rapidly introduced in the wake of a series of corporate financial scandals, including Enron, Arthur Andersen and WorldCom.

**SEC (Securities and Exchange Commission):** (see Securities Acts).


**Securities and Futures Authority (SFA):** The UK regulatory body responsible for authorising and monitoring firms which carry out investment business, replaced by the Financial Services Authority (FSA) in 2000.
Sell forward: To sell foreign currency, commodities, securities, and so on at a specified price for a future date.

Settlements: The process by which a trade is entered into the books and records of all parties involved in the transaction. This includes completion of any payment between any of those parties related to the transaction.

Short position: see Position.

Short seller: Someone who borrows a security (or commodity futures contract) from a broker and sells it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker. In the US, SEC rules limit the circumstances in which investors can sell short.

Short-term paper: see Commercial paper.

Special purpose entity or vehicle (SPE or SPV): Company formed for a single purpose, usually to hold assets or receive cash flows in a financial transaction. Often such vehicles are not formally owned by the company which benefits from the financing transaction and are not, therefore, consolidated in the financial statements.

Straddles: Position created by combining an equal number of put options and call options on the same underlying security, at the same strike price and maturity date. A seller of straddles anticipates that the underlying price of the security will stay close to the strike price of the options sold.

Structured finance: Any non-standard means of raising funds, where the lender may tailor the financing to meet the specific client’s needs. Generally this involves highly complex financial transactions.

Swap contract: (i) Interest rate swaps – an agreement by which two parties agree to pay each other interest on a notional amount over a defined period but calculated according to different interest bases. (ii) Currency swaps – an agreement between two parties to sell agreed amounts of specified currencies to each other on a future date at an exchange rate established at the outset.

Switching: see Arbitrage.

Syndicate: A small group of banks which provide a loan or other means of finance as opposed to a ‘bilateral loan’ between one lender and the borrower.

Tabaksblat code: Dutch code of corporate governance which came into effect for financial years beginning on or after 1 January 2004 and intro-
duced a number of wide-reaching standards and principles, notably increasing shareholder rights.

**Tracker stocks**: A tracker stock is a new class of share issued by a company to represent the financial performance of a specific division. The tracker stock does not represent a separate legal entity but the company has to report results and balance sheets separately for the different divisions and for the company as a whole.

**Trading book**: Financial instruments or commodities held either with the intent to trade or in order to hedge other positions of the trading book. Each trading book consists of positions in a similar category of instrument or commodity so that an institution often has a significant number of different trading books.

**Unconsolidated associates**: A company whose financial statements are not consolidated into the parent or holding company’s financial statements because the parent company’s interest is less than 50 percent or the parent company does not control the company.

**Underwriting fees**: Fees charged by securities houses, banks and other financial institutions for an arrangement by which they undertake to buy a certain agreed amount of securities of a new issue on a given date and at a given price, thereby assuring the issuer of the full proceeds of a financing.

**Unrealised loss**: The anticipated loss that will result from a transaction when the transaction is completed, at which point the loss is realised.

**Unvested options**: Options that cannot be exercised (that is, buy/sell shares) for a period of time or until some other conditions are fulfilled.

**US GAAP (US Generally Accepted Accounting Principles)**: A widely accepted set of rules, conventions, standards, and procedures for reporting financial information that have been defined by the US Financial Accounting Standards Board. The term GAAP is also applied to accounting rules and requirements in other countries.

**Value at Risk (VaR)**: A model used to estimate the market risk of a trading portfolio. VaR is widely used by banks, securities firms, commodity and energy merchants, and other trading organisations.

**Vendor allowance**: System whereby the purchasing company receives a rebate, credit note or reduction from a supplier depending on the volume or value of sales that the purchasing company realises from customers.
Vendor finance: Where the vendor of an asset also acts as a lender, allowing the purchaser to repay the cost of the asset over a period of time. This type of financing is particularly common in industries requiring heavy capital investment, in plant and equipment, for example.

Volumetric production payments (VPPs): Financing mechanism whereby a gas producer enters into a long-term contract for the supply of a fixed volume of gas at a fixed price in return for an upfront payment.
### Index

An asterisk (*) after a page number denotes a glossary entry

**A**

ABB 15

accounting profession, reform of 180–2  
*see also* auditors

accounting scandals 7

acquisitions 2, 79

Ahold, *see under* Ahold

Marconi (GEC) 99, 106–7, 108

Tyco 84, 86–7, 94

WorldCom (LDDS) 61–5, 73, 74  
*see also* overexpansion; remote operations

Adelphi Communications 59

ADT 84

ADT Automotive 87

Ahold (Royal Ahold; Koninklijke Ahold)  
*Chapter 8: 135–52, 185*

acquisitions

Asia 138

Eastern Europe 137, 138, 139

South America 138, 139

US 136–7, 138, 139, 140, 141

Western Europe 136, 137, 138, 139, 140, 141

background 136–7

board, ineffective 7, 149–50, 176

causes of failure 147–51

CFO qualification 6

criminal charges 146

discharges 146

divestment programme 140, 147

due diligence 2, 148

earnings per share (EPS) 138, 144, 189*

failure 143–7

food service industry 140–2

fraud 145, 146, 151

greed 4, 149

internal controls 5, 149, 151

joint ventures, management control 146

key messages 151

overexpansion 3, 147, 148

risk management 2

segregation of duties 150

share issues 150

share options 4

share prices 143, 144, 145, 147

strategic decisions, poor 2, 147–8

vendor allowances 142–3, 146, 197*

airline industry

deregulation 117

global alliances 117–18, 120

Alcazar 118

Alitalia 126

Allfirst 1, 13, 26–7

internal audit function 28, 29–30

Ludwig report 27, 28, 29

matrix management 28

remuneration linked to profitability 28

risk management 28

Value at Risk (VaR) system 29

Allied Irish Bank (AIB)  
*Chapter 2: 13, 26–31*

causes of failure 29–31

internal audit 29

key messages 31

matrix management 28

Reuters, price feed 1, 29

risk management 28

segregation of duties 28

AMP 86

Andersen Consulting 64

AOL 2

arbitrage (switching), Baring Securities (Japan) Limited (BSJ) 22, 187*
Arthur Andersen (Andersen)  
and Enron 7, 33, 43, 48, 49, 52, 54–5, 174  
and WorldCom 70, 71–2, 78  
Ashcroft, Michael 84  
asset light strategy, Enron 36, 187*  
audit committee 7, 179  
Enron 53  
WorldCom 71–2  
auditing  
EU draft directive 175  
poor 174  
auditors  
auditing firms 7–8  
external, failure of, Enron 54–5  
internal, Enron 6, 54  
mandatory rotation of 168, 171  
reform of accounting profession 180–2  
WorldCom 70–2  
see also individual auditing firms  
Azurix 41–2, 47  

B  
Bandle, Alain 118, 121–2, 125–6  
bankers, greedy 55–6  
Bankers Trust 15, 38  
Bank of America 157, 164, 169  
Bank of England 13, 17, 25  
Bank of International Settlements (BIS) 24, 188*  
Banque Nationale de Paris (BNP) 22  
Baring, Peter 13, 19, 24–5  
Baring Futures (Singapore) Pte Limited (BFS) 20–1, 22  
funding of 24  
Barings (Barings Bank, Barings plc, Baring Brothers Bank, Baring Investment Bank (BIB)) Chapter 2: 13–32  
background 16–18  
business drivers 31  
causes of failure 28–9  
collapse 8, 24–6  
committees 19–20  
derivatives trading 13, 21, 22, 189*  
formal inquiries 25  
fraud 7, 173  
internal audit function 5–6  
internal controls, weak 5–6, 28–9, 30, 173  
key messages 31  
matrix management 19–20, 21, 30  
poor strategic decisions 2  
remuneration linked to profitability 28  
risk management 2, 5, 26  
segregation of duties 28  
Baring Securities (Japan) Limited (BSJ) 20–1, 22  
arbitrage (switching) 22, 187*  
Baring Securities Ltd (BSL) (previously Henderson Crosthwaite) 17–19, 20  
Batson, Neal 49, 55, 56  
Belnick, Mark 85  
charges 91, 93  
‘Big Bang’ 17  
Blockbuster Video 42  
Board of Banking Supervision 25  
boards  
chairman/CEO combined role 6–7, 176–7  
improving performance 175–7  
ineffective 6–7  
Ahold 7, 149–50, 176  
Enron 7, 53–4  
Marconi 7, 176  
Parmalat 7, 163  
Swissair 7, 125–6, 131–2, 176  
Tyco 6, 7, 91, 95  
WorldCom 6, 7, 76–7  
see also directors  
Boies inquiry (Boies, Schiller & Flexner) 90, 93  
Bondi, Enrico 162–3, 164, 165  
Bonlat 161, 164, 168, 169  
boom and bust cycles 9–11  
Breeden, Richard 72, 74  
Breen, Edward 90, 93  
British Aerospace (BAe) 105  
British Telecommunications plc (BT) 62, 111  
Bruggisser, Philippe 122, 123, 126, 127  
bull market 8, 9–10, 174, 188*  
business drivers, understanding of 31  

C  
California Public Employees Retirement Scheme (CalPERS) 44–5  
Canadian Imperial Bank of Commerce 56  
Carrefour 139–40, 148  
cash control  
Enron 6, 52  
Marconi 6  
WorldCom 6  
cash v. profit 182  
caveat emptor 11  
Cazenove 17
Centre for the Study of Financial Innovation (CSFI) 27
CEOs
and chairman, combined role 6–7, 176–7
dominant 3–4, 176
Parmalat 3–4
Swissair 132
Tyco 3–4
WorldCom 3–4, 7, 74–5
CFO qualification 6
chairman, CEO role combined with 6–7, 176–7
charitable donations 92, 178
CIT Group 88, 89–90, 93, 94
Citigroup (Citicorp) 15
and Enron 45, 56
and Parmalat 156–7, 159, 163, 166, 169
and WorldCom 67, 76
collapses, millennium meltdown 8–12
Combined Code (UK) 175
compensation, executives 177–9
computers, influence of 15–16
consultants, overreliance on 133
cookie jar accounting 69, 174
Corporate Monitor 72, 74
Corti, Mario 127
Cronin, David 27, 29
Crossair 129
D
Dabhol power project 35, 47, 50–1
dealers, performance levels 30
Deloitte & Touche (Deloitte)
and Ahold 143, 145
and Parmalat 7, 161–2, 168, 169, 170
deregulation
airline industry 117
energy industry, US 37–8
financial 17
derivatives trading 14–16, 189*
Barings 13, 21, 22
changing trading environment 14–15
Deutsche Bank 16, 45, 169
Digex 64
directors
election of 177
non-executive 79
independence of 176
Disco Holdings Ltd (Disco) 139, 144, 146, 148
dot-com bubble burst 64, 108
Dresdner Kleinwort Benson 17
dual strategies, Enron 50, 51, 52
due diligence 2, 189*
Ahold 2, 148
Marconi 112–13, 115
Parmalat 170, 172
Tyco 2
US Foodservice 2, 143, 148
WorldCom 2
Duncan, David 54, 55
criminal charge 56
Dynergy Inc. 49
E
early warning signs, ignoring 29
earnings per share (EPS) 189*
Ahold 138, 144
Enron 6
Ebbers, Bernard J. 74–5
background 60–1
compensation decisions 75
control of WorldCom board 76–7
dominant CEO 3–4
loans 67–8, 75
prison sentence 59
EBITDA 182, 189*
Elscent 103
energy industry deregulation, US 37–8
Enron Chapter 3: 33–58, 184
asset light strategy 36, 187*
audit committee 53
board, ineffective 7, 53–4
cash control 6, 52
causes of failure 50–6
CFO qualification 6
chairman/CEO combined role 6–7
collapse 8, 33–4, 48–9
creation of 35–6
criminal charges 56
culture 36–7
dual strategies 50, 51, 52
earnings per share (EPS) 6, 189*
employee performance assessment 36
external auditors’ failure 54–5
fraud 7, 173
greed 51–2
hubris 4
immediate earnings 40
increasing revenues 43
internal audit function 6, 54
key messages 57
LJM1/LJM2 partnerships 45, 46, 49
mark-to-market accounting 39–41, 42, 51–2, 192*
New York Power Authority supply contract 38
off-balance-sheet transactions 44–6, 193*
overexpansion 3
overseas expansion 41
pre-pay schemes 56
remuneration based on deals/short-term profits 36–7, 52, 57
risk management/assessment 2, 5, 40–1, 52–3
share options 4
share slide 46–8
Special Investigation (Powers) Committee and report 48–50, 55
special purpose entities (SPEs) 34, 44–6, 48, 196*
strategic decisions, poor 2, 50–1
subsidiaries 36
volumetric production payments (VPPs) 38–9, 198*
Enron Broadband Services (EBS) 42, 47, 51
EnronOnline 41
entrepreneurs 79
Epicurum Fund, Parmalat 161–3, 166, 168
Ernst & Young and Skandia 7
survey of top UK companies 29–30
ethical codes, adherence to 57
eToys 10
Eurolat SpA 158, 165
European Union, draft directive on auditing 175
executives, compensation 177–9
expenses, reduction in 31
Financial deregulation 17
Finmeccanica 104
First Maryland Bancorp 27
Foreign Corrupt Practices Act (US) 107
FORE systems (FORE) 106–7, 109, 110, 112–13
Fort, John 82, 83
fraud 7, 173
Ahold 145, 146, 151
Barings 7, 173
Enron 7, 173
Parmalat 7, 153, 170, 173
WorldCom 72, 78–9, 173
fund managers 112
performance levels 30
G
G30 (Group of Thirty) 15
GAAP (Generally Accepted Accounting Principles), see US GAAP
Gaziano, Joseph 82
GEC-Alsthom 100, 102–3
GE Capital 16, 45, 88
GEC Plessey Communications (GPT) 100, 103
General Electric (GE) 15, 88
Gilbarco 103
Glisan, Ben 46, 56
global 24-hour trading 14–16
Global Crossing 64, 66
Global Excellence Network (GEN) 117–18
Grant Thornton, and Parmalat 164, 168–9, 170
greed 4
Ahold 4, 149
bankers 55–6
Enron 51–2
Parmalat 4
Tyco 4, 94–5
WorldCom 4, 75–6
Group of Thirty (G30) 15
growth
for growth’s sake 74, 79
see also acquisitions; overexpansion
Grubman, Jack 66, 75–6
H
Heath, Christopher 17, 18, 19
hedge funds 182–3
hedging 14, 190*
Henderson Crosthwaite 17, 18
holidays (vacations), mandatory 29, 31
Hope & Co. 16–17
Index

hubris 4
  Enron 4
  Tyco 94–5
  WorldCom 4

hunter strategy, Swissair 123–4, 127, 130

I
  ICA Group (ICA) 140, 146
  IDB Communications Group Inc. 61
  institutional investors 177
  Intermedia 2, 3, 64–5, 73

  internal audit
    personnel for 31
    weak 5–6
      Allfirst 28, 29–30
      Allied Irish Bank (AIB) 29
      Barings 5–6
      Enron 6, 54
      Tyco 6, 95
      WorldCom 5–6, 71, 72

  internal controls
    lack/failure of 5–6
      Ahold 5, 149, 151
      Barings 5–6, 28–9, 30, 173
      Marconi 5, 114
      Swissair 132
      Tyco 95
      WorldCom 5, 71–2, 77
    personnel for 31

  Internationale Nederlanden Groep N.V. (ING) 25

  international expansion, Parmalat 155, 156–7, 158–9, 170

  Internet traffic 62, 63

  investment banks 174
    reform of 179–80
      WorldCom and 66–7, 93

J
  Jett, Joseph 16
  J. P. Morgan 15, 45, 56

K
  Katz, Jeffrey 122, 126
  Kendall International 83
  Kidder Peabody 16
  Kinder, Richard 35, 36
  Kobe earthquake 23
  Kopper, Michael 45, 46
  Kozlowski, Dennis 81, 83–5
    background 82
    charitable donations 92
    dominant CEO 3–4
    indictments 90–1
    lifestyle 91–2
    relocation loans 85, 86
    resignation 90
    share options 84–5

  KPMG
    PCAOB review of 181
    and Swissair 127, 132
    and WorldCom 72
    and Xerox 7

L
  Lactis SpA 165
  Lay, Kenneth 35, 36, 47, 53
    trial 56
  Lazard 163
  Leeson, Nick 13, 14, 27, 30
    career with Barings 20–2
    disguised losses 23, 25
    extradition and sentence 25
    hidden account 88888 23, 23–4
    resignation 24

  LJM1/LJM2 partnerships, Enron 45, 46, 49

  loans
    Tyco relocation loans 83–4, 85–6, 87
    WorldCom, B. J. Ebbers 67–8, 75

  Long Distance Discount Services (LDDS), see WorldCom

  Long-Term Capital Management (LTCM) 182
  Ludwig report (Allfirst) 27, 28, 29
  Lufthansa 129

M
  McKinsey
    and Enron 34
    and Swissair 118–20, 123–4, 129–30, 131

  management information systems 133
  Marconi (GE) 5, 99, 102

  Marconi (GE) Chapter 6: 98–115, 185
    acquisitions 99, 106–7, 108
    background 99
    board, ineffective 7, 176
    cash control 6, 100
    causes of failure 112–15
    communications division 103–4
    defence division
      demerger 105
      Tracor 104
    due diligence 112–13, 115
    fibre-optics transmission systems 103–4
| **industrials division (Picker International)** | 103 |
| **internal controls failure** | 5, 114 |
| **key messages** | 115 |
| **management information system** | 5, 99, 102 |
| **overexpansion** | 112–13 |
| **R&D expenditure** | 100, 107 |
| **reorganisation** | 101 |
| **risk management** | 2 |
| **share options** | 4, 108 |
| **share prices** | 108, 110, 111 |
| **strategic decisions** | 2, 113–14 |
| **strategic vision** | 102 |
| **telecommunications business** | 103–4, 105–11, 112–14 |
| **warning signs** | 114–15 |
| **Mark, Rebecca** | 35, 47, 50, 52 |
| ‘marking up the curve’ | 40 |
| **mark-to-market accounting** | 192* |
| **Enron** | 39–41, 42, 51–2 |
| **Marzano law (‘Parmalat law’)** | 164, 192* |
| **matrix management** | 30 |
| **Allied Irish Bank and Allfirst** | 28 |
| **Barings** | 19–20, 21, 30 |
| **Mayo, John** | 102, 109, 110, 112 |
| **MCI Communications Corporation (MCI)** | 62, 63, 73 |
| **MCI Inc** | 72–3 |
| **Mediobanca** | 163 |
| **Merrill Lynch** | 45 |
| **and Enron** | 45 |
| **and Parmalat** | 159 |
| **and Tyco** | 93 |
| **and USF** | 143, 148 |
| **Metallgesellschaft** | 14, 16 |
| **Meurs, Michiel** | 137, 143 |
| **criminal charges** | 146–7 |
| **no accounting qualification** | 6 |
| **resignation** | 145 |
| **MFS Communications Company** | 62 |
| **Miller, Jim** | 141, 146 |
| **minority investments, Swissair** | 121, 124, 130, 131 |
| **Morgan Grenfell Asset Management** | 14 |
| **Morgan Stanley** | 20, 169 |

| **O** |
| **Odeon TV** | 158, 170 |
| **off-balance-sheet transactions, Enron** | 44–6, 193* |
| **outsourcing strategy, Swissair** | 119, 130 |
| **overexpansion** | 2–3, 79 |
| **Ahold** | 3, 147, 148 |
| **Enron** | 3 |
| **Marconi** | 112–13 |
| **Parmalat** | 3, 171 |
| **Tyco** | 3 |
| **WorldCom** | 3, 61–5, 73, 74 |

| **P** |
| **Parma AC** | 155–6, 165, 170 |
| **Parmalat (Finanziaria Centro Nord (FCN), Parmalat Finanziaria SpA)** | Chapter 9: 153–72, 185 |
| **acquisitions** | 156, 170 |
| **background** | 154–5 |
| **board complacency** | 7, 163 |
| **bond issues/loans** | 156–7, 167, 170 |
| **causes of failure** | 170–1 |
| **criminal investigations** | 165–6 |
| **debt levels** | 165, 166–7 |
| **decline** | 159–61 |
| **directors’ resignations** | 163 |
| **dominant CEO** | 3–4 |
| **due diligence** | 170, 172 |
| **Epicurum Fund** | 161–3, 166, 168 |
| **family control** | 6, 170–1, 177 |
| **fraud** | 153, 170 |
| **greed** | 4 |
| **growth rate** | 156–7 |
| **insolvency** | 164, 166 |
| **international expansion** | 155, 156–7, 158–9, 170 |
| **key messages** | 171–2 |
| **overexpansion** | 3, 171 |
| **risk management** | 3 |
| **share trading suspensions** | 162, 164 |
| **sports sponsorship** | 155–6 |
| **strategic decisions, poor** | 2 |
| ‘Parmalat law’ (Marzano law) | 164, 192* |
| **Parmatour** | 158 |
| **Parton, Mike** | 111 |
| **personnel, mandatory rotation of** | 29, 31 |
| **Picker International** | 103 |
| **Plessey** | 100 |
| ‘Ponzi’ scheme | 34 |
| **Portland General Electric** | 42, 51 |
| **power, desire for** | 4 |
Index

Powers committee/report (Enron) 48–50, 55
pre-pay schemes
   Enron 56
PricewaterhouseCoopers (PwC)
   and Ahold 143, 146
   and Parmalat 163, 165
   and Swissair 127, 132
   and Tyco 7, 85, 92
profits
   v. cash 182
   disproportionately high 22–3, 31
Public Company Accounting Oversight Board (PCAOB) 181
pyramid scheme, see ‘Ponzi’ scheme

R
rating agencies 174
Reltec Corporation 106, 111
remote operations 5, 151
   Ahold 149
   Parmalat 170
remuneration
   based on deals/short-term profits, Enron 36–7, 52, 57
   linked to profitability 28
   rewarding risk-taking behaviour 30
Reuters, price feed 1, 29
Reutlinger, Paul 122
risk, asymmetric 30
risk management 2, 26, 31
   Ahold 2
   Allied Irish Bank/Allfirst 28
   Barings 2, 5, 26
   Enron 2, 5, 40–1, 52–3
   Marconi 2
   Parmalat 3
   Swissair 2
‘rogue traders’ 13, 14, 26, 27
Rolls-Royce 3, 8, 182
rotation of personnel 29, 31
Rusnak, John 26, 27, 28–9
   sentence 28

S
Sabena 121–3, 128, 131
Salomon Smith Barney (SSB) 66–7
Sarbanes-Oxley Act of 2002 (SOX) 11–12, 75, 174–5, 195*
Scalzo, Richard 92
Schroders Salomon Smith Barney 159
Securities and Exchange Commission (SEC), US 16, 174, 195*
   and Ahold 146
   and Enron 39, 48
   and Parmalat 166, 167
   and Tyco 87, 89, 90–1
   and WorldCom 68
Securities and Futures Authority (SFA) 21, 195*
segregation of duties 31
   Ahold 150
   Allied Irish Bank 28
   Barings 28
   Tyco 95
shareholder involvement 177
share options 4, 178
   Ahold 4
   Enron 4
   Marconi 4, 108
   Tyco 4, 84–5, 95, 96
   WorldCom 4
Showa Shell (Royal Dutch/Shell) 14, 15
Siemens 100
Simpson, George 98–9, 110, 111, 112
   background 101
Singapore International Monetary Exchange (SIMEX) 15, 20–1, 22, 24
Skilling, Jeffrey 35, 36, 51, 52
   resignation 37, 47
   trial 56
special purpose entities (SPEs), Enron 34, 44–6, 48, 196*
special purpose vehicles (SPVs) 126–7, 196*
sports sponsorship, Parmalat 155–6
spring loading 87
Sprint Communications Inc. (Sprint) 64, 74
Standard & Poor’s (S&P)
   and Parmalat 160, 169
   and Tyco 89
‘star performers’ 4, 20–2, 23, 30
status 4
strategic decisions, poor 2
   Ahold 2, 147–8
   Barings 2
   Enron 2, 50–1
   Marconi 2, 113–14
   Parmalat 2
   Swissair 2, 129–30
   Tyco 2, 94
   WorldCom 2, 73
Sullivan, Scott 60, 61, 75, 76
   and audit committee 71–2
   dismissal 72
line costs 69–70
Sumitomo 14
Swartz, Mark 83, 86, 95
indictments 90–1
Swissair (Swiss) Chapter 7: 116–34
background 116–17
board, ineffective 7, 125–6, 131–2, 176
causes of collapse 129–33
collapse 128
directors’ resignations 127
dominant CEO 132
equity stakes 120
global alliances 117–18, 120
hunter strategy 123–4, 127, 130
implementation issues 130–1
internal controls 132
international expansion, minority
holdings 121, 124, 130, 131
key messages 133
McKinsey proposals for 118–20,
123–4, 129–30, 131
minority investments 121, 124, 130, 131
outsourcing strategy 119, 130
Phoenix Project 128–9
refusal to relinquish control 133
risk management 2
strategic errors 2, 129–30

T
Tabaksblat Code 150, 175, 196–7*
Tanzi, Calisto 153, 170
arrest 165
background 154
dominant CEO 3–4
resignation 163
Telecommunications Act (1996) 61–2
Time Warner 2
Tobin’s Q 10
Tokyo Stock Exchange 22
Tokyo stock market collapse 19
Tonna, Fausto 153, 157–8
admissions 167
resignation 160, 163
tracker stocks 197*
WorldCom 65–6
Tracor 104
Tyco (Tyco Laboratories, Tyco
International Inc.) Chapter 5: 81–97, 184
acquisitions 84, 86–7, 94
background 81–2
board failings 6, 7, 91, 95
Boies inquiry 90, 93
causes of failure 94–6
chairman/CEO combined role 6–7
dominant CEO 3–4
due diligence 2
greed 4, 94–5
healthcare division 83, 93
hubris 94–5
internal audit function 6, 95
internal controls, weak 95
Key Employee Loan Program (KELP) 85
key messages 95–6
overexpansion 3
relocation loans 83–4, 85–6, 87
SEC investigation 87, 89
segregation of duties 95
share options 4, 84–5, 95, 96
share price 88–90, 93
strategic errors 2, 94
TyCom 87, 89, 90, 93

U
US Foodservice (USF) 140–1, 148
due diligence 2, 143, 148
vendor allowances 142–3, 148, 149,
151, 197*
US GAAP (US Generally Accepted
Accounting Principles) 69, 70, 72, 144,
197*
US Surgical Corp. 86–7
UUNet Technologies Inc. 62, 73

V
vacations (holidays), compulsory 29, 31
Value at Risk (VaR) system 26, 29, 197*
van der Hoeven, Cees
acquisition drive 138–40
ambition 149
background 137
criminal charges 135, 146–7
resignation 145
Velox 144, 148
vendor allowances 197*
Ahold/USF 142–3, 146, 148, 149, 151
Verizon Communications 73
Videojet 103
e volumetric production payments (VPPs),
Enron 38–9, 198*

W
Wal-Mart 139
Walsh, Frank 88, 93
Watkins, Sherron 48
Weinstock, Arnold (Lord Weinstock) 98, 99
  financial ratios/trend lines 5, 99, 102
  leadership style 100–1
Wessex Water 3, 41, 47
whistle-blowing 175
WorldCom (LDDS)  Chapter 4: 59–80, 184
  accounting practices 68–9
  acquisitions 61–5, 73, 74
  audit committee 71–2
  auditors, internal/external 70–2
  background 60–1
  bankruptcy 72–3
  board complacency 6, 7, 76–7
  cash control 6
  causes of failure 59–60, 73–9
  collapse 8–9, 59–60, 72–3
  dominant CEO 3–4, 7, 74–5
due diligence 2
fraud 72, 78–9, 173
  greed 4, 75–6
  growth for growth’s sake 74, 79
  hubris 4
  integration problems 63
  internal audit 5–6, 71, 72
  internal controls failure 5, 71–2, 77
  and investment banks 66–7
  key messages 79
  line costs 69–70
  management dispersal 63
  overexpansion 3, 61–5, 73, 74
  pre-paid capacity 70, 72
  share options 4
  share price decline 64, 66, 67–8, 72
  strategic failures 2, 73
  tracker stocks 65–6, 197*
Z
Zini, Gianpaolo 167–8