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# Introduction

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 ineffective 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, Ebberts 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.<sup>1</sup>

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 Ebberts. 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.<sup>2</sup>

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'.<sup>i</sup> 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.<sup>3</sup> 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'<sup>ii</sup> 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.<sup>4</sup> We saw the emergence of 'day traders' whose activities were enabled by the technological revolution in which they were investing. We also witnessed

i 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.

ii 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

- 1 Sarah Anderson, John Cavanagh, Scott Klinger and Liz Stanton, 'Executive Excess 2005: 12th Annual CEO Compensation Survey', Institute for Policy Studies and United for a Fair Economy (2005).
- 2 J. K. Galbraith, *A Short History of Financial Euphoria* (Knoxville: Whittle Direct Books, 1990).
- 3 Robert J. Shiller, *Irrational Exuberance* (Princeton University Press, 2000).
- 4 Driek Desmet et al., 'Valuing dot.coms', *McKinsey Quarterly* (Issue number 1, 2000), p. 148.

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