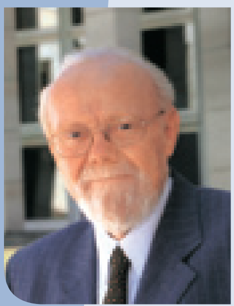
IMD
No. 135, July 2006

Perspectives for Managers

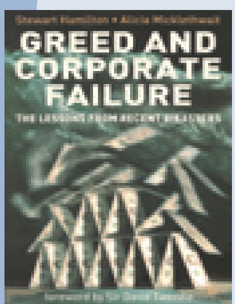
www.imd.ch

Sarbanes-Oxley Will Make Little Difference – Understanding the real reasons for corporate failure



Stewart Hamilton
IMD Professor
of Accounting and Finance

Alicia Micklethwait
IMD Research Associate



Published by Palgrave
www.palgrave.com

When first Enron, and then WorldCom, collapsed in spectacular fashion to be followed by many others (including Parmalat which removed any residual European belief that these were American problems), the headlines were screaming 'accounting scandal' as if this was the sole cause of these failures.

To be sure, so-called "aggressive" accounting policies and earnings management,[1] often embarked upon to meet analysts' expectations, were part of the stories, but these primarily served to conceal, for far longer than should have been possible, much more significant problems. That companies were assisted in this by greedy and craven auditors encouraged that simplistic explanation.

Reacting to the media outcry and the anguished moans of the many that had lost jobs, pensions and savings, the US Congress rushed to pass an ill-considered and hasty piece of legislation, the Sarbanes-Oxley Act (S-Ox) in early 2002. It sought to prevent future "Enrons", an objective that is doomed to fail as it does not, and cannot, address the underlying problems.

The fundamental causes of corporate failure are more complex. Accounting, or, more accurately, the misuse of accounting, was not the main problem. Rather the uncontrolled pursuit of flawed strategies, coupled with greed on the part of many, were the real reasons for the downfall of household names and previous stock market favourites.

From our research into recent corporate failures, and into earlier examples like Metalgeselshaft, Rolls-Royce, Guinness and Barings Bank, we have identified what we believe are the main causal factors.[2]

The recurring themes are: poor strategic decisions; over-expansion, especially through (ill-judged) acquisitions; the dominant CEO, or "one man band"; the greed, hubris and power lust of CEOs and other "star" performers; poor risk management and weak internal controls, particularly with regard to cash; and, most importantly, ineffective boards and their audit committees.

While any one of these on its own would not necessarily be sufficient for failure, the combination of two or more is likely to be lethal.

In our book,[3] we selected (from a large possible choice) a representative sample of eight of the more high profile cases, across five industries and five countries, and sought to determine the commonalities.

Strategic failures

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 over-capacity in fibre-optic 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.

Neither Ahold nor Parmalat (in South America), nor Enron (in India) really understood the country and the political risks they faced. When Swissair made a large minority investment in Sabena (Belgium), it failed to judge the difficulties associated with transforming 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; WorldCom blindly accepted its advisors' overvaluation of Intermedia's local network assets.

Over-expansion driven by greed

Many companies, frustrated by their inability to grow organically sufficiently quickly, turn instead to acquisitions. Despite many empirical academic studies showing 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.
People tend to be naturally greedy, rarely content with what they have accomplished. 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 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.
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 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, and in an earlier era, Robert Maxwell and Macmillan US.

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 previous success. But later, 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.

Control failures

Blurred reporting lines leave holes in control systems, nowhere more obvious than at Barings, where no one believed that they had overriding responsibility for the activities of rogue trader Leeson. Dispersed departments add to the problems: it is more difficult to pool knowledge of goings on when departments do not work closely together. At 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.
Changing the organizational 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 deteriorating 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 and earlier, at Diawa Bank and Showa Shell.
A fundamental contributor to control 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.
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.
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 specialization), 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.
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 behavior.

Independent directors

The examples we have chosen underline the lack of genuinely independent directors. A board is supposed to provide a non-partisan judgement of the senior management's actions and strategic proposals and to look after the interests of shareholders. Directors with strong financial or other links to the company may well find their judgement clouded. Even where directors were formerly classified as independent, they may not have been so independent after all. At WorldCom, many 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.
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. In this respect at least, S-Ox may make a difference.

Complacency

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 adopted in the late 1990s. But once share prices started to fall and the 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; rubberstamped 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.
Recent events have put the spotlight on corporate governance as never before. In each of the examples cited, the board has failed in its responsibilities to the 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 nor specific industry experience required to make an effective contribution (Swissair, 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.
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 the tough questions and get answers, and to walk away if not satisfied. If this became the norm, then board behavior would take a turn for the better. Trying to explain the sudden departure of a board member causes problems for companies who 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.

Some steps to make such failures less likely

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 more constructive use of time. An effective 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.
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 if he is the CEO himself, as was the case at Tyco and Enron. As part of a necessary system of checks and balances, the roles of chairman and CEO should be separate in all cases. Each has a separate and distinct contribution to make. Furthermore, a retiring CEO should not step up to the chairman's position as that risks emasculating or at least overshadowing the new incumbent.
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.

Re-align executive compensation

Executive compensation packages should be designed to encourage long-term thinking and focused 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 or, at the very least, 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 the share price movement relative to an index of its peers – would avoid the problem of excessive or negligible rewards because of general 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 private use of aeroplanes should be disclosed in annual reports at their pre-tax value.

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 performance before the CEO could benefit.

“The passing of legislation like the Sarbanes-Oxley Act will do little to prevent future failures as it cannot address the underlying causes.”

Legislation isn't enough

The passing of legislation like the Sarbanes-Oxley Act will do little to prevent future failures (while in the process undeservedly enriching the very accounting firms who were, in part, culpable in the recent disasters) as it cannot address the underlying causes.

While S-Ox and other corporate governance guidelines call for more independent directors (with a stricter definition of "independent"), splitting the CEO and chairman role, outlawing company executive loans, protecting whistleblowers, explicitly making directors responsible for the accounts (section 404), and specifying the make-up and duties of audit committees, this will not be enough.

Provisions are already being watered down. The cost of implementation has caused calls for the easing of requirements. More importantly, memories are short, especially politicians', and it is highly probable that the attempts to water down the provisions will succeed.

What directors, managers and others need to remember is that ethics matter and must be demonstrated from the top; that it is better to manage market expectations rather than to manage earnings to meet expectations; and that it is false economy to scrimp on information and control systems.

None of this will prevent companies pursuing flawed strategies or making poor acquisitions. Nor will it rein in the overly ambitious and greedy CEO unless there is a strong, knowledgeable and challenging board.

1 A problem highlighted by SEC Chairman, Arthur Levitt in a speech in 1998, *The Numbers Game*

2 Failure is defined to include shareholder value destruction in companies that do survive in a legal sense e.g. Marconi, Tyco, Ahold, Parmalat

3 *Greed and Corporate Failure: the lessons from recent disasters*, Palgrave Macmillan, April 2006

IMD
P. O. Box 915, CH-1001 Lausanne,
Switzerland
Tel.: +41 21 618 0111
Fax: +41 21 618 0707
info@imd.ch
http://www.imd.ch

Editor: Roger Whittle

IMD INTERNATIONAL
Real World. Real Learning®