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Management Risk

The Bottleneck is at the Top of the Bottle

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Contents

List of Figures and Tables

Figures

Tables

Preface

Based on an extensive research project in the US, UK, and continental Europe, this book has been written for both professionals and the academic market, particularly senior-level and graduate studies in Business Administration and Management. In the professional market, the book addresses practitioners in business and industry: manufacturing companies, merchandising firms, commercial banks, securities houses, service companies, and consultancies. It is designed for people interested in the benefits provided by sound management, as well as the avoidance of malpractices which lead to investors being misled by the companies' senior management, financial analysts, and public accountants.

The information resulting from this research will be vital to members of the board, chief executive officers (CEOs), chief operating officers (COOs), financial directors, members of Audit Committees, auditors (both internal and external), and lawyers (corporate and partners of law firms), institutional investors, investment advisors, financial analysts, operations managers, consultants, and regulators.

The text outlines the reasons why *management risk* must be examined within the perspective of each company's business challenges. Research results suggest there is a synergy between shareholder value and business ethics. Senior executives who participated in the research and during the meetings underlined:

- Senior management's accountability not only for financial results but also for *reliable financial reporting*
- The benefits as well as the risks associated with *value differentiation* through novel strategic policies
- The reasons why *honesty is the best policy* at the level of the board, the CEO, and senior management
- The risks associated with *near-sighted management*, skills obsolescence, overcentralization, and dubious deals.

Among the critical questions this book addresses are: What can be learned from Enron, Global Crossing, Tyco International, WorldCom, Allied Irish Banks (AIB), the American International Group (AIG), American Express, Merrill Lynch, J.P. Morgan Chase, and a great number of other companies. Was management skill really lacking, or was it that management attention was absent because the board, the CEO, and senior executives had spread themselves too thin dealing with diverse and uncorrelated issues?

Management risk has many origins, and lack of management attention is a central one. As the complexity of business increases, one of the scarcest commodities becomes the time and attention of senior management. Very few business leaders are able to cope with troubles on many fronts. Globalization, innovation, technology, new sophistication of financial instruments, the flood of information, and the amount of risk being assumed has changed the nature of crisis management. Much more powerful tools – and a new code of ethics – are needed to cope with simultaneous fights on several fronts.

* * *

In practically every Group of Ten (G-10) country, and in many others, in the 2000–3 timeframe, the banking system had to contend not only with a deteriorating overall economic situation but also with a persisting bear market on the stock exchanges and substantial loan losses. This caused credit institutions to set up risk provisions in their balance sheets, while insurance companies found themselves obliged to liquidate equities in their portfolios. Although it cannot be inferred from this situation that banks, insurance firms, and other companies had acute liquidity or solvency problems, financial and industrial firms throughout the G-10 landscape and elsewhere have been confronted with serious profitability issues. The better-managed entities took measures to cut costs and reduce their risk exposure, but few used a really sharp knife to cut the salaries of their senior executives, or significantly reduce their stock options.

Whether in cash or through options, *overpay* is one of the manifestations of management risk. The same is true of any remuneration, beyond a basic salary, not related to performance. Overpay has another major negative – inciting senior management to take inordinate risk, and use a high level of leverage, to get a bigger bonus. France Télécom is a prime example. After privatization, its top brass ran up a debt of Euro 70 billion, outstripping the gross domestic product (GDP) of every African country except Egypt and South Africa. The French taxpayers had to pick up more than half of the bill, since the French government owned 56.5 percent of France Télécom.

Mismanagement is a glaring example of management risk, and so is malfeasance. On February 25, 2003, four former Qwest Communications executives were indicted by a grand jury in Denver, CO, on criminal charges stemming from an alleged accounting fraud that investigators said had improperly boosted the US telecom group's revenues. The Securities and Exchange Commission (SEC) also filed a civil complaint against eight executives at Qwest Communications, claiming that they had manipulated another contract to inflate revenues by $100 million. John Ashcroft, the US Attorney General, characterized the investigation of the telecoms group as "active and on-going," suggesting that additional action might follow.

In the 2001–3 timeframe, with Enron, Global Crossing, Adelphia Communications, WorldCom, Tyco and many other well-known companies either going bankrupt or facing serious legal troubles, the SEC, Department of Justice, and Attorney Generals of several states had their hands full. On April 28, 2003, announcing a settlement with ten major Wall Street firms, William Donaldson, the Chairman of SEC, said that he was profoundly saddened and angry, about the conduct alleged in the SEC complaints, adding that: "There is absolutely no place for it in our markets, and it cannot be tolerated."

Heavy penalties, "disgorgement" of fraudulently acquired profits, and the like, are manifestations of management risk. Nor was the nearly $1.4 billion settlement the end of the worries of banks involved in the malpractice referred to in the preceding paragraph. More red ink may still run as, after having settled with the Attorney General and the regulators, Wall Street firms can now expect plaintiff lawyers to start civil suits, including class actions. Eliot Spitzer, the Attorney General of New York State, who brought the charges, remarked during the settlement that malfeasance went well up the corporate food chain. While the CEOs of the financial institutions which reached the settlement may have been spared personal indictment, legal proceedings in the future may well cover further aspects of malfeasance. All entities should therefore get serious about the legal implications of management risk.

* * *

The twelve chapters of this book have been divided into two parts. Part I examines senior management's responsibility towards their shareholders. Starting on a positive tone, Chapter 1 draws the reader's attention to the correlation between management ethics and personal accountability.

Chapter 2 presents the opposite perspective: what constitutes the background of mismanagement and how difficult it is to get rid of a bad CEO whose actions damage the company. Chapter 3 explains some of the means that have been employed to mislead investors, other stakeholders, and regulators. Creative accounting and Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) are the two key issues here.

The damage to investors from financial analysts and others who should have been reliable in their reporting is the theme of Chapter 4. Many of their fraudulent acts led to reputational risk. While the abuse of management pay and executive options is not yet a criminal act, Chapter 5 demonstrates that as this practice spreads and increases in magnitude, legislators and regulators may have to act to bring it under control.

Chapter 6 completes Part I by focusing on the responsibilities of certified public accountants (CPAs, chartered accountants) and of the board of directors. The text presents the reader with a history of audit miscarriages, and concludes with the evolution of legislation regarding financial malfeasance. A basic principle in business is: "if you have nothing to hide, don't hide anything."

The six chapters of Part II concentrate on case studies of highly leveraged companies, their rapid ascent to stardom, and their equally swift crash. Chapters 7 starts with the deals done at Enron which eventually brought down the company, its shareholders, and its employees – but not its senior management, which was pulled out of the wreckage relatively unscathed. The blame for Enron's débâcle does not fall on one single person but on several, as Chapter 8 suggests. Enron's superleveraging started soon after the Commodities Future Modernization Act, on which its top brass capitalized to gear the company sky-high. Then came kickbacks and forays into non-core business, like broadband, which became financially disastrous. Enron was helped by its bankers in superleveraging itself, as well as in some other deals which were on the borderline of legality, as Chapter 9 suggests. Beefing up the value of its stock through a very favorable but unrealistic equity analysis was instrumental in attracting investors. From private individuals to pension funds, those who bought Enron's equity came down with the company.

Chapter 10 draws the reader's attention to the Ponzi games that can be played with derivative financial instruments. As Warren Buffett aptly suggested, derivatives are so complex and based on outcomes so distant that parties on both sides of the same bet can book a notional profit. If that means big trading bonuses today, who cares about future losses which may destroy shareholder value and bring a company to its knees?

Chapter 11 explains how securitization of loans can be done, and gives advice on how a company can protect itself from being taken to the cleaners. Chapter 12 presents examples of companies which should have known better about how to avoid a downturn, or a very expensive settlement with clients. Bad loans, derivatives gambles, and basic mismanagement mean that for credit institutions the going is tough. A common point in all of the case studies in this book is that senior management should be much more alert, able to avoid tunnel vision, and steer away from deals which cost much more than they are worth. Market power is one of the most basic conditions for innovation – but not market power at any price.

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