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Looking for Patterns in Corporate Failures

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1. Introduction

This paper is about the failure of companies when they are confronted with critical governance matters. According to Christensen (2002), “Companies stumble for many reasons, of course, among them bureaucracy, arrogance, tired executive blood, poor planning, short-term investment horizons, inadequate skills and resources, and just plain bad luck” (p. xi). But this paper is not about the failure of such companies caused by such weaknesses. It is about companies which were regarded as well managed and competitive (perhaps too competitive) till they suddenly failed; companies which were much admired by the stock market, analysts, investors and shareholders, companies which came to be widely acknowledged for their business models, companies which were led by men and women whose examples people were asked to emulate till it was discovered that they had feet of clay. Corporate governance with the trappings of rules, regulations, procedures, legal systems, ethics, culture, and ethos is like a harness which can help drive a company on a sustainable growth path, without which the growth of a company can often become illusively spectacular only to end in business disruption, financial depravation and devastation. We study a few of these companies in order to find patterns which could help to establish a framework for governance.

2. Need to recognise patterns

Recognising patterns and finding order in a chaotic clutter of data is important for businesses. There could be patterns in financial performance, profits, consumer tastes and behaviour, formats of stores or even in supermarkets. Since knowledge and innovation drive today's business more than ever before, good managers are known to study and identify patterns before they take business decisions at the strategic, technical, and operational levels. It enables them to have a better understanding of potential outcomes. The foundation for pattern recognition is data and information, and so they resort to data mining and gather information and search for patterns.

Historically, cognitive anthropologists and naturalists have resorted to identifying patterns from masses of data. Clinical psychology and the behavioural sciences also rely on pattern recognition.

Studies of the more (in)famous corporate frauds in different countries over the years show that governance failures also fall into identifiable patterns. It might be of interest to find out what these patterns are and draw lessons from them, though admittedly, the recurrence of patterns seems to indicate that lessons are not easily learnt whenever there is a specious association of money and ambition. Our studies show that ever so often there are instances of a single deliberate intransigence necessitated by the desire of the management to avert an immediate crisis, that lead to a series of consequential infringements costing the entire corporation dear. We find that boards are often unaware of the infringements, or are deliberately kept unaware by the managements. We find that even when the boards notice these, their first reaction is to ignore the signals, or to treat them as weak signals, followed by attempts to cover up the misdemeanours under the guise of business expediency, or to find convincing justifications. More often than not boards hesitate to question the logic/need driving the action: It has been observed that in such companies, charismatic leadership coexists with cultism and unethical behaviour thrives on internal aggression; there is a facade of team work, behind which lurks a punitive environment; there is an atmosphere of ingratiation stifling critical upward communication.

Because it may be a while before financial results are affected, extant financial results may not reflect the true state of affairs at the company. The sanctity of financial numbers must of course remain paramount. But no amount of rigour or sophistication of the mathematical models can assure the accuracy of the conclusions, if the input numbers themselves are wrong, a truth that is so often lost on those who reach conclusions by crunching numbers alone.

3. The march of folly

Tuchman (1984) describes folly as "the pursuit of policy contrary to the self-interest of the constituency or state involved...folly is a policy that is counter-productive" (p. 5). To count as folly, the acts must necessarily have four attributes— these must be clearly contrary to the self-interest of the organisation or group pursuing them; these should be committed over a period of time, not just in a single burst of irrational behaviour; these should be conducted by a number of individuals, not just one deranged maniac; and there must be people alive at the time who correctly pointed out why the act in was folly.

In those companies where the lack of adherence to the principles of corporate governance resulted in an apocalyptic collapse, some common patterns are visible in the following areas—the genesis of the company itself; the ideas, ambitions, and personal dreams of the person(s) who sets up the business; the business model itself; the course of the business and its growth; the board composition, design, and the manner of its functioning; the internal management processes and controls; the overzealous reaction of the rest of the world to the initial success; the behaviour and aggressive culture of the organisation; the external connectivity, reliance on high connections and political support; the sudden discovery of what is actually going on; the speed of the collapse; the consequences of the collapse; and the extreme response of the external regulators in the wake of the collapse to the prevent recurrence.

We now turn to a review of three instances in this march of corporate folly—Maxwell, Parmalat, and Enron. We follow up with a few others as well, although very briefly. A common feature in all these would be an initial intense phase of euphoria, “a mass escape from reality, that excludes any serious contemplation of the true nature of what is taking place” (Galbraith, 1994), followed by a spectacular collapse. The global financial crisis of 2008 is another classic example of this phenomenon.

The fall of Maxwell Corporation

The fall of Maxwell Corporation is integral to this discussion because it triggered the genesis of a regulatory framework of Corporate Governance in the UK and Europe, serving as a reference point for corporate governance for the rest of the world.

In November 1990, the body of Robert Maxwell, the British media magnate was discovered in a luxury yacht floating in the waters around Canary Islands and in it was. The cause of his death was unknown. Robert Maxwell had rapidly built his media empire in the UK through a series of acquisitions in the 1980s. The acquisitions were highly leveraged and it was found well after his death that the debts were financed by diverting resources from the pension funds of his companies. At the time of his death the total debt of his companies was $5 billion, and £440 million (GBP) were missing from the company’s pension funds.[1] The failure of the Maxwell Corporation prompted the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in the UK to set up a committee in 1991 chaired by Sir Adrian Cadbury to investigate the British corporate governance system, and to suggest ways to restore investor confidence in the system.[2]

Robert Maxwell (born Jan Ludvik Hoch) was the son of a poor Czech Jewish farmer. He fled from Czechoslovakia to the UK to escape extreme poverty and the German repression of the Jews. He changed his name several times and became a naturalised citizen in 1946, when he adopted of the name Robert Maxwell.

His burning ambition to become wealthy, his zealousness and business acumen led him to try out the publishing business. While serving in the British army, he had developed contacts with the Allied forces and became a distributor for Springer Verlag which he acquired after the Second World War. His next acquisition was Pergamon Press in 1954 which he transformed into a major publisher of scientific journals by 1957 and took it public in 1964. In 1970 Maxwell established the Maxwell Foundation in Liechtenstein. In 1981 he turned the British Printing Corporation into a profitable venture and named it Maxwell Communications Corporation. By 1980 he saw the fulfilment of his ambition, when he became a British media millionaire. Between 1980 and 1990 his multiple acquisitions were funded largely through bank borrowings. He bought and sold companies at a rapid rate, apparently to conceal the unsound foundations of his business. The Mirror Group was acquired; he also bought the interests of the Macmillan Publishing House. Maxwell pioneered the dissemination of highly specialised scientific information, responding to the exponential growth of investment in academic research.

Maxwell held majority stakes in his listed companies, controlling them through a web of private companies established in Liechtenstein and operated by a Swiss lawyer. He used public money through rights issue of Maxwell Communications and floated the Mirror Group to pay off debts, while continuing on an acquisition spree and pledging the same assets multiple times. He manipulated his stocks on the London Stock Exchange to get better valuations and win the confidence of his bankers, and to increase his wealth. He used the best of the bankers—Midland, Lloyds, National Westminster, Barclay's, Sumitomo Trust, Credit Lyonnais, Citicorp and Bankers Trust. His auditors were Coopers & Lybrand and Deloitte, who helped him to clean his books before the year end. His reputation enabled him to fill the board with people of high repute in Britain, who knew very little about his business. The prestigious board of directors, auditors, and bankers gave him and his companies an enviable reputation. He became a Labour Party MP in the House of Commons, serving for 6 years. He was appointed to multiple boards. He had varied interests, one of which was keeping in touch with the totalitarian regimes of Eastern Europe and with Israel, and the other was sports. He bought the Oxford United Football Club with his company's funds saving them from bankruptcy, and goaded them to the top of English football—they won the League Cup in 1986. He also bought into Derby County Football Club in 1987. It was important for him to have these trappings of power, and he paid enough money to maintain them.

Maxwell's management style was marked by secrecy; he trusted no one—neither his employees, nor his board members. He personally signed all important cheques. His own office and those of his board members were wired, and he tapped the telephone of even his own finance director. His personal life style was flamboyant. The Department of Trade and Industries had become suspicious, and conducted an investigation. Consequently in 1990 he sold Pergamon Press and Maxwell Directories to Elsevier for £440 million partly to cover his debts, but mainly to buy the *New York Daily News;* he also launched an ambitious new project, a transnational weekly newspaper called *The European*.

In 1991, Britain went into recession, and the interest rates rose. Maxwell had substantial borrowings secured on his shareholdings in his public companies, Mirror and Maxwell Communications. The banks were permitted to sell these holdings in certain circumstances, which they did, depressing the share price and reducing the coverage of the remaining debt. Maxwell then used more money—both borrowed and redirected from pension funds and even the daily balances of his businesses—to buy shares on the open market, in an attempt to prop up the price and provide the shares as collateral for further debt (Stiles & Taylor, 1993).

By May 1991 there were reports that the Maxwell companies and pension schemes were failing to meet statutory reporting obligations. Maxwell employees lodged complaints with British and U.S. regulatory agencies about the abuse of Maxwell company pension funds. Soon after that, Robert Maxwell's body was found on his yacht off the Canary Islands.

The empire which Maxwell had built over four decades crumbled in four months. His sons Ian and Kevin were convicted for fraud.

Calisto Tanzi and Parmalat

We now turn our attention to Calisto Tanzi who founded the multinational Italian dairy and food corporation Parmalat SpA. The episode under discussion happened about a decade after the fall of Maxwell Corporation.

In the 1990s Parmalat was the leading global company in the production of Ultra High Temperature milk (UHT). By 2003, it was embroiled in fraud and financial failure, and had filed for the biggest corporate bankruptcy (€14 billion; $20bn; £13bn) in Europe. The US Securities and Exchange Commission filed a suit charging Parmalat with one of the largest and most brazen corporate financial frauds in history. The company was reorganised in 2005, and today Parmalat is a company with a global presence, having major operations in Europe, Latin America, North America, Australia, China and South Africa.[3]

Calisto Tanzi, is a third generation entrepreneur from Parma. Tanzi's grandfather set up a small family shop selling sausage and cheese in a Parma dairy farm. His father began selling milk and cheese from door to door. After his father's death in 1961, Tanzi took over; however the small family business did not satisfy him. He wanted to be the largest milk and dairy product company in the world and to be known as the "Coca Cola of Milk". He also wanted to control the reins of power in Italy, which he did, for more than a decade. By the time Parmalat collapsed in 2003, Calisto Tanzi had become a legendary figure in Italy, viewed as a classic entrepreneur who rose from a small door to door vendor of milk and cheese, and built a world-class company (which was Italy's eighth largest) and a global consumer brand.

Those who knew Calisto Tanzi considered him as a charismatic person, and a steady leader; he was so good at math that he always spotted calculation errors in presentations. Soon after founding Parmalat as a dairy company in 1961, he adopted a new pasteurisation technology that allowed milk to stay fresh for months without refrigeration. Parmalat's distinctive cartons soon became a fixture in stores across Italy, and ultimately conquered Europe and much of the world.

He financed politicians, bailed out fellow industrialists, won a knighthood and seats on bank boards, discovered the power of sports marketing, and plastered the Parmalat name on events from World Cup skiing to Formula One racing, and even courted the mafia. He was a pious Catholic and a generous benefactor who renovated cathedrals. He loved power but seemed modest about his achievements. He didn't smoke, drank little, drove his own Lexus, maintained close relationships with the Christian Democrats and dispensed the equivalent of $2.4 million a year in political donations from a fund earmarked for regulatory fees.

Parmalat's finances were weak at least since the 1980s. Tanzi encouraged the falsification of accounts if it would help to get more debt from the bankers. Between 1961and 1980 Parmalat's business grew, but the slow growth did not satisfy the entrepreneur in Tanzi. Debt was necessary for a more rapid expansion of the company. But as he expanded, he also failed and problems started brewing behind Parmalat's façade of success. He took the help of auditors to hide the losses. In 1987, he spent €130 million on a station called Odeon TV to build Italy's third major network. The project collapsed after three years. To stave off bankruptcy, Tanzi engineered a so-called reverse merger, under which it sold itself to a dormant holding company already listed on the Milan stock exchange. The combined firm then raised about €150 million from outside investors. This enabled Parmalat to go public in 1990, and plug some of the gaps in its accounts; at the time it had a market value of around €300 million.

As early as 1993, Parmalat also began to invent financial transactions to pad its balance sheet. While the company should have posted losses every year from 1990 onwards, it posted profits, masking its problems with a mixture of fictitious transactions and aggressive acquisitions of dairy and other companies in Italy, Brazil, Argentina, Hungary and the US.

Tanzi's forgery was crude and simple to the extent of being offensive and ridiculous. He borrowed money from global banks and justified those loans by inflating Parmalat's revenues through fictitious sales to retailers. The core of the fraud was a system of double billing to Italian supermarkets and other retail customers. This helped Parmalat create the impression that its accounts receivable were much larger than they really were.

To maintain and grow the already inflated bubble, Tanzi had the support of a band of executives, the best bankers of Europe and the US, and compliant auditors. The executives along with the bankers helped structure a complex financing scheme; through a Delaware company arrangements were made involving offshore companies. The auditors Grant Thornton helped in certifying the important parts of the accounts of Parmalat's business including a fictitious account of €2.8 billion in the Bank of America. The bankers and auditors earned huge commissions. Almost half of Parmalat's total debt went to pay interest, commissions and of that, €2.8 billion went to the banks alone. As many as 300 people at Parmalat knew of this. But if anybody thought there was something wrong, they didn't dare to say so publicly. Tanzi's formidable reputation in Italy and his connections with business, politics and sports enabled him to get the support of persons with high connections for Parmalat's board. This helped Parmalat to maintain its respectability and enhance its aura. The board knew nothing of the internal working; little information was shared with the members, and neither did they ask.

While Parmalat's finances were on the brink of collapse, praise from all quarters did not wane until 2003. The company retained the glitz, the stock market valuations were kept high, and its credit rating was investment grade. Tanzi was regarded as a legend who had single-handedly created Parmalat.

Parmalat's true debts became too big to hide. In 1999, a fake Cuban milk scheme was set up with money transferred to shell companies in the Cayman Islands. It was claimed that the fake company had sold enough powdered milk in one year to feed every family in Cuba. The fictitious assets of the shell companies became enormous (up to $8 billion) and the company had to invent a Cayman Islands-based investment fund to take over some of its fictitious credits. This soon attracted the attention of auditors and Italy's stock market regulator in November 2003. Deloitte, the other auditor besides Grant Thornton, raised doubts over the financial transactions. It then transpired that cash balance to the tune of a few billion Euros which appeared in the balance sheet did not in fact exist. Within a month, the whole scam imploded. Tanzi and 15 other Parmalat executives were accused of fraudulent accounting and market manipulation, and were sentenced to 10 years' imprisonment.

The rise and fall of Enron

The eponym for corporate governance disaster was not the Maxwell episode or Parmalat SpA, but the bankruptcy of the Texas-based energy company Enron Corporation in November 2001, and the dissolution of Arthur Andersen (the oldest audit and accountancy partnership in the US).[4] It happened immediately following the burst of the dot-com bubble in the US and the crash of the US stock market. It was succeeded by several comparable corporate governance disasters which undermined the very foundations of capitalism.

Enron Corporation was established in 1985 through the merger of Houston Natural Gas and InterNorth, two natural gas pipeline companies. It was founded by Kenneth Lay. The son of a Baptist minister who was also a farmer, Lay dreamt of making it big.

Energy companies had been lobbying with the Congress in the 1980s for deregulation of the energy business. When the policy changed, Lay benefited from it and established the Enron Corporation. The deregulation of electricity made it possible for Enron and other companies to sell energy at higher prices and thrive. While local governments cried against price volatility, Lay used his political connections to keep the free market alive. But Lay was not happy making money only by generating electricity and setting up gas pipelines. Being capital intensive, future cash flows from the company's projects were bound to be slow. Lay wanted to make money quickly. He recruited Jeff Skilling in 1990, who helped transform Enron from a natural-gas pipeline company into an energy-trading powerhouse. It also diversified into other areas like weather, bandwidth, and other derivatives. Enron changed its business model—from power generation and distribution, to power trader to electricity trader to energy trader, and then to trader in energy derivatives—to make money even faster. Enron began to bet against future movements in the price of gas-generated energy. Enron was said to buy and sell tomorrow's gas at a fixed price today. A major portion of Enron's revenue came from energy trading and not from the pipelines it was laying in Central America or elsewhere.

By 2001, Enron had become a conglomerate that owned and operated gas pipelines, pulp and paper plants, broadband assets, electricity plants, and water plants internationally. When Enron was in the natural gas business, it had straightforward accounting. However Skilling insisted that a trading business should adopt mark-to-market accounting, in order to record true economic value. He used mark-to-market accounting with the approval of the US SEC, and extended it to book revenue on the basis of hypothetical future cash flows. Skilling called it the "hypothetical future value accounting" which was used for all Enron's businesses.

This policy led to a growing mismatch of profits and cash. The accounting policy helped to raise profits, the value of its stock and record ever higher revenue and profitability growth year on year. The stock increased by 56% in 1999 and a further 87% in 2000, compared to a 20% increase and a 10% decline for the index during the same years. By December 31, 2000, Enron's stock was priced at $83.13 and its market capitalisation exceeded $60 billion—70 times earnings and six times book value—an indication of the stock market's high expectations about its future prospects. Enron was regarded as the most innovative company in the US, figured six times in the Fortune 500 list of Most Admired Companies, and was sixth in *Fortune's* Global 500 list in 2000. Public accolades helped sustain the aura which was built around Enron. Enron was meeting Wall Street's expectations.

Executive compensation was high and was paid through bonuses and stock options. So the executives of Enron had an interest in keeping the stock prices high. While the stock prices rose, so did the value of options, and employees, board members and key executives encashed the options in the rising stock market. Enron was able to recruit a group of derivative traders who were known for their aggression. The aggressive management style and HR practices and performance management system encouraged aggressive behaviour. The new recruits emulated the aggression of Skilling and idolised Lay.

Enron needed money for new investments and acquisitions; besides there was a growing mismatch between cash and profit. Enron resorted to heavy debt, but did not want to show any debt on its balance sheet. In order to hide the debts from its books, it created a web of special purpose vehicles or limited partnerships in tax havens. Some of the more familiar ones were Raptor, Jedi, Chewco, and LJM. The best of the bankers in the US invested in them and Enron entered into complicated structured transactions with these shell companies, which were very little understood by anyone in Enron, except Andrew Fastow, the Chief Financial Officer who managed them, and a handful of investment bankers. But what mattered was that these LPs and structured transactions helped Enron earn revenue and profit and also mask debt on the balance sheet; and what mattered to the market was that Enron's quarterly earnings were growing quarter on quarter.

Enron had the support of a 15-member board of directors which was the envy of corporate America, with only 3 internal directors. Enron also had a risk management system, which was so complicated that no one but Skilling understood it. It also had a code of ethics with the acronym RICE, standing for Respect, Integrity, Commitment and Excellence. However, Lay was not known for his ethical practices. In 1987 at the Enron International Oil Inc. unit in Valhalla there were two rogue traders who incurred $85 million in losses by making risky, disastrous bets. But he allowed the traders to go unpunished because they had earlier helped generate millions of dollars for Enron. The auditing firm Arthur Anderson aided the company by certifying its accounting policies, the structured deals with the shell companies and the marked to market accounting, in return for commissions. When the scandal broke out they also helped to shred the evidence.

Finally the debt was too big to hide and Enron had little cash in business. Realising that Enron was on the verge of collapsing, Jeff Skilling resigned as CEO on 14 August, 2001, citing personal reasons. He was replaced by Kenneth Lay. By 12 October, 2001 Arthur Andersen, at the prompting of their internal lawyers, began shredding all incriminating documents. On 16 October, 2001 Enron announced writing down of quarterly earnings of $393 million. On 22 October, 2001 the US Securities and Exchange Commission opened inquiries into a potential conflict of interest between Enron, its directors, and its special partnerships. On 8 November, 2001 Enron restated its financials for the previous four years to consolidate partnership arrangements retroactively. The earnings from 1997 to 2000 declined by $591 million, and the debt for 2000 increased by $658 million. The stock price fell rapidly to 1 penny and on 2 December, 2001 Enron filed for bankruptcy in New York.[5]

The enormity of the scandal necessitated the involvement of the US Congress. Besides the investigations by SEC, the Congress began an extensive hearing. At the end of the investigations, all the officials involved were convicted. Fastow and his wife, Lea pleaded guilty to charges of fraud, money laundering, insider trading, and conspiracy. Fastow was sentenced to ten years in prison. Lea was sentenced to one year in prison for helping her husband. Skilling was convicted and sentenced to 24 years and 4 months in prison. Lay faced a total sentence of up to 45 years in prison, but died on July 5, 2006. Arthur Anderson closed down, resulting in the loss of 85,000 jobs. Enron's shareholders lost $74 billion in the four years before the company's bankruptcy, and more than 20,000 jobs were lost.

Between December 2001 and April 2002, the US Senate Committee on Banking, Housing, and Urban Affairs, and the House Committee on Financial Services held numerous hearings about the collapse of Enron and related accounting and investor protection issues. These hearings and the corporate scandals that followed Enron[6] led to the passage of the Sarbanes-Oxley Act on July 30, 2002. The end result of all these corporate scandals was increased supervision, greater emphasis on risk management, stringent disclosures, limitations on the accounting and consultancy linked audit firms, greater responsibilities on the chief executives, and expensive compliance.

Others who also marched

In 1980, 16 year-old Barry Minkow started a small, door-to-door carpet cleaning operation ZZZZ Best in his parents' garage. But the business was too small for his satisfaction. He then set up an insurance restoration business, and a ponzi scheme in 1980. ZZZZ Best experienced explosive growth in both revenues and profits during the initial years of its existence. From 1984 to 1987, the company's net income surged from less than $200,000 to more than $5 million on revenues of $50 million. Minkow lured investors through bank borrowing, forgery, theft, and the ponzi scheme. The media was in love with the "wonder boy" (Akst, 1990). When ZZZZ Best went public in 1986, Minkow and several of his close associates became multimillionaires overnight.

Minkow had next to no problems from his board as they were not very vigilant and attended few meetings. As suggested by his network of friends he had retained Ernst & Whinney as auditing partners. They helped him with the accounts and also gave him the respectability he required.

The fraud was found out in 1987, within a year of the public issue. Minkow was eventually convicted of fraud and sentenced to 25 years in prison following US SEC's investigation.

MicroStrategy was a business intelligence, enterprise reporting, and on-line analytical processing software vendor, founded in 1989 by Michael Saylor, Sanjeev Bansal, and Thomas Spahr. It became a NASDAQ listed company in 1998. Its product line rapidly advanced, its profitability grew rapidly and it caught the attention of the market and the analysts.[7]

In January 1999, the company announced a 93% rise in the revenues. The company notified the SEC of plans to sell a new issue of stock, including up to 1.9 million shares owned by Saylor. Four days later the stock price hit a peak of $333, more than 80 times the price when the company went public in 1998.

However, MicroStrategy was engaging in complicated accounting transactions which allowed top executives to refrain from signing major contracts until after the end of each quarter, after which they would sign enough of them to allow the company to meet revenue targets, while delaying the others for use in future quarters. The auditors PricewaterhouseCoopers approved these before they reversed course. This allowed the company to book higher revenues and higher profit. The national office of PricewaterhouseCoopers learned of these dubious accounting practices from criticisms of the company's accounting in some complicated transactions in *Forbes* magazine. The company was forced to restate its books, and the profits disappeared. Saylor along with two other officials were accused by the SEC of fraud in reporting profits when the company was actually losing money.[8]

Satyam Computers followed in the footsteps of all these organisations in the march of folly. Satyam was one of the four big software companies in India along with Infosys, TCS and Wipro. Its profitability was rising. It had a wonderful code of ethics. The stock market analysts prized the stock. The company got a number of awards; its founder Ramalinga Raju (who was from a family of farmers) won awards for best corporate governance. Its nine-member board was packed with men and women who were very well respected academicians and industry experts. The auditors were PricewaterhouseCoopers.

Though Raju's main business was software, he always had a preference for property and real estate. He set up two property and infrastructure companies—Maytas Infrastructure and Maytas Properties. The former was listed and the latter remained unlisted. Ramalinga Raju's two sons were the CEO and Vice Chairman of the two companies.

On December 16, 2008, Satyam's Board discussed a proposal for buying out the two Maytas companies as good investment decision to diversify using Satyam's cash. The cost of the deal was $1.6 billion. The independent directors of the board unanimously favoured the decision. The Board was only concerned with the valuation aspect but the issues of conflict of interest or corporate governance did not seem to unduly concern them, even though Satyam's funds were to go to the Raju family.

When the news broke out, the stock market reacted badly and the share prices fell forcing Ramalinga Raju and the Satyam board to reverse and withdraw the deal. The institutional investors and the media raised concerns of corporate governance. Raju came under pressure and disclosed that audited financials over the years had reported inflated revenues and assets, understated liabilities and the substantial reported cash of Rs. 50400 million shown in the balance sheet did not actually exist. PricewaterhouseCoopers distanced themselves and stated that the accounts could not be relied upon. The Government of India and regulators stepped in quickly. The board was dismissed, and a new board was appointed by the government. Ramalinga Raju along with a few key executives of the company and the auditing firm were arrested. The criminal and other litigations have not yet been fully heard or completed.

Quick action by the government and good crisis leadership and management by the new board of directors helped the company to survive the initial shocks. It was bought over by Tech Mahindra of the Mahindra group, and has been renamed Mahindra Satyam.

4. Patterns in folly

The examples in this march of folly have invariably followed a sequence which led these companies and their boards down the slippery slope to their doom. The principal protagonists were those who were the promoters of the companies. They gave shape to companies through their ideas, were instrumental in their rise, and ultimately were the reasons for the downfall of their companies. Thus they are in many ways similar to the protagonists in Greek tragedies who were brought down by a *tragic flaw (hamartia* in Aristotelian terms).

The pattern that emerges from the study of these various corporate frauds has the following sequence.

(1) At the beginning of the march, there is a new company or an existing business operating with an initial business model which is sound, but promises low growth. But low growth is unsatisfying.

(2) The company seeks rapid growth and quick rise in profitability. The company finds that changing the business model or strategy may help, so the business model is changed in search of a higher growth trajectory.

(3) Acquisitions and mergers bring faster inorganic growth, so the company gets involved in acquisitions for more rapid growth.

(4) But rapid inorganic growth requires high level of financial leverage. Banks help, more assets are collateralised, and the borrowings increase.

(5) However, higher growth is not enough; profitability must increase.

(6) The continuous growth and profitability bring recognition to the company and its leadership.

(7) There is an emphasis on the bottom line, a compelling urge for better quarterly results. The need to always beat the main street and to seek approbation of the analysts and the media as a validation of its success becomes a compulsive obsession.

(8) When there is high growth and high profitability, executives are rewarded; executive compensation increases, much of which is paid in stocks. The executives have an interest in the buoyancy of stock prices. Good times bring in public plaudits. The company and its management get rewards.

(9) The Chairman, the CEO and the CFO become heroes.

(10) The spectacular growth is never questioned. It gives the board a sense of unerring infallibility leading to complacency, and inculcates a sense of invincibility in the company's management which in turn translates into an aggressive and cult-like leadership style in the company.

(11) The leadership style silences the potential critics and whistleblowers within the company. The flow of information

to the board is weak. The board does not read or interpret weak signals.

(12) The halo built around the company and its CEO help to attract respectable names onto to the board as independent directors.

(13) However, board members are not enough; good auditors are needed to give credibility to the accounting numbers. So the best among auditors are appointed. They are compliant and accommodative. In return they get lucrative assignments. When continuous growth and quarter on quarter increase in profitability are no longer possible, these auditors either actively help with creative accounting or turn a blind eye to anything unacceptable; their reputation helps to brush aside any criticism of (or challenge to) their certification.

(14) A complacent and somnolent board, and compliant and friendly auditors make a good cocktail. Public accolades and praise from the analysts make the cocktail headier.

(15) But rapid inorganic growth and high level of leverage assumes availability of unlimited liquidity. Higher leverage strains the financial condition of the company and results in an unstable equilibrium, but assures growth as long as the macro economic conditions remain buoyant.

(16) Unfortunately sustenance of macroeconomic buoyancy cannot always be guaranteed. It is a function of multiple factors and externalities over which the company and its executives have little control.

(17) Then there is an unexpected external economic shock, often a high impact, hard to predict event in the domestic or global macro economy; the fragile financial equilibrium is threatened. The company is unable to service its financial obligations.

(18) Efforts are first made by the management and the chief executives not to acknowledge the problem. The complacent board hears nothing, sees nothing, and says nothing.

(19) But then the problem becomes too big to hide. Financial and accounting fraud is discovered.

(20) The end then comes very quickly. The company declares bankruptcy or a new owner takes over.

(21) The regulators and the justice system gear into action. The guilty are penalised. New laws are made to plug all conceivable loopholes. The laws are harsh, and compliance expensive.

Such companies are usually set up by individuals with an entrepreneurial spirit who hail from humble backgrounds, but harbour soaring ambitions to grow fast and be rich. They are intelligent. They understand business, but are always unsatisfied and seek more. Their business strategies and their lives are guided by their *hubris*. They often have an opulent lifestyle and their management styles are oppressive and aggressive. They have scant regard for governance, but pretend to do so. They love to build empires, and seek to build connections with political powers, and nurture the symbiotic relationship between business and politics which help them to survive and unjustly prosper. They resort to tunnelling of funds to help families and friends. But in the end when trouble brews, they are deserted by politicians, and the political system pulls all stops to insulate itself from the consequences of the fallout.

In sum

The disquisition shows how circumstances (across countries and time) have followed certain patterns which first gave the stock market and the institutions associated with it (the shareholders, the media, and the analysts) an illusion of wealth creation and protected that illusion, only to descend into financial dementia and depravity. Exercise of leverage and risky investment, compulsive obsession with profits, connivance of the Chairman, the CEO and the CFO, compounded by a merely ceremonial board, overwhelming public applause, courtship with high connections and display of opulence, pomp and show, together with the hubris of the individuals associated with the companies are the five major contributories in this fairly uniform pattern. These five circumstances also throw powerful signals for the company boards, especially their non-aligned directors, institutional shareholders, other stakeholders, media and the society at large to sit up and take notice. When they fail to interpret these signals correctly and in time, the affected constituents of the society end up picking up the costs, which can be very substantial. Success in sustainable wealth creation has visited those companies and those boards who have heeded these signals well.

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Notes

[1] For more details, see Arcot and Bruno (2005), Miranda (2001), among others.

[2] The Cadbury Committee Report embodied a set of recommendations which was accepted as the UK Code of Corporate Governance and became applicable to all listed companies on the London Stock Exchange reporting their accounts after 30 June, 1993. Subsequently several committees were set up to refine the code and the monitoring and compliance systems. The present code is the Combined Code of Corporate Governance.

[3] For more details, see Di Castri and Francesco (2005).

[4] See Munson (2005).

[5] For details, see Healy and Palepu (2003).

[6] The scandals involving World Com, Global Crossing, Adelphia and Tyco Global occurred soon after the Enron scandal.

[7] For more details, see "Saylor's Soldiers", Washington Business Journal (17 March, 2006).

[8] These are not the only instances of fraud in recent corporate history. We have used these as examples to show that a pattern exists in the march of folly. Other notable incidents would include the fraud at MiniScibe (the Denver based disk storage products manufacturer), the collapse of Barings Bank in the UK, among others.