PRESS CUTTING

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How to Avoid Dealing with Companies which Fail

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Abstract

At the highest level there are two routes to crisis and collapse: first, honest failure, usually triggered by financial mismanagement; second, straight fraud. There is little doubt that innocent failure is invariably rooted in creeping financial deterioration resulting from a fatal combination of persistent optimism with relative inexperience.

The companies scuttled by shameless fraud reveal certain characteristics, although the range of case-by-case variations is infinite: Corporate failure used to be slow, gradual and well flagged. Today, one can wake up and see the shares propping up one's pension lose 60% by breakfast time, and be suspended close to zero by lunch.

As there are said to be many ways to skin a cat, so are there endless ways in which a company can collapse. There is little point in classifying and sub-classifying the different potential and proven reasons for corporate crisis: the exercise would merely resemble a museum or library project, gratifying but commercially unproductive in itself.

At the highest level of the family tree/dichotomous key/binary gateways, there are two routes to crisis and collapse: first, honest-to-goodness failure, usually triggered by financial mismanagement (when it is not a 'key man' death, a political or legislative act, or an obscure reason such as someone inventing a better mousetrap at a competing rodent-extermination company that precipitates it); second, dishonest-to-badness fraud.

The key characteristic of company collapse in this age of the silicon chip lies in this. In the days when brokers wore top hats and settlements clerks wore bowlers, markets weren't global, communication was restricted to gossip, letters and the occasional telegram, people networked without having to burrow through Chinese Walls to do so, and rumours and news of difficulties at Company 'x' spread outwards like sleepy ripples on a dozing pond. According to their closeness to the action, their acumen and the speed of decision-making and response, investors could get out if not before it got worse, then a little lower down as the company's fortunes gave way with dignity and gradual subsidence, like a ruptured zeppelin. Even the last man out would exit without pain – he had probably bought on the residual asset-value or on the rumours of a buyer addicted to distressed entities, and made a bit on the way.

Unless it took the form of something spectacular such as black tulips or a bubble in the South Seas, corporate failure was unexciting, almost an everyday event. It was slow, it was gradual and it was well flagged. The need for detection, the lot of an investor - let alone calls for pre-emptive analysis and early warning - were irrelevant to most who read the papers and invested in shares.

Today, one wakes up and the shares or bonds or policies propping up one's pension – Mayflower, Versailles, Enron, Equitable Life, Marconi, Parmalat – have suddenly lost 60% by breakfast time and are suspended close to zero by lunch. The difference – the key characteristic - 100 years on is that it has happened by the time one hears about it, there is next to no value left, and there was no way of knowing what was about to happen ... even if there was, one could not do anything it for fear of insider trading and concert party charges. All the investor can do is sit and cry over spilt milk, and even that won't help. Global markets, instantaneous communication, 24-hour dealing, multi-market quotations, market-timing misbehaviour, technological tampering and foolishness or fraudulence have all already played their respective and lethal parts.

As a Phoenix out of the spilt milk (amazing what mixed metaphors can do for one), so rises the self-righteous cry, "What could I have done? What can we do to make sure that doesn't happen again?" What indeed. The biblical optimists have been looking for the Holy Grail for centuries, and alchemists have been at their quest for even longer. What odds identifying a method of avoiding investment in a healthy, stylish, growth company which will be lying in ruins come next Thursday?

The next incarnation of the Phoenix of the spilt milk is in the form of Independent Research. This identity represents a line where the analysts are not beholden to the wider pressures and expectations of a bank or brokerages. They write what they believe and see and sense, more often than not driven by many years' training and familiarisation, tempered by scepticism, experience, wisdom and sixth senses. They take time and trouble to identify what the investor really needs in order to succeed, to outperform, to make money – and they structure and develop what is required without having a Head of Research, a Head of Corporate Finance, an Editor in Chief or a Global Branding Officer breathing down their necks.

These independent analysts are the people with the Grail, with the answers to the alchemists' prayers. They have heeded the fact that too much investor value is lost too often and too easily in corporate collapses, and that a pre-emptive detection skill is – dare one say it? – worth its weight in gold. What powers, what sensitivities, what analytic skills are there which bring these very few alchemists together? The answer is that they have developed and refined those abilities which can identify and understand the DNA, the micro-symptoms, the nascent vibrations and the chromosomes of companies which will fail, but of which the market-place and even their own management are not yet aware.

The independent analysts have worked out on what level they must recognize and respond to which tremors, and they have no reservations about making their findings known: unlike the traditional analysts, who do not even flare their nostrils at the changing breeze, the independents resemble the cat that does not hesitate to arch its back and slink away at the sniff of approaching death.

To try and list definitively here and now the characteristic clues, the evidence, the early symptoms of a dodgy or weak company is a pointless exercise: the independent analysts specialising in such diagnoses do it far better. However, to give an idea of the tricky context within which they work, consider the HCFs (or should it properly be the LCDs?) at play, detectable in a detailed examination of numerous recent cases of corporate failure and fraud.

Establishing the underlying causes common to such collapses is not a snip: every case throws up its own idiosyncratic mix of history, changes, intricacies, weaknesses, causes and effects.

Having said this, there is little doubt that innocent failure – 'tried his hardest, could have done better, pity about the wooden spoon' – is invariably rooted in creeping financial deterioration resulting from a fatal combination of persistent optimism with relative inexperience. This leads more often than not to recurrent shortfalls in revenues and profits against projections, which, in turn, prompt further and increasingly injudicious investment, usually funded by equally injudicious additional debt. The blueprint is completed by the pattern compounding itself, and before you know where you are, covenants are breached and the bank is banging at the door.

The companies scuttled by shameless fraud reveal certain predominant Lowest Common Denominator biometric characteristics under the microscope, although the range of case-by-case variations is infinite. These LCD traits are fourfold. The seat of the fraud is likely to be one of two versions – **first** and more likely is the deliberate and escalating mis-statement of revenues, as often as not involving , at the risk of sounding simplistic, blurring of the boundaries and the working definitions governing paid invoices, receivables, new orders, rebates, commissions, inventories and work in progress. 'When is a Sale not a Sale?' you may well say, and that nursery riddle says it all.

If it's not that version - and sometimes in addition to that – the fraud is likely to spring, **second**, from off-Balance-Sheet debt and/or liquidity, more often than not vested in SPEs (Special Purpose Entities – consider Enron: they managed to set up hundreds before it all ended in tears), with identification trails which either don't exist in the first place or soon vanish in the mists. In case that sounds esoteric and rarefied, think of whom you know who has raised various mortgages on different properties, each time without declaring the existence of the others … same idea.

Third, either base-version of fraud is likely to involve one and the same rogue component of a group of at least three (one or two won't do, for various reasons) senior corporate officers who collaborate in their common ruse of developing and concealing the ways in which they gradually siphon off liquidity and make merry with the proceeds. Apart from anything else, and indicative of the increasing incidence and seriousness of such scams, this is one of the reasons for ever more complex money-laundering precautions: it's not so much the drug baron from Medellin as the nice company executive from next door who needs to be stopped from laundering his ill-gotten gains through the savings accounts.

Fourth, the fraud is almost always perpetrated over a period of at least three years, and often far more, before it takes its final toll on the company. Not for those three corrupt corporate officer the clean-cut, swift, overnight sting: that would incriminate them straight away, and – horror of horrors - they would have to hide out for ages in Cuba or Brazil rather than spend the dosh in genteel verisimilitude on Aston Martins and on toys and trinkets from the best bazaars of Bond Street.

So much for the roots of the evils. What of the clues and the evidence? Just as hard to categorise and rank as are the base root-formations of the scams themselves. Again, emphasising that the full spectrum of tell-tale signals is infinite, the density-cluster of symptoms of mischief stands out under the magnifying-glass. It takes the form of a series – generally random in terms of time, place and type, so meat for the chaos-theory-trained SFO investigator – of anomalies and inconsistencies, usually in records and accounts. The shared characteristic of these instances, invariably recognized with the wisdom of hindsight, is that they can almost always be convincingly explained away to the puzzled auditor, compliance officer or shareholder within the context in which they arise – i.e. that year's accounts, the current business trends in such-and-such a region, changes in procedure in this division, delayed returns in respect of the new product-line … and so it goes on. This sparse trail of clues and evidence, with dust so cleverly brushed across it, more often than not carries a fatal mutant gene which causes it to incriminate itself. The habit of this gene is to betray the trail by establishing a trend which, over the longer term, becomes distinctly at odds with the norms for the sector, with expectations, with performance projections or with the history of the company itself.

The Catch-22 impact of the habits of this gene is exactly that: to take effect only over the longer term, allowing its host trail to lie

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hidden over shorter periods. It becomes visible under the microscope, and with leeway for timely reaction, only to the occasional genius (in all probability that independent analyst) with the sharpened sense of long perspective and with intuitive understanding of criminal habits, and only to him; otherwise it appears in the tear-stained rear-view mirror of the investor caught unawares.

The auditor chancing on this sort of anomaly and inconsistency, having swallowed the finance director's glib explanation, will check the substantiating vouchers and statements (also pre-doctored, of course), perhaps add a note to the accounts if he is conscientious or wants to cover his rear, or even both. The traditional broker's analyst, in his turn, may or may not pick it up: if he happens to do so, he is only likely to apply it – if at all - as grist to the mill of his pre-ordained objective, rather than to pursue it as an unexpected aberration worthy of further investigation.

Spare a thought for the unfortunate auditor – not least because the majority of investors who have been caught trouserless by collapsed companies will have assumed during their decision-making moments that a big accountancy name must be unimpeachable. A reasonable assumption – they are experts, they are well trained and paid, they are aware of reputational risk ... but then why does it so often go wrong? Why don't they spot the frauds and failures from a mile off? Why are they forever being sued by their clients, the shareholders, the quangos, the suppliers, the creditors?

There may be many answers, but it is important to remember that the auditor's job is to audit the accounts for the period in question – generally the year. Increasingly, institutional investors and private shareholders alike know that their performance, their money, their retirement, their fate is linked to the certified earnings for that period. The focus of all concerned is, understandably, on that period and, in the case of the most thorough observers – notably the auditors – on the way in which it relates to the previous and to the following accounting periods. Paradoxically, there is no apparent reason, no motivation, no instinct to stand back and scan the horizon to check that the big-scale, long-term accounting seascape or skyline are continuous, uninterrupted and consistent.

It could be said that in many ways the auditor is, in his turn, often as much an unwitting victim as is the trusting investor. The independent analyst, however, who has nailed his colours to the mast of a forensic or detective system, has developed the skill to identify companies which are more likely than not to falter or collapse through financial frailty or fraud (or, equally but conversely, to outperform) in due course.