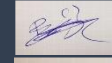
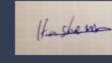
TYCO INTERNATIONAL – CORPORATE SCANDAL

(Morningstar, 2018)

Done By:

Rami Sheik – Introduction, ethical scandal, group opinion Signature: 

Hashem Hadid – Accounting Scandal, results, group opinion Signature: 

Tyco International – Corporate Scandal

Problems and results

Introduction

Tyco international operated in over 100 different countries and was a large producer of electrical components. They designed and produced underwater telecommunications systems, fire protection, plastics and adhesives, electronic security services, specialty valves and have a big market share of disposable medical products.

In 1992, Dennis Kozlowski was appointed as CEO of Tyco International. During the years 2002 and 2003, two cases were brought towards Kozlowski along with the CFO for Tyco, Mark H. Swartz. The results came out in 2005, Kozlowski and Swartz were convicted of counts of grand larceny, conspiracy, securities fraud, and falsifying business records. (White, 2005)

Ethical Scandal

Kozlowski was the main person that influenced and persuaded other senior Tyco employees to get involved or conceal about his operations in exchange for financial benefits. The CEO and CFO started to Commingle the assets and started to use capital from the company for personal expenses. An example of commingling is: when Kozlowski made Tyco to pay $30 million for his apartment and $14,7 million for an artistic painting. All of this became easier to manipulate since the company had already programs allowing this kind of misusage of the company's assets.

According to (Romero, 2017), the Tyco scandal wasn't just mere stealing of funds. It was an exploitation of financial loopholes in the firm policies. (Romero, 2017)

The fraud was executed through the CEO and CFO who provided themselves with loans containing very low interest sometimes even disguised as bonuses that weren't approved by the board and never paid back.

Some of these "loans" where part of "Key Employee Loan" a program that the company offered. Further they were accused of selling the company's stocks without informing investors, which is a requirement under SEC regulations.

Up to 40 loans were later "forgiven" as part of Tyco's loan-forgiveness program. Something to keep in mind is that many didn't know they were doing something wrong.

Money had also been paid out purchasing their silence about Kozlowski's actions in the company through the company programs. This lead to further corruption of the top branch of leaders in Tyco making Kozlowski bolder as time passed. (U.S. Securities and Exchange Commission, 2002)

Accounting scandal

Tyco took an advantage of the financial term “acquisition” and implemented accounting loopholes to mislead investors. To grab the admiration market watchers with remarkable and incredible financial performance Tyco followed a special path of acquisitions. Throughout that it concentrated solely on showing outstanding results avoiding the weak organic growth it really had. It acquired several companies and insisted on pursing that scheme for few years playing a wicked gimmick to hide the slow organic growth by taking advantage of the accounting techniques of acquisitions and disposals to inflate the CFFO.

The trick that Tyco played focused on shifting between two sections of the cash flow statement: the operating and the investing cash flows, particularly, the acquisitions accounts. Rather than having an outflow through the operating section Tyco tricked and carried it through the investing one. This affects the CFFO positively by showing strong numbers on quarterly basis. Tyco was a professional gimmick master in doing so by taking advantage through loopholes. When it acquired another company, of course, this can be done through two ways: either by offering stocks in exchange, which there is no cash outflow, or through paying out cash, which falls as an investing outflow under accounting regulations. When Tyco now owns the company, this makes it benefit from the new inflows of the acquired company, in that case, all the revenues of the acquired are recorded as sales on Tyco financial statements and the same for all the other accounts, falling under one company. (Shcilit & Perler, 2010)

This affected and showed a strong performance of CFFO by adding new sales streams from new companies boosting the operating section. This can indubitably be enormously affective if you do this repeatedly within few years. Between 1999 and 2002 (the scandal period), Tyco spent around $29 billion on acquiring and including companies under its wing, which obtained over 700 new companies (Shcilit & Perler, 2010). During these years Tyco generated the following CFFO:

Table 12-1

($ millions)	2002	2001	2000	1999
Cash flow from operations	5,696	6,926	5,275	3,550

Source: (Shcilit & Perler, 2010)

Tyco used malicious accounting methods to inflate its profits significantly. During the scandal period, Tyco's home security monitoring division, ADT, was boosting in the 1990s becoming a well-known desirable brand. To increase a company's profits, it is important to have higher number of contracts with new customers. In a normal case, a firm can implement this through its sales department or it could be through dealerships, which are considered an external network in that example. Tyco, though, used both methods but relied heavily on the last one.

The gimmick that Tyco benefited significantly from was that it used several sales forces from dealers as an outsourcing service; thus, not including them in the expenses legend as a payroll, but as they are selling security contracts. In return, Tyco purchased each new client contract an amount of $800. The main problem was in recording these into financial statements, Tyco manipulated accounts by considering these payments amounts as "acquisition to contracts". Hence, shifting this from an expense to an investing outflows in the cashflow statement. Of course, doing so and playing this card would overstate the cash flow from operations (CFFO). However, it appeared that Tyco enjoyed the game and exaggerated this action by going further into another shenanigan.

Tyco invented a special bogus charge that plugged millions into its firm. It created a fee calling it "dealer connection fee" which represents a $200 payment paid by the dealer for every contract Tyco buys in. In this case it benefits from a $200 operating inflow into its cashflow. Well, doing so will defiantly upset the dealers as its going to decline the net profit of a contract to $600 down from $800. But then again, Tyco already thought of that and just raised the purchasing payment to the dealers from $800 to $1000. In this case, everyone was happy except that Tyco would benefit from it as an operating inflow by the $200 bogus "dealer connection fee" which generated in total of $719 million in CFFO during those years. (Shcilit & Perler, 2010)

Results

In 2006, SEC has filed a complaint alleging the Tyco violated the law of federal securities by engaging in several improper practices. The complaint stated that Tyco distorted its financials by overstating the results through misusing acquisition accounting standards by misrepresenting its operating income and boosting it by around $500 million. Not only that, but Tyco, also, misled investors by hiding considerable party transactions and excessive compensations and bonuses to senior executives. (U.S. Securities and Exchange Commission, 2006)

In addition, the commission has ruled out that Tyco misused the accounting regulations by aiming in spreading fraudulent information to investors using the contract purchases method. It discovered that a huge duplicitous amount has been pumped to the CFFO and other $567 million were deceitfully generated to operating income.

Tyco was ordered to pay out around $50 million into a special fund to compensate affected investors from its fraudulent actions during the period of 1996 – 2002. (SEC v. Tyco International Ltd., 2006)

Group opinion

We learned that to avoid this type of financial risk in the future from companies who misrepresent and overstate their financial reports, there are essential techniques to avoid the risks in investing in such companies. Investors must carry out or rely on a deep analysis that include through understanding of the financials. To companies who have been engaged in any acquisitions, like Tyco, this can be easily noticed by running a free cash flow (FCF) after acquisitions measure rather than depending on the CFFO results. This can clearly present red alerts to financial analysts and investors and warn them from allocating their investments in such companies.

In our example, this measurement could have been done as the following showing that some fraudulent actions were performed behind the scenes. The table below proves that:

($ millions)	2002	2001	2000	1999
Reported Cash flow from operations (CFFO)	5,696	6,926	5,275	3,550
Subtract: Capital Expenditures	(1,709)	(1,798)	(1,704)	(1,632)
Subtract: Construction in Progress	(1,146)	(2,248)	(111)	-
Free cash flow	**2,841**	**2,880**	**3,460**	**1,918**
Subtract: Acquisitions	(3,709)	(11,851)	(4,791)	(5,135)
Free cash flow after acquisitions	**(868)**	**(8,971)**	**(1,331)**	**(3,217)**

Source (Shcilit & Perler, 2010)

The table above indicates that the free cash flow before subtracting acquisitions is positive for all scandal years. However, after removing acquisitions, the analyst can easily notice negative amount of FCF after acquisitions representing in accounting and finance a downside indicator for the company and proving that the company carrying out this practice of purchasing other companies only to hide the real free cash flow.

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Reading guide

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