HEAR NO SEE NO SPEAK NO FRAUD

The Cendant fiasco shows that in high-profile M&A's, due diligence takes a back seat.

By Ronald Fink

Who's to blame for the mess at Cendant Corp.? The product of the merger last December of CUC International Inc., a discount shopping-club operator, and franchising giant HFS Inc., Cendant shocked Wall Street last April with news of widespread accounting irregularities.

True, Walter Forbes, the 55-year-old founder of CUC, has resigned as Cendant chairman, satisfying the demands of many disgruntled investors. They hold him responsible, at least indirectly, for the apparent fraud that may force Cendant to reduce reported net income for 1997 by more than a third. But investigations said to be under way by the Securities and Exchange Commission and the U.S. attorney's office in Newark, New Jersey, have a long way to go before they're complete. And at last count, nearly 70 shareholder lawsuits filed against the company were still outstanding. Against that backdrop, Forbes's departure raises as many questions as it answers.

One thing, however, is already clear. Various parties involved in the transaction could have seen trouble brewing had they looked more closely at Stamford, Connecticut-based CUC. The possibility that they did not calls fresh attention to the fact that the due diligence performed on many mergers is woefully-- indeed, dangerously--inadequate.

Silent Watchdog

Perhaps as interesting as who's to blame is (to paraphrase Sherlock Holmes) why did the watchdog fail to bark? First of all, where were the auditors? CUC had a well-documented history of accounting problems. Yet Ernst & Young had signed off on CUC's results since the early
1980s. Henry Silverman, Cendant's chairman and CEO, has described these results as so inaccurate as to constitute a fraud of "historic" proportions.

A postmortem forensic audit by Arthur Andersen and the New York law firm Willkie Farr & Gallagher found that CUC had fabricated some $500 million in revenue and pretax income during the past three years. It also overstated its earnings by another $200 million through improper accounting. Ernst & Young responds that it believes it was misled by CUC's financial management. That team was headed by former CFO Cosmo Corigliano.

Some analysts predict that Cendant will end up suing Ernst & Young for malpractice. Reason: The discrepancy between CUC's stated earnings before interest, taxes, depreciation, and amortization (EBITDA) and its actual cash EBITDA is so large that the problem goes beyond mistimed matching of revenues with expenses. "Cash is cash," says Bob Renck, founder and CEO of R.L. Renck & Co., a New York broker/dealer and investment advisory firm. "Either the accountants verified the cash balances with the financial institutions holding them or they did not."

Renck notes that Cendant's disclosure that it had dismissed Ernst & Young went on to say that Cendant's investigation into accounting problems at CUC may result in "disagreements" between Cendant and E&Y regarding previously reported financial statements. "We view this as a prelude to naming Ernst & Young as a defendant," says Renck. A spokesman for Cendant says the company is indeed considering suing the accounting firm.

Don Howarth, a spokesman for Ernst & Young, says the firm hasn't yet been sued by Cendant, though it is named in shareholder suits against the company. And while Howarth declined to comment on the details of E&Y's work, he insists that "our audits of CUC's financial statements were performed in accordance with professional standards."

To be sure, a report issued by Cendant after the forensic audit contains plenty of evidence that CUC went to great lengths to fool Ernst & Young. For example, the report says that CUC withheld a model used for internal purposes that illustrated how and when revenue it claimed was deferred was instead recorded immediately. The report also contends that CUC told Ernst & Young--on more than one occasion--that assets CUC had written off were impaired, when in fact they were not. But if Cendant's report is true, then the professional standards that Ernst & Young claims it met were not tight enough to detect the fraud that CUC apparently committed.

**Standard Practice?**

Then there are the bankers. Bear Stearns and Goldman, Sachs, which
combined earned approximately $45 million by helping put together the
$14 billion merger, issued their considered opinions that the deal was
"fair" to investors. Yet Cendant's stock more than halved within days of
the company's first disclosure of accounting irregularities at CUC. The
Wall Street firms' excuse for missing the gamesmanship: They relied on
the outcome of Ernst & Young's audits.

But if bankers relied on Ernst & Young, and E&Y was fooled, what
about merger partner HFS? The owner of the franchising rights to such
brands as Howard Johnson and Ramada Inn hotels, Avis rental cars, and
Century 21 real estate prided itself on its due-diligence practices. In fact,
Michael Monaco, who was CFO of the Parsippany, New Jersey-based
HFS and is now Cendant's vice chairman and chief financial officer, told
CFO a little over a year ago that HFS routinely performed painstaking
due diligence when scouting out acquisition targets. (See "Diligence
Undone," September 1997.) Indeed, he said detailed analysis of a
company's books was standard practice at HFS. That came as little
surprise at the time. Much, if not all, of the franchising company's success
has been a result of its ability to make acquisitions.

Monaco told CFO that HFS usually sampled a week's worth of a
target's book entries just to ferret out any adjustments that it might be
making to its results. "The less human intervention...the better," Monaco
said last year. He added that if HFS suspected there was so much
intervention that fraud might have been involved, it would enlarge the
scope of its review of book entries to cover a longer period of time.

So what happened when HFS examined CUC's books? Monaco isn't
saying, declining a request for another interview. A spokesman for
Cendant says the company cannot comment on its due diligence in the
case, because it is subject to litigation.

Some observers believe that few companies do as much due diligence
as they claim. Says an analyst for an investment firm with a sizable stake
in Cendant: "I'm not sure how thoroughly due diligence is being done
these days. There are a lot of 22- and 23-year-olds [involved in the
process]. The CFO doesn't go down [the line] to look at the practices."

A close read of Monaco's earlier comments to CFO on due diligence
suggests more ambiguity about the purpose of due diligence. At least as
far as HFS was concerned, he said, the point wasn't to avoid risk so
much as to justify it. "You want to win," said Monaco, "so you take some
informed risks." In hindsight, the risk that HFS took on CUC could only
be called uninformed.

Other analysts believe HFS's evident lack of due diligence in the case
was inevitable, given the structure of the deal. The transaction was
supposedly a so-called merger of equals. CUC was the larger company in a stock-for-stock transaction. "In a merger of equals reputed to be of high quality, it's not easy for one party to imply that the other's accounting is improper," says Jeff Kinzel, an analyst for Stein Roe Farnham Inc., an investment firm in Chicago that held (as of August) 930,000 shares of Cendant stock. Oddly, although CUC was apparently larger, the agreement called for Silverman and his lieutenants, including Monaco, to get first crack at the top management spots, and then for Silverman and Forbes to switch jobs.

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In fairness to Silverman and Monaco, the particular nature of the apparent shenanigans at CUC made detection difficult. Kinzel says it was his understanding that "Henry asked to look at the books, but [the managers of CUC] were dragging their feet." Moreover, the report Cendant released after the forensic audit notes that HFS was provided with "limited access" to nonpublic information on CUC's businesses. In part, this was due to CUC's concern that HFS might get competitive information if the merger were not consummated. (Not long before the merger was announced in May 1997, HFS had been negotiating for the purchase of a membership business that competed with CUC.)

In addition, the report says that Silverman visited many of CUC's subsidiaries in the company of CUC's principal officers. Silverman reported that he was told these subsidiaries were not experiencing any significant problems. "To the contrary," says the report, "each said they were meeting or exceeding budget." But CUC was engaged in a "shell game," according to Kinzel. He explains that Cendant told him that CUC used to reclassify fees from one membership club as those from another, thereby double-counting revenue. "You can't just look at the accounting numbers and figure this one out," he continues. Kinzel accepts Silverman's explanation that this kind of fraud is difficult, if not impossible, to detect.

(Cosmo Corigliano failed to respond to a request for an interview. His lawyer claims that the former CFO of CUC is unaware of any of the alleged misdeeds. Corigliano was among two CUC senior executives to be fired by Cendant a week before the problems were disclosed. Forbes, whose lawyer failed to respond to a request for an interview, has also professed ignorance of any wrongdoing.)

**A Tricky History**

But surely CUC's history should have put Silverman and Monaco on guard. After all, this isn't the first time that CUC's practices have been called into question. The company restated its earnings in 1989, after the SEC forced it to amortize market costs over one year instead of three.

In 1991, the company had to amend its previously filed financial
In 1991, the company had to amend its previously filed financial statements six times between October and December. Then, in the mid-1990s, analysts say, the company continued to play fast and loose with U.S. accounting rules by creating large merger reserves and translating operating expenses into one-time charges. This would have made subsequent earnings look better than they really were.

Some analysts mistook what CUC was doing for a practice that many other companies were engaged in at the time. So prevalent were huge one-time charges for restructuring during the mid-1990s that the practice came to be known as big-bath accounting, and investors learned to expect it.

But Renck, for one, has long argued that CUC's accounting was particularly aggressive. In the first instance, CUC failed to treat marketing costs as operating expenses, which is standard practice under U.S. accounting rules, but instead capitalized them, spreading the costs over three years. The result, again, was to overstate earnings for preceding years. That practice was supposed to have stopped in 1989, but apparently continued while Stuart Bell was CFO. (Bell, who failed to respond to requests for an interview, left CUC in 1995 and was replaced by Corigliano).

The practices that have more recently been called into question also involve amortization of marketing expenses, but on a grander scale. And the company also drew on merger reserves to create fictitious revenues. According to Renck, CUC was doing similar things with one-time charges for acquisitions. "Starting in 1992, their acquisitions helped to obfuscate earnings of the underlying credit-card business," he says. And in a recent report he noted, "Our historical contention has been that the individual membership services business was not as profitable on a GAAP accounting basis as previously portrayed by old CUC management." That conclusion was based in part on an analysis of CUC's amendments to its financial statements in late 1991.

Yet Renck believes HFS's contention that it could not have discovered accounting fraud at CUC, in part because the correspondence between the SEC and CUC over its amendments wasn't easily available. He says that he gained access to that correspondence only through a Freedom of Information Act request that took the SEC 12 months to grant, over the objections of CUC management. Still, Renck is perhaps overly generous here. He himself published a cautionary report about the company's accounting as long ago as 1991, and HFS could have had access to it. Renck says, however, "You can't detect fraud from the outside--this was a very skillful fraud on the part of CUC." But surely his own research should have raised a red flag.

**Eyes Wide Shut?**
Some observers have gone so far as to speculate that perhaps HFS had some inkling that CUC's accounting might not be sterling, but looked the other way. "I find it hard to believe that Henry Silverman would be blindsided in this way, or that he would have agreed to give up the CEO job," says one analyst at an investment firm that is currently advising Cendant. And Monaco told CFO last year that accounting fraud discovered during due diligence wouldn't necessarily cause HFS to drop a pending deal. If HFS could be assured that the target's fundamentals were still attractive, it might look on the problem as a negotiating tool.

Some observers who doubt that HFS was as totally in the dark about CUC as it claims wonder if Silverman planned all along to use CUC's accounting problems as a means of undoing the merger's terms, and thereby keep the CEO spot for himself. "There is the view out there that the whole thing is based on [Silverman's] desire to get rid of Forbes," says one observer who claims to be a friend of Silverman's. As evidence, an observer in CUC's camp cites Silverman and Monaco's highly public denigration of CUC's accounting practices before Cendant's audit committee released the results of Arthur Andersen's forensic audit in late August. "They announce the problems and then launch an investigation," he says, adding that the disclosures strike him as increasingly "bizarre and political."

The report of the forensic audit describes an instance in which CUC claims Silverman was responsible for an accounting irregularity that occurred after the merger closed in December 1997. According to the report, a CUC official says Silverman suggested that the cost of renegotiating more-favorable terms for an insurance contract held by CUC be charged against the reserves set up for the merger, when in fact that was improper. In his defense, Silverman says he ultimately left the decision up to a CUC executive, and Monaco claims that in taking the charge, Cendant relied on Ernst & Young's advice that it was proper, according to the report.

If Silverman did go into the CUC deal with his eyes shut, he's certainly paid a steep price. Granted, he exercised 1.7 million of the approximately 46 million shares of common that he owned in late March, when the stock was still trading at around $36. But the subsequent meltdown has wiped out almost $1 billion of the value of the stock options that he holds.

While Silverman declined a request for an interview, a spokesman labels charges that Silverman is exaggerating accounting problems "illogical" given Silverman's stake in the company. The spokesman also notes that Silverman offered to give up his salary, bonus, stock options, and even his job at the special board meeting he called in late July. Instead, the meeting ended in Forbes's resignation.
Several analysts also dismiss the idea that Silverman looked the other way. "Why would he want to see half of his company disappear?" notes one. "Henry's lost a tremendous amount of credibility on Wall Street as a result of this," adds Stephan Haimo, a mergers-and-acquisitions lawyer in the New York office of Gibson, Dunn & Crutcher LLP, which is not involved in the dispute. Another lawyer, this one from a firm representing investors suing Cendant, notes that Silverman "was a darling on Wall Street." No longer.

But if zeal to do the deal led HFS (and its bankers) to overlook some warning signals, what about the argument that such things can be overlooked if the fundamentals are OK? Some analysts are calling into question the validity not only of CUC's business, but of the former HFS as well. The reason goes to the rationale of the merger itself.

Both companies' businesses are based on fees--in CUC's case, from new shopping-club members and from renewals by existing ones; in HFS's case, from franchising its brand names. Assets and liabilities are minimized. This makes for handsome returns on equity as long as fee income exceeds marketing costs. So growth of the underlying business ultimately depends on retaining existing customers.

CUC evidently failed to get as many renewals as it claimed it did, and the HFS part of Cendant may or may not be keeping franchisees on board. Indeed, its success on that front is difficult to discern, because so much of its growth has come from acquisitions. "What is the underlying growth of this business?" asks an analyst for a major mutual fund company with a big position in the company. "No one can tell me."

So to the extent that Cendant's ability to make further acquisitions is hampered, its earnings may no longer grow at the pace they once did. "There will be a long process of rebuilding credibility," says the analyst. "Until then, the stock won't get the same premium."

In the meantime, he says, investors will worry that Cendant's business model is a "house of cards." When any sort of disappointment occurs, he says, the fear will be that "the whole thing will come crashing down." Perhaps HFS's own dependence on acquisitions for earnings growth blinded it to CUC's fundamental problems.

Lots of Pressure
Whatever the ultimate outcome of CUC's accounting fiasco, the situation suggests that the pressure to do deals can make due diligence in high-profile mergers and acquisitions a sham. As such, it reflects the pressure that senior management is under to meet or exceed Wall Street's expectations. According to a recent survey of almost 100 chief financial officers by Business Week magazine, roughly two-thirds have been
asked by senior management to misrepresent results. And while 55 percent said they fought off the request, another 12 percent admitted to acceding to it. "Pressure to create shareholder value has led to pressure to misrepresent results," says Nell Minow, a principal at Lens Fund, an activist money manager based in Washington, D.C.

So concludes the report on the results of the forensic audit of CUC: "The amount of the income adjustments at each quarter closely mirrored the amount needed to bring CUC's results into line with Wall Street earnings expectations."

Whether the misrepresentations are trivial or as significant as Cendant's, we can expect to see more of the same in the future. As long as earnings remain under pressure, acquisitions represent a tempting substitute for internal growth, and executive compensation is tied to stock prices, companies will feel compelled to push the envelope when it comes to presenting results. Baldly put, too many parties--from investment bankers and accountants to buyers and sellers themselves-- have too much at stake to allow due diligence to undo a much-ballyhooed deal.

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