

The Great Financial Scandal of 2003
(An Account by Charles T. Munger)

The great financial scandal erupted in 2003 with the sudden, deserved disgrace of Quant Technical Corporation, always called “Quant Tech”. By this time Quant Tech was the country’s largest pure engineering firm, having become so as a consequence of the contributions of its legendary founder, engineer Albert Berzog Quant.

After 2003, people came to see the Quant Tech story as a sort of morality play, divided into two acts. Act One, the era of the great founding engineer, was seen as a golden age of sound values. Act Two, the era of the founder’s immediate successors, was seen as the age of false values with Quant Tech becoming, in the end, a sort of latter day Sodom or Gomorrah.

In fact, as this account will make clear, the change from good to evil did not occur all at once when Quant Tech’s founder died in 1982. Much good continued after 1982, and serious evil had existed for many years prior to 1982 in the financial culture in which Quant Tech had to operate.

The Quant Tech story is best understood as a classic sort of tragedy in which a single flaw is inexorably punished by remorseless Fate. The flaw was the country’s amazingly peculiar accounting treatment for employee stock options. The victims were Quant Tech and its country. The history of the Great Financial Scandal, as it actually happened, could have been written by Sophocles.

As his life ended in 1982, Albert Berzog Quant delivered to his successors and his Maker a wonderfully prosperous and useful company. The sole business of Quant Tech was designing, for fees, all over the world, a novel type of super-clean and super-efficient small power plant that improved electricity generation.

By 1982 Quant Tech had a dominant market share in its business and was earning \$100 million on revenues of \$1 billion. It’s costs were virtually all costs to compensate technical employees engaged in design work. Direct employee compensation cost amounted to 70% of revenues. Of this 70%, 30% was base salaries and 40% was incentive bonuses being paid out under an elaborate system designed by the founder. All compensation was paid in cash. There were no stock options because the old man had considered the accounting treatment required for stock options to be “weak, corrupt and contemptible,” and he no more wanted bad accounting in his business than he wanted bad engineering. Moreover, the old man believed in tailoring his huge incentive bonuses to precise performance standards established for individuals or small groups, instead of allowing what he considered undesirable compensation outcomes, both high and low, such as he believed occurred under other companies’ stock option plans.

Yet, even under the old man’s system, most of Quant Tech’s devoted longtime employees were becoming rich, or sure to get rich. This was happening because the employees were buying Quant Tech stock in the market, just like non-employee

shareholders. The old man had always figured that people smart enough, and self-disciplined enough, to design power plants could reasonably be expected to take care of their own financial affairs in this way. He would sometimes advise an employee to buy Quant Tech stock, but more paternalistic than that he would not become.

By the time the founder died in 1982, Quant Tech was debt free and, except as a reputation-enhancer, really didn't need any shareholders' equity to run its business, no matter how fast revenues grew. However, the old man believed with Ben Franklin that "it is hard for an empty sack to stand upright," and he wanted Quant Tech to stand upright. Moreover, he loved his business and his coworkers and always wanted to have on hand large amounts of cash equivalents so as to be able to maximize work-out or work-up chances if an unexpected adversity or opportunity came along. And so in 1982 Quant Tech had on hand \$500 million in cash equivalents, amounting to 50% of revenues.

Possessing a strong balance sheet and a productive culture and also holding a critical mass of expertise in a rapidly changing and rapidly growing business, Quant Tech, using the old man's methods, by 1982 was destined for 20 years ahead to maintain profits at 10% of revenues while revenues increased at 20% per year. After this 20 years, commencing in 2003, Quant Tech's profit margin would hold for a very long time at 10% while revenue growth would slow down to 4% per year. But no one at Quant Tech knew precisely when its inevitable period of slow revenue growth would begin.

The old man's dividend policy for Quant Tech was simplicity itself: He never paid a dividend. Instead, all earnings simply piled up in cash equivalents.

Every truly sophisticated investor in common stocks could see that the stock of cash-rich Quant Tech provided a splendid investment opportunity in 1982 when it sold at a mere 15 times earnings and, despite its brilliant prospects, had a market capitalization of only \$1.5 billion. This low market capitalization, despite brilliant prospects, existed in 1982 because other wonderful common stocks were also then selling at 15 times earnings, or less, as a natural consequence of high interest rates then prevailing plus disappointing investment returns that had occurred over many previous years for holders of typical diversified portfolios of common stocks.

One result of Quant Tech's low market capitalization in 1982 was that it made Quant Tech's directors uneasy and dissatisfied right after the old man's death. A wiser board would then have bought in Quant Tech's stock very aggressively, using up all cash on hand and also borrowing funds to use in the same way. However, such a decision was not in accord with conventional corporate wisdom in 1982. And so the directors made a conventional decision. They recruited a new CEO and CFO from outside Quant Tech, in particular from a company that then had a conventional stock option plan for employees and also possessed a market capitalization at 20 times reported earnings, even though its balance sheet was weaker than Quant Tech's and its earnings were growing more slowly than earnings at Quant Tech. Incident to the recruitment of the new executives, it was

made plain that Quant Tech's directors wanted a higher market capitalization, as soon as feasible.

The newly installed Quant Tech officers quickly realized that the company could not wisely either drive its revenues up at an annual rate higher than the rate in place or increase Quant Tech profit margin. The founder had plainly achieved an optimum in each case. Nor did the new officers dare tinker with an engineering culture that was working so well. Therefore, the new officers were attracted to employing what they called "modern financial engineering" which required prompt use of any and all arguably lawful methods for driving up reported earnings, with big, simple changes to be made first.

By a strange irony of fate, the accounting convention for stock options that had so displeased Quant Tech's founder now made the new officers' job very easy and would ultimately ruin Quant Tech's reputation. There was now an accounting convention in the United States that, provided employees were first given options, required that when easily marketable stock was issued to employees at a below-market price, the bargain element for the employees, although roughly equivalent to cash, could not count as compensation expense in determining a company's reported profits. This amazingly peculiar accounting convention had been selected by the accounting profession, over the objection of some of its wisest and most ethical members, because corporate managers, by and large, preferred that their gains from exercising options covering their employers' stock not be counted as expense in determining their employers' earnings. The accounting profession, in making its amazingly peculiar decision, had simply followed the injunction so often followed by persons quite different from prosperous, entrenched accountants. The injunction was that normally followed by insecure and powerless people: "His bread I eat, his song I sing." Fortunately, the income tax authorities did not have the same amazingly peculiar accounting idea as the accounting profession. Elementary common sense prevailed, and the bargain element in stock option exercises was treated as an obvious compensation expense, deductible in determining income for tax purposes.

Quant Tech's new officers, financially shrewd as they were, could see at a glance that, given the amazingly peculiar accounting convention and the sound income-tax rules in place, Quant Tech had a breathtakingly large opportunity to increase its reported profits by taking very simple action. The fact that so large a share of Quant Tech's annual expense was incentive bonus expense provided a "modern financial engineering" opportunity second to none.

For instance, it was mere child's play for the executives to realize that if in 1982 Quant Tech had substituted employee stock option exercise profits for all its incentive bonus expense of \$400 million, while using bonus money saved, plus option prices paid, to buy back all shares issued in option exercises and keeping all else the same, the result would have been to drive Quant Tech 1982 reported earnings up by 400% to \$500 million from \$100 million while shares outstanding remained exactly the same! And so it seemed that the obviously correct ploy for the officers was to start substituting employee stock option exercise profits for incentive bonuses. Why should a group of numerate engineers care

whether their bonuses were in cash or virtually perfect equivalents of cash? Arranging such substitutions, on any schedule desired, seemed like no difficult chore.

However, it was also mere child's play for the new officers to realize that a certain amount of caution and restraint would be desirable in pushing their new ploy. Obviously, if they pushed their new ploy too hard in any single year there might be rebellion from Quant Tech's accountants or undesirable hostility from other sources. This, in turn, would risk killing a goose with a vast ability to deliver golden eggs, at least to the officers. After all, it was quite clear that their ploy would be increasing reported earnings only by adding to real earnings an element of phony earnings – phony in the sense that Quant Tech would enjoy no true favorable economic effect (except temporary fraud-type effect similar to that from overcounting closing inventory) from that part of reported earnings increases attributable to use of the ploy. The new CEO privately called the desirable, cautious approach “wisely restrained falsehood”.

Plainly, the new officers saw, it would be prudent to shift bonus payments to employee stock option exercise profits in only a moderate amount per year over many years ahead. They privately called the prudent plan they adopted their “dollop by dollop system” which they believed had four obvious advantages:

First, a moderate dollop of phony earnings in any single year would be less likely to be noticed than a large dollop.

Second, the large long-term effect from accumulating many moderate dollops of phony earnings over the years would also tend to be obscured in the “dollop by dollop system.” As the CFO pithily and privately said: “If we mix only a moderate minority share of turds with the raisins each year, probably no one will recognize what will ultimately become a very large collection of turds.”

Third, the outside accountants, once they had blessed a few financial statements containing earnings increases only a minority share of which were phony, would probably find it unendurably embarrassing not to bless new financial statements containing only the same phony proportion of reported earnings increase.

Fourth, the “dollop by dollop system” would tend to prevent disgrace, or something more seriously harmful, for Quant Tech's officers. With virtually all corporations except Quant Tech having ever-more-liberal stock option plans, the officers could always explain that a moderate dollop of shift toward compensation in option-exercise form was needed to help attract or retain employees. Indeed, given corporate culture and stock market enthusiasm likely to exist as a consequence of the strange accounting convention for stock options, this claim would often be true.

With these four advantages, the “dollop by dollop system” seemed so clearly desirable that it only remained for Quant Tech's officers to decide how big to make their annual

dollops of phony earnings. This decision, too, turned out to be easy. The officers first decided upon three reasonable conditions they wanted satisfied:

First, they wanted to be able to continue their “dollop by dollop system” without major discontinuities for 20 years.

Second, they wanted Quant Tech’s reported earnings to go up by roughly the same percentage each year throughout the whole 20 years because they believed that financial analysts, representing institutional investors, would value Quant Tech’s stock higher if reported annual earnings growth never significantly varied.

Third, to protect credibility for reported earnings, they never wanted to strain credulity of investors by reporting, even in their 20th year, that Quant Tech was earning more than 40% of revenues from designing power plants.

With these requirements, the math was easy, given the officers assumption that Quant Tech’s non-phony earnings and revenues were both going to grow at 20% per year for 20 years. The officers quickly decided to use their “dollop by dollop system” to make Quant Tech’s reported earnings increase by 28% per year instead of the 20% that would have been reported by the founder.

And so the great scheme of “modern financial engineering” went forward toward tragedy at Quant Tech. And few disreputable schemes of man have ever worked better in achieving what was attempted. Quant Tech’s reported earnings, certified by its accountants, increased regularly at 28% per year. No one criticized Quant Tech’s financial reporting except a few people widely regarded as impractical, overly theoretical, misanthropic cranks. It turned out that the founder’s policy of never paying dividends, which was continued, greatly helped in preserving credibility for Quant Tech’s reports that its earnings were rising steadily at 28% per year. With cash equivalents on hand so remarkably high, the Pavlovian mere-association effects that so often impair reality recognition served well to prevent detection of the phony element in reported earnings.

It was therefore natural, after the “dollop by dollop system” had been in place for a few years, for Quant Tech’s officers to yearn to have Quant Tech’s reported earnings per share keep going up at 28% per year while cash equivalents grew much faster than they were then growing. This turned out to be a snap. By this time, Quant Tech’s stock was selling at a huge multiple of reported earnings, and the officers simply started causing some incremental stock-option exercises that were not matched either by reductions in cash bonuses paid or by repurchases of Quant Tech’s stock. This change, the officers easily recognized, was a very helpful revision of their original plan. Not only was detection of the phony element in reported earnings made much more difficult as cash accumulation greatly accelerated, but also a significant amount of Ponzi-scheme or chain-letter effect was being introduced into Quant Tech, with real benefits for present shareholders, including the officers.

At this time the officers also fixed another flaw in their original plan. They saw that as Quant Tech's reported earnings, containing an increasing phony element, kept rising at 28%, Quant Tech's income taxes as a percentage of reported pre-tax earnings kept going lower and lower. This plainly increased chances for causing undesired questions and criticism. This problem was soon eliminated. Many power plants in foreign nations were built and owned by governments, and it proved easy to get some foreign governments to raise Quant Tech's design fees, provided that in each case slightly more than the fee increase was paid back in additional income taxes to the foreign government concerned.

Finally, for 2002, Quant Tech reported \$16 billion in earnings on \$47 billion of revenues that now included a lot more revenue from interest on cash equivalents than would have been present without net issuances of new stock over the years. Cash equivalents on hand now amounted to an astounding \$85 billion, and somehow it didn't seem impossible to most investors that a company virtually drowning in so much cash could be earning the \$16 billion it was reporting. The market capitalization of Quant Tech at its peak early in 2003 became \$1.4 trillion, about 90 times earnings reported for 2002.

However, all man's desired geometric progressions, if a high rate of growth is chosen, at last come to grief on a finite earth. And the social system for man on earth is fair enough, eventually, that almost all massive cheating ends in disgrace. And in 2003 Quant Tech failed in both ways.

By 2003, Quant Tech's real earning power was growing at only 4% per year after sales growth had slowed to 4%. There was now no way for Quant Tech to escape causing a big disappointment for its shareholders, now largely consisting of institutional investors. This disappointment triggered a shocking decline in the price of Quant Tech stock which went down suddenly by 50%. This price decline, in turn, triggered a careful examination of Quant Tech's financial reporting practices which, at long last, convinced nearly everyone that a very large majority of Quant Tech's reported earnings had long been phony earnings and that massive and deliberate misreporting had gone on for a great many years. This triggered even more price decline for Quant Tech stock until in mid-2003 the market capitalization of Quant Tech was only \$140 billion, down 90% from its peak only six months earlier.

A quick 90% decline in the price of the stock of such an important company, that was previously so widely owned and admired, caused immense human suffering, considering the \$1.3 trillion in market value that had disappeared. And naturally, with Quant Tech's deserved disgrace, the public and political reaction included intense hatred and revulsion directed at Quant Tech, even though its admirable engineers were still designing the nation's best power plants.

Moreover, the hatred and revulsion did not stop with Quant Tech. It soon spread to other corporations, some of which plainly had undesirable financial cultures different from Quant Tech's only in degree. The public and political hatred, like the behavior that had caused it, soon went to gross excess and fed upon itself. Financial misery spread far

beyond investors into a serious recession like that of Japan in the 1990s following the long period of false Japanese accounting.

There was huge public antipathy to professions following the Great Scandal. The accounting profession, of course, got the most blame. The rule-making body for accountants had long borne the acronym “F.A.S.B.” And now nearly everyone said this stood for “Financial Accounts Still Bogus”.

Economics professors likewise drew much criticism for failing to blow the whistle on false accounting and for not sufficiently warning about eventual bad macroeconomic effects of widespread false accounting. So great was the disappointment with conventional economists that Harvard’s John Kenneth Galbraith received the Nobel Prize in economics. After all, he had once predicted that massive, undetected corporate embezzlement would have a wonderfully stimulating effect on the economy. And people could now see that something very close to what Galbraith had predicted had actually happened in the years preceding 2003 and had thereafter helped create a big, reactive recession.

With Congress and the S.E.C. so heavily peopled by lawyers, and with lawyers having been so heavily involved in drafting financial disclosure documents now seen as bogus, there was a new “lawyer” joke every week. One such was: “The butcher says ‘the reputation of lawyers has fallen dramatically’, and the check-out clerk replies: “How do you fall dramatically off a pancake?””

But the hostility to established professions did not stop with accountants, economists and lawyers. There were many adverse “rub-off” effects on reputations of professionals that had always performed well, like engineers who did not understand the financial fraud that their country had made not a permissible option but a legal requirement.

In the end, much that was good about the country, and needed for its future felicity, was widely and unwisely hated.

At this point, action came from a Higher Realm. God himself, who reviews all, changed His decision schedule to bring to the fore the sad case of the Great Financial Scandal of 2003. He called in his chief detective and said, “Smith, bring in for harsh but fair judgment the most depraved of those responsible for this horrible outcome.”

But when Smith brought in a group of security analysts who had long and uncritically touted the stock of Quant Tech, the Great Judge was displeased. “Smith,” he said, “I can’t come down hardest on low-level cognitive error, much of it subconsciously caused by the standard incentive systems of the world.”

Next, Smith brought in a group of S.E.C. Commissioners and powerful politicians. “No, no,” said the Great Judge, “These people operate in a virtual maelstrom of regrettable forces and can’t reasonably be expected to meet the behavioral standard you seek to impose.”

Now the chief detective thought he had gotten the point. He next brought in the corporate officers who had practiced their version of “modern financial engineering” at Quant Tech. “You are getting close,” said the Great Judge, “but I told you to bring in the most depraved. These officers will, of course, get strong punishment for their massive fraud and disgusting stewardship of the great engineer’s legacy. But I want you to bring in the miscreants who will soon be in the lowest circle in Hell, the ones who so easily could have prevented all this calamity.”

At last the chief detective truly understood. He remembered that the lowest circle of Hell was reserved for traitors. And so he now brought in from Purgatory a group of elderly persons who, in their days on earth, had been prominent partners in major accounting firms. “Here are your traitors,” said the chief detective. “They adopted the false accounting convention for employee stock options. They occupied high positions in one of the noblest professions, which, like Yours, helps make society work right by laying down the right rules. They were very smart and securely placed, and it is inexcusable that they deliberately caused all this lying and cheating that was so obviously predictable. They well knew what they were doing was disastrously wrong, yet they did it anyway. Owing to press of business in Your Judicial System, you made a mistake at first in punishing them so lightly. But now you can send them into the lowest circle in Hell.”

Startled by the vehemence and presumption, the Great Judge paused. Then He quietly said: “Well done, my good and faithful servant.”

This account is not an implied prediction about 2003. It is a work of fiction. Except in the case of Professor Galbraith, any resemblances to real persons or companies is accidental. It was written in an attempt to focus possibly useful attention on certain modern behaviors and belief systems.