At the beginning of 1994, Bausch & Lomb was a respected company with an apparently strong position in the US optical products and eye-care sector. It had charmed investors with double-digit earnings growth most years from the mid-1980s up until 1994.

But it was about to be plunged into a strategic crisis and a growing scandal concerning the figures it had reported to investors. By the end of 1994, the US Securities & Exchange Commission (SEC) had begun a formal investigation into the company’s accounting practices.

The investigators were to conclude that, during 1993, executives at two of the company’s main divisions artificially boosted the company’s reported earnings by wrongly recognising dubious revenue from the sale of contact lenses, and by inventing fictitious sales of Ray-Ban and other branded sunglasses.

The SEC finding, published in 1997, described a series of bad practices at the divisions. It concluded that Bausch & Lomb had made materially false and misleading financial statements in 1993–94 that led to an overstatement of revenue by $42.3 million and net income by at least $17.6 million or 11 per cent.

Well before those findings were published, the accounting scandal had obliged Bausch & Lomb to issue an earnings retraction, and had led to the departure of executives at the problem divisions. Although SEC investigators found no evidence of complicity in the fraud by senior corporate officers, the debacle severely tested investor faith in Bausch & Lomb’s corporate culture and internal controls.

It also marred the record of Bausch & Lomb’s long-term chairman and chief executive officer, Daniel Gill, who retired in late 1995 as shareholders grew increasingly restive about the SEC investigations and the company’s poor 1994–95 results. The value of the company’s shares sank by about a third in that period.

Bausch & Lomb survived, but the scandal alerted investors to the major strategic problems that the company faced. Over the past seven years, the company has struggled to identify a successful long-term strategy – a struggle that entered another phase in late 2001 and early 2002 with the announcement of a new chief executive officer and more attempts to restructure the company.

The lessons of the Bausch & Lomb case seem pertinent again in 2002, as the receding economic tide reveals how easy it is for companies to focus on the form of their financial reporting, rather than the economic substance of their activities.

**Lessons learned**

- Star performers – whether people or divisions – require careful inspection and controls.
- Senior corporate executives who exhort subordinates to reach targets must make sure that the reported figures are real.
- Aggressive sales drives and accounting practices can, for a while, mask strategic business weaknesses.
- Companies should watch out for a growth in receivables and credit lines, which can be used to inflate reported earnings that might never turn into cash flow.

**The story**

At the time of its accounting scandal, Bausch & Lomb was one of the longest established companies in the US. It was proud of a heritage that began as early as 1853, when John Bausch, a German immigrant, set up an optical goods shop in Rochester, NY – a city that remains the headquarters of the modern company.

Through the 20th century the business made many fundamental innovations in optical technology. It claims to have produced the first optical quality glass made in the US, and to have made the lenses that took the first satellite pictures of the moon. Early in the 20th century it developed some of the earliest effective sunglasses, and from the early 1970s it brought to market some of the first soft contact lenses.
From the early 1980s, a more driven style of management at Bausch & Lomb under new CEO Gill began to turn that technical expertise into fast business growth. This growth was substantially led by contact lens and lens care products, and by international sales of key brands such as the classic Ray-Ban sunglasses. But these star performers also lay at the heart of the company’s developing problems in the early 1990s.

The contact lens division’s sales were dominated by a type of soft contact lens known as SVS, designed to be worn for around six months. However, since the mid-1980s, this kind of contact lens had been inexorably losing market share to disposable contact lenses.

Bausch & Lomb had entered the market for disposable lenses late because it had not wanted to cannibalise existing product lines. As a result, the contact lens division found itself playing catch-up in this developing market sector with some powerful rivals, notably Johnson & Johnson.

During 1993, it became apparent that the division was going to have difficulty maintaining its record of constantly increasing sales and meeting the aggressive targets it had agreed with corporate headquarters. Even more than in most companies, Bausch & Lomb divisional executives knew that they would be judged in terms of whether they made those numbers.

The contact lens division decided that it might best be able to meet its targets if it concentrated all the sales of old-style SVS soft contact lenses in the hands of its established third-party distributors. This strategy was designed to allow the in-house direct sales force to shift its attention to the product of the future: disposable contact lenses. But, crucially, the strategy also concentrated SVS sales efforts within a sales channel that could sign up to large inventories of contact lenses.

During the second half of 1993, the senior executives of the contact lens division achieved their September quarterly sales target by discounting the SVS product and thus selling large amounts to key distributors. This made the task of meeting the December target even more difficult.

The SEC enquiry later found that, to achieve the December target, the contact lens division devised a sales & marketing programme that, in effect, allocated vast numbers of contact lenses to third-party distributors. There was little demand among the distributors for this inventory, but they were keen to retain their status as ‘authorised distributors’ of Bausch & Lomb products. They were also assured that sales that in the past had been channelled to the direct sales team would now be pushed towards the third-party distributors (this later turned out not to happen to any useful degree).

A few distributors refused to accept the terms of the sales programme, under which distributors were given Bausch & Lomb credit lines for their inventory but were obliged to pay the money back through 1994, mainly in a large ‘balloon’ payment in the month of June.

The majority agreed to the programme but demanded concessions from executives at various levels within the contact lens division.
sion that, cumulatively, changed the nature of the programme and shifted the economic responsibility for its success back to Bausch & Lomb.

For example, when some distributors said they did not have the warehouse space to accept so many lenses, certain executives within the contact lens division arranged interim facilities for them. Existing credit lines were raised substantially in a way that led to some significant credit exposures.

Worse still, promissory notes that senior Bausch & Lomb managers had designed to ensure the company could demand payment for the stock were, in many cases, left unsigned. And certain junior executives within the division, under pressure to sign up the distributors, began to promise distributors that they could return any contact lenses that were not sold.

Later on, as the balloon payments became due in summer 1994, this is precisely what happened. The distributors told Bausch & Lomb that they had too much stock, forcing the company to recognise the reality of the situation and, in June, to communicate some of the bad news to investors. By October 1994, Bausch & Lomb had taken back a substantial amount of the oversupply.

By that point, however, it had broken accounting rules in its reporting for the 1993 financial year. These rules allow a company to recognise sales before it receives payment for its goods or services. But the rules say that sales must be accounted for in a way that reflects their economic substance, not their form: revenue should not be recognised in company statements until it is ‘realised’ and ‘earned’.

All rules are subject to interpretation, but SEC investigators were later in little doubt that Bausch & Lomb’s December programme broke generally accepted accounting principles with regard to revenue recognition.

In findings eventually published in 1997, the SEC accepted that senior corporate managers at Bausch & Lomb did not know about the realities of the December sales programme, as implemented at various levels within the contact lens division. But the SEC said the company had failed to maintain a system of internal accounting controls sufficient to ensure that it followed revenue recognition rules.

Investigations by business journalists as the scandal developed, particularly those of Business Week, suggested that the December programme was, in part, the outcome of a target-driven corporate culture across Bausch & Lomb that emphasised headline results above everything else. Bausch & Lomb senior management denied that this was a fair interpretation of the leadership style at the company, and maintained that any problems at divisional level were aberrations.

During the summer of 1994, as the effects of the December programme became apparent and Bausch & Lomb began to own up to investors that its earnings for 1994 would be affected by surplus inventory, the company was also becoming concerned about another star performer, the Asia-Pacific division.

This $100-million revenue division had for years provided some of the cream on the returns from Bausch

Timeline of events

June 1994: The Bausch & Lomb audit team begins work in the Asia-Pacific division’s Hong Kong operation.

August 1994: Bausch & Lomb corporate managers receive an anonymous letter from Asia-Pacific division staff asserting the fraudulent booking of sales by certain local management.

October 1994: CLD management takes back much of the December programme oversupply. By now, Bausch & Lomb and external auditors are also uncovering the scheme to book false sales by managers in the Asia-Pacific division. Investors brace themselves for a shocking fall in profits in the 1994 financial year, after years of consistent growth.

December 1994: Following articles in the December 19 edition of Business Week magazine, focusing on the booking of sales at Bausch & Lomb’s CLD, the SEC begins to investigate.

Early to late 1995: The company is under increasing scrutiny over its distribution strategies and reporting practices. It also faces increasing investor pressure after its poor financial performance in 1994 continues into 1995.

December 1995: Bausch & Lomb hires a former SEC enforcement chief, Gary Lynch, to conduct an outside director internal enquiry into the accounting scandal.
& Lomb’s expanding international operations. But by 1994, an increasing proportion of its earnings was in the form of receivables – or money owed – rather than hard cash.

In June, Bausch & Lomb internal auditors began work in the Hong Kong divisional headquarters, and, in August 1994, corporate managers back in Rochester were sent an anonymous letter from Asia-Pacific division staff, which said that certain of their management had been booking fraudulent sales.

Bausch & Lomb moved to strengthen the audit team and brought in external auditors, who began an extended investigation. By the autumn of 1994, they were uncovering an elaborate scheme at the division’s Hong Kong offices to bump up sales of Ray-Ban and other brands of sunglasses.

The mechanics of the fraud took various forms, including both the assignment of sales to customers without their knowledge, and the assignment of sales to compliant customers.

The motivation for the fraud might have arisen out of strategic business challenges. Bausch & Lomb faced increasing pressure from competition in its premium sunglasses sector, and from shifts in eyewear fashion. An international grey market existed in branded goods that could have been used to siphon away any excess inventory after sales targets had been met, though this would have been against strict company policy.

Whatever the motivation, by the time the investigators arrived, the situation had got out of hand. The perpetrators had created a complex chain of paperwork to sustain their actions. The SEC investigation found that “Asia-Pacific personnel prepared false paperwork reflecting non-existent transactions, including ‘customer requests for exchange’, warehouse receipts and ‘credit notes’”.

The ‘customer requests for exchange’ of sunglasses were important because they could be used to freshen up the fraudulent transactions. They provided an excuse for the fact that cash payments for the booked transactions were abnormally delayed. Without them, the transactions would soon have begun to look like bad debts, and would have attracted corporate attention. For the same reason, certain computer records had been tampered with.

The aftermath

The Bausch & Lomb staff involved in the fraud in the Asia-Pacific division worked at various levels, from certain senior divisional executives through to certain warehouse personnel. After the scheme was discovered – largely by the internal and external auditors – the company replaced the Hong Kong personnel that it held responsible for the fraud.

During 1994, Bausch & Lomb began to communicate the problem of its overflowing inventory and distribution chain to investors, but it did not offer much in the way of detail. However, many of the problems in the contact lens division were then publicly revealed in a sensational article in Business Week magazine in December 1994.

Commentators began to speculate about the management culture at Bausch & Lomb, and the SEC began its long investigation into whether the company had, Timeline of events

13 December 1995: CEO Daniel Gill resigns after a 13-year term, under pressure from both investigations into the scandal and the company’s continuing poor performance. By now, the company has lost $1 billion in market capitalisation since the bad news began to break, and earnings are back at 1991 levels.

January 1996: Interim CEO William Waltrip voluntarily amends Bausch & Lomb’s Forms 10-k for 1993 and 1994 to include restated financial statements, though the company maintains that its senior management acted in good faith in the original statements. Bausch & Lomb begins to restructure itself in an attempt to build a stronger position in the contact lens and other markets, but analysts say it now has an uphill task.

May 1996: Committee of outside directors at Bausch & Lomb says in a report that the top five corporate executives at the company did not know about the misdoings at two of its main divisions in 1993-4.

November 17, 1997: After a long enquiry, the SEC imposes cease and desist orders against Bausch & Lomb, and some of its divisional senior executives at the time of the offences, in relation to overstatement of revenue and other violations of federal securities laws. But it agrees with the Bausch & Lomb internal report that there is no evidence that top corporate executives knew what was going on.
through its reporting failures, let down shareholders and broken federal securities laws.

Gill, CEO for more than 13 largely successful years, found himself having to explain to shareholders a drop in profits in 1994 that continued into 1995. Despite a recovery plan that involved top executive pay freezes and ideas for a major restructuring, he decided to retire at the end of 1995 after a series of difficult shareholder meetings.

An internal enquiry subsequently cleared Gill and other top corporate executives of involvement in the frauds, as did the later SEC findings, published in November 1997. But the SEC findings criticised Bausch & Lomb’s performance as a company, saying: “Bausch & Lomb violated the anti-fraud, reporting and record keeping, and internal controls provisions of the Exchange Act.”

It also found against three senior executives in the contact lens division at the time of the flawed December programme. (Bausch & Lomb, and the senior divisional executives named in the order, settled with the SEC without admitting or denying any wrongdoing.)

Commentators were quick to point out that while senior corporate officers at Bausch & Lomb had been putting pressure on divisions to meet aggressive targets, they had not balanced this with internal controls sufficient to prevent malpractice.

As a result of its failings, Bausch & Lomb was subject to various penalties, including the embarrassment of the SEC enquiry and findings: earnings retractions; share price volatility; settlement of a shareholder lawsuit; and a loss of corporate reputation. Despite significant management efforts in the later 1990s to restructure the company – including selling off the sunglasses division in 1999 – Bausch & Lomb never recovered its earlier consistent levels of growth. In early 2002 it released details of its latest programme of restructuring, to include the loss of 700 jobs.

It is difficult to be sure whether the 1993–4 accounting scandal, certainly disastrous in the short term, has also played a critical part in Bausch & Lomb’s long drift sideways.

The company faced significant strategic challenges even before the scandal broke as margins in its key business lines narrowed.

There is little doubt, however, that Bausch & Lomb’s misreporting of revenues precipitated a crisis in investor confidence that hampered early efforts of its management to develop a new approach.

Notes

1 For the SEC findings, on which this case study substantially relies, see the cease and desist order published as part of SEC Release no. 39329 on November 17, 1997. Bausch & Lomb and the senior divisional executives named in the order settled with the SEC without admitting or denying any wrongdoing.

2 In autumn 2001, the company appointed Ronald Zarrella as its new CEO. It was a move that provoked some comment, as Zarrella had been chief operating officer at Bausch & Lomb in the period immediately before Bausch & Lomb’s accounting scandal broke in autumn 1994. However, as we explain in the main text, the internal and SEC investigations cleared senior corporate executives of knowledge of the malpractice at divisional level that caused the company to misstate its revenues. Zarrella spent the intervening period as a prominent head of General Motors’ North America division.

3 In the words of SEC investigators, the division “told its distributors…to purchase an unprecedented amount of traditional SVS inventory less than two weeks before the end of its fiscal year”.


It is difficult to be sure whether the 1993–4 accounting scandal, certainly disastrous in the short term, has also played a critical part in Bausch & Lomb’s long drift sideways’