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Hollate Manufacturing Case Study

About this case study:

This case study was developed as a joint effort by the Center for Audit Quality, Financial Executives International, The Institute of Internal Auditors, and the National Association of Corporate Directors. These four organizations have formed the Anti-Fraud Collaboration to actively engage in efforts to mitigate the risks of financial reporting fraud. The Collaboration's goal is to promote the deterrence and detection of financial reporting fraud through the development of education, programs, tools and other related resources.

For more information about the Anti-Fraud Collaboration and its resources please visit www.AntiFraudCollaboration.org.

Jack Brennahan had his dream job. He had always wanted to head a manufacturing company and five years earlier he received that opportunity at Hollate when he was promoted from the CFO position. He enjoyed the work, the exciting environment he had helped create, and the people around him. As CEO, however, Brennahan understood that the buck stopped with him. He took his responsibilities seriously both in running a successful business and ensuring that the business met all regulatory requirements and ethical expectations of being a good corporate citizen. He never wanted to be ashamed of anything he read in the newspaper about Hollate. Brennahan, however, had just received a call from Cara Porcini, Hollate's external auditor, followed immediately by a call from Mike Soltany, Hollate's audit committee chair. They had news that stopped him cold.

HOLLATE

Hollate began manufacturing products for the home construction industry in the 1950s. For most of its history it comprised one division that made windows and doors for the Southeastern region of the United States. These products were sold under several private-label and store brand names. Seven years earlier, two years before Brennahan became CEO, Hollate acquired a Midwestern door and window manufacturer that also had a division that made roofing products. The acquisition enabled Hollate to gain access to new geographic and product markets, and also gain economies of scale in management and in raw material purchasing. Following this acquisition, Hollate held an initial public offering (IPO) and became a public company. Hollate used proceeds from the IPO to acquire a manufacturer of home siding products, a manufacturer of prefabricated sheds and garages, and two other smaller home construction product businesses.

In recent years a downturn in the housing sector impacted the entire home construction industry, including the manufactured products segment. Hollate had taken a hit in both its revenue growth and profit margins, but overall it had fared better than its peers. In hindsight, Hollate might have overpaid for that first acquisition which had occurred before the downturn. Its subsequent acquisitions, however, were made on favorable terms as they came after the early days of the downturn had driven down the valuations of many manufacturers.

Hollate now had 14 divisions throughout the U.S. and Canada. It had 2,100 employees, sales of $1 billion, profit margins in line with historical industry norms, and a market capitalization of approximately $1.5 billion. With one or two exceptions, each division was profitable and was maintaining market share.

CEO JACK BRENNAHAN AND THE MANAGEMENT TEAM

Brennahan had joined Hollate ten years earlier as CFO after working his way through several management positions and promotions at two other firms. While his background was in finance and accounting, he always considered himself a general manager. As CFO, Brennahan had played a leading role in integrating Hollate's first acquisition and making it a success both operationally and financially. He also played a leading role in taking Hollate public and identifying its other acquisitions. When the previous CEO retired, Erik Hanloon, Hollate's Board Chairman, saw Brennahan as the ideal candidate to lead Hollate's continued growth. As CEO, Brennahan, with Hanloon's support, spearheaded Hollate's last four acquisitions.

Shortly after becoming CEO, Brennahan conducted a search for a CFO using a respected recruiting firm. Because Brennahan planned to continue to grow the company, he wanted a top-notch CFO with skills beyond what Hollate might need at present. In particular, he wanted someone with significant public company experience, something the other members of the top team lacked. Brennahan reflected that if he was applying for the CFO position today, he might not make the cut. In the end, Brennahan hired William Blackburt.

Before coming to Hollate, Blackburt had served as CFO of a manufacturer that had grown through acquisitions, but had reached the limits of its growth some years earlier. Because of this, he was looking for a new opportunity. Overall, Blackburt had 25 years of experience after earning his MBA and he was also a CPA. A former colleague called him extremely intelligent and hardworking—someone who was the first to arrive in the morning and the last to leave at the end of the day. The colleague also noted that Blackburt had "nerves of steel" and kept his cool under the most pressure-filled circumstances.

Blackburt believed that Hollate would not find many candidates with his level of experience directly aligned with the company's needs. When he was offered the job, he negotiated hard for a compensation package that included significant bonus opportunities. In particular, his bonus levels were tiered so that higher awards kicked in when Hollate reached higher revenue growth levels. Under the most favorable scenarios, Blackburt's bonus could be as high as his base salary—literally doubling his cash pay. He received no bonus at all if the company failed to meet its lowest tier targets. His pay package also included long-term incentives in the form of restricted stock. Blackburt's contract, which he had negotiated prior to the start of the economic downturn, was closely linked to Hollate's acquisition strategy. Because home construction was historically not a high-growth industry, it would be unlikely for Blackburt to earn even the lowest tier bonus—and essentially impossible for him to earn a higher-tier bonus—if Hollate did not make any acquisitions.

In watching these negotiations, Brennahan liked Blackburt's aggressive nature and can-do attitude and felt that Blackburt would be a big help to him in growing the business into a leading national competitor. After finalizing Blackburt's employment contract, the board's compensation committee restructured Brennahan's contract to reflect similar targets.

In addition to Blackburt, Brennahan had three others on his top team: chief operating officer Robert Sojohn, marketing and sales vice president Stan Rellon, and general counsel Margaret Mallie. Sojohn had joined Hollate to work in the company's original manufacturing plant right after earning an undergraduate degree in engineering. In the 18 years since, he had held a variety of engineering and operational positions before being promoted to the COO position just prior to the first acquisition. Sojohn had the longest tenure at Hollate but was the youngest member of the top management team and the only one not put in his position by Brennahan.

Rellon joined Hollate nine years earlier in the marketing department. He had previous experience in marketing and sales and had done well at Hollate. Rellon's predecessor left the company after being passed over for the CEO position. Brennahan promoted Rellon rather than conduct an external search. Mallie had been with Hollate for three years and was the company's first general counsel. At Hollate, she spent much of her time on contracts and legal matters relating to customers, but she also worked closely with the outside firm that Hollate relied on to handle acquisitions and other legal work.

COMPANY STRATEGY

Under Brennahan's leadership, Hollate was pursuing a growth-through-acquisition strategy. The industry was undergoing significant consolidation and Hollate was well positioned to take advantage of this trend as an acquirer. Although he viewed the industry downturn as a setback that made financing new acquisitions more difficult, and he acknowledged the need to focus on efficient operations, Brennahan remained committed to growth through acquisitions. In this regard, Brennahan considered himself eager, but cautious. He did not want to get Hollate into any deals it could not handle or afford.

Brennahan planned to jumpstart Hollate's growth as market conditions improved by making additional acquisitions with an eye towards filling in gaps in its product lines and geographic coverage. For example, Hollate was a leading supplier of doors and windows in the Southeast and Midwest, but was only a modest player in the Northwest. Yet it was a leading supplier of prefabricated sheds in the Northwest and Midwest, but had no shed operations in the Southeast. To fund its acquisitions strategy, Hollate maintained a $150 million line of credit. Its agreement with the bank included several stringent covenants, including EBITDA (earnings before interest, taxes, depreciation, and amortization) targets.

The top team spoke regularly about the growth strategy and while they all supported it, they each had a somewhat different perspective. Brennahan was looking to find "good fits" that improved Hollate's market position. Sojohn enjoyed figuring out how to most efficiently organize all the different manufacturing plants and when he thought about acquisitions he looked at them as opportunities to improve how things worked. Rellon believed that a larger operation would improve Hollate's negotiating position with the large, national retailers. Blackburt seemed most excited by finding and negotiating the next deal. Overall, Blackburt was the most aggressive supporter of making acquisitions and overcoming whatever obstacles hindered progress and he spoke often about his belief that

Hollate could become one of the largest home products manufacturers in North America. Sojohn and Rellon were excited about the growth plan, but looked to the CEO and CFO to take the lead. Somewhat behind the scenes, Chairman Hanloon agreed with Brennahan's plans and was a supporting voice for him on the board.

BOARD OF DIRECTORS

Erik Hanloon had been a member of Hollate's board for 12 years and its chair for six. When he first joined the board, Hollate was a steady performer. He sometimes thought that "boring" might be an apt description for Hollate at that time and there were certainly no grand plans for acquisitions or public offerings in that era. Hanloon felt that the whole atmosphere at Hollate changed with the arrival of Brennahan and he came to believe that Brennahan was just what the company needed. After the success of the first acquisition and subsequent IPO, Hanloon played a leading role in promoting Brennahan to the CEO position. His positive impression of Brennahan was apparent to the other directors on the board and they respected his views. Hanloon had more executive experience than any other director, and the second longest tenure on the board.

In total, the board had eight directors including the CEO. One director was a descendant of the company founder and a large Hollate shareholder, but had no managerial experience. Two directors had significant management experience. Brennahan had worked with these two directors earlier in his career and had recruited them to join Hollate's board shortly after he was named CEO. Two other directors had joined the board as part of two of Hollate's acquisitions and had been chief executives at those companies. These two were also large shareholders. The remaining director, Mike Soltany, served as audit committee chair. Soltany had been identified by an outside recruiter and he had no previous relationship with Hollate.

BOARD COMMITTEES

At the time of its IPO, Hollate reorganized its board to include the three standard board committees: audit, compensation, and nominating and governance, all required under the listing requirements of the company's stock exchange. Audit Committee Chair Mike Soltany joined the board two years earlier as a member of the audit committee and he had served as that committee's chair for the past year. Soltany had served on the audit committee of another public company board, but this was his first stint as audit committee chair. While he was not a CPA, Soltany had a background in finance and was the designated financial expert on the audit committee. The two other members of the audit committee were the acquaintances Brennahan had recruited to the board. They were financially literate (could read and understand financial statements) but not particularly well-versed in accounting rules, even the most basic ones governing matters such as recognition of revenues and expenses.

One of the first steps Soltany took when he became chair of the audit committee was to select a new external auditor. While he had no cause to doubt the previous auditors, a smaller regional firm that had served Hollate well for ten years, he reasoned that because Hollate had grown significantly, and planned to continue to grow, a larger national accounting firm would bring new capabilities, experience, and geographic reach. Other than one comment by CFO Blackburt, who insisted that the previous firm was a good fit for Hollate, no one objected to the change. Soltany also believed that the board, and the audit committee in particular, needed some instruction in basic accounting matters. He brought this up to Brennahan, who was receptive to the idea. In the press of other concerns, however, this director education never took place.

INTERNAL AUDIT FUNCTION

The internal audit function at Hollate had not grown as fast as the company itself and currently had four people. Jonas Durand, chief audit executive (CAE), had been with Hollate for 15 years. Early in his career, Durand had worked for five years as an accountant for another manufacturing company and also for a retail company in junior level positions. He joined Hollate's internal audit function under an experienced CAE and quickly learned the ropes of internal audit and Hollate's business. One year after Hollate made its first acquisition, Durand's predecessor moved out of state and left the company. Durand took over the position.

While Durand did not have a CPA or experience in internal auditing beyond Hollate, he had a deep understanding of the business and had taken a variety of professional development courses since becoming an internal auditor. The lead engagement partner of the previous external auditing firm once commented that what Durand lacked in professional certifications he made up for in his tenacity and his mindset for the auditing role: he liked to ask questions and test assumptions, he kept work relationships on a professional level, and above all, he was not easily intimidated.

The internal audit function periodically evaluated internal controls for each division and selected sites for testing on a rotating basis. Durand's understanding of internal controls was based on standards put forward by the leading professional standards group, and included a broad understanding of material financial risk, including the risk of financial statement fraud. Internal audit mainly tested internal controls from an operational perspective, rather than testing financial reporting. Durand reasoned that the CFO, audit committee, and outside auditor could play the primary watchdog role there.

Historically, the internal audit function reported directly to the CFO. When the company went public, it also received a dotted line reporting relationship to the board's audit committee. With the exception of the work related to special requests from the CFO, internal audit sent its written reports to both the CFO and the audit committee chair. Durand and Blackburt had talked about one day having internal audit report directly to the audit committee, but making that change did not appear to be an immediate priority for Blackburt. In practice, Durand regularly met with Blackburt and rarely with the audit committee. The dotted line reporting to the audit committee meant little more than sending reports. When Durand had a question about something he did not understand he went to Blackburt. When the audit committee asked to speak to the internal auditor, Blackburt assured the directors that he was in frequent communication with Durand and could convey Durand's findings directly to the committee on Durand's behalf.

As Hollate had grown, Durand enjoyed digging into the new businesses. His main hurdle, however, was the small size of the internal audit function, which limited how much it could do and frequently left it behind on its divisional reviews. When he first became the CAE he hired a junior level auditor who had several years of auditing experience at a public company. That person had further developed his skills under Durand and after six years the two worked well together. Durand had received verbal assurances from CFO Blackburt that he could hire another accountant with internal audit experience when business growth resumed or before the company made any new acquisitions. For the time being, however, Durand found it difficult even to do his normal internal audit work. Blackburt had him doing several acquisition related projects that made it difficult for him to execute his audit plan.

EXTERNAL AUDITOR

LPS LLC (LPS) was an established national public accounting firm with a good reputation in the marketplace and was fully capable of auditing an issuer with multiple divisions and locations. It did not have a significant presence outside of the U.S., but could call on resources of non-affiliated audit firms that had non-U.S. operations. Much like Hollate, most of LPS's foreign work was in Canada and that part of its audit business was growing.

Before LPS agreed to take on Hollate as a client, Cara Porcini, LPS's lead engagement partner for the Hollate audit, had contacted Hollate's previous external auditor. She found the previous auditor had no significant concerns regarding the integrity of Hollate's management and had had no significant disagreements with management over accounting principles or audit procedures. Furthermore, the previous auditor said it was not aware of any fraud or illegal acts, and that all of Hollate's financial statements had been filed on time with the SEC.

CULTURE

Brennahan had influenced the culture at Hollate in a way that matched his personality: hardworking, but friendly and social. And while competence and results mattered most to him, what also made the job satisfying for Brennahan was the work environment that had developed. In particular, he, his CFO Blackburt, COO Sojohn, and Rellon, the VP of marketing and sales, had developed positive professional and personal relationships. Everyone seemed to enjoy coming to work and joining the occasional friendly poker games and fishing trips on the weekends, which sometimes included managers beyond the top team. Various "fishing stories" were well known at the company offices.

At headquarters, there were few relational formalities. Everyone treated each other as equals, called each other by first names, and office doors were generally kept open. Managers took advantage of the open-door environment and frequently dropped by the offices of their colleagues to bounce ideas or seek help. This included Brennahan, who liked collaborating but did not micromanage; he tended to let his managers run their own areas.

The environment led to a sense of trust among most top managers at Hollate headquarters and a belief that they were all part of a team and working together for the same goals. Brennahan, who spent most of his time looking for potential acquisitions, and dealing with customers and investor relations issues, frequently used the word "trust" in meetings and speeches and he often told his managers he had confidence in them to do the right thing and what was best for Hollate. Formal accounting and control procedures were in place, but exceptions could be made for the good of the company. For example, if a $25,000 invoice needed to be paid quickly to ensure that a vendor shipped parts that would keep one of Hollate's manufacturing plants running, senior managers thought little of overriding normal procedures—perhaps bypassing a step in the payment review process—to get the invoice paid on time.

The presidents and CEOs that had run the businesses that Hollate acquired had largely left the company. The managers who remained in the divisions tended to have strong operational or sales backgrounds. While they knew their businesses well, they still looked to headquarters for the nuances of public company reporting requirements. Headquarters tried to be welcoming when managers visited from the field. These visiting managers, however, came from different environments—generally nose to the grindstone working—and many did not quite know what to make of headquarters or its culture. When at headquarters, they tended to keep their visits short and focused on what they needed to get done.

The most significant cultural contrast was between management and the board of directors. Brennahan had occasionally invited different board members to attend a fishing trip, but none of them had taken him up on the offer. After a while, he mostly stopped trying, assuming that the directors wanted to maintain professional-only relationships. Directors were seldom seen at headquarters for anything other than formal meetings. Audit Committee Chair Soltany had received a few invitations and had politely turned them down. He was impressed by the track record of Brennahan and his team, but he noted to himself that he had never been a part of, or even seen, a management team as close professionally and personally as the one at Hollate. He had the impression that they were all friends and it would be difficult to be a part of that as a director. He wondered how he would approach a senior manager if he wanted to speak confidentially about a sensitive matter involving a colleague.

The board and management, despite their different styles, set a unified, if low key, tone for ethics. When Hollate went public, it introduced a compliance program and code of conduct aimed at making clear the ethical expectations for employees. The first drafts of these documents were written by an outside consulting firm. Brennahan did not have much experience with such programs and so he made few changes to what the consultant proposed. He had initially planned to make these programs very visible, but the excitement of the public offering, the acquisitions, and managing the downturn put them on the back burner. In the end, each employee received a written copy of the code of conduct and it was posted on the company website. Individual managers were supposed to discuss it with each employee as part of their annual performance reviews, but despite good intentions this did not always happen. Overall the program received little attention. For example, Hollate had a whistleblower hotline system managed by an outside organization that sent reports to both the board's audit committee chair and to the general counsel. General Counsel Mallie indicated she would seriously investigate any hotline tips, but since its introduction, the hotline had received very few calls and none of major importance.

NAVIGATING THE DOWNTURN

The home construction industry had been in decline for several years: builders were constructing fewer homes, many homeowners had delayed or scaled back remodeling plans, and home sales, a frequent driver of remodeling, were below historical norms. While some industry watchers felt that the worst of the decline might be over, there were few signs of a return to previous sales levels.

When the downturn became evident, Hollate had responded by reducing costs, laying off some workers, and slowing production at its manufacturing plants. Brennahan, however, was more optimistic than most regarding the future of the industry. He believed that a turnaround would happen soon and he wanted to be well prepared for when that happened. This led him to make as few cuts as possible and instead look for efficiency gains. He encouraged his managers to look for ways to reduce spending that would not preclude a quick return to full capacity production.

To maintain revenues, Brennahan pressed his division heads to get out and close sales. He reminded them that Hollate had a great reputation as a supplier of quality products and that when retailers cut back, they could be convinced to cut back on suppliers other than Hollate. Blackburt backed this approach. When Blackburt spoke with divisional financial staff, he reminded them of Brennahan's expectations and reiterated the need for them to reach their performance targets. Rellon pressed his divisional sales teams reminding them that the company's larger size since its acquisitions should provide them with increased leverage when negotiating with its leading customers. Some division heads, however, felt that the talk coming out of headquarters left the impression that the company's senior executives were so focused on obtaining results that they were ignoring the tough competitive climate in the field where people were worried about losing their jobs.

During the previous two years, raw material prices had increased sharply, but the decline in demand for housing products limited Hollate's ability to pass along higher costs to customers. Because of Hollate's strong position in its markets, it managed to grow its sales slightly despite the downturn, but due to rising costs it endured a steady decline in gross margins and overall financial performance. While Hollate was still outperforming its peers, its peers were performing poorly.

By the 4th quarter, the company was barely meeting the covenants related to the $150 million in debt financing it had secured the previous year to fund acquisitions. Blackburt became increasingly focused on the debt covenants. Under the debt agreement, Hollate had to meet certain quarter-to-quarter requirements for EBITDA. If performance slipped further, and Hollate violated the covenants, the company would be forced to restructure its debt and put off any new acquisitions for the foreseeable future.

STOPPED COLD

When Brennahan took the call from Porcini during the year-end audit and one week before the 4th quarter earnings were to be announced, he didn't know what to expect. He quickly learned that the call was about some unexplained accounting transactions in the Storm Windows division. It seems that the external auditors from LPS had found some journal entries that they did not understand, yet when they took their questions to the Storm Windows controller, the controller was reluctant to answer. Further inquiries by the external auditors revealed a series of unsupported journal entries from Storm Windows. The entries appeared to increase inventory and reduce costs of goods sold during the 4th quarter.

This led Cara Porcini, LPS's lead engagement partner, to contact CFO Blackburt. For the short time she had known Blackburt, she found him extremely competent and helpful. Porcini was surprised therefore when Blackburt's explanation did not sufficiently clarify her questions about the entries. She thought about his response and felt that she must be missing something, so she went to meet with him a second time. This discussion was no better than the first. Blackburt explained that the accounting matters behind the entries were complicated, but he assured her there was nothing to worry about. Porcini did worry and she contacted Brennahan and Soltany.

After hanging up the phone, Brennahan was initially unsure what to think, but the more he reflected the more concerned he became. In his years at Hollate, he had never heard of a controller not cooperating with an external audit—such cooperation was expected. Even more perplexing was the lead auditor's inability to get an answer from Blackburt. Blackburt was very experienced, knew Hollate's financials better than anyone, and, Brennahan felt, was adept at making complex issues clear. If Blackburt could not explain something to Porcini, an experienced auditor and CPA, something was wrong. Brennahan's next step was to speak with Blackburt himself. Brennahan found the situation puzzling and somewhat troubling, but he was confident that Blackburt would clarify matters.

Brennahan's conversation with Blackburt did not go well. At first Blackburt gave a vague explanation of the entries, but then quickly expressed frustration and anger that he was being repeatedly questioned on the matter even though the books had always been clean and there were more pressing issues the company should be worried about. After finishing with Blackburt, Brennahan looked at the entries himself and could not make sense of them though he could tell that the amounts involved were significant, and he reported his impression to Soltany when he called him back about the matter.

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