The New York Times
nytimes.com

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February 25, 2003

Ahold's Accounting Scandal Raises Questions on What's Being Cured

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It represented the best of all worlds: a rapidly growing company in a safe business. But now an accounting scandal has forced the departure of the man who led Royal Ahold as it grew, and the company says it will restate its books in ways that will reduce both reported earnings and sales.

The Royal Ahold accounting scandal may reflect the new vigor of auditors in the post- Enron environment. It was auditors from Deloitte Touche Tohmatsu who determined that the company had inflated profits by about $500 million, primarily in its U.S. Foodservice unit, in 2001 and 2002. That figure represents nearly half the profit it had reported in that area.

Just how that came to be is far from clear. The company spoke of overstatements of promotional allowances from companies that sold food to its food service company, which in turn supplied restaurants and other food preparers like hospitals, schools and stadiums.

Many such allowances are based on volumes — with suppliers effectively offering lower prices to customers that buy more of their product — and Royal Ahold could have failed to meet volumes that it expected, forcing it either to repay allowances it had received or to not collect allowances that it had expected to receive.

But such errors in forecasts would hardly seem to call for the harsh action the company, based in the Netherlands, took yesterday. It said Cees van der Hoeven, who would have celebrated his 10th anniversary as chief executive next month, would resign, along with Michael Meurs, the chief financial officer.

Henny de Ruiter, the nonexecutive chairman, did not place responsibility for the errors on the men, and in a conference call answered a question from one analyst by saying: "You are quite right. At this point, no charge against the C.E.O. or the C.F.O."

At U.S. Foodservice, which Royal Ahold acquired in 2000 and then expanded through more acquisitions that year and in 2001, neither the chief executive, James Miller, who founded the company in 1989, nor the chief financial officer was suspended or fired. But an undisclosed number of executives below them were suspended. The company did not explain how those officials, along with the very top officials in the Netherlands, could be held responsible but that intermediate officials could not.

In any case, the treatment of such promotional allowances has been controversial, in large part because companies seeking to meet quarterly earnings expectations could do so by changing their estimates of volume in the remaining months of the year, producing more discounts and higher reported profit.

The Emerging Issues Task Force, a part of the Financial Accounting Standards Board, which sets American accounting standards, began wrestling with that issue last year, and some accountants expected it would change the accounting rules to require companies to take the discounts only after they had earned them rather than reporting discounts that they expected to receive but had not yet qualified to get. But the task force decided last month not to

change the rules.

For U.S. Foodservice, the restatement represents a large part of its operating profit in the last two years. In 2001, the company said operating profit was $481 million. In the first nine months of 2002, it came to $587 million.

The effect of the overstatement of promotional allowances was to increase profit but not revenue, because those allowances reduce the cost of the food the company buys.

But another accounting change, which the company said was made after its auditors learned more information about its various international subsidiaries, will reduce reported sales but apparently will not affect profit.

Those subsidiaries had previously been consolidated, even though they were not fully owned. That meant all the revenue was reported by Royal Ahold, although it would then deduct from its profit the portion of profit controlled by other investors in the subsidiaries. Now the subsidiaries will be partly consolidated. The effect will be that a subsidiary that was 50 percent owned, with $1 million in sales, would now show as having provided only $500,000 in sales.

Such partial consolidation is acceptable under Dutch accounting rules, the company said. And while it is not allowed for American companies, the Securities and Exchange Commission allows foreign companies to keep such consolidations when they reconcile their financial statements to United States rules.

Just what facts the auditors found to make them want to stop the company from fully consolidating the sales was not clear, and Mr. de Ruiter said he could not comment on it.

But the effect will be to reduce the explosive top-line growth of the company. In 1992, the year before Mr. van der Hoeven took over, Royal Ahold had sales of 9.8 billion euros. By 2001, that was up to 66.6 billion euros, and in 2002 reported sales were up 12.2 percent for the first nine months.

Even before yesterday's disclosures, which sent the share price down 61 percent, or $6.53, to $4.16, the company had run into problems and investors had grown cautious as it reduced its profit forecasts and disclosed problems in Argentina. The share price had peaked in early 1999 at $41.88.

Royal Ahold's growth under Mr. van der Hoeven included an aggressive expansion in the United States that made it one of the largest supermarket operators as it bought chains like Stop & Shop, Giant, BiLo, Tops and Bruno's. The grocery store results were not affected by the problems announced yesterday.

Unlike many European companies, Royal Ahold became an aggressive issuer of stock options. In 2000 and 2001, Mr. van der Hoeven appears to have made more than $3 million cashing in options, and Mr. Meurs more than $1 million. The company did not disclose option exercises in previous years, nor has it disclosed exercises for last year.

Now the share price is under the exercise price of the remaining options, and the company is scrambling for cash. It announced new borrowing arrangements yesterday but declined to say which banks had provided the money or what assets it had put up to secure the loans. It said it would cut costs and step up sales of subsidiaries that it viewed as being underperformers or not central to its business plan.

Mr. de Ruiter refused to specify what was for sale, but he said that despite the profit overstatement, "We have full confidence in the long-term future of our U.S. Foodservice."

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