

HP and Autonomy: An Unethical Marriage Made in Hell

Sarah D. Stanwick

Associate Professor
School of Accountancy
Auburn University

Peter A. Stanwick

Associate Professor
Department of Management
Auburn University

Introduction

Autonomy is a software based company that uses programs to sort unstructured data. The software programs take data from mediums such as e-mails, pictures, instant messages and develop common themes to help categorize the data. The software programs are based on the work of eighteenth century mathematician, Thomas Baynes who developed pattern-recognition algorithms to organize data. Up to 80 percent of data within a company is considered to be unstructured, creating an urgency to develop a method that will organize the information contained in the data. Furthermore, the organization of this data is essential to comply with any regulatory and/or legal requirements.

The Acquisition

On August 18, 2011, it was announced that HP would buy Autonomy for approximately \$11.7 billion. This was 10 times the company's prospective revenue. The average European software company was sold for 10 times its earnings instead of its revenues. HP's CEO, Leo Apotheker explained that the acquisition of Autonomy was beneficial to HP since "Autonomy presents an opportunity to accelerate our strategic vision to decisively and profitably lead a large and growing space."¹

At a price of \$42.11 per share, HP paid approximately 64 percent premium for Autonomy.

Autonomy was founded in 1996 by Mike Lynch who owned 8 percent of the company when they were acquired by HP. HP's CEO, Leo Apotheker, stated that HP wanted to potentially sell off its PC unit and focus more on Software sales. Some investors were outraged by the announcement since HP had stated publicly that they were going to sell the PC unit which made the unit a "lame duck"² both within HP and the subsequent evaluation of the unit once it went up for sale.

HP defended the action by stating it had to disclose its strategy in order to comply with the Securities and Exchange Commission's disclosure rules. Yet, HP was the global market leader with 18 percent of the total PC sales, while Dell was in second place with 13 percent. Leo Apotheker stated that HP's strategy to move out of the PC market was based on the belief that HP could no longer afford to invest in consumer PC devices and should focus on new corporate PC products. Investors also identified the synergistic advantages HP had by being active in the PC market. HP's corporate customers bought bundles of technology solutions which included PCs, tech services and server systems. The synergy also was translated into reduced costs by buying, in bulk, microchips and other components which were used in multiple applications.

¹ Dealbook. 2011. "H.P. Extends Autonomy Offer." *The New York Times*. September 13.

² Justin Scheck & Joann S. Lublin. 2011. "Investors Rebel Against H-P Plan." *The Wall Street Journal*. August 20.

The Real Motive

It was argued that the true intentions of Leo Apotheker was not necessarily to move to a higher growth market of software, but, is related to his previous work experience. Apotheker was formerly at SAP which is a German based software company. Therefore, Apotheker was much more comfortable focusing on software instead of hardware. Furthermore, critics of Apotheker alleged that he tried of change the focus of the board by having his own personal “cronies”³ so that he could shift the focus of HP without being challenged.

The vision of Apotheker was myopic in nature. Less than one month after the strategic shift took place at HP, rumors started circulating that the board was being pressured into replacing Apotheker. One observer close to the HP decision makers stated that Apotheker was “...like an organ transplant that didn’t take.” While George Colony, founder of Forrester Research, stated that HP “...is a company with no clear strategy.”⁴ On September 22, 2011, HP named Margaret Whitman as the new Chief Executive Officer replacing the short tenure of Leo Apotheker of just over 11 months. Apotheker who was hired in November 2010, was considered to be deficient in the necessary leadership, communication and operations skills needed for an effective CEO. As a parting gift to the former CEO, Apotheker was given \$7.2 million in severance pay and a bonus of \$2.4 million. The acquisition of Autonomy officially took place on October 3, 2011 and newly appointed CEO Meg Whitman stated that “(t)he exploding growth of unstructured and structured data and unlocking its value is the single largest opportunity for consumers, businesses and governments. Autonomy significantly increases our capabilities to manage and extract meaning from that data to drive insight, foresight and better decision making.”⁵

The Beginning of the End

In May 2012, Mike Lynch, the founder of Autonomy, and the manager for the Autonomy division within HP was fired. In connection with the firing, Meg Whitman stated that Autonomy’s problems were “not the product...it’s not the market...it’s not the competition, this is classic entrepreneurial company seeking challenges – it’s a whole different ballgame.”⁶ The firing was the result of “very disappointing” licensing revenue of Autonomy which resulted is a significant decline based on the previous year.

On November 20, 2012, HP announced that it was going to write-down approximately \$8.8 billion in value from the Autonomy acquisition in which close to \$5 billion was based on accounting irregularities. HP made the allegation that Autonomy had taken certain accounting actions which had artificially inflated the financial performance of the company. Meg Whitman stated that “There appears to have been a willful effort on the part of certain former Autonomy employees to inflate the underlying financials of the company in order to mislead investors and potential buyers.”⁷ Former HP CEO, Leo Apotheker stated that “I’m both stunned and disappointed to learn of Autonomy’s alleged accounting improprieties. The developments are a shock to the many who believed in the company, myself included. But I also share the sentiment of HP’s current leadership and continue to believe in Autonomy’s market potential, as its core software expertise remains sound.”⁸

One of the allegations was that Autonomy was selling low profit margin hardware at a loss and then subsequently booking the revenue as high profit margin software. In fact, the hardware was being sold at a loss and the loss was recorded as a marketing expense. The marketing expense increased as Mike Lynch was trying to make a deal for the acquisition of Autonomy. It was also discovered that Autonomy was recognizing licensing revenue upfront before it received the money. In addition, it was alleged that Autonomy was recognizing revenue by using value-added resellers as middlemen who sold software on behalf of Autonomy. These sales were recorded as purchases to end user customers who did not exist. The allegations were submitted to the SEC and the Serious Fraud Office in Britain in order to start a formal investigation.

³ Al Lewis. 2011. “H-P’s One-Year Plan.” *The Wall Street Journal*. August 28.

⁴ Joseph Menn. 2011. “HP rises over talk about Apotheker Successor.” *The Financial Times*. September 21.

⁵ Dealbook. 2011. “H.P. Completes Acquisition of Autonomy.” *The New York Times*. October 3.

⁶ Chris Nuttall. 2012. “HP Confirms 27,000 Job Cuts.” *The Financial Times*. May 23.

⁷ Arik Hesseldahl. 2012. “What Exactly Happened At Autonomy?” *The Wall Street Journal*. November 20.

⁸ Rolfe Winkler. 2012. “Leo Apotheker: Due Diligence of Autonomy Was Meticulous.” *The Wall Street Journal*. November 20.

In defending the allegations, former CEO Mike Lynch stated that “HP’s due diligence review was intensive, overseen on behalf of HP by KPMG, Barclays and Perella Weinberg. HP’s senior management has also been closely involved with running Autonomy for the past year.”⁹

A Clash of Cultures

One of the underlying challenges which faced HP in the acquisition of Autonomy was the attempt to integrate the two very different cultures. Mike Lynch accused HP of being very bureaucratic and slow to address any issues. In addition, it was alleged that the formal culture at HP forced out the top level employees at Autonomy after the acquisition took place. Lynch claimed that “They drove out the top 100 people from Autonomy, and a bunch of trainees were put in...HP salesmen got better commissions for selling our competitors’ products.”¹⁰ A HP executive responded by stating the Lynch was not interested in moving forward once the deal was completed. “He was at every strategy session, was in person or on video for every meeting of the executive council...He wouldn’t work with anyone. Sometimes he was enthusiastic, but other times he’d say, ‘This makes no sense. I’m going back to London.’”¹¹

Investors and Authorities Respond to the Allegations

On November 26, 2012, investors filed a class action lawsuit against HP for paying too much to acquire Autonomy which resulted in a significant drop in the stock price. The investors claimed that HP had released financial statements and prospects that were false and misleading from the time the acquisition with Autonomy was announced in August 2011 until the time that HP had written off \$8.8 billion from the acquisition in November 2012. Toni Sacconaghi, a technology analyst at Stanford C. Bernstein, claimed that the acquisition of Autonomy “will arguably go down as the worst, most value-destroying deal in the history of corporate America.”¹²

By the end of December 2012, HP stated that at least 10 class action lawsuits had been filed related to the Autonomy acquisition. In addition, HP stated that they were cooperating with the United States Department of Justice in their investigation of Autonomy’s questionable accounting practices.

On February 11, 2013, The United Kingdom’s accountancy regulator, the Financial Reporting Council, launched an investigation into the financial reports of Autonomy and the role of Autonomy’s external auditor, Deloitte UK. In March 2013, the British Serious Fraud Office (SFO) announced that they had opened an investigation into the accounting practices at Autonomy, In an ironic twist, the investigation was to start on February 6 but the Serious Fraud Office had to delay the start because they needed to established whether using Autonomy’s own software program in the investigation, Introspect, would be considered to be a conflict in interest.

On January 5, 2014, the United States Air Force claimed that Autonomy had booked revenues from uncompleted transactions for a number of quarters in order to meet sales targets. Using evidence, from an internal HP investigation, the Air Force stated that it would bar Autonomy from undertaking any work in which the United States federal government was a customer. The Air Force gave the example of three deals in which Autonomy had booked the revenue before the transaction was completed. In the three deals, one deal was not completed while another deal was completed at a lower sum that what Autonomy had recorded.

On February 3, 2014, HP’s auditor, Ernst & Young announced that it had made a number of major revisions on the Autonomy financial results. Two significant changes were the 81 percent drop in operating profit from a major Autonomy subsidiary and a 54 percent drop in sales for 2010. Michael Thacker, who is a spokesperson for HP, stated that “The substantial work necessary to prepare these accounts has revealed extensive accounting errors and misrepresentations in the previously issued 2010 audited financial statements, including the problems previously identified by HP.”¹³

⁹ Arik Hesseldahl. 2012. “What Exactly Happened At Autonomy?” *The Wall Street Journal*. November 20.

¹⁰ Quentin Hardy. 2012. “Autonomy Founder Challenges H.P.’s Claims.” *The New York Times*. November 25.

¹¹ Quentin Hardy. 2012. “Autonomy Founder Challenges H.P.’s Claims.” *The New York Times*. November 25.

¹² James Stewart. 2012. “From H.P., A Blunder That Seems to Beat All.” *The New York Times*. November 30.

¹³ Michael J. De La Merced. 2014. “HP Revises Autonomy Financial Reports, Citing Accounting Errors.” *The New York Times*. February 3.

A former senior manager at Autonomy stated that “We continue to reject these allegations by HP. Given the size of HP’s write-down, we are very surprised by the small size of the adjustments in Autonomy Systems Limited that are attributed to the ongoing accounting dispute.”¹⁴

The Disclosures Begin

In February 2014, internal documents were released which described the internal actions within Autonomy. Autonomy’s CFO, Sushovan Hussain, sent an email to Mike Lynch raising concerns pertaining to Autonomy’s sales forecast. He wrote “(r)eally don’t know what to do Mike. As I guessed revenue fell away completely...There are swaths of reps with nothing to do...So radical action is required, really radical. We can’t wait any more.”¹⁵ The end of quarter gave the employees more of a motive to “adjust” the figures to ensure the numbers met the forecast for the quarter. HP also reported that “(o)ur investigation showed that Autonomy often resold generic hardware at a loss in the last few days of a quarter with the sole purpose of masking its real financial performance...In addition, Autonomy engaged in improper transactions with certain value-added resellers to create the appearance of software licensing revenue at the end of the each quarter.”¹⁶

The Settlements

On June 30, 2014, HP settled three shareholder lawsuits against HP’s directors, officers and advisers. The shareholders received no financial compensation and the defendants did not have to pay any financial settlement. The result of the lawsuit was the agreement by HP that it would implement future corporate governance revisions pertaining to the board of directors and pay the legal fees for the plaintiffs.

In July 2014, former Autonomy CFO Sushovan Hussain, filed a motion to block the HP settlement with its shareholders. Hussain stated in the court filing that “By this settlement, HP seeks to forever bury from disclosure the real reason for its 2012 write-down of Autonomy: HP’s own destruction of Autonomy’s success after the acquisition...And by the broad bar order it seeks, HP seeks to absolve itself of its own responsibility for its losses.”¹⁷ Hussain argued that the settlement was a great win only for HP since it would prevent shareholders from making HP financially accountable for their alleged mismanagement. A response by a spokesperson of Mike Lynch stated that “This motion reveals the depth of the corruption that permeates the settlement. The lawyers who spent more than a year documenting the errors and misrepresentations of HP executives in their acquisition and integration of Autonomy have been bought off by the promise of tens of millions of dollars. HP and its executives, who squandered billions of dollars and produced a report whitewashing the whole affair, avoid answering a single question. And the shareholders who have borne the losses get nothing, and learn nothing about what really happened. Three years on, shareholders deserve more than this, they deserve answers.”¹⁸

Continuing the Saga

On August 24, 2014, United District Court Judge Charles R. Breyer rejected the proposed HP shareholder settlement. Judge Breyer stated that HP and the lawyers must file a revised version of the proposed settlement agreement. The focus on the revised settlement would include how HP can improve its behavior including changes in its corporate governance structure. On September 11, 2014, a group of former Autonomy executives, including former CEO Mike Lynch, claimed that HP had grossly overvalued the value of Autonomy during the acquisition process. HP had filed documents in a California federal court which estimated that Autonomy was potentially worth approximately \$17 billion based on a stand-alone value of \$9.5 billion and an additional \$7.4 billion through generated synergies.

¹⁴ Michael J. De La Merced. 2014. “HP Revises Autonomy Financial Reports, Citing Accounting Errors.” *The New York Times*. February 3.

¹⁵ Daniel Thomas and Richard Waters. 2014. “HP/Autonomy Investigation: Tangles Web Of Hardware and Resellers.” *The Financial Times*. February 17.

¹⁶ Spencer E. Ante. 2014. “New Documents Shed Light on Autonomy Deals Amid H-P Probe.” *The Wall Street Journal*. February 18.

¹⁷ Michael J. De La Merced. 2014. “Ex-Executive of Autonomy Seeks To Block HP Settlement Over Disastrous Deal.” *The New York Times*. July 21.

¹⁸ Michael J. De La Merced. 2014. “Ex-Executive of Autonomy Seeks To Block HP Settlement Over Disastrous Deal.” *The New York Times*. July 21.

The former executives stated that “Autonomy’s management cannot be held responsible for HP’s excessive forecasting of synergies...The write off is due to HP’s own recklessness and not due to any accounting improprieties.”¹⁹

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¹⁹ Lisa Fleisher. 2014. “Former Autonomy Execs Turning to Unusual Strategy In Fight With Hewlett-Packard.” *The Wall Street Journal*. September 12.