IMA EDUCATIONAL Case Journal | Case Study

INSTITUTE OF MANAGEMENT ACCOUNTANTS
Advancing the Profession™

ISSN 1940-204X

Turnaround and Down with Richard Brown: EDS 1999-2003

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INTRODUCTION

In the period 1999-2001, Dick Brown posted spectacular results as the CEO and chairman of EDS (Electronic Data Services) Corporation. In 2002, Bossidy and Charan used Brown's success at EDS to illustrate how to properly execute a turnaround strategy in their bestselling business book, *Execution: The Discipline of Getting Things Done.* Surprisingly, just over a year after the book was published, Brown was unceremoniously dumped by the board of EDS. Many inside and outside of EDS were left scratching their heads, wondering how Brown, a highly profiled corporate turnaround star, fell so far, so quickly. Was Brown just unlucky to be caught in the wake of the economic downturn that followed the terrorist attacks of September, 11, 2001, or were EDS' issues more systemic?

EDS: THE COMPANY[i]

With revenues of $21 billion in 2003, EDS was one of the largest players in the $140 billion IT outsourcing market. EDS delivered infrastructure services (running mainframe and desktop services), application services (developing and operating software applications), and business process outsourcing services (handling payments/bills and operating help desks), to clients in the manufacturing, financial services, healthcare, communications, energy, transportation, and consumer and retail industries, as well as to governments around the world. In 2003, EDS' 130,000 employees:

- Supported 3 million desktops in 60 countries,
- Operated more than 50,000 servers in 15 service management centers, more than 250 contact centers, and more than 94 application solution centers around the world, and
- Managed 350 million-plus customer relationships and more than 2 billion customer interactions in 41 languages.

While the IT outsourcing market was growing as more firms outsourced their IT operations and business processes, it was highly competitive. In the infrastructure services market, EDS' main competitors were IBM, Computer Sciences Corporation (CSC), HP, Unisys, and Fujitsu. In the application services market, its main competitors were IBM, Accenture, Bearing Point, Cap Gemini Ernst & Young, Deloitte Consulting, and CSC. In the business process outsourcing market, EDS faced competition from Accenture, Affiliated Computer Services, Convergys, Fiserv, and Concord EFS. EDS also faced increasing competition from offshore IT outsourcing firms, such as India's Wipro, which paid lower taxes and drew from a well-educated, multilingual workforce willing to work for lower wages.

EDS, a pioneer in the IT outsourcing industry, was founded by former U.S. presidential candidate Ross Perot in 1962. Perot later sold the company to General Motors in 1984 and by the time GM had spun EDS off as a separate entity in 1996, its profits were down, revenues were flat, and it had missed the start of the e-commerce revolution. By the end of 1998, EDS was suffering from a number of ailments including indecisiveness, poor accountability, and an organizational structure that did not fit its environment.[1] Many industry observers felt that EDS needed a shake-up.[2]

[i] In May 2008, EDS was purchased by HP. EDS now operates as a stand-alone division of HP, and is known as "EDS, an HP Company."

Richard "Dick" Brown, then 51, had just completed a successful turnaround of Cable and Wireless PLC when he was approached by members of EDS' board in December 1998. EDS' board included political heavyweights, such as James Baker III, who had served as Secretary of the Treasury under President Ronald Reagan and as U.S. Secretary of State under President George H.W. Bush, and Dick Cheney, who had served as U.S Secretary of Defense under President George H.W. Bush and who would serve as the Vice President of the United States under President George W. Bush.[ii] The EDS board recruited Brown to turn around EDS. In announcing Brown's hiring, James Baker III was effusive in his praise for EDS' newest leader: "Dick has an impressive record as a successful, results-orientated change agent, with a strong background in strategy, operations, and marketing. Dick is truly the ideal executive to lead EDS into the next century."[3] In order to lure Brown away from Cable and Wireless, EDS made Brown a very attractive offer: He received a signing bonus of $4.45 million, 50,000 EDS shares (which were worth approximately $2.5 million at the time of signing his employment contract on 01 January 1999), and 1,000,000 EDS stock options which were vested over a five-year period (the first 200,000 were exercisable at $41.50/share) plus an annual salary of $1.5 million and an annual bonus of $1.5+ million. Brown started working as EDS' chairman of the board and CEO in January 1999.

BROWN TURNS AROUND EDS

"The EDS you see one year from now will be very different from the company you know now."

—Richard Brown speaking to analysts in April 1999[4]

Brown revised EDS' strategic mission to read,[iii]

"EDS … the recognized global leader in ensuring clients achieve superior value in the digital economy," explaining, "We are in the deployment of technology business… we are in the impact of technology business. We release the impact of technology… and in so doing derive value that's meaningful to our clients and their customers.[5]

In order to reach his new mission, Brown fine-tuned EDS' strategy by placing a stronger focus on the customer, by building skills in e-commerce areas, and by aggressively chasing mega-outsourcing contracts.[iv]

Brown strongly encouraged his managers to win mega-outsourcing contracts (see Figure 1 for a list of EDS' mega-outsourcing contract signings 1999-2002). Brown likened the long-term mega-contracts to annuities, as they lock in revenue streams for a significant period of time (ten years is not uncommon). However, these long-term mega-contracts can also be double-edged swords as they involve significant up-front cash outlays, which are typically debt financed, to purchase the clients' IT equipment, construct new data networks, and develop customized software systems. Long-term mega-contacts also locked EDS into costs associated with running the client's data processing operations for the duration of the contract period.

EDS set the contract prices in negotiation with clients based on estimates of future costs, transaction volumes, ability to achieve cost efficiencies over time, and recovery of up-front investments. The contract price typically decreased over the life of the contract:

> Given the competitive market in which we operate, our client agreements generally provide for pricing during the beginning of the contract term at what we believe to be market rates, with contractual rates decreasing over time to levels that are below market rates at the beginning of the contract based on our expectation of achieving operating efficiencies, and other cost reductions over the contract term.[6]

In addition, many EDS contracts had provisions for benchmarking. After an initial period, the client could benchmark its contract price to prices charged by EDS' rivals, and if large discrepancies were found, the client had the opportunity to negotiate a lower contract price. Clients also had the option to cancel the contract in the event EDS failed to perform to agreed standards, and if this happened, EDS was not reimbursed for any of EDS' up-front investment in equipment, networks, training, or software. Other events that would have reduced EDS' contractual revenues included economic downturns that led to lower transaction volumes, or clients lost through bankruptcy, merger/acquisition, and non-renewal of their contracts.

Brown spent his first three months at EDS becoming acquainted with its employees and operations around the world before undertaking a number of initiatives to turn around EDS. Brown's prescription to improve EDS' performance was threefold:

[ii] Dick Cheney resigned from EDS' board in August 2000 after being selected as George W. Bush's vice presidential running mate.

[iii] EDS' previous strategic mission, from 1994, read, "EDS will be the leader in shaping how information is created, distributed, shared, enjoyed, and applied for the benefit of enterprises and individuals."

[iv] Mega-outsourcing contracts are typically considered to be those with a total contract value greater than $200 million.

Figure 1
Mega-Outsourcing Contract Signings 1999-2002

12/10/2002	EDS signed contract renewals and add-on agreements valued at $240,000,000 with Weyerhaeuser Company and Integral Energy.
10/04/2002	EDS was awarded a seven-year contract with Aon Corporation's human resources (HR) outsourcing group.
07/22/2002	EDS signed a five-year contract with SN Brussels Airlines for a full suite of industry-customized information technology services.
06/28/2002	EDS announced IT services contracts valued at $445,000,000 with three U.S. organizations.
04/22/2002	EDS announced contracts with new Swiss intercontinental carrier SWISS and several subsidiaries of the former Swissair Group.
03/08/2002	EDS was awarded a 10-year, $250,000,000- contract to upgrade Bank of Queensland Limited's information technology (IT) infrastructure.
02/06/2002	EDS was awarded a $175,000,000 seven-year contract to provide 7-Eleven, Inc. with a full information technology package.
02/01/2002	EDS signed $250,000,000 contracts with two clients in the UK.
01/09/2002	EDS signed a $250,000,000 10-year contract with Bumiputra-Commerce Bank.
11/28/2001	EDS and Xerox Corporation signed a $1,500,000,000 five-year IT outsourcing contract extension to operate the Xerox worldwide computer network.
10/22/2001	EDS announced $1,000,000,000 in contract signings with public and private sector clients in North America and Europe.
10/01/2001	EDS signed a 10-year, $679,000,000 contract with Westpac Banking Corporation to manage Westpac's mortgage processing operations.
07/13/2001	EDS and Franklin Covey signed a 15-year $469,000,000 contract for EDS to provide customer relationship management and IT services.
07/09/2001	EDS announced $900,000,000 in new business agreements with public and private sector clients in Europe and North America.
05/24/2001	EDS agreed to acquire Structural Dynamics Research Corporation (SDRC) for approximately $950,000,000 in cash.
04/06/2001	EDS entered into an agreement to acquire Systematics AG. The total cash and stock transaction is valued at approx. $570,000,000.
03/22/2001	EDS signed an agreement to acquire Sabre Holding Corp.'s airline infrastructure outsourcing business and internal IT infrastructure assets for $670,000,000.
03/05/2001	EDS was awarded a five-year contract worth $300,000,000 from Telstra to provide software maintenance and development for its billing functions and shared services. 03/02/2001 EDS Canada Inc. was awarded a long-term contract with Canadian Pacific Railway to improve customer service and increase business efficiency across the railway.
01/31/2001	EDS signed a $317,000,000 contract with PSEG to provide midrange and mainframe operational support.
12/21/2000	EDS signed $2,000,000,000 worth of contracts with Dow Chemical Company, Weyerhaeuser Company, and BellSouth.
12/12/2000	EDS was awarded a $6,900,000,000 contract from the U.S. Navy to streamline and improve information technology services for the Navy and Marine Corps.
08/22/2000	EDS announced it was awarded the outsourcing contracts totalling $3.3 billion by a British government agency.
10/06/1999	EDS announced it received an eight-year, $1.5 billion contract to provide computer services to Continental Airlines.
07/08/1999	EDS announced it received a five-year contract with Delphi Automotive Systems.

- Cut costs (by selling non-core assets he cut $1 billion in expenses out of a total $16 billion),
- Downsize employees (he fired 13,500 employees, which later became colloquially known as "brownsizing"), and
- Regain the trust of clients and the financial markets.[7]

Brown saw trust as a key business driver in the outsourcing business, noting that "trust is the organization's most important asset"[8] as it "wins business and retains it."[9] Brown explained that trust is built on performance, and performance was the result of successfully executing EDS' strategy. In order to improve EDS' strategy execution, he aimed to change the attitudes and behaviors of EDS' remaining 130,000 employees.

EDS' 1999 Annual Report committed EDS to achieving three financial objectives:

- Revenue growth greater than market growth by year,
- EPS growth greater than revenue growth, and
- Operating margins greater than 10 percent.

These goals surprised EDS' employees and industry observers, leaving many with the feeling it would be difficult, if not impossible, for EDS to achieve them.[10] In order to reach these ambitious goals, Brown made four key changes to EDS "social software:"[11] 1) He reformed EDS' culture and beliefs, 2) altered its incentive system, 3) reorganized the company into four lines of business, and 4) improved employee communication and accountability. To justify his bold financial objectives and tactics to achieve them, he stated, "Companies don't leave a legacy by failing to act. We had to change—and *fast.*"[12]

1) **Culture and Beliefs.** Dick Brown believed that EDS needed a new corporate culture—in his words, "Culture is really the behavior of its people. And leaders get the behavior they tolerate."[13] One of his first actions was to eliminate executive parking and force executives to move their offices from the executive floor to where their employees sat. Brown advertised that he wanted EDS to be the home of the "best and brightest." He built world-class training programs, many of which were offered online to increase accessibility and reduce cost. By 2001, EDS U was training more than 100,000 employees each year. Brown wanted to generate passion for improving performance and felt he had to lead the way. His personal motto, which he attached to all messages addressed to EDS' employees, was "*action, urgency, excellence.*"[14]

   One of Brown's first priorities was to identify EDS' old beliefs and work at infusing a new set of beliefs into EDS' employees: [15]

Old EDS Beliefs		New EDS Beliefs
• We are in a commodity business with low profit margins and due to our large size we can't grow at market rates		• We can grow faster than the market and increase profitability and productivity year in and year out
• Each division leader owns the resources and control of resources is key to their success • My peers are my competitors	→	• Collaboration is the key to our success
• People aren't accountable	→	• We are going to be accountable and committed
• We know more than our clients • Our people tell clients what solutions they need	→	• We will be better listeners to our clients • We are committed to our clients' success • We are will achieve service excellence

Brown wanted everyone on the same page. According to an EDS employee who served under Brown, EDS provided a policy manual and employee handbook to each employee during their initial orientation, and employees were required to sign off on EDS' code of conduct on a yearly basis. The EDS policy manual addressed such items as conflicts of interest, improper payments to officials, confidentiality of information, employees' use of company assets, etc.

2) **The Performance-Rewards Link.** Brown made the connection between performance and employee pay very explicit by modifying EDS' incentive system to handsomely reward those employees who were responsible for winning mega-outsourcing contracts, for improving customer satisfaction scores, and were seen to live EDS' new beliefs. For example, under Brown managers were rewarded based on their collaboration with other divisions.[16]

   EDS' new performance review system aimed to establish "a performance-based and compensation-based culture, where achievers thrive" and non-achievers are forced out.[17] In order to separate the achievers from the non-achievers, Brown directed managers to evaluate their staff using a forced ranking system, and then tied each employee's pay directly to their ranking (e.g., if a manager had 12 staff reports, only three would be ranked in the top quartile, three in the second quartile, three in the third quartile, and three had to be ranked in the bottom quartile. Employees in the top quartile received bonuses of 15-20 percent, those in the second quartile may receive bonuses of 5-10 percent, while those in the third and bottom quartiles did not receive a bonus). Brown felt that, "Some people are not good enough to stay at EDS. But we have to make sure the top performers are recognized and rewarded."[18] He wanted his people to know "the jungle has a justice." Brown's actions went beyond mere words: By 2000, 27 of 37 senior executives were replaced either by internal candidates or external recruits and one-third of its sales force was let go due to poor performance.[20]

3) **Organizational Structure.** Dick Brown inherited an organization with 48 distinct business units that vigorously competed with each other for resources and clients, rather than cooperating. Brown altered this by restructuring EDS into four lines of business that were organized around the client. His goal was "to focus the marketing message and foster better cooperation among divisions."[21] Brown hoped the reorganization would unlock some of the potential synergies that had been previously blocked due to intense competition between business units.

4) **Communication and Accountability.** As a way of driving change, Brown sent bi-weekly e-mails to EDS employees around the globe in which he discussed current issues, outlined his thoughts, and reiterated his performance expectations. Employees were encouraged to respond to his e-mails and provide feedback, as Brown thought that "open, frequent, unfiltered communication is an essential partner to change."[22] Brown received 122,000 e-mails from employees in 2000.[23]

Prior to Brown's hiring financial and sales figures at EDS were only communicated to the senior management team on a quarterly basis. Brown modified this so that key financial numbers were reported daily to the firm's top 125 managers. To promote his devotion to service excellence, in 1999 EDS introduced the "service excellence dashboard," a visual, interactive web-based tool that tracked service quality as rated by clients in real time.[24] As Brown explains:

> Clients score our work directly. No filters. It's open, it's honest and it sometimes stings, but it's absolutely essential to attaining our goal of being the undisputed service leader in the world.[25]

By measuring items such as availability and transaction response times, the dashboard captured whether EDS was meeting its commitments to clients. The global director of service excellence explained, "The culture of EDS is to use the dashboard to nurture, monitor, and develop client relationships. It ensures the quality of service we deliver to our clients is known at all times."[26] The dashboard was used by over 10,000 EDS employees and was reviewed by senior management on a daily basis. For example, if a client's contract flashed "red," then the manager responsible would expect a call from Brown or another senior executive asking how the manager planned to fix it.

Brown closely followed the financial performance of each division. At the beginning of each month, Brown held a performance review meeting by telephone with his top 125 managers to closely scrutinize each division's performance. The CFO read the sales, financial, and service figures for each unit aloud so everyone knew who had hit their budgeted numbers and who had not.[27] Broadcasting the results in front of their peers forced managers to be proactive; if they had not hit their numbers, they needed to come up with a plan to make the numbers before the next meeting.

Dick Brown continually emphasized that managers needed to commit to their budgeted numbers. He argued that failing to meet budget let the EDS team down.[28] He followed up weaker performers "after-class," calling these events "coachable moments." As Brown explained, "We don't try to embarrass people with those calls; we try to help them."[29] Brown also held three face-to-face meetings each year with the global senior management team where "they roll up their sleeves and interactively discuss the business."[30]

THE TURNAROUND RESULTS

"Relationships are built on trust … and trust is built on performance. You trusted us when we told you EDS would be back. We are."

—Richard Brown quoted in EDS' 2001 Annual Report

EDS posted exceptional results for the period 1999-2001. During a speech at Southern Methodist University in November 2001, Brown boasted that the stock price was up 62 percent, and EDS had 10 quarters of double-digit comparable year-over-year earnings per share growth. Further, Brown proudly told the audience that EDS had enjoyed 10 consecutive quarters of year-over-year operating margin improvement which, he explained, was due in large part to $3.5 billion of cost cuts (see Figure 2 for selected financial data for EDS 1998-2002).[31] Brown's service excellence strategy also paid dividends as client contract renewal rates were above 85 percent in 2000.[32]

Figure 2
Selected Financial Data for EDS 1998-2002
(in millions, except per share amounts)

	As of and for the Years Ended December 31,				
	2002	**2001**	**2000**	**1999**	**1998**
Operating results					
Revenues	$ 21,502	$ 21,141	$ 18,856	$ 18,401	$ 16,892
Cost of revenues	17,744	17,086	15,289	15,067	13,993
Selling, general and administrative	1,889	1,880	1,776	1,853	1,838
Aquired in-process R&D and other acquisition-related costs	–	144	24	–	–
Restructuring and other charges	(3)	(15)	(22)	1,038	48
Other income (expense)	(347)	102	(27)	180	65
Provision for income taxes	518	794	643	224	372
Income from continuing operations	1,007	1,354	1,119	399	706
Income from discontinued operations	109	33	24	22	37
Cummulative effect on prior years of a change in accounting for derivatives, net of income taxes	–	(24)	–	–	–
Net income	1,116	1,363	1,143	421	743
Per share data					
Basic earnings per share of common stock:					
Income from continuing operations	$ 2.10	$ 2.88	$ 2.40	$ 0.82	$ 1.43
Net income	2.33	2.90	2.45	0.87	1.51
Diluted earnings per share of common stock:					
Income from continuing operations	2.06	2.79	2.35	0.80	1.42
Net income	2.28	2.81	2.40	0.85	1.50
Cash dividends per share of common stock	0.60	0.60	0.60	0.60	0.60
Financial position					
Current assets	$ 9,385	$ 7,374	$ 6,159	$ 5,877	$ 5,633
Property and equipment, net	3,023	3,082	2,474	2,460	2,708
Other assets	6,472	5,897	4,059	4,185	3,185
Total assets	18,880	16,353	12,692	12,522	11,526
Current liabilities	6,129	4,012	3,955	4,691	3,443
Pension benefit liability	1,113	325	355	305	214
Long-term debt, less current portion	4,148	4,692	2,585	2,216	1,184
Minority interests and other long-term liabilities	417	644	529	508	406
Shareholders' equity	7,022	6,446	5,139	4,535	5,916

(Source: EDS 2002 Annual Report, EDS.com)

His strategy of focusing on mega-outsourcing contracts paid off as EDS posted 11 consecutive quarters of record contract signings (see Figure 3 for the total amount of outsourcing contracts won by EDS 1999-2003).[33] The contract backlog, business signed but not booked, was four times revenues in 2001, a claim that neither IBM nor CSC could make. Brown also successfully diversified EDS' client base geographically, as over 40 percent of EDS' revenues in 2001 were from outside the U.S., as well as reducing its reliance on General Motors. Although General Motors was still EDS' largest client in 2001 (with $3.1 billion in revenues), GM's percentage of total revenue was lower than in pre-Brown years.[v]

Figure 3
Outsourcing Contracts Won by EDS 1999-2003 (in billions)

	1999	2000	2001	2002	2003
Contracts won	**24.9**	**32.6**	**31.4**	**24.4**	**14.0**

(Source: EDS 10K for 2003)

[v] As part of EDS' spin off from General Motors in 1996, EDS signed a 10-year Master Service Agreement with GM to be GM's primary IT service provider around the world.

Some of the largest deals signed during Brown's tenure included a $6.4 billion IT services contract with WorldCom and a $1.5 billion contract with Continental Airlines, both won in October 1999, and the purchase of Sabre Holding Corp.'s airline infrastructure outsourcing business and IT infrastructure assets for $670 million in March 2001. Sabre's airline infrastructure outsourcing business included American Airlines, US Airways, and other airlines. The acquisition made EDS the leading provider of IT services to the airline industry. EDS also acquired Structural Dynamics Research Corporation for $950 million in cash, which provided EDS a beachhead into the European outsourcing market. The prize deal, however, was the richest IT outsourcing contract ever granted. In December 2000, EDS won a $6.9 billion contract from the U.S. Navy and Marine Corps (NMCI contract) to build the world's largest secure intranet. What made this victory even sweeter was that EDS bid very aggressively[vi] and beat out its two strongest rivals, CSC and IBM, to win the contract.

Given his phenomenal success in turning around EDS, at the end of EDS' December 2001 board meeting, Richard Brown received a standing ovation from the board, and each board member personally congratulated him.[34] Brown received more than just thanks from EDS' board for his efforts though; his total take-home pay for 2001 was $55 million.

THE WHEELS FELL OFF IN 2002

"For the first time as a CEO, I got whacked off the saddle of a horse."

—Brown commenting on the problems experienced by EDS in 2002[35]

Unfortunately, EDS' turnaround was much shorter than anyone anticipated. By the autumn of 2001, EDS had hit its earnings target, but missed its cash flow target by more than $600 million. Brown explained the cash shortfall was due to the large capital outlays associated with buying clients' IT equipment as part of winning mega-contracts. Its shares fell significantly in February 2002 as investors, spooked by Enron's bankruptcy, began to question EDS' method of accounting for long-term outsourcing contracts. EDS used a percentage of completion method to account for 40 percent of its revenues. This method involved estimating the total profit to be earned over the life of the contract and recognizing this on a periodic basis (i.e., on a 10-year contract, EDS would recognize 1/120 of the expected revenues and 1/120 of the expected expenses each month).[36] Analysts worried that changes in estimates would lead to large restatements of revenues and profits.[37] Responding to these concerns, Brown replied that "EDS' financial foundation is rock solid. Our accounting is conservative, clear, and concise."[38]

At the same time that EDS' rivals were warning analysts of an impending economic downturn in the wake of the fallout from the terrorist attacks on 9/11, Brown remained optimistic, stating, "We are well insulated. We do well in times like these."[39] The economic downturn hit the airline industry hardest, as many organizations reduced their air travel expenditures due to the fear of additional airline terrorist attacks. Technology firms were also hit hard as the Internet technology bubble burst in 2001. Still Brown was undeterred, saying in February 2002 that EDS would still grow its current year revenues by 13-16 percent and improve its operating margins. In response to analysts' queries regarding declining prospects, Brown frequently stated, "We're the fastest horse on a muddy track."[40]

In June 2002, Brown met with his global senior management team to discuss EDS' near-term profit forecast. To many in the room, it was clear there was going to be a financial downturn, as several executives presented dismal earnings forecasts.[41] However, Brown still aggressively pushed managers to meet their targets. "He said we weren't trying hard enough. We were told there was gold in the hills and to go find it," said a former high-ranking executive. Despite seeing the writing on the wall,

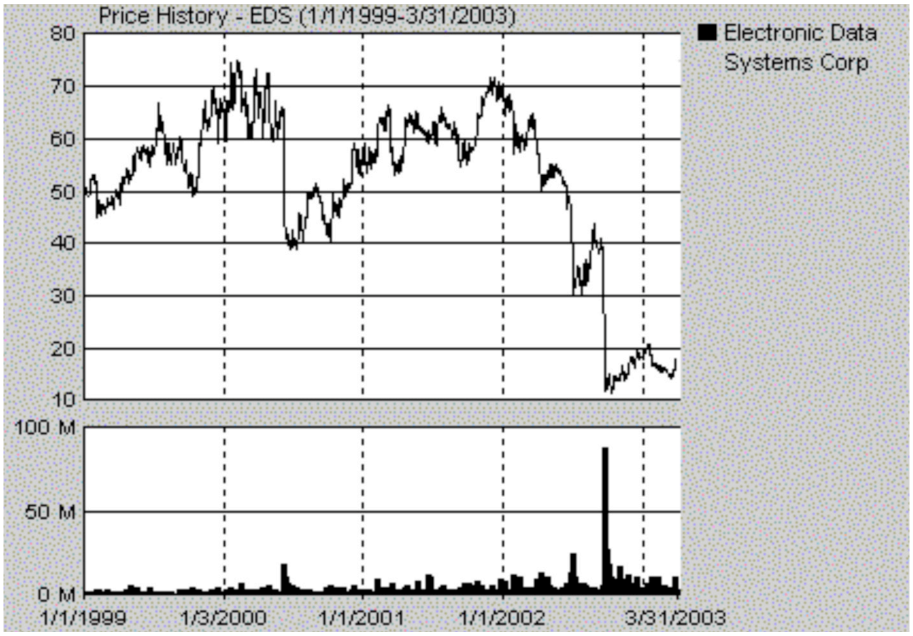
> …executives made little effort to rein in Brown's expectations out of fear of being publicly humiliated, according to former senior executives who were there. Says one, "You'd be singled out as a quitter." Another former executive added, "Delivering bad news was not a good thing. So you postponed it for as long as you could." EDS later denied disregarding dissenting opinions.[42]

In August 2002, Brown toured six cities, repeatedly telling analysts and investors that EDS would hit its third quarter earnings targets.[43] This was in spite of the fact that WorldCom, which represented $610 million of EDS' 2002 revenues, declared bankruptcy in July 2002, and US Airways, which represented $190 million of EDS' 2002 revenues, filed for bankruptcy in early August 2002.[vii] An analyst from

[vi] It was rumored that in its earnest to win the NMCI contract from its two largest rivals, CSC and IBM, EDS bid the contract with only a 4 percent profit margin rather than the industry average of 7 percent.

[vii] In EDS 2002 10K, EDS reported it recorded net reserves and asset write-downs totalled $118 million against its WorldCom revenues and $109 million against its US Airways revenues due to uncertainties regarding the recoverability of receivables and up-front investments. Eventually, US Airways, WorldCom (now MCI,) and American Airlines used their bankruptcy status to force EDS to accept lower prices.

Figure 4
Share Price History and Volume



Oakmark Funds recalled being told by EDS in August 2002, "Business is great, and we're still comfortable with the earnings guidance we've given you."[44] However, in September 2002, Brown issued a profit warning; third quarter earnings were expected to be 80 percent less than the guidance given just three weeks earlier. As a result, EDS' stock price fell to below $10 and EDS lost 80 percent of its market value when compared to its high (see Figure 4 for EDS' share price history and volume).

Brown blamed the profit warning on higher costs for some European contracts[45] and sluggish markets, saying no one could have forecasted these conditions.[46] But other dark clouds also appeared at this time. EDS announced that the Navy and Marine Corps Intranet (NMCI) contract would not show a profit until the end of 2003. Another looming cloud on the horizon was the increased threat of offshore outsourcing firms, such as Wipro in India, which were able to offer similar outsourcing services at lower costs.

Immediately after the third quarter profit warning in September 2002, Brown took action to improve EDS' bottom line and cash position, which had been drained by the large, up-front purchases of its clients' IT equipment. The plan, "Project Next Level," was outlined in an e-mail to staff:[47]

Improve Forecasting. A committee was formed to study how to get more accurate forecasts of market trends. Brown later noted he was skeptical this would work as EDS had 15,000 contracts outstanding, and it would be very difficult to get accurate forecasts on the status of each.[48]

Rebuild Trust. Brown planned to hold discussions with employees to open dialog and gain insights on how to further improve performance.

Improve European Contracts. Several contracts were to be examined to see if there were ways to increase profitability and reduce the potential for making similar errors in the future.

Further Downsize the Workforce and Reduce Severance Benefits. Brown cut severance pay to a maximum of 4 weeks (previously 26 weeks), before he let more EDS employees go in October. The head of HR argued that reducing severance payments meant fewer job cuts.

Brown also pledged to trim overhead expenses by a further $75 million and sell off another $500 million in non-core assets.

BROWN EXITS EDS

"Dick Brown had lost investors' confidence. It was time to move on."

—Humberto Andrade, Analyst with Technology Business Research[49]

Project Next Level was not successful. EDS' 2002 results were lower than expected and the bond rating agencies, S&P, Moody's, and Fitch, announced they had downgraded EDS' debt rating. For example, S&P downgraded EDS' short-term debt rating from A1 to A2, which impacted not only EDS' interest expense, but also its contractual obligations, as several of EDS' contracts contained provisions that EDS must maintain investment grade debt ratings. If EDS was unable to maintain investment grade debt ratings, certain contractual payments might have to be accelerated, or in the worst case, the contract could be voided.

During the same period, Brown revealed that Alstom, a large French firm that had chosen EDS in November 2002 as the preferred supplier for IT service outsourcing, had backed out of the deal. If the deal had gone through, EDS would have managed Alstom's data processing and applications in 13 countries and taken on 1,300 Alstom employees. Later, P&G announced it was postponing signing a $7-8 billion outsourcing contract with EDS. P&G later broke off negotiations with EDS and eventually outsourced its HR operations to IBM, one of EDS' largest rivals. Some analysts speculated the reason P&G chose IBM was EDS' weak financial position.

Brown stated EDS would not cut prices to win new contracts and hired a new CFO in January 2003 to ensure this did not happen.[50] The new CFO preached the need for EDS to not only generate revenue and earnings, but to also generate a positive cash flow. EDS' CFO reported that EDS was still interested in winning mega-outsourcing contracts, but preferred those that did not "require it to make heavy capital expenditures up-front and wait for cash flow."[51] As the chief sales officer explained, "EDS is generally more selective now in the contracts it goes after, and that it is definitely not chasing everything that moves."[52]

All this was "too little, too late" for EDS' board, as they started a search for a new CEO and chairperson in late February 2003. On 20 March 2003, EDS' board forced Brown to resign and announced they had hired Michael Jordan as his replacement. Brown walked away a wealthy individual; pursuant to the terms of his employment contract, his total severance package exceeded $37 million (which included a $12 million cash payment, vesting of 349,000 stock options, and $19.6 million in deferred pension benefits).

The EDS Board of Directors and Dick Brown have mutually agreed it is in the best interests of the company to effect a leadership change at this time. We thank Dick for his many contributions to EDS. The company's organization, client service and competitive position are all stronger today than they were four years ago.

—Press release issued by the EDS board of directors[53]

THE JORDAN ERA BEGINS

"The EDS Board believes the new management team of Jordan and Heller has the opportunity to move EDS forward unencumbered by past events."

—Roger Enrico, an EDS board member, in a press release issued by EDS board of directors[54]

EDS hired Michael Jordan, 66, as chairman and CEO, and Jeffrey Heller, 63, as president and COO. Jordan had successfully led a turnaround of CBS Networks and Frito-Lay, while Heller had held the post of EDS vice-chairman from 2000-2002 and prior to that was EDS president and COO from 1996 to 2000.[55]

Jordan and Heller were brought in to steady the ship. In June 2003, Jordan announced that EDS would not significantly alter the strategy that EDS pursued under Brown other than to stop aggressively chasing mega-contracts; 2003 was the first year EDS did not land a mega-outsourcing contract since 1992 (see also Figure 3, Outsourcing Contracts Won by EDS 1999-2003). Under Jordan, EDS' three key initiatives were to:[56]

1. **Strengthen its balance sheet and liquidity position.** Initiatives to accomplish this included laying off an additional 2 percent of employees (fortunately for those laid off, Jordan increased the maximum amount of severance pay to 20 weeks), further rationalization of administrative processes, and the sale of non-core assets. To address the need for short-term cash Jordan assumed an additional $1.8 billion in debt.
2. **Stabilize and grow its core IT outsourcing business.** Jordan had lengthy discussions with EDS' customers and decided that in order to simplify client relations and to improve accountability each client would have only one point of contact in EDS. In a message to EDS' staff, he admonished the sales staff for pushing what EDS had to offer, instead of selling customers what they need. Jordan wanted salespeople to be more responsive and less aggressive, adding that they needed to be more focused on the clients' business issues.[57]

3. **Evolve a broader business footprint by investing in new growth opportunities such as additional capabilities in business process outsourcing services.** Jordan's goal was to leverage EDS' global leadership in IT outsourcing into adjacent markets.

Driven by a desire to increase investor transparency, Jordan announced that EDS would stop using the percentage of completion method to account for its long-term outsourcing contracts for the year ended December 31, 2003. In March 2004, EDS' financial results for 2003 were released. The results were poor; revenues were flat and EDS posted a loss of $1.7 billion, largely due to write-offs related to the Navy and Marine Corps Intranet (NMCI) contract[viii] and the adoption of new accounting standards that related to the recognition of profit on long-term outsourcing contracts.[ix]

[viii] EDS' 2006 10K (pg. AR-7) filing disclosed the following: "We provide end-to-end IT infrastructure on a seat basis to the Dept. of Navy (the NMCI contract). Prior to 2006, the contract had a significant adverse impact on operating results. In 2003, we incurred operating losses of $389 million, excluding a deferred contract cost write-off of $559 million, and reported a negative free cash flow of $824 million relating to this contract. In 2004, we incurred operating losses of $487 million, exclusive of a $375 million non-cash impairment charge to write down long-lived assets to estimated fair value, and reported a negative free cash flow of $423 million associated with this contract. In 2005, we incurred operating losses of $75 million and reported a positive free cash flow of $125 million associated with this contract."

[ix] The total impact of adopting new revenue recognition accounting standards was a $2.24 billion non-cash revenue reversal before tax. The charge related primarily to reversing the unbilled revenue for percentage-of-completion contracts.

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"We provide services under time-and-material, unit-price or fixed-price contracts which may extend up to 10 or more years. Under time-and-material and certain unit-price and fixed-price contracts under which costs are generally incurred in proportion with contracted billing schedules, revenue is recognized when the client may be billed. For certain unit-price and fixed price contracts, we follow the guidance contained in AICPA Statement of Position ("SOP") 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. SOP 81-1 requires the use of percentage-of-completion accounting for certain long-term contracts that contain enforceable rights regarding services to be provided and received by the contracting parties, consideration to be exchanged, and the manner and terms of settlement, assuming reasonably dependable estimates of revenue and expenses can be made. We use the cost-to-cost percentage-of-completion method whereby amounts recognized in revenue are calculated using the percentage of services completed, on a current cumulative cost to total cost basis. Costs associated with the purchase of long-lived assets to be used on a specific contract are capitalized and excluded from current cumulative costs in calculating the percentage of services completed. Depreciation and amortization of such costs are included in such calculation over the period of use of the asset. Cumulative revenues recognized may be less or greater than cumulative costs and profits billed at any point in time during a contract's term. The resulting difference is recognized as unbilled or deferred revenue.

"Any estimation process, including that used in preparing contract accounting models, involves inherent risk. We reduce the inherent risk relating to revenue and cost estimates in percentage-of-completion models through corporate policy, approval and monitoring processes. Risks relating to service delivery, usage, productivity and other factors are considered in the estimation process. If sufficient risk exists, a zero-profit methodology is applied to a specific client contract's percentage-of-completion model whereby the amount of revenue recognized is limited to the amount of costs incurred until such time as the risks have been partially or wholly mitigated through performance. This methodology is primarily used at the inception of our largest IT services contracts where the amount of profit to be recognized on a contract over its term is not yet determinable. Our estimates of revenues and expenses on client contracts change periodically in the normal course of business, occasionally due to modifications of our contractual arrangements. In addition, the implementation of cost saving initiatives and achievement of productivity gains generally results in a reduction of estimated total contract expenses on affected client contracts. For client contracts accounted for under the percentage-of-completion method, such changes would be reflected in results of operations as a change in accounting estimate in the period the revisions are determined.

"Approximately 10% of our IT service contracts representing approximately 40% of total revenues use the percentage-of completion method of revenue recognition. Unbilled and deferred revenue were $3.0 billion and $830 million, respectively, in our consolidated balance sheet at December 31, 2002. The net change in unbilled and deferred revenue, which represents the difference between amounts billed in accordance with contractual terms and amounts recognized as revenue in our income statement, equated to 3.9% of 2002 total revenues. This net change was primarily associated with certain contracts requiring large up-front system development and construction efforts. These contracts are structured in a manner that generally provides payment for these efforts over periods of time beginning subsequent to the completion of the development and construction efforts. The NMCI Contract and the contracts with the U.K. government represent the largest contracts of this type. Excluding the NMCI Contract and these U.K. government contracts, the net change in unbilled and deferred revenue equated to 0.1% of total revenues during 2002."

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