SF bulletin

By Stephen Barlas, Dennis Odlum

GOVERNMENT

Financial Reform Bill

By Stephen Barlas

The financial reform bill that President Obama signed into law July 21, 2010, impacts U.S. companies in the broadest sense (financials, industrials, retailers, etc.) in the way it regulates derivatives, which have been unregulated. The Dodd-Frank Wall Street Reform and Consumer Protection Act is tougher on Wall Street companies who trade derivatives as a money-making strategy than on Main Street companies who use them to hedge business risks and often put up plant and equipment as collateral in conjunction with derivative use. Nonetheless, these so-called "end-users" still face new costs, the dimensions of which are unclear. The International Swaps and Derivatives Association, Inc. (ISDA), which represents the dealers subject to new, nettlesome, and costly requirements, naturally says "the sky is falling." It estimates about $400 billion would be needed as collateral that corporations could be required to post with their dealer counterparties to cover the current exposure of their OTC derivatives transactions. ISDA estimates that $370 billion represents the additional credit capacity that companies could need to maintain to cover potential future exposure of those transactions. Tom Quaadman, vice president of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC), is a bit more circumspect. He says the bill will drive up the costs of hedging, but how high those costs go is dependent on how federal agencies define the "exemption" for end-users from having to list derivatives on exchanges. Quaadman states, "Key terms that shape the exemption are vague and left to the regulators to define, creating uncertainty for many companies about whether they will in fact qualify for the exemption."

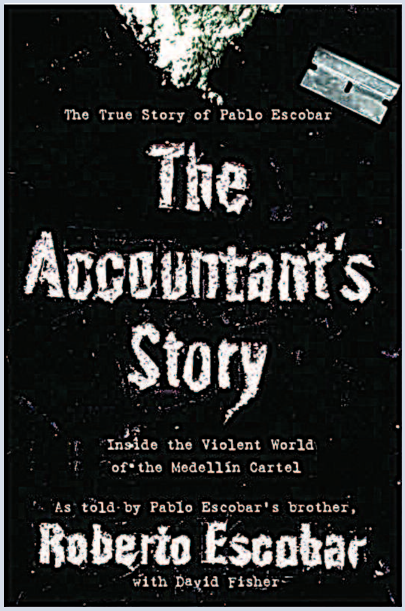
R&D Tax Credit and Other Business Bennies Go Down

The Senate's failure in late June to pass the jobs/stimulus bill the House sent over sounded the death knell for extension of the research & development (R&D) tax credit that expired on December 31, 2009. At least for now. Established in 1981, the credit is used by about 18,000 companies, 70% of them manufacturers. This is the 14th time it has expired, and the jobs bill (H.R. 4213) had a one-year extension at a cost of $6.6 billion over 10 years. The House had sent over a bill with a $200 billion price tag, which Senate Democratic leaders whittled down in the face of deficit concerns to $100 billion with about two-thirds of the spending offset by tax increases, mostly on executives at private equity companies. The big issue was the cost of the extension of unemployment benefits, which wasn't offset. Congress decided one month later that lack of an offset was outweighed by the need to extend the benefits, so it passed H.R. 4213 (now called the Unemployment Compensation Extension Act) with only one provision: the unemployment benefits extension. Remaining in the legislative grave (resurrection is possible when Congress returns from its summer recess in September) with the R&D tax credit extension were other business tax enhancements, such as a provision that would have allowed corporations to receive a refund of a portion of their AMT credits if they invest during 2010 in capital equipment for use in the United States and another giving retailers a one-year extension (through 2010) of the special 15-year cost recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements.

BOOKS

The Cartel's CFO

In *The Accountant's Story: Inside the Violent World of the Medellin Cartel*, Roberto Escobar outlines the life and times of Pablo Escobar and the Colombian Medellin Cartel from the mid-1970s until Pablo's death in 1993 from the perspective of the organization's chief financial officer. Rather than focus on the violent side of the story, such as the thousands of murders and assassinations per year that took place, I will focus on the business side of the book.



The cartel was formed in the early 1970s and began running black market cigarettes from Panama into Colombia. But after losing a shipment and equipment, Pablo decided the cigarette business was too risky. In 1972, the cartel moved into the cocaine business.

Roberto details the cartel's operations just like any other business. The first step was getting raw materials. This involved transporting coca paste from Peru in specially designed wheel wells of three yellow Renaults, with about three kilos in each car. In 1972, a kilo of coca paste cost around $60 and, after processing, could be sold for more than $50,000 in the United States. Eventually, the three Renaults would be replaced by trucks and, later, airplanes.

Then there's manufacturing. In Medellin, Colombia, the cartel set up a "kitchen" in Pablo's house to convert the paste into cocaine. This "kitchen" would eventually be franchised out into almost 500 locations throughout Colombia. Each "kitchen" was essentially an independently operated location referred to as a farm. Each farm employed several hundred employees and their families. The cartel was responsible for all of life's amenities on each farm: housing, schools, medical facilities, stores, recreational activities, and, of course, the important airport.

Demand for its product was never an issue. The cartel's primary problem lay in maintaining the supply chain. Creativity was necessary to stay ahead of the authorities in Colombia and across the globe whose goal was to disrupt delivery of the cartel's product.

Roberto describes the various methods the cartel used, from smuggling it aboard commercial airlines to drops in the Everglades to submarines that would transport the product offshore of Florida, where it would be transferred into local boats. Electronic appliances (mostly televisions) would be shipped legally from Japan to the cartel in Colombia; the insides of the televisions would be emptied and replaced by bundles of cocaine. The televisions were reloaded onto container ships and delivered into the ports of the U.S. and then delivered to special distribution centers. Thousands of scientists were on the cartel's payroll to devise methods to blend the finished cocaine into other legitimate products, such as wine, food, and clothing, and then chemically extract it in the U.S.

Aside from delivery, salary and bribery costs were enormous. Pilots could earn as much as $1 million per flight. One Panamanian general was paid $1.5 million per month, and there were always bribes to pay: airport officials, customs officials, air-traffic controllers, shipyard bosses, police, government officials, etc.

During the height of the Cartel's distribution years (the late 1980s), cocaine sales in the U.S. alone amounted to nearly $350 million per week. Roberto estimates that approximately 25% of the gross would eventually make its way back into the coffers of the cartel, with 10% being the acceptable rate of shrinkage, spoilage, theft, and simply being misplaced during the return shipments.

A much more difficult situation arose

on how to get the $100 million cash out of the U.S. and into Colombia each and every week. Approximately one-third of the profits were laundered into convenient commodities such as electronics, jewelry, and diamonds, but laundering was expensive—almost 60% of the face value was lost. Therefore, most of what came back to Colombia was cash: hidden in suitcases, duffle bags, Piper Cubs, exported automobiles on outbound freighters, etc.

Roberto estimates that he was spending the equivalent of $2,500 a week in rubber bands to bundle the cash. (I did the math at a local Staples: In today's prices, this would be more than 600,000 rubber bands per week.) The banking laws in Colombia were far less strict than in other countries, but bank accounts had to be opened up in the name of employees, of living and dead family members of employees, and of people who simply didn't exist. In order to legitimize the cash, real estate, professional sports teams, art, and diamonds were purchased.

After all the bank deposits and purchases were made, the cash that was still on hand was hidden—in the walls of employees' homes, in garbage bags buried all over Colombia, in waterproof containers in the bottom of swimming pools, in furniture….Roberto says that he alone, as CFO, knew where all the money was located. He memorized the locations.

The Medellin Cartel transformed itself into a mobile business unit in 1989. From then until Pablo's death in 1993, it operated on the run to avoid strengthened extradition laws between the U.S. and Colombia. By having better communications equipment and a better network than their pursuers, the cartel continued to operate successfully. In December 1993, a task force involving an American Delta Force, the CIA, and the Colombian National Police cornered Pablo on a rooftop in Medellin and assassinated him, effectively putting the cartel out of business.

The Accountant's Story is fascinating. It is the inside story of one of the most successful businesses in the world for more than 20 years, as told by its CFO. With a sense of humor—and the same proclamations of innocence made by jailed executives such as Bernie Madoff, Bernard Ebbers, Dennis Kozlowski, and Sanjay Kumar—Roberto Escobar delivers a factual accounting of the organization with which he made his living.—Dennis Odlum, CMA, CFM, dodlum@theconnectioninc.org