CA's Swainson Hit by Skittish Investors, Fraud Legacy (Update1)
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(Adds third-quarter earnings in fourth paragraph.)

By Ron Day
Jan. 24 (Bloomberg) -- In October, CA Inc. Chief Executive Officer John Swainson was hosting his biweekly cafeteria get-together with employees, dubbed ``Java With John.''
Peter Bordonaro asked whether the Islandia, New York-based software maker would meet a December deadline to install part of a $100 million computer program that the U.S. Justice Department required as a condition of CA's 2004 fraud settlement. The system ties together accounting, purchasing and sales data to improve CA's financial transparency.
``I'd love the answer to be, `We can get it done by the end of the year,' but I'm not counting on it,'' Swainson told Bordonaro. ``Shit happens.''
Getting the mandated software running is just one challenge dogging CA, which today said fiscal third-quarter net income almost doubled to $59 million, or 10 cents a share, from $31 million, or 5 cents, a year earlier as the company cut costs and acquisitions lifted revenue. Sales rose to $967 million from $917 million.
Swainson, a 6-foot-2-inch (1.9-meter) Canadian, arrived at CA in November 2004 after a quarter century at International Business Machines Corp.
Two months earlier, Computer Associates International Inc., as the company was called before it unveiled its new name this past November, admitted that from 1998 to 2000 it had extended its financial quarters by several days and had shifted a total of $2.2 billion in sales into previous periods.

`35-Day Month'

The tactic, which the company's audit committee subsequently termed a ``35-day month,'' let CA improperly record revenue when its books should have been closed.
Like the accounting gimmicks at Enron Corp. and WorldCom Inc., CA's fraud helped the company meet or beat Wall Street expectations and hide its real financial performance from investors.
Starting in March 1999, CA shares surged 79 percent to a record $75 on Jan. 26, 2000. They fell 8 cents to $28.88 at 4 p.m. in New York Stock Exchange composite trading today.
None of the analysts who cover the company are expecting a quick turnaround. Seventeen rate the stock ``hold,'' and two recommend selling, according to Bloomberg data.
``It's going to be a tough road for these guys,'' says Credit Suisse analyst Jason Maynard, who rates the shares ``neutral.'' ``You can't fix CA in a day.''

Not Guilty Plea

On Sept. 22, 2004, former CEO Sanjay Kumar, 43, who'd quit three months earlier, was indicted for securities fraud and obstruction of justice. He pleaded not guilty. He was indicted again on June 29, 2005, for allegedly paying $3.7 million to buy the silence of an Asian businessman who threatened to report an improper transaction.

``Mr. Kumar expects to be exonerated at trial,'' says his lawyer, Jack Cooney of Davis Polk & Wardwell in New York. The trial is scheduled to begin April 24 in U.S. District Court for the Eastern District of New York before Judge Leo Glasser, Cooney says.

CA General Counsel Steven Woghin was fired on April 8, 2004. Woghin, 59, pleaded guilty to obstruction of justice and securities fraud conspiracy on the same day Kumar was indicted. He said that at Kumar's behest, he had coached employees on how to conceal the 35-day month from investigators.

Fourteen other top CA executives have been indicted or fired. Five have pleaded guilty. CA is on probation and faces prosecution by the Justice Department if it doesn't meet the settlement terms.

`A Lot of Issues'

``We have a lot of issues,'' says Swainson, 51, who became CEO in February 2005. In July, he cut $75 million in annual labor costs by firing 800 employees, or 5 percent of the workforce.

Swainson's biggest challenge may be persuading investors that he can turn CA around -- and that they will benefit. In 1998, founder Charles Wang paid himself, Kumar and Executive Vice President Russell Artzt $1.1 billion in restricted stock. The trio cashed in on a 1995 shareholder-approved incentive plan that required CA shares to close above $53.33 for a total of 60 days in the preceding one-year period.

On July 21, 1998, Wang, 61, disclosed a $675 million after-tax charge for the payment, sending CA shares plunging 31 percent the next day. On Sept. 15, shareholders Lisa Sanders and Edward Bickel sued CA in Delaware Chancery Court, charging that the $1.1 billion payout exceeded the compensation plan's limit. CA settled the suit in 2000 by agreeing to return $234 million in CA stock to the company.

`Ill-Gotten Gains'

Wang, who retired in 2002 amid the accounting probe, is now chairman emeritus. He has not been charged with wrongdoing and declined to comment for this story.

Chairman Lewis Ranieri says CA is working with the Justice Department to get bonuses that were paid based on fraudulent accounting returned to the company. ``We are still trying to get the ill-gotten gains,'' he says.

Michael Cuggino, president of Pacific Heights Asset Management in San Francisco, says CA may be sold outright or in pieces. ``It's an industry that's ripe for consolidation,'' says Cuggino, whose firm owns 80,000 CA shares among its $450 million under management.

``The board and management are focused on building long-term value for the company's shareholders by continuing CA's strategy as an independent company,'' CA spokeswoman Shannon Lapierre says.

Mainframe Software

While Swainson wrestles with CA's ghosts, addresses the settlement and replenishes the executive suite with managers hired from No. 1 personal computer maker Dell Inc., network software company Novell Inc. and IBM, he has to figure out how to boost sales at the world's No. 2 maker of software for mainframe computers.

CA gets an estimated 55 percent of its revenue from mainframe programs, says Moskowitz at Susquehanna Financial. That's a declining market. Total sales of software for the big machines are forecast to dip to $2.94 billion in 2009 from $3 billion in 2004, according to Framingham, Massachusetts-based research firm IDC.

CA's 11 percent operating margin in fiscal 2005 reflects the company's predicament: Microsoft Corp., the world's biggest software maker, and Oracle Corp., the world's No. 3 software company, both enjoy 37 percent operating margins.

Swainson is pushing CA's 5,300 engineers to design more programs for data storage and computer security. CA already sells eTrust, which controls access to computer networks to prevent break-ins and the spread of computer viruses. Rival Symantec Corp., the biggest maker of anti-virus software, recorded a 38 percent leap in sales in the year ended on March 31, 2005, compared with CA's 7.2 percent increase in the same period.

Move the Needle

``CA isn't well positioned from a growth standpoint,'' says Chuck Jones, a San Francisco-based analyst at Atlantic Trust Stein Roe, which manages $16 billion and owns 2,400 CA shares. ``They have a number of products with second-, third- or fourth-place market share. It's very hard to dramatically move the needle.''

On the sales side, Swainson is visiting and telephoning wary customers, trying to undo damage from what he says were the previous regime's heavy-handed tactics.

Greg Corgan, 52, another IBM transplant who now heads CA's sales team, says customers would beg him for products that would let them dump CA when he was IBM's chief software salesman. CA retaliated by suing clients who tried to get out of license agreements before the contracts expired.

`Mission Critical'

``We knew we had them by the throats because our stuff was mission critical,'' Corgan says, referring to CA's products. ``In many cases, there were no alternatives.''

A CA program called Unicenter spots potential trouble on a company's computers and network, provides an inventory of the equipment and tracks its installation and maintenance history. Because the software does so many things, it's difficult and

expensive to remove, says Kevin Buttigieg, an analyst at A.G. Edwards & Sons Inc.
One of Swainson's goals is to sell more CA programs to overseas customers. They account for about 40 percent of the company's $3.6 billion in annual sales, compared with about two-thirds for Hewlett-Packard Co. and IBM.
CA sells most of its software to large companies such as Caterpillar Inc., the world's top maker of earth-moving equipment, and No. 2 computer services seller Electronic Data Systems Corp. Now, it wants to bring in smaller customers, says Chief Operating Officer Jeff Clarke, 44, who joined CA eight months before Swainson.

Eight Cylinders

Swainson says he needs about three years to cut costs by closing 75 of CA's 100 software development centers. He plans to create a single system instead of the hodgepodge of programs that engineers use to design CA's products.
Now, a developer may use different methods and tools than someone in another office. In three years, Swainson says, CA Labs, a unit he started in August, and the rest of the engineering staff will be cranking out security and storage programs to spark growth.
``We are starting to see the company work again,'' Swainson says, seated in his office with a view of the Long Island Expressway and electric towers poking above nearby treetops. ``It was working on two cylinders; now, it is working on four or five,'' he says, noting that the amount CA billed customers climbed 14 percent to $975 million in the second quarter, the fastest pace in five years. ``Imagine, I say to people, when it begins to work on eight.''

Right Track

There are signs that Swainson -- who managed the IBM division that made WebSphere software for running Internet sites and corporate networks -- is on the right track. Moskowitz expects CA to report a 7.4 percent sales increase to $3.82 billion in the fiscal year ending on March 31, a slight improvement from the 7.2 percent rise a year earlier.
On Sept. 21, CA announced that Time Warner Inc.'s America Online unit had bought CA's anti-spyware product called PestPatrol. On Oct. 24, Swainson told investors that French insurer Axa SA had paid CA $7 million for software and services during the second quarter.
``I spoke with the CEO of Axa Tech many times and made several visits to see him,'' says Swainson, referring to New York-based Axa Technology Services CEO Leon Billis.
In the second quarter, 8 percent of CA's billings were from products the company developed in-house, a percentage Swainson expects will increase with software from CA Labs. The rest came from acquisitions, a holdover from Wang's growth strategy.

Buying Spree

Since November 2004, CA has spent more than $1.11 billion to buy Niku Corp. to manage customers' networks; Concord Communications Inc., which helps clients detect problems on phone and data lines; and Netegrity Inc., which provides data security.
On Jan. 5, CA announced a $375 million deal to buy Wily Technology Inc., a closely held company based in Brisbane, California, that makes programs to analyze glitches in a company's software while it's running.
Wang, who made 60 acquisitions during 30 years, fled communist China with his family for Queens, New York, in 1952 at age 8. With Artzt and other friends who were interested in technology, he started Computer Associates in 1976 in an office near a bowling alley in Garden City, on New York's Long Island.
Wang bought his first company in 1978, choosing Datachron Corp., which managed IBM mainframes. His goal was to develop programs to help companies wring more efficiency from the big computers that were proliferating in banking, insurance and manufacturing.

Like Plumbing

CA's software handled functions such as sorting data. It was like a home's plumbing, fundamental and -- once installed -- costly to remove, says investor Mark Morris of Los Angeles-based NWQ Investment Management Co., CA's No. 3 shareholder. NWQ held 41.7 million shares as of Sept. 30, up from 1.22 million in 2002.
As sales climbed to $1.5 billion in 1992, Wang moved CA east, to a 778,000-square-foot (72,280-square-meter) headquarters on 63 acres (25.5 hectares) in rural Islandia. Workers enjoyed a fitness center and day care for their children.
Wang wasn't oblivious to the shift from mainframes. In the mid-1990s, he began buying data storage and security software companies. He paid $1.74 billion for Legent Corp. in 1995 and $1.19 billion for Cheyenne Software Inc. in 1996.
By 1998, CA had 11,400 workers. Profit soared past $1 billion for the first and only time, and CA's market cap topped $40 billion. In 1999, Wang added to CA's technology consulting offerings by buying Platinum Technology International Inc. for $3.5 billion. He purchased Sterling Software for $4 billion in 2000 to add more storage software.

Dot-Com Bubble

CA shares peaked in early 2000 amid the dot-com bubble and then tumbled 54 percent in the year through Jan. 26, 2001, as CA twice missed analyst forecasts for sales and earnings and officials agreed to settle the shareholders' lawsuit.
In 2002, the Justice Department and the U.S. Securities and Exchange Commission began investigating whether CA had inflated revenue.
On Sept. 22, 2004, CA admitted in U.S. District Court for the Eastern District of New York in Brooklyn that it had used a 35-day month in its accounting. Robert Giuffra, a lawyer from New York-based firm Sullivan & Cromwell who represented CA,

apologized in the courtroom on behalf of the company.
CA agreed to pay $225 million in the settlement. The government put off prosecuting for 18 months, a period that ends in September.
The Justice Department said it would seek to dismiss charges if CA meets the terms of the agreement. Among them are starting an ethics program, hiring a compliance officer to implement the program and bringing in an independent examiner to send quarterly progress reports to the Justice Department, SEC and CA's directors.

Big Cleanup

``We are doing five company-level projects simultaneously,'' Swainson says. ``It's not surprising people are a little uncertain how all the pieces fit together.''
Clarke, the new COO, was among the first to see how big a cleanup CA would require.
As chief financial officer at Compaq Computer Corp., Clarke had helped combine the Houston-based PC maker with Hewlett-Packard before joining CA in April 2004. His job was to hire new executives, help negotiate the settlement and improve the company's financial controls.
In his first days in Islandia, Clarke says, directors asked him to review e-mails and transcripts of lawyers' interviews with executives in the legal and finance departments about the company's accounting practices.

African Game Farm

Based on his review, Clarke says, he fired 10 executives because they had known CA was fudging numbers and had done nothing about it. CA issued a press release on April 19, 2004, saying the firings were the result of ``issues'' uncovered when the board's audit committee investigated the company's accounting.
``The people who had been in leadership positions, who knew what had gone on and had not cooperated fully, would need to leave the firm,'' Clarke says of the firings.
When he asked around the company for a list of CA's customers and vendors, nobody had one, Clarke says. While reviewing assets, he discovered CA owned a South African game farm, which it had inherited in an acquisition. It also owned a horse farm on Long Island, bought with an eye to expansion. He sold the farms; it took a month to get the customer list, Clarke says.
While Clarke pored over documents, new General Counsel Kenneth Handal began rebuilding the law department. Two dozen CA attorneys were scattered about the company, adrift after the firing of Woghin, their previous leader.

`Easily Pressured'

Handal says he discovered an unusual arrangement: CA's sales department had its own lawyers who approved contracts and didn't

report to the corporate legal department.
``They were easily pressured in bad times to do things that weren't quite appropriate,'' Handal, 57, says. ``They were easily susceptible to the 35-day month.''
Before Handal arrived, calls placed to a hotline that let employees report bad conduct reached an answering machine on the desk of a secretary for Woghin, who'd admitted coaching employees on how to hide the 35-day-month accounting fraud. The answering machine's placement sent the wrong message to anyone who contemplated reporting misdeeds, Handal says.
In April, Handal hired Global Compliance Services of Charlotte, North Carolina, to run CA's 24-hour hotline. Live operators answer calls, and Global Compliance sends messages to Handal and other CA lawyers when a complaint comes in.
``To say they were dispirited is an understatement,'' Handal says, referring to the legal team he inherited.

`Calm Down'

He got rid of the lawyers' cramped cubicles, which he says were unusual for a legal department and undermined professionalism. He added 10 new attorneys. ``I want things to calm down,'' he says.
In December 2004, Swainson hired Patrick Gnazzo as chief compliance officer, fulfilling one settlement provision. Gnazzo's job is to set up programs to encourage good corporate behavior and oversee compliance with government regulations.
Infractions persist, Gnazzo says. Among them, he says, are indications that salespeople may be writing secret agreements with customers. These ``side letters'' may allow a client to quit a software contract early, after the salesperson has been paid a commission and CA has booked costs. Side letters were a cause of one of CA's earnings restatements, Gnazzo says.
``You have 2,500 salespeople out there, and some of them are not looking at this as a career,'' Gnazzo says. ``They are only looking at their commissions for one year.''
About 17 percent of CA's workforce turns over each year as people either quit or retire. Swainson says the company is losing too many employees.

Rate of Change

When he attended a workshop for new CEOs at Harvard Business School in April, he says he learned that CA's rate of change -- everything from a switch in more than a dozen top executives to the company's new name -- is greater than in most corporations. That pace may upset workers, he says.
To clean up the sales department and to boost revenue, Swainson changed the company's compensation strategy. In the past, CA paid a commission based on a contract's value at the time it was signed. There was no penalty if a buyer backed out later before the order expired.
Salespeople are now paid based on the number of new programs they sell. They get bonuses when a customer boosts the size of a contract and get nothing extra for renewing at the same amount,

says Corgan, the head of sales. ``It's a little harder money to make,'' he says. ``Some of those guys are bailing, and they ought to be bailing.''

Franks With Frank

To keep in touch with workers, Swainson writes a Web log, which he says is read by more than half of CA's 15,500 workers, and holds his ``Java With John'' sessions.

Swainson took the idea for the name from ``Franks With Frank,'' the lunch meetings held by Frank Clegg, president of Microsoft's Canadian business. ``We tried to be clever with my name and that was the best we could come up with,'' Swainson says.

One big topic at CA is the breakneck pace of change. ``They tell you not to go through it this fast,'' Swainson says. ``We had to do it and do it quickly, probably faster and harder than prudence might dictate.''

Heath Riccobono, who works in CA's treasury department and has been with the company for two years, says meeting the settlement mandates has put a strain on workers.

Even so, duties such as documenting CA's compliance efforts are necessary to lift the cloud hovering over the company. ``It's going to be part of our daily lives,'' he says.

New Optimism

Swainson's efforts have helped people feel optimistic, Riccobono says. ``We've seen a lot of new hires from the top levels,'' he says. ``It was tough when I got here, stressful, with the terminations.''

Jerry Hernandez, who helps manage computer networks for Austin Energy, the electric company owned by the city of Austin, Texas, says he's now getting quick replies to phone calls and e-mails from his CA salespeople. Even so, he says, there have been days when, eager to make him forget bad behavior, they've tried too hard.

In mid-2004, Austin Energy bought the eTrust security product and two other CA programs -- one that helps employees report problems with the company's computers and another that tracks maintenance records. In November, representatives of Austin Energy attended a software conference hosted by CA.

``They even laminated our agendas,'' Hernandez says. ``They understand they've had a lot of bad press and have stepped it up a notch. Maybe too much.''

Future Bet

Analysts Andrew Brosseau, formerly of SG Cowen & Co. and now retired, and Moskowitz say investors may be turned off by CA's shares. That's because the company's financial reports mix revenue from contracts signed years ago with sales of software under a newer subscription method CA adopted in 2001, making attempts to figure out the true performance confusing.

Morris of NWQ says he looks at the cash CA generates. In the last fiscal year, CA's free cash -- or cash from operations minus capital spending -- rose 17 percent from the previous period to $1.46 billion. That amounted to $2.48 of free cash per share -- more than for BMC Software Inc., Microsoft, Oracle or Symantec in their recent fiscal years.

``Even if everything that was swirling around the company were true, it didn't affect the cash flow,'' Morris says. ``To take a CA product out takes a lot of money and a lot of time.''

Cuggino says one reason he invested is CA's ability to compete in many areas.

``They've had corporate governance issues, management shake-ups, but their fundamentals are strong,'' he says. ``CA is a bet on the future.''

For CA investors who have been burned before, Swainson and his new team can't erase the past quickly enough.

--Editor: Roche (rah/awj/rbg)

Story illustration: For a chart of CA's management, see {CA US <Equity> MGMT <GO>}. For its credit profile, see {CA US <Equity> CRPR <GO>}. For more Bloomberg Markets stories, see {MAG <GO>}

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