Cooking the Books

by Norm Alster
January 13, 1999

On Nov. 3, President Clinton signed the Securities Litigation Uniform Standards Act of 1998. It was a victory for high-tech lobbyists anxious to curb the rise of class-action lawsuits.

Sound familiar? In 1995, lobbyists persuaded Washington, D.C., legislators to pass the Private Securities Litigation Reform Act, which was aimed to make it tougher to sue in federal court. Then, with some shareholders bringing suits at the state level, tech lobbyists persuaded Congress and Clinton to tighten the screws yet again by passing a new law last year requiring that class-action suits be filed only in federal courts under the stricter federal standards.

But it appears that curbing the rights of shareholders to seek redress for corporate fraud is a classic case of encouraging crime by shielding the offenders. In the first quarter of 1998, the volume of class-action suits, most of which involve fraud charges, insider trading or both, nearly quadrupled compared with the first quarter of 1996, according to a June 1998 Stanford Law School study.

Indeed, accounting fraud of all types seems to be flourishing. Outlandish merger and acquisition write-offs, restated earnings and misstated inventories have drawn the attention of Securities and Exchange Commission (SEC) Chairman Arthur Levitt, who promises to get tough on creative financial reporting.

Cooking the books is nothing new, of course. But when the kitchen is hot, the books boil faster.

That's why the fevered pace of business formation, pell-mell merger activity and gyrating stock values have made high tech a bubbling cauldron of flimflam. More than 57 percent of all class-action securities lawsuits filed in early 1998 were against tech companies, according to the Stanford study.

Could it be that Washington's willingness to protect corporations from fraud has actually stimulated fraud? Cause and effect are difficult to unravel here. But there's no question that fast and loose accounting is on the rise. Indeed, financial report printers have had a field day as a parade of penitents, many chastened by the SEC, have restated previously reported earnings.

Creative accounting can take many forms. For example, corporate finaglers can bury salaries and can either overstate or understate inventories. In addition, some CFOs have been using write-offs and reserves aggressively to even out financial peaks and valleys.

To some degree, financial shenanigans in high tech merely mirror those in the broader corporate world. In a late September speech at the New York University Center for Law and Business, Levitt questioned the quality of corporate financial reports overall and warned of companies that "operate in the gray area between legitimacy and outright fraud."

Noting that "integrity in financial reporting is under stress," Levitt called for tightened accounting and disclosure rules, as well as improved internal audit oversight.

In the meantime, shareholders unhappy with the financial performance of their investments have taken the classic American approach to voicing their displeasure--they've been heading to court. It would be a mistake to conclude that all class-action suits have merit. Some are simply knee-jerk reactions to stock nosedives, a convenient source of revenue for plaintiffs' law firms.

But it would be every bit as dangerous to conclude--as corporate shills often assert--that all class-action suits are "frivolous." Plaintiffs' attorneys have discovery rights, giving them access to records companies otherwise hold tight. And in roughly 80 percent of all cases, companies end up paying to settle. Of course, some say that the high cost of litigation forces them to settle, even when they believe they're being falsely accused.

In recent years, the average settlement has ranged from $6 million to $10 million, according to Michael Perino, who co-wrote the Stanford report and is now an associate professor at St. John's University School of Law in New York. Most cases brought in recent years are still unresolved. "The federal courts are sitting on an inventory of [more than] 400 cases," estimates Stanford Law School Professor and former SEC Commissioner Joseph Grundfest.

The SEC has just 935 funded positions in its enforcement branch, which is empowered to prevent and suppress fraud. Some believe that's not nearly enough to fulfill its watchdog duties. The Department of Justice, the SEC, the U.S. attorney's office and the state attorneys general do not have the funds or the staffing to do adequate policing, argues plaintiffs' attorney Harvey Greenfield of New York.

But don't take his word for it: SEC Chief Accountant Lynn Turner, while noting that his agency reviews the filings of 3,000 companies each year, concedes that it cannot hope to

sniff out all the bad eggs. "I don't think we're going to find all the fraud," he says. "Human nature being what it is, there [will] be people who go out and commit fraud and defraud the investing public."

One clue to the merit of class-action suits is the way defendants deal with them. Often, charges are never countered. Defendants move instead to have the case dismissed. If the case survives such a motion, defendant companies will then shift to stonewalling and stalling tactics, resisting discovery as much and as long as they can. "They fight you every inch of the way," Greenfield notes. Most telling of all: When companies do settle, they almost invariably insist on having all documents sealed. Even as they pay to settle, admissions are rarely made, the truth rarely revealed.

But keep in mind that 88 percent of these cases involve serious allegations--either fraud, insider trading or both. So how is it that high tech, accounting for more than half of all cases, is such a magnet for alleged miscreants? First of all, temptation is probably strongest in high tech, where worshipful investors have been willing to buy grandiose claims and elegant concepts in lieu of genuine financial accomplishment. Traditionally, fraud has involved embezzlement, but for some high-tech executives, schemes to pump up stock prices are less risky and far more lucrative.

"Why would you want to steal $50,000? Wouldn't you rather overstate earnings and sell your stock?" asks Ian Ratner, an Atlanta-based principal with the international firm of Lindquist Avey Macdonald Baskerville Inc., which specializes in fraud investigations.

With executive compensation often tied to revenue targets, the penalties for doing everything to jack up a stock price don't begin to offset the rewards. "As long as they don't cross the line between civil and criminal fraud, the law favors puffery to keep the stock price up," says Jim Newman, publisher of the Securities Class Action Alert newsletter.

Even officers and directors who lose in class-action suits, which are civil cases, are usually covered by liability insurance, Newman notes. "If they get caught, what's the downside?" A high stock price can mean millions in bonuses, the ability to unload shares for huge profits and enhanced corporate flexibility in making merger and acquisition deals.

Nowhere have all these factors come into better focus than in the kinetic data networking equipment industry--a sector that has witnessed a high level of merger activity during the past few years. The sector also has been the target of a lot of class-action suits. Could these facts be related?

Class-action suits filed against 3Com Corp. of Santa Clara, Calif.; Alameda, Calif.-based Ascend Communications Inc.; Bay Networks Inc. (now a unit of Northern Telecom Ltd. of Brampton, Ontario); and Madge Networks NV of Wexham Springs, England, suggest they are.

Of course, attorneys for the plaintiffs in these suits haven't yet proved specific claims against these companies. And because settlements are almost invariably kept secret, there may never be a definitive resolution of these charges. But one thing is clear: All the charges involve companies operating in a business environment that offers tremendous incentive to executives who can keep their stock prices flying high.

That's because the aggressive merger and acquisition activity of industry leader Cisco Systems Inc. of San Jose has dictated the rules of combat in data networking for the past half-decade. Since the early '90s, Cisco has leveraged its lofty stock valuation to buy more than two dozen companies with key technologies and market positions. The company has been able to make deals on attractive terms because of its blue-chip stock valuation. "If you're going to build through acquisition, then the higher your share price, the less expensively you get off," notes Craig Benson, chairman and CEO of Cabletron Systems Inc. in Rochester, N.H.

In February 1997, Cisco rival 3Com announced that it would use stock to purchase leading modem-maker U.S. Robotics Corp.--a $6.6 billion deal done without cash. What evidence is there that Cisco's actions helped force 3Com's hand? Look no further than 3Com's first-quarter 1997 SEC filing: "Certain of the Company's major competitors have also [been engaging] in merger and acquisition transactions. Such consolidation by competitors [is] creating entities with increased market share, customer base, technology and marketing expertise, sales force size or proprietary technology in segments in which the Company competes. These developments may adversely affect the Company's ability to compete in such segments."

Fair enough. To compete with Cisco, 3Com had to grow through acquisition. Whether in executing such transactions 3Com and its executives operated legally or in the "gray area"--or beyond--remains to be seen. But several facts are worth noting.

In response to what 3Com describes as an SEC "inquiry," the company restated several of its earnings reports. Partially at issue were the U.S. Robotics results of April and May 1997, which 3Com hadn't reported during the time it sought merger approval. It turned out that these were horrible months in which sales for the two months shriveled to $15 million, and U.S. Robotics suffered a net loss of $160.8 million.

Several class-action suits, now consolidated in the U.S. District Court for the Northern District of California (San Jose), charge that 3Com deliberately withheld April and May results until it had secured shareholder approval for the merger. The suits further charge that U.S. Robotics was able to report excellent business conditions for March because it had engaged in "channel stuffing" of new U.S. Robotics modems. Only after shareholders approved the deal did the company (now part of 3Com) reveal that April and May were dreadful months, with high returns of unsold modems.

Did 3Com deliberately mislead investors with a rosy picture of U.S. Robotics modem sales? While plaintiffs say that channel-stuffing in March led to the April-May sales slump, 3Com asserts that there were other reasons for the falloff: notably "confusion"

regarding two competing standards for the new-generation 56Kbps modems. And because U.S. Robotics and 3Com were on different fiscal years, the company says it was legitimate to hold off reporting the two bad months.

By October 1997, 3Com had begun to reveal the falloff in sales at U.S. Robotics, and its share price had plunged from roughly $55 to about $30 within a month. But by then, corporate insiders had unloaded $221 million in stock, according to the suit now pending in the U.S. District Court. A 3Com spokesman didn't dispute the insider sales figures cited in the suit. But he declined to comment on the other charges, noting that the company doesn't discuss matters that are in litigation.

Just as Cisco's acquisitions put the heat on 3Com, 3Com's purchase of U.S. Robotics put the heat on other networking equipment makers. Ascend Communications, which produces equipment used by Internet service providers and phone companies, was concerned about 3Com's acquisition of U.S. Robotics, according to a suit filed in December 1997 in the U.S. District Court for the Central District of California. At the time, analysts said the 3Com-U.S. Robotics combination would hurt Ascend's position in the remote-access equipment market. In response, the suit alleges, Ascend moved to buy high-flying Cascade Communications Inc. in a $3.7 billion stock swap.

In order to buy Cascade without spending cash, the defendants "were motivated to maintain an artificially high price for Ascend stock," the suit claims. The suit, which is pending, further charges Ascend with misleading analysts and investors for a period of months before announcing that the company's July 1997 revenue would not meet expectations.

"We believe the charges are without merit," says Ascend spokesman Eric Warren. "Most of the networking companies have suits against them," he adds.

That would include Bay Networks and token ring-switch maker Madge Networks, which is charged with misrepresenting business conditions so that it could acquire Lannet Data Communications Ltd. and Teleos Communications Inc. less expensively. "The artificial inflation of Madge's stock enabled [the company] to successfully complete the Lannet and Teleos acquisitions and to do so by issuing a far lower number of shares than would otherwise have been the case, thus making the acquisitions less dilutive to Madge and its controlling shareholders," charge court documents filed by the plaintiffs. The Madge case is in discovery in U.S. District Court in San Jose. The Bay Networks suit, also pending in San Jose at press time, charges that insiders had incentive to keep Bay's stock price up to complete acquisitions and fatten their bonuses. Bay Networks' attorneys have asked that the case be dismissed.

Could it be that all these cases against networking companies are without merit, as defendants generally claim? Perhaps.

But certain facts suggest otherwise. In several cases, executives unloaded stock during the class periods--that period of time in which suing investors bought their stock and thus

were allegedly victimized. And 3Com does acknowledge restating its financials as the result of an SEC inquiry. In addition, all the companies were engaged in aggressive merger activity that hinged on maintaining high stock prices. The company selling with the highest multiple could therefore use the least amount of stock to purchase a target.

In a consolidating industry such as data networking, however, it's not just the buyers who have incentive to keep their stock prices high. Potential sellers also are motivated to dress up for the dance. In fact, as fraud examiner Ratner observes, many new telecom companies have been formed in recent years with the express intent of being bought out.

"A lot of people are starting companies with the idea of selling out in five to 10 years," Ratner says. For such companies, operating in a rapidly consolidating industry, there's huge incentive to "inflate revenue to get a higher price," he says.

The toolbox

With ample motive, companies must still find the means to puff up their financials. What are some of the specific techniques they use?

In the creative accountant's bulging toolbox, inflating revenue is the most popular Mr. Fix-It. But accountants can also overstate or understate inventories, bury salaries, capitalize expenses, overstate merger charges and create "cookie jar" reserves that can be used to sweeten future financial reports. In the shell game of accounting, categories such as revenue, expenses and inventory are the walnut shells; pry the CFO's hand off the nut, and there's no telling what might be inside.

Improper revenue recognition has long been the favorite accounting scam, says Helane Morrison, the assistant district administrator for the SEC's office in San Francisco. "We've seen situations where revenue is recognized before shipment, or for shipments of incomplete products, or for products that weren't ordered," she says.

Revenue inflation isn't necessarily a subtle scam. Now-defunct disk drive-maker MiniScribe Corp. of Longmont, Colo., perpetrated one of the industry's most infamous scams in 1989. According to investigators, the company shipped bricks, boxed as disk drives, to warehouses and booked these shipments as disk drive sales. And California Micro Devices Corp. of Milpitas, Calif., booked revenue on IC components "that had been neither shipped nor, in most cases, manufactured," according to a suit brought by the SEC last September. The suit, filed against two former company executives, is pending; it charges that they went so far as to create false shipping documents and invoices.

Creating fictitious invoices is common, fraud experts say. But shouldn't such billings be spotted by auditors? Not necessarily, says Howard Silverstone, a principal with Lindquist Avey Macdonald Baskerville in Philadelphia. "There's a level below which auditors don't check," Silverstone says. "If you [have]a company with $100 million in revenue, you're not going to look at every $1,000 invoice."

Sometimes, companies book revenues on sales to distributors without allowing for the right of distributors to return unsold products. A class-action suit filed in the U.S. District Court for the Southern District of Florida charges that CyberGuard Corp., a network security and electronic-commerce solutions company in Fort Lauderdale, Fla., booked revenue on shipments to distributors who had no obligation to pay unless the goods were sold. CyberGuard announced the restatement of its third-quarter earnings in August; the class-action suit is pending.

Specific industry sectors have their own revenue recognition issues. A company selling a $30,000 computer system, for example, is selling hardware, software and perhaps a three-year service contract, Ratner explains. The sale may also include the promise of a software upgrade within 24 months. Should the company record all the revenue at once? Or should it delay recording revenue associated with the service and upgrade, as it hasn't yet incurred the expenses for these offerings?

"If you record them all at once, you're not recognizing the fact that you haven't earned all the service revenues yet," Ratner notes. "You're not matching your continuing expenses with revenue."

But deferring revenues, as some software companies do, constitutes a different form of revenue management. Microsoft Corp., for example, defers revenue from its Windows and Office suites. As of Sept. 30, 1998, the company had more than $3 billion in deferred revenue from Windows, Office 97 and other software products. Theoretically, that revenue can be booked, as needed, to smooth out financial performance in the future, seemingly undermining the value of quarterly reports. Still, the SEC seems more concerned with companies that are aggressive in booking revenue than with those that defer it. "To tell the truth, it seems that accelerated revenue recognition [is examined more closely] than deferred revenue recognition," says SEC accountant Ron Baer.

Accounting rules do allow companies a certain amount of latitude. "Generally accepted accounting principles are broad enough with regard to revenue recognition that there's an opportunity to interpret [them] to your advantage," Ratner says. But companies that record revenues aggressively up front often find that their expenses keep mounting, even though revenues have been fully booked. If there's a slowdown in sales growth, these companies may have trouble meeting earnings targets. That's when the temptation grows to fudge a little further. "You certainly start off managing earnings," Ratner says, "[but] eventually, you wind up manipulating them."

Inventory accounting is another magnet for fraud. Understating inventory to cloak poor sales is an obvious practice. And though it may seem counterintuitive, overstating inventory is also an appealing fraud.

That's because in calculating gross profit, companies deduct the cost of goods sold from sales. One factor that influences the cost of goods sold is the value of closing inventory. The higher the value of a company's inventory at the end of a reporting

period, the lower its cost of goods. Hence, the higher its earnings. "That's why everyone wants to overstate inventory," Ratner says.

And yet in high tech, where products can become obsolete almost overnight, there's constant downward pressure on the value of inventories. Introducing a new modem, microprocessor or PC can rapidly deflate older products' value. The SEC's Baer says high-tech companies should be writing down inventories "on a regular basis." When they don't, they may be inflating earnings and building toward a massive write-off.

Some companies believe massive one-time write-offs--called "big bath accounting"--are preferable to regular adjustments. The theory is this: Analysts and investors hold companies to every penny of earnings estimates, but if a company declares a one-time write-off, the market is willing to overlook hundreds of millions of dollars on the assumption that earnings going forward will remain intact.

"What we're currently looking at are the big charges that companies take," says the SEC's Morrison.

And there are plenty to review. In just the first two quarters of 1998, U.S. companies had taken (or announced) more than $41 billion in such write-offs, according to Jack Ciesielski, whose investment research firm R.G. Associates Inc. publishes The Analyst's Accounting Observer newsletter. IBM Corp., Lucent Technologies Inc. and Motorola Inc. are a few that have taken write-offs in excess of $1 billion in recent years.

Write-offs can be legitimate, of course. But excessive write-offs violate an accounting principle known as "the matching concept," which holds that the costs associated with revenues from a given period are expensed for that period. When a company prematurely writes off a production facility or research project that might yield revenue in the future, it clears the way for future revenue gains that will be expense-free.

Merger and acquisition-related write-offs are an especially convenient sinkhole for expenses that companies want to bury. In response to an SEC inquiry, 3Com reduced its U.S. Robotics merger-related charges from $426 million to $270 million, a decrease of $156 million.

The SEC is especially concerned about the high-tech industry's rising volume of merger-related write-offs being taken for in-process R&D, says Chief Accountant Turner. Buyers are allowed to write off acquired companies' in-process R&D, which reduces the amount of depreciation the buyer must take for goodwill--the amount a company pays beyond the book value of its target company.

Last fall, America Online Inc. of Dulles, Va., reduced planned merger-related write-offs after the SEC took issue with its accounting practices. And MCI WorldCom Inc. slashed its merger-related write-offs by as much as $3 billion, saying it was acting under SEC guidance.

Still, in some cases, buyers are writing off nearly the entire price of an acquisition to R&D. Says Turner, "When you see a high percentage of the purchase price--more than 90 percent of a business--being written off, you say, 'How is it that 90 percent of the fair value of that business was related to R&D that was under way?' Common sense would tell you that would raise eyebrows and concerns about whether the accounting is being done right."

Also, some small companies report high levels of R&D, which impresses analysts and investors. But sometimes, notes Ratner, the money is actually being spent on things the company would like to hide--such as executive salaries and unreported debts.

But here's the ultimate tribute to the tireless ingenuity of accounting wizards: They've even figured out a way to make the year 2000 issue work for them. Companies report Y2K work as an extraordinary expense--yet another handy walnut shell. Some companies, however, have tucked regular expenses beneath that shell, providing another artificial way to make the books look better. "A lot of people are using Y2K [charges] to do [regular] system maintenance," Ratner says.

SEC scrutiny

The SEC hopes to address all these issues on a variety of fronts. It wants the accounting profession to tighten standards. It is also encouraging efforts to define and eliminate conflicts of interest that arise from auditors who happen to be doing a thriving business as IT consultants working closely with the companies they're supposed to be keeping honest.

In addition, the SEC wants corporate audit committees to meet more regularly and ask the tough questions of auditors and CFOs. Turner says the SEC has run into some audit committees that meet "a couple of times a year over breakfast before the regular board meeting. I can guarantee you they're not getting the job done," he says with a sigh.

The truth, as noted earlier, is that book cooking seems to be getting worse, and the volume of class-action suits has spiraled, notwithstanding the heavily lobbied 1995 law designed to curb them. It appears that Congress, by shielding business from the legal consequences of financial shams, has made more work for the SEC.

Feel free to contact us: Magazine Ad Sales, Online Ad Sales, Editorial, Feedback.
For UPSIDE Magazine subscriptions: Questions, Back Issues. Change of address. Renewals.
Subscribe to UPSIDE Magazine today! Copyright ©1997-1999 Upside Media Inc. All rights reserved.