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When the Numbers Just Don't Add Up

By KARL SCHOENBERGER AUG. 19, 2001

INDUS INTERNATIONAL, a computer software maker, moved to Atlanta from the frenzy of Northern California's high-technology scene earlier this year, after it paid $4.3 million to settle a passel of investor lawsuits accusing it of fraudulently overstating revenue.

Executives of the once-profitable company, which sells software and services to help large corporations manage their assets, say they are confident that its revenue growth is back on track and that its bookkeeping problems are history.

But Indus International is not out of the woods. Not yet.

Back in San Francisco, officials of the Securities and Exchange Commission and the Justice Department are completing parallel investigations of the accounting methods used by the company in late 1999 that led to the investor lawsuits. They are expected to announce their findings late this month. People close to the investigation said that both civil and criminal charges against the company and former employees were under consideration in the case.

Indus, in a document filed last week with the S.E.C., disclosed that it had been cooperating with the S.E.C.'s formal investigation and had offered to settle the matter without admitting or denying wrongdoing. J. Michael Highland, chief financial officer of Indus, said the company otherwise had no comment on the S.E.C. and Justice Department investigations.

As if things were not difficult enough for Indus and other technology start-ups that managed to survive the Internet collapse through brutal restructuring and job cuts, many are now under investigation by law enforcement authorities for the way they recorded the ringing of their cash registers during the feverish competition of Nasdaq's bubble years.

Responding to widespread concerns that investors were not always given reliable financial information in that time of frantic revenue growth, regional offices of the S.E.C., the Federal Bureau of Investigation and the United States attorney's office here are cooperating in a legal crackdown on accounting violations.

A tough law-enforcement response to accounting irregularities, of course, is not new. In the past year, federal investigators have pursued cases of irregularities at companies like Waste Management, Cendant and Sunbeam. But now the government is turning up the heat in Silicon Valley, home to a preponderance of questionable accounting, particularly among software companies, during the Internet boom.

Over the last four years, nearly one in five accounting restatements -- red flags for potential misconduct -- have been by companies in California, according to a study by Arthur Andersen, the accounting firm. (Arthur Andersen was itself the recent subject of an S.E.C. civil sanction for the way it audited the books of Waste Management, the trash-disposal company, and agreed to a settlement without admitting or denying civil fraud allegations.) In the same four-year period, the total number of restatements for all industries has nearly doubled, Arthur Andersen's report said.

So far in the technology sector, federal investigators and prosecutors here have set their sights on relatively small companies, where a high proportion of problems center on what accountants call improper "revenue recognition" -- the recording of revenue that does not exist. It could be, for example, from a pending sale that is misclassified as completed, or a service contract in which money has not yet changed hands.

The Arthur Andersen study of accounting restatements from 1997 to 2000 showed that 27 percent of the restatements nationwide had been filed in the software and computer industries. About 62 percent of the software companies involved had annual gross revenue of less than $100 million.

The rise of accounting fraud investigations, specifically related to overstatement of revenue, reflects a serious white-collar crime trend in the high-technology sector in recent years, said Leslie B. Caldwell, chief of the securities fraud section for the United States attorney's office here.

''The pressure to do this in the technology industry was intense because the expectation for growth was so high, and it wasn't sustainable,'' she said, without commenting on specific cases.

The inquiry at Indus International focused on revenue for the third quarter of 1999. According to the shareholder lawsuits against the company and former executives, the revenue total included sales derived from ''irregular contracts,'' money that was not received during the quarter in question. Last October, Indus International agreed to settle the suits for $4.3 million without admitting or denying wrongdoing.

Previously, Ms. Caldwell said, her office waited for the S.E.C. to refer cases for criminal investigation. But now, ''we're taking the bull in our own hands,'' she said.

''There are a number of matters under investigation of corporations that cooked their books to meet Wall Street's expectations -- expectations that the companies themselves created,'' she added.

Harris Miller, president of the Information Technology Association of America, a trade group, said accounting problems in the software industry had arisen because of what he called vague rules covering sales of licensing agreements, which resulted in many companies claiming revenue that they expected to receive.

''The rules for revenue recognition were a bit cloudy, not just for software companies but for any company that delivers services over time,'' Mr. Miller said. His organization, he said, was not making excuses for executives who intentionally violated regulations. ''Yes, there was pressure to drive the top line,'' he said. ''But you can never justify misconduct.''

Ms. Caldwell's unit of seven lawyers, responsible for expediting complicated and paper-intensive securities investigations, was created in February 2000 by Robert S. Mueller, United States attorney for the Northern District of California, whom President Bush chose to serve as director of the F.B.I.

Matthew J. Jacobs, a spokesman for the United States attorney's office here, said Mr. Mueller had made the prosecution of accounting fraud a major objective because of its prevalence in both economic booms and declines. Mr. Mueller was not available for comment, the United States attorney's office said on Friday.

In its most prominent case to date, Ms. Caldwell's team obtained indictments last September against two former executives at McKesson, the pharmaceutical and medical technology company based here. The defendants were charged with accounting fraud related to the 1999 merger of McKesson and HBO & Company, a software company based in Atlanta. Prosecutors said $9 billion in shareholder losses resulted. The defendants pleaded not guilty to the charges, and the case is in the pretrial phase.

THE F.B.I. and federal prosecutors here are investigating about 50 cases of possible criminal securities fraud in the district, more than a dozen of them focusing on companies suspected of accounting fraud.

In addition to Indus International, at least six small and medium-size software companies in Northern California are under federal criminal and civil investigation, according to officials. Among them is Critical Path, a San Francisco company that sells e-mail messaging technology to other businesses and reported $135.7 million in sales last year. In February, after an internal investigation that led to the departure of its chief executive and two other executives, Critical Path restated revenue for the third and fourth quarters of 2000, subtracting a total of $19.4 million from what it had claimed. The company's share price plummeted and class-action suits were filed, contending deception and fraud. Critical Path has said it is cooperating with investigators.

In another case, the S.E.C. filed a civil complaint last September in Federal District Court here against three former executives of the Cylink Corporation, a Santa Clara company that makes cryptographic software for computer network security, accusing them of violating accounting rules by recognizing spurious transactions as sales in quarterly earnings statements. The complaint said Cylink recognized more than $900,000 in revenue in the second quarter of fiscal 1998 for sales in which some customers were given a three-month window to cancel their orders.

"When senior officers are involved in this kind of conduct we're going to hold them responsible," Robert L. Mitchell, head of the S.E.C.'s enforcement office in San Francisco, said when the complaint was issued. "Companies only act through individuals." The S.E.C. settled a separate administrative "cease and desist" proceeding with the corporation. In the civil litigation against three former Cylink executives, each was accused of securities fraud, circumvention of Cylink's internal controls and falsification of records.

IN July, according to court records, one of the former Cylink executives, Thomas Butler, who had been vice president for sales, signed a consent decree, without admitting or denying the charges, agreeing to pay a $100,000 fine and forfeit a $25,000 bonus he had been awarded by Cylink for his sales performance. Litigation against the two other defendants is still pending. Robert Fougner, Cylink's general counsel, said that he and other company executives could not comment on the case.

In cases in which criminal charges are brought against company executives, potential penalties can be harsh. In addition to fines imposed by the S.E.C., a conviction of an executive on a criminal securities fraud charge can result in a prison sentence of up to 10 years and a fine as high as $1 million. Conviction on a lesser charge, like wire fraud or conspiracy, carries a maximum five-year sentence and $250,000 fine.

Until recently, the pace of these investigations had been plodding, owing to their complexity and a shortage of resources. For example, Scorpion Technologies, a software company that was based in Los Gatos, Calif., and is now defunct, was accused of fraudulently claiming as much as $3.6 million of its $12.4 million in reported 1991 revenue. The S.E.C. filed civil charges and federal prosecutors indicted company executives on securities fraud charges in 1996. The last of the Scorpion defendants, John T. Dawson, was indicted in 1999. Last November, he pleaded guilty to charges that he had helped create offshore companies that masqueraded as buyers of Scorpion software products. Mr. Dawson's sentencing hearing is set for Oct. 2.

The Justice Department has a high threshold for criminal prosecution in these cases, with a distinction being made between misleading accounting practices and criminal fraud, Ms. Caldwell said. A suspicious accounting trick, by itself, cannot be the basis for seeking an indictment without other facts establishing deliberate fraud, she said.

Some major technology companies, including Lucent Technologies, have been subject to recent class-action suits contending irregularities in the way the companies accounted for their growing revenue before their businesses weakened. The S.E.C. started examining Lucent's books last November, after the company had disclosed an accounting problem, fired an employee and filed a restatement lowering its revenue for its fiscal year 2000 by $679 million.

Lucent, however, seems an exception. For now, at least, it appears to be the smaller technology companies that are receiving the most scrutiny.

A common thread in the companies under investigation is the restatement of quarterly financial results after internal accountants or outside auditors have found problems. A restatement almost always results in plunging stock prices, indignant investors and shareholder class-action suits.

The S.E.C. has strengthened its investigations of revenue-recognition cases since its former chairman, Arthur Levitt, warned of what he called the erosion of the quality of financial reporting in corporate America in a speech at New York University in September 1998 and announced tightened enforcement. Mr. Levitt said he was concerned that ''the motivation to meet Wall Street earnings expectations may be overriding common-sense business practices.''

''Too many corporate managers, auditors, and analysts are participating in a game of nods and winks,'' he added.

INVESTOR advocates like Barbara Roper, director for investor protection at the Consumer Federation of America, have expressed concern that Mr. Levitt's successor, Harvey L. Pitt, a Wall Street lawyer, may take a less aggressive approach on enforcement. Mr. Pitt, a former general counsel for the S.E.C. who, while in private practice, represented Ivan F. Boesky, who was convicted of insider trading, has advocated streamlining S.E.C. regulations.

But Mr. Pitt assured the Senate Banking Committee at a confirmation hearing in July that he would "ensure vigilant enforcement of sound rules that protect all investors against fraudulent, deceptive and manipulative misconduct."

Charles D. Niemeier, chief accountant for the S.E.C.'s division of enforcement in Washington, said the agency took action in 100 cases of suspected financial disclosure fraud last year, compared with 75 in 1998 and 40 in 1991. Fifty-seven of last year's cases involved revenue-recognition problems, Mr. Niemeier said.

He described a snowball effect -- the possible compounding of revenue-recognition problems from quarter to quarter.

"Once a company goes down the path of earnings management, it's very difficult to get off, because artificial earnings become the floor of future earnings," said Mr. Niemeier, who also serves as co-director of the S.E.C.'s new Financial Fraud Task Force. "What starts out as a small accounting problem by the end becomes monumental. It's like having a noose around your neck, and you're the one tightening it."

Software companies like Indus, Critical Path and Cylink are particularly susceptible to encountering accounting problems -- and accusations of fraud -- because of the complex nature of the licensing agreements they must negotiate to sell their products. Unlike service providers in other industries, software vendors have relied heavily on a customer base of dot-com start-ups, many of them now insolvent or financially unstable.

Indeed, the software sector figured prominently in the roster of federal securities class-action lawsuits filed in 2000. It was the single biggest industry category -- 18 cases out of the total of 107, or nearly 17 percent of those involving accounting violation charges., according to a study by PricewaterhouseCoopers. The study also showed a sharp increase in total cases involving companies in the computer services, electronics and telecommunications industries -- to 45 percent of the total last year from 34 percent in 1999.

The securities class-action suits may be a rough barometer of the severity of the problem, law enforcement officials say. But the real test for federal investigators is determining whether accounting violations were isolated errors or a part of a pattern of deception known as "revenue management," in which corporate officers act with the intent to bend accounting rules or to cover up past mistakes.

"The cases we take on involve the corporate culture, the true situation at the top of the organization, where the boss says, 'We have to make these numbers or else,' " said Ms. Caldwell. "The Justice Department is not interested in renegade salespeople."

At Indus International, the accounting problems appeared to be limited to one quarter, and the company's board took swift corrective action, issuing a restatement of the revenue in question and restructuring the company's upper management.

At issue in the case was a practice said to be common among many companies, including those in software, that artificially inflates revenue to meet ambitious growth targets by pushing products and licensing agreements on customers. It often involves transactions in which money does not necessarily change hands. Such deals typically pivot on undisclosed side letters or confidential agreements laying out terms allowing distributors to return unsold products, for example, or default on financing.

Joan P. Platt, the chief financial officer at Indus in 1999, said in a brief telephone interview that the use of side letters by the company's sales force -- without the knowledge of company accountants -- caused the revenue-recognition problems under investigation. She declined to elaborate. Ms. Platt, a 20-year veteran of Coopers & Lybrand, resigned from Indus in December 1999 to join MarketWatch.com, a financial news service, as chief financial officer and vice president for finance.

The management realignment that coincided with Ms. Platt's departure led to the replacement of the company's chief executive, William J. Grabske, in early January 2000 by Kent O. Hudson, who had been a full-time management consultant at the company. At the end of that month, Mr. Hudson and his new management team issued a statement saying that the company's third-quarter 1999 revenue had been overstated by $5 million, "all of which related to licensing fees."

Mr. Grabske, who led the company during the period when the problems occurred, could not be reached for comment last week.

The adjustment lowered revenue for the quarter to $45.8 million and reduced net earnings to $1.1 million from $3.5 million. The company later reported net earnings of $23.8 million for all of 1999 on revenue of $178.5 million. Last year, the downturn in the industry cut the company's revenue by 18 percent and left it with a net loss of $58.7 million.

Results for its latest quarter suggest that Indus is getting back on its feet: revenue rose 32 percent, to $43.1 million; its net loss was $6.7 million, including the effects of an $8 million restructuring charge, compared with a net loss of $20.2 million a year earlier. Its stock price, which hit a bottom of $1.50 in December, now trades at $7.10.

COMPARED with Lucent's financial accounting restatements of $679 million and the problems that have befallen that company, the amount of shareholder equity lost in Indus's case seems inconsequential. Indus's $4.3 million class-action settlement was also relatively small. To settle its lawsuits last year, Cendant, the big real estate and travel company, paid $3.5 billion -- more than 10 times greater than the second-largest federal securities class-action settlement in history, which was paid by the network equipment company 3Com, also last year. In proportion to income, however, the settlement by Indus was a significant burden for the company.

Federal regulators have taken action against some big companies. The S.E.C. penalized Arthur Andersen, the big accounting firm, in June, obtaining a $7 million fine for Andersen's failures at Waste Management, which led to a $1.43 billion restatement of revenue in 1998.

The S.E.C. would not comment on other Fortune 500 companies that may be under investigation, but there are clues suggesting possible targets.

Federal investigators say they monitor Stanford Law School's securities class-action clearinghouse, a database of court records that includes a wide variety of accounting fraud charges against public corporations of all sizes. The number of cases tracked by the Web site, at securities.stanford.edu/index.html, has been climbing rapidly since the Nasdaq plummeted last year. Many of the lawsuits contend wrongdoing in allocations of shares in initial public offerings. More than 270 cases have been reported so far this year, versus 211 for all of last year.

Bill Parish, an independent investment portfolio manager and financial analyst in Portland, Ore., is one of many investment professionals who blame the accounting industry for the rise in accounting irregularities. An accountant who formerly worked at Arthur Andersen's Portland office, Mr. Parish said the big accounting firms had placed too high a priority on expanding their lucrative tax advisory and business consulting operations in recent years, at the expense of traditional accounting services. As a result, the firms have become less rigorous in examining client books and lack the necessary independence as auditors to challenge irregular practices, he said.

The S.E.C. civil fraud complaint against Arthur Andersen in June is a case in point, he said.

''If you want to know how these things are allowed to happen, you have to look at the accountants,'' Mr. Parish said. ''There's been a collapse of the integrity of accounting profession. In a way, I feel sorry for the C.E.O.'s.''

But the circumstances behind accounting fraud are rarely simple, and fault is hard to pin down, said Harvey Kelly, a partner at PricewaterhouseCoopers who practices forensic accounting, the examination of books for possible legal violations. The lines are particularly blurry in the high-technology industry, he said, where there are ''increasingly creative transaction structures.''

Accounting for the revenue from these transactions is a challenge. ''The accounting industry and the regulators have come out with guidelines for this,'' Mr. Kelley said, ''but it's not uncommon for the creativity of the business side to outpace the rules.''