Accounting Déjà Vu: Have We Seen These Earnings Before?

Executive Summary

A study released by the GAO in October 2002, Financial Statements Restatements: Trends, Market Impact, Regulatory Responses and Remaining Challenges, reported that the number of restatements increased 145% from 1997 to 2001. In 2002, a study by Huron Consulting Group reported that the number of restatements increased an additional 22% over 2001. Both reports noted a growing presence of large companies making restatements.

Many restatements move to future periods earnings that have been recognized previously. For example, a restatement entailing premature revenue recognition may result in deferral of that revenue for future recognition. Capitalized costs written down through restatement eliminate future amortization expenses. The net result of such restatements is that companies report the same earnings twice - once in prior years and then again in future periods. Not all restatements, however, affect future earnings. For example, restatements that eliminate fictitious revenue and assets do not move prior-year earnings to future periods.

This report looks at the effects of restatements on future earnings. Our objective is to highlight selected restatements that were filed with the SEC during 2002 and early 2003 that will benefit future-period earnings by material amounts.

April 2003
DuPree Financial Reporting and Analysis Lab
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DuPree Financial Reporting and Analysis Lab
The DuPree College of Management Financial Reporting and Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

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A financial statement restatement occurs when a company, either voluntarily or prompted by auditors or SEC regulators, revises and reissues public financial information for periods that were previously reported. Most restatements can be classified as resulting from improper application of accounting rules, fraudulent behavior, or simply clerical error. In recent years, the number of restatements has increased significantly. A study by Huron Consulting Group, *An Analysis of Restatement Matters: Rules, Errors, Ethics for the Five Years Ended December 31, 2002*, reports that restatements categorized by the year they were filed grew from 158 in 1998 to 330 in 2002 – a growth of 109%.

There are a number of likely factors that have contributed to the rise in restatements. SAB 101, *Revenue Recognition*, issued by the SEC in 1999, forced many firms to adjust their revenue-recognition practices. The enactment of the Sarbanes-Oxley Act in 2002 established stricter rules for reporting entities and sent a strong message supporting the need for improvement in our corporate governance and accuracy and integrity of our financial reporting system. The demise of Arthur Anderson LLP in 2002 is also likely to have triggered additional restatements.

The focus of this report is on the specific reasons for a company’s restatement and the effects of restatement on future earnings. We were particularly interested in restatements of prior-period financial statements that benefited future earnings by increasing revenues or decreasing expenses – improvements that would not have occurred without a restatement. The most obvious of such circumstances relates to premature revenue recognition. An example might be revenue that is recognized up front even though it is earned over an extended period. Such revenue, recognized improperly in prior periods, is restated and deferred to future periods to be recognized again.

Although less frequent, we also found examples of restatements resulting from improper application of GAAP in dealing with expenses that will directly improve future earnings. For example, improper capitalization of amounts that should have been expensed as incurred leads users of financial statements to anticipate an earnings drag in future periods from amortization. Through restatement, an asset is written down and future amortization expense is reduced or eliminated. Similarly, accruals may have been improperly understated. Restatement would increase their balances and require reduced future expense accruals.

Not all restatements result in the transfer of prior-period earnings to future periods. For example, a restatement of fictitious or nonexistent revenues will not boost future earnings. Similarly, a restatement of fictitious assets that are not subject to amortization, such as cash, investments, accounts receivable or inventory, or understated liabilities that are not linked to accruals, such as financing obligations, generally will not increase future earnings.

In our research we examined restatements that were reported in SEC filings during 2002 or during January, February and March 2003. Our interest was in identifying those restatements that we thought would increase future earnings by a material amount. Our list of restatements is not exhaustive but is representative of the more noteworthy ones affecting future earnings.
Bristol-Myers Squibb Company
Form 10-K/A for the year ended 12/31/2001 (03/19/2003 filing date)

Bristol-Myers Squibb was found to have recognized revenue prematurely at the time of shipment when it stuffed distribution channels by offering sales incentives to wholesalers in its U.S. pharmaceuticals business. On advice from its auditor that such incentivized transactions should be accounted for on a consignment basis, the Company restated its financial statements for the three years ended December 31, 2001 and the quarterly periods ended March 31, 2002 and June 30, 2002. Years prior to 1999 were also restated. As a result of the adjustment, the Company restated its net sales downward by $1,096 million, $475 million and $409 million and its pre-tax income downward by $866 million, $399 million and $322 million for 2001, 2000 and 1999, respectively. Such revenue will be deferred until the products are sold by wholesalers at which time the Company will recognize the previously reported revenue a second time.

Upon further review, the Company uncovered additional items in need of restatement. Historically, the Company recorded sales returns based on actual product returns rather than on an accrual using estimated returns. Adopting an accrual method of accounting for returns, the Company’s restatement resulted in a reduction in net sales for the years ended December 31, 2001, 2000 and 1999 by $28 million, $47 million and $5 million, respectively. Prior to the restatement, future earnings would have been reduced by actual returns occurring in these periods. Through restatement, these returns have been shifted to prior periods lowering returns that must be recorded in future periods.

The Company also found errors in its accounting policy for payments related to the acquisition or licensing of patent rights. Previously, the Company capitalized such payments regardless of whether the underlying asset had received marketing approval from the FDA. These payments were subsequently amortized to earnings using a straight-line method over the term of the agreement or expected life of the product. GAAP requires that such costs be charged to earnings when incurred. Retained earnings as of January 1, 1999 were reduced by $46 million for the after-tax earnings effect of these adjustments on periods prior to 1999. In addition, pre-tax results for the year ended 1999 were reduced by $139 million, while pre-tax results for 2000 and 2001 were increased by $24 million and $25 million, respectively. As a result of these adjustments, earnings in 2002 and beyond will be increased.

Household International, Inc.
Form 10-K/A for the year ended 12/31/2001 (08/27/2002 filing date)

The Company incorrectly treated payments made in connection with credit card marketing agreements as prepaid assets and amortized them according to the terms of the agreements. According to GAAP, the Company should have expensed these payments when made or amortized them over shorter lives. The cumulative reduction in pre-tax income totaled $567.9 million between 1994 and 2001 and will serve to boost income in future years.
The Interpublic Group of Companies, Inc.
Form 10-K/A for the year ended 12/31/2001 (03/07/2003 filing date)

The Form 10-K/A identified restatements affecting interim periods in 2002. In the restatement, the Company identified $181.3 million that should have been expensed in prior periods. The majority of this amount, $101.0 million, was incorrectly included in accounts receivable and work-in-process. Because such assets are not subject to amortization, their write off as part of a restatement generally would not serve to boost future earnings. Other components of the $181.3 million restatement would tend to boost future earnings and included estimates of insurance proceeds not yet realized, improperly capitalized costs and understated liabilities. The $181.3 million was restated in its financial statements for periods up to and including June 30, 2002.

The Company also identified $118.7 million in charges including $82.1 million of goodwill impairment, $24.6 million of fixed asset write-offs, and $12.0 million to record the fair value of an associated put option that needed to be restated. An additional $47 million was identified that related to inappropriate purchase accounting adjustments, compensation costs that had been deferred instead of being expensed, and other items. Generally, these items will reduce future income statement charges and have a positive effect on future earnings.

Xerox Corporation
Form 10-K/A for the year ended 12/31/2001 (01/27/2003 filing date)

The Company changed its accounting method for leased equipment. Historically, it had accounted for certain leased equipment as equipment sales and, accordingly, had recognized revenue up-front. Through its restatement, the Company changed to operating lease accounting treatment for such transactions where revenue and profit will be recognized over time. Xerox’s restatement included a reversal of $1.9 billion in revenue from leases previously recorded as sales-type leases. For years 1997 to 2001, the reversal included a reduction in equipment sales revenue of $6.4 billion offset by an increase of $5.1 billion in service, rental, document outsourcing and financing revenue. The Company anticipates that the previously recognized revenue of $1.9 billion will be shifted and is estimated to be included in earnings over the next several years through 2006 as follows: $800 million—2002, $570 million—2003 and $530 million—thereafter.

WorldCom Group
Form 8-K (03/14/2003 filing date)

WorldCom has released its expected restatements for the first quarter of 2002 and years 2001, 2000 and 1999, although they have not yet filed their amended 10-K. Through the restatement, the Company expects to write-down goodwill, PP&E and other intangible assets by $45 billion, $39.2 billion and $5.6 billion, respectively. These adjustments will have a positive effect on future earnings by eliminating anticipated amortization and depreciation charges. For example, the Company expects depreciation and amortization expense for the month of December 2002 to decrease by approximately $337 million, from $480 million to $143 million. Similar expense reductions can be expected in future years.
Gemstar-TV Guide International, Inc.
Form 10-K/A for year ended 12/31/2001 (03/31/2003 filing date)

In its restatement of years 2001 and 2000, Gemstar reversed an aggregate of approximately $90 million of previously recognized revenue, which it expects will be recognized in future periods. Each of the following items will result in increased revenues or decreased expenses in future periods.

In connection with the sale of the WGN Superstation distribution business in April 2001, the Company secured a six-year $100 million advertising commitment pursuant to which the Company will be required to run advertising until 2007. Advertising revenues recognized from this contract in the year ended December 31, 2001 were $12.0 million. Through restatement, this amount has been reversed, resulting in a reduction to pre-tax income by $4.8 million for the year ended December 31, 2001. As a result, $10 million will be recognized as advertising revenue and $15 million as interest income over the six-year contract term.

In October 2000, the Company entered into an agreement to settle all outstanding claims with a cable set-top box manufacturer and was awarded a cash payment of $188 million. From this, $117.5 million was recorded as a prepayment of a 10-year technology licensing agreement, with $51.2 million and $12.7 million recognized as licensing revenue during the year ended December 31, 2001, and the nine months ended December 31, 2000, respectively. The Company has determined that the licensing revenue should be recognized on a straight-line basis over the 10-year term of the license. Accordingly, revenues in the Technology and Licensing sector were decreased by $38.3 million and $9.5 million for the year ended December 31, 2001 and the nine months ended December 31, 2000, respectively (subsequent to December 31, 2000, the Company changed its fiscal year from a fiscal year ending March 31 to a fiscal year ending on December 31, with the nine-month period from April 1, 2000 through December 31, 2000 constituting a short fiscal year). Additionally, revenues in the Interactive Platform sector were decreased by $14.4 million for the year ended December 31, 2001. Pre-tax income decreased by $9.5 million for the nine months ended December 31, 2000, and $52.7 million for the year ended December 31, 2001, respectively.

In January 1998 and May 1999, the Company entered into eight-year and twenty-year license agreements with two customers, respectively, under which the Company received upfront license fees of $47.5 million. As of December 31, 2001, the Company recognized all of the pre-paid license fees as revenue, rather than recognizing such license fees on a straight-line basis over the term of the agreements. As a result of this restatement, revenues in the Technology and Licensing sector have decreased by $28.0 million during the year ended March 31, 2000, and increased by $1.1 million and $4.1 million during the nine months ended December 31, 2000 and the year ended December 31, 2001, respectively.

Gemstar also restated to correct improper accounting treatment for expenses. During the year ended December 31, 2001, the nine months ended December 31, 2000, and the year ended March 31, 2000, the Company capitalized patent prosecution costs and patent litigation costs, rather than expensing such costs as incurred. As a result of this restatement, operating expenses increased by $3.0 million, $8.4 million and $45.1 million during the year ended March 31, 2000,
the nine months ended December 31, 2000, and the year ended December 31, 2001, respectively. Restatement of this item will benefit future periods by decreasing the required income statement charges to account for amortization that would be needed going forward.

**BroadVision, Inc.**
Form 10-K405 for the year ending 12/31/2001 (04/01/2003 filing date)

Broadvision restated its financial statements for the nine months ended September 30, 2001. The restatement relates to amounts under a single contract with a customer that the company subsequently determined should not have been recognized as revenue in the third quarter, but should have been recognized ratably over a four-year period. As a result of its restatement, software license revenues were decreased by $3.381 million and service revenue were decreased by $.145 million for the nine months ended September 30, 2001. Although details as to the exact timing of recognition of the reversed revenue are not available, unearned revenue has been increased by $3.526 million and is expected to be recognized again in future periods.

**Peregrine Systems, Inc**
Form 8-K (02/28/2003 filing date)

Peregrine Systems announced several material restatements affecting revenues and asset carrying values for the years ended March 31, 2001, March 31, 2000 and earlier. Revenue problems included sales to resellers that were subject to conditions and contingencies that should have delayed recognition. Other sales entailed reciprocal agreements. In certain instances, the Company purchased products from or made investments in customers who agreed to license the Company’s products. In these cases the Company generally recognized revenue for the product licensed and capitalized the acquired product received from or investment made in the licensee. In other instances, the Company engaged in non-monetary exchanges, trading Company software or services for a customer’s product. Here the Company recorded the product or services received as either inventory or prepaid expenses and recognized license revenue for the Company product licensed. Other improperly recognized revenue included the use of long-term installment contracts. The contract fee was generally recognized as revenue at the time the installment contract was signed. However, based on the Company’s review of the collection history of these contracts, along with the Company’s history of providing concessions to customers, the Company restated results to reflect revenue upon collection of the extended payment.

As a result of these revenue-recognition inaccuracies, revenues for the years ended March 31, 2001 and 2000 were reduced by $254.1 million and $121.7 million, respectively. However, while we were not able to determine the amount, it is important to note that a significant amount of these revenue adjustments will not shift revenue to future periods.

As part of its restatements of its financial statements, the Company also recorded asset impairments of goodwill and certain other assets and intangibles. In total, long-lived asset carrying values were reduced by $734 million. As a result, future amortization charges and possible impairment charges will be reduced.
Switchboard, Inc.
Form 10-K/A for year ended 12/31/2001 (09/19/2002 filing date)

Switchboard restated its financial statements for the year ended December 31, 2001 due to a variety of misapplications of GAAP discovered when investigating the improper treatment of revenue from 2001. The one item in the restatement that appears to affect future-period earnings is an $11.7 million impairment charge related to the Directory Agreement. This impairment charge will reduce future amortization charges.

SkillSoft plc (formerly known as SmartForce plc)
Form 8-K (11/20/2002 filing date)

The Company has announced that it intends to restate its historical financial statements for 1999, 2000, 2001 and the first two quarters of 2002. The restatement will include corrections to errors in revenue recognition.

First, the Company recognized approximately $3.5 million of revenue in the fourth quarter of 2001 under a reseller arrangement. The Company has since determined that the proper accounting treatment for that reseller arrangement is to recognize revenue only as payments are received from the reseller. The Company expects that $1.4 million of the reversal will be recognized in 2002 and the remaining $2.1 million of revenue will be recognized in the future as payments are received from the reseller. Second, the Company recognized revenue upon shipment of software under several customer contracts that involved payment schedules extending over several years. While the timing of revenue recognition was appropriate, the amount of revenue recognized immediately should have been discounted to reflect the time value of money in connection with the payment stream. Accordingly, the Company reversed a portion of the $8 million in revenue recognized under these agreements and instead will recognize that revenue over the term of the agreements. A third item relates to $28.6 million of revenue previously recognized in 1999, 2000 & 2001. The Company is still in the process of evaluating whether it was proper to recognize this amount as revenue upon execution of the contracts. To the extent that it was not, the amounts will be restated for previous periods and recognized over the term of the contracts (generally four to five years).

Nicor Inc.
Form 10-Q/A for the period ended 03/31/2002 (08/14/2002 filing date)

Nicor’s restatement of its first quarter 2002 results includes a reduction in pre-tax earnings of $2.3 million to defer a gain related to the termination of interest rate hedging instrument that had previously been recognized. Future periods will benefit by this deferred amount.
**Transaction Systems Architect, Inc.**  
Form 10-Q/A for period ended 06/30/2002 (01/14/2003 filing date)

Through restatement of the three and nine month periods ended June 30, 2001 and 2002, the Company reversed revenue from license fees previously recognized upon delivery of the software products. Subsequently, the Company determined that the license fees did not meet the criteria of SOP 97-2, which requires that a software vendor's fee be fixed or determinable before it can recognize the license fee revenue upon shipment of the software. The amounts reversed are approximately $9.6 million and $18.3 million from the nine months ended June 30, 2002 and 2001, respectively. With software license terms generally ranging from 12 to 60 months (with some arrangements extending beyond 60 months), these revenues will be shifted to future periods.

**Vail Resorts, Inc.**  
Form 10-K/A for year ended 07/31/2001 (10/25/2002 filing date)

Vail Resorts, Inc. restated revenue recognized from initiation fees related to the sale of memberships in private member clubs for years ended 2001, 2000 and 1999. The fees will now be recognized over the life of the facilities, which the Company estimates to be 30 years (for facilities still under construction, recognition will begin when construction is complete). The restatement reduced prior revenues by approximately $15.5 million, $14.0 million and $14.2 million for the years ended 2001, 2000 and 1999, respectively. The aggregate amount of the restatement, $43.7 million, will benefit future periods for many years to come.

**Tyco International Ltd.**  
Form 10-Q/A for the period ended 06/30/2002 (12/31/2002 filing date)

Tyco restated results for the quarter and nine months ended June 30, 2002 to record the amount by which dealer reimbursements exceeded the actual costs incurred by the company during these periods. As a result of the restatement, amounts received are now recorded as deferred credits. The decrease in net income of $80.7 million for the nine months ended June 30, 2002 will be amortized on a straight-line basis over a ten-year period, shifting this once previously recognized income to future periods.

The company also increased its goodwill impairment charge by $218.6 million in one unit and $112.8 in another and adjusted downward by $10.4 million interest that had been capitalized. With these additional write-downs, a portion of anticipated future amortization expense and potential future impairment charges are reduced.
Qwest Communications International, Inc.
Form 8-K (02/13/2003 filing date)

The Company’s impending restatement will include the reversal of $148 million in revenue that was improperly recognized upon the sale of equipment. Accordingly, Qwest will defer and recognize this revenue across future periods. Through its restatement, the Company also expects to correct the under-accrual of expenses primarily related to employment, benefit and compensation expenses. This correction will result in a decrease of previously reported EBITDA of $131 million and $21 million for 2001 and 2000 financial statements, respectively. As a result, Qwest has increased its accrual balances and will not require increased future accrual charges to its income statement. The Company will also restate previously reported expenses that had been deferred in anticipation of recovery that ultimately went unrecoverable. The Company will decrease pre-tax earnings by $17 million and $34 million for 2001 and 2000, respectively. These deferred charges will no longer serve as a drag on future period earnings.

Abiomed, Inc.
Form 10-K/A for the year ended 03/31/2002 (08/2/2002 filing date)

Abiomed modified its methods of revenue recognition for certain sales contracts and funded research and development contracts, resulting in the shifting of portions of revenues and related expenses between periods. Through its restatement, the Company decreased deferred revenues by $0.2 million as of March 31, 2000 and March 31, 2001 and increased deferred revenues by $2.8 million as of March 31, 2002. The increase in deferred revenue on March 31, 2002 is scheduled for recognition as revenue in the fiscal year ending March 31, 2003.

Parametric Technology Corporation
Form 10-K/A for the year ended 09/30/2002 (01/28/2003 filing date)

The Company used a restatement to correct the misallocation of deferred maintenance revenues from 1999 through 2002. The Company identified $33.4 million of maintenance revenue recognized during these periods that should have been deferred to be recognized in 2003 and later periods.

NCO Group, Inc.
Form 10-K/A for the year ended 12/31/2002 (03/21/2003 filing date)

NCO Group restated its financial statements for fiscal years 2001 and 2000 to correct an error in revenue recognition for a long-term guarantee contract. The change resulted in the deferral of previously recognized revenue. The restatement decreased revenue by $18.4 million and $17.6 million for 2000 and 2001, respectively. These amounts will be deferred and recognized in future periods.
Dun & Bradstreet Corp.
Form 8-K (02/06/2003 filing date)

D&B Corp announced its plans to restate its financial statements to correct errors in revenue recognition during the period January 1, 1997 through September 30, 2002. The restatement is expected to reduce revenue by $32.2 million for this period. This revenue, which was previously recognized at the time of billing, will now be deferred and recognized over the customer contract period.

Frontstep, Inc.
Form 10-K/A for the year ended 06/30/2002 (12/05/2002 filing date)

The Company restated improperly recognized revenue for the years ended 1998 through 2002. The Company previously recognized revenues related to reseller agreements upon the initial sale of product support to its customers as license fees. The Company has since determined that these revenues relating to the sale of initial product support to its customers and the related annual customer renewals by its customers should have been deferred as post-contract customer support in accordance with AICPA Statement of Position 97-2 "Software Revenue Recognition" and amortized over the performance period as maintenance revenue. In aggregate approximately $1.0 million in maintenance revenue will be deferred to future periods.
A Final Note

The company examples included in this report vary in their reasons for restating and in the sizes of their restatements; however, they all are similar in one way. Through restatement of prior periods, they have each benefited future period financial performance. By deferring previously recognized revenue or writing-down intangible and tangible assets, each company’s restatement has enabled them to improve future-period results.

As companies continue to make accounting mistakes and the SEC continues to enforce restatements, shifting of revenue and expenses will continue to mislead users of financial statements. Consequently, it is critical that users of financial data attend to such restatements and understand their impact on future periods.