



Restatements at Vesania Networks

By Jim Moulton

Vesania told everyone they could grow 3% to 5% faster than the industry. Can Vesania Network recapture credibility with Wall Street?

Abstract

Lynn Holland, the new chief financial officer of Vesania Networks, quickly realizes the company's accounting practices reflect a desire to please Wall Street analysts. Examine the facts and determine the course of action you believe should be taken.

Background

"This move was absolutely necessary." Dorothy Jenkins, vice-president of public and investor relations, was speaking of the board's decision to fire Vesania's chief executive officer, Dan Gilbert, and replace him temporarily with Jeremy Cress, a former board member. "Investors have lost patience with us, and our business appears to be going from bad to worse."

The executive council was in an emergency meeting this October morning. Jeremy called the meeting in hopes of finding a group consensus on the need for significant changes, and he wanted to settle on a timetable for identifying remedial actions.

An exasperated division president, Bill Wilkins, proved that consensus was yet to build. "Our business isn't broke. The stock tanked. So what? This too shall pass. I'm not saying the board shouldn't have acted, and firing CEOs is how boards show they feel investors' pain. But we'll be back, maybe even next quarter."

Another division head said, "I don't see how you can be so optimistic, Bill. It's obvious we're late to the party in some sectors. We can't turn on a dime. Our time-to-market was never the best. I agree with Dorothy. We need real change."

The vice-president of corporate development added, "What we can and should do about our product mix can't be the problem. Analysts know our products and markets and nothing has changed that dramatically since last year. I think our problem is the widespread view that management is dysfunctional. Dorothy talks to reporters every day. I want to hear more of what she's hearing."

Feeling vindicated, Dorothy continued. "Management has no credibility, period. Why? Let me count the reasons. We kept saying our problems were behind us, or under control,



or temporary, and that everything would be fine next quarter. It would be even better after that. Then next quarter comes. Boom! We're not going to make it. We issue another warning. We repeat the same litany. One pundit now suggests we schedule quarterly warnings.

"We never said we had real problems, that we had promised too much, that we simply couldn't deliver growth at the rate we said we could. We told everyone we could grow 3% to 5% faster than the industry. This despite the fact that the industry is growing at 15%, despite the fact that we're huge, despite our getting most of our revenues from older technologies, where sales are declining.

"When we missed, we blamed the market, currency exchange rates, vendor supplies, timing of product introductions and 50 other reasons I don't even remember. It was never our fault. We never mismanaged. We weren't responsible.

"Investors just think we lied to them. Maybe Dan and the operations guys really believed what we fed the Street. Well, that's no consolation. If we weren't lying, we were stupid."

Nobody was anxious to comment, but Dorothy subsided. Lynn Holland, the CFO hired just six months before, considered how Dorothy must have felt. For months, Dorothy had upheld the official view on shortfalls when replying to angry investors who were losing three-quarters of their investment.

At last the vice-president of human resources spoke up. "I know everyone here realizes that our stock's collapse did a lot of damage. Morale is at an all-time low; 90% of outstanding options are under water; savings and retirement plans are devastated; and our best talent is leaving."

The general counsel added, "While we're discussing public perceptions, there's a host of class action suits, the kind you always see after a stock tanks. And in our case, because of our repeated guidance, it won't be so easy to get those suits dismissed. Another suit, small in terms of potential liability but quite harmful to perceptions, is a whistleblower suit. Lydia Paisano claims she was fired after telling Dan our revenue targets were unachievable. Notably, she cites our aggressive discounting and generous financing offers in prior quarters as a major obstacle to meeting future sales targets."

Jeremy glanced at Lynn. Just this morning they had discussed the adverse impact on the balance sheet from financing start-ups. Bill Wilkins asked, "What's wrong with discounts and financing? Those are standard practice among equipment vendors."

The counsel said, "Yes, it's common practice. But we were exceptionally aggressive. Lydia's allegations reinforce a perception we were managing earnings to meet analyst expectations. You know we also faced controversies about aggressive accounting. So beyond the negative perceptions, there's also a risk of Securities and Exchange Commission inquiries."



Lynn added, "I think it's pretty clear that some of our sales came from writing deals nobody else would touch. We've taken huge risks."

Bill was flustered. "Wait a minute here. We did this with our eyes open. We went after emerging carriers, especially abroad. They didn't have any money. We decided financing them was the right strategy: Win them as customers, then they'd keep buying from us. What suddenly changed?"

Lynn responded. "You're missing the point Bill! Nobody's suggesting we give up on emerging carriers, or even that we stop using financing as part of our strategy for building share. The point is that we had this incredible string of earnings reports where we pumped revenues. That record's now beginning to resemble a stack of cards." After a short pause she added, "There's another point, as long as you've raised it. In our current condition, I think we do have to tighten standards on financing. We don't have the resources, and we can't afford any more risk."

Bill spat back, "We're already falling short of sales targets and now you want to handicap us on financing?"

"In my opinion, we have no choice. We'll just have to compete on quality and service."

Bill searched the table, looking for support. No one offered any.

After several more hours of discussion and debate, Jeremy coaxed the meeting toward a close and summed up. "We're in for some tough times. We need to finalize a comprehensive plan within six weeks and announce it publicly by year-end."

The Problem

A few weeks later Fred Wilkins, controller, delivered an analysis of past performance that Lynn had requested. She had asked specifically where accounting decisions and methods were contributing to reported results.

Fred started with bad news. "Lynn, we have a problem. We just discovered that one of our sales teams wrote a contract giving the customer discounts on future purchases. We'll have to restate the earnings we just reported. It shouldn't have happened. It's a clear violation of policy. They just didn't communicate clearly with finance, and the submitted documentation was incomplete."

After further review, they called Jeremy and Dorothy and helped outline a press release that would alert investors to the misstatement and rescind earnings guidance for the next quarter. Lynn insisted it would be inadvisable to issue revised guidance, despite Dorothy's observation that the stock would be hit harder.

After hanging up, Lynn asked Fred, "Do you think we need a closer review of our revenue recognition practices?"



“It’s already begun. In fact, that leads us right into our discussion of past performance.”
That sounded alarming.

“Our sales process, our culture and Wall Street’s demands together create a vicious cycle. The sales division makes its quota by loosening credit and raising discounts at quarter-end. That brings sales forward. The following quarter, they do it again, and so on. Over time they also get more aggressive. It’s like an addict needing a bigger hit to get high. We’ve been doing this forever, but it was benign before our spin-off made us a public company. After that we had a fast-rising stock and everyone getting rich. We had an accident in the making.”

Lynn prompted, “You seem to want to say something more.”

“I don’t want you to misinterpret me. I believe our people have integrity. What I’m saying, I guess, is that the environment was ripe for some problems. With Dan’s direction, we got quite aggressive in setting sales targets. Sales felt the pressure. They pushed distributors to take delivery. I was once even asked if we could insert a distributor in front of our customers as a trick to boost sales and move inventories. We never did it, but you see what I mean.

“Then there’s another angle in this performance analysis. Take our financing of start-ups, for example. There could be a big difference between booked revenues and collections. We may collect most of it; I hope we do. But, in the meantime, especially with the economy heading South and capital drying up, there’s a legitimate question about how good those reported revenues were.

“Compounding the problem, from the standpoint of earnings, is the fact that, over two years, we reduced our bad debt allowance from over 5% of receivables to just over 3%.”

Lynn asked, “Are you saying reserves weren’t a function of experience?”

“I’m saying management judgment was that we were overly conservative two years ago, and reserves are set by management judgment.”

Lynn observed, “Some skeptics might suggest management judged meeting earnings targets more important than exercising its fiduciary duties.”

“Many managers believe they can either build reserves when results surpass targets or use a one-time catch-up after a string of bad quarters. That looks better than missing expectations by a penny or two to maintain reserves. And if you need a catch-up, you can exclude it from the pro forma results you talk about. Many analysts will play along and treat it as a nonrecurring item.”

Lynn observed, “But we’re including those uncollectible revenues in pro forma earnings when we book them. How does it compute to ignore the subsequent bad debts?”



“I’m just playing devil’s advocate. But it seems most analysts don’t really care, so long as your stock’s hot. They hear what they want. Of course, if the news turns bad . . .”

“As we’re seeing,” Lynn said. “OK, I guess the same applies to inventory reserves. What else do you have?”

“I assumed you mainly wanted big things, things you can see in footnotes and such.” Lynn nodded. “Well, we had large restructuring reserves set up at the spin-off. We’ve been drawing against them for four years. They allowed us to do a lot of streamlining with no further impact on earnings. That strikes me as a performance issue.

”Then we also had reversals of restructuring reserves. The controversy here, if any, is whether it is prudent or ambitious accounting to estimate on the high side when you set up reserves.”

Lynn said, “It’s hard to fault a company for apparent prudence, but I know the pressure to take as big a charge as possible.”

“Next comes pension accounting. Since we changed methods in 1986, we’ve been amortizing the unrecognized gain on fund assets. It’s fully disclosed, but it’s a pretty big piece of our net and it goes largely unnoticed.”

“Every sophisticated investor knows about it,” Lynn said.

“Don’t get me wrong. I’m only saying that a large chunk of earnings has no connection to the demand for our products or the performance of our business.

“Taking it a step further, then, is our most recent change to pension accounting. We now recognize changes in market value more quickly. Given the bull market of the last decade, that change increased our pension income and also boosted earnings growth for the year following adoption. Again, it’s all disclosed, but I don’t recall any analysts quantifying the impact on earnings growth, and we sure didn’t highlight it.”

“I suppose we would have if it hurt comparisons?”

“No!” Fred said, in mock shock. “Well, those were the biggest items. But I’ve a word or two about some smaller items. First, we routinely make reclassifications and restatements that are immaterial without comment or disclosure. By some coincidence, though, these usually help comparisons. For example, because we told Wall Street we would lower SG&A in relation to revenues, we found opportunities to make reclassifications between costs and expense. In effect, some gross margin improvements were transformed into expense reductions. You get better press from cutting overhead than from savings in manufacturing and purchasing.”

Lynn observed, “When earnings growth depends too much on cost-cutting, that’s also often a cause for concern.”



“We knew cost-cutting had a limited shelf life. That’s why we became obsessed with top-line growth. If we could convince the Street we could grow faster than the industry and deliver on that promise, our stock would simply explode.”

“Hmm. It certainly exploded.”

“Yes. My last item is accounting changes we deem immaterial. For example, we changed from accruing all vacation pay at the start of the year to making monthly accruals.”

Lynn asked, “And you didn’t disclose that?”

“It was immaterial. We also argued we changed accounting for employee benefits all the time, so disclosing this one change was inappropriate.”

Lynn said, “Well, what’s done is done.” She could see that Fred had finished. “I see how you approached my question now, as how we portray earnings to investors. That’s not exactly the angle I expected, but it is really thought-provoking.”

Fred was pleased to discover that Lynn wasn’t preparing to criticize his past accounting decisions.

She continued. “The accounting you discussed is entirely legal; it’s in accordance with generally accepted accounting principles. You had your auditors’ tacit acceptance of your accounting if not their wholehearted support. So the question really becomes one of how you’ll spin your earnings. The final question is whether it’s wrong to deliver what Wall Street wants, so long as you can do it legally. Good job! I want to think about this some more.”

Three weeks later, Fred updated Lynn on the audit and the news was again bad. “We’re going to need a bigger restatement,” he said. “We have some additional issues with revenue recognition. We have another case in which sales offered future discounts and one case of a system that wasn’t completely shipped. There’s no choice but to restate for those. The larger issue isn’t quite as clear-cut; it pertains to sales to distributors whose customers no longer want the equipment. The distributors want us to take it back. We haven’t been able to confirm this, but the distributors claim they were promised we would.”

The Choice

Later that week, Lynn was preparing for her meeting with Jeremy. He would be expecting her recommendations and comments on several issues. First, what should be in the restatement and how should the restatement be announced? Then she would need to propose characterizations of the deteriorating outlook for the coming year. More generally, and of much greater import, she needed to advocate changes in the company’s approach to Wall Street expectations. Then she needed a position on further restructuring



charges. Many of the executives were pushing for another “Big Bath.” Last but not least, she needed to take action regarding weaknesses in the system of internal controls.

If you were Lynn, what would you do?

Comments on “Restatements at Vesania Networks”

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As chief financial officer for Vesania Networks, Lynn needs to take immediate action in the following areas:

Restatement of Earnings

Vesania management has a moral and legal obligation to restate earnings for all errors that are violations of generally accepted accounting principles. The most troubling issues seem to surround Vesania’s revenue recognition policies. For example, recognizing 100% of a sale that is tied to a future contingency is a clear violation of GAAP. If distributors did in fact have the ability to return product to Vesania for a full refund, then no revenue should have been recognized until the contingency period had expired. Similarly, if discounts were offered to stimulate sales, a portion of the discounted amount should have been applied to offset current period earnings. Finally, no revenue should be recognized on any product that has not been shipped by the end of the accounting period unless title to the property and risk of loss has passed to the customer by this date. The Securities and Exchange Commission and the Financial Accounting Standards Board have focused on revenue recognition in recent years due to management abuses of the rules. Under the new rules, improper revenue recognition policies could even subject Vesania management to criminal penalties if a determination is made that fraud was involved.

Other potential areas for restatement include the reduction of receivable reserves from historical levels of 5% to 3% at year-end. Based on the company’s declining fortunes, management should re-evaluate the adequacy of reserves and bring them back up to appropriate levels. Any other changes that were not in compliance with GAAP, whether or not material to the overall financial position of the company, should be considered for restatement.

Restructuring Reserve

Vesania’s restructuring reserve should represent management’s current estimate of charges that need to be taken to adequately restructure operations. Amounts in excess of those needed--“a big bath” in other words--should not be permitted. If the company has



in fact overestimated the amount of reserves required in the past, then a subsequent reversal into income would be allowed. However, this reversal should be identified as “non-core” earnings and should not be included in earnings from continuing operations. This will help investors to analyze the true results from operations versus the impact of one-time, extraordinary events.

Wall Street Approach

Vesania’s restatement of earnings must be communicated to Wall Street through an amended SEC filing, along with a description of the reasons for the revisions for analysts. Lynn should be honest and straightforward about the company’s problems as well as management’s plans to improve results. Vesania got itself into trouble through its effort to build sales, net income and market share, including:

1. Aggressive discounting and financing to distributors.
2. Aggressive marketing to emerging carriers, especially abroad.
3. More liberal credit policies to improve margins and stimulate earnings.
4. Efforts to push product sales through distributors.

Although aggressive and ill advised, management’s actions were an attempt to grow the company to improve shareholder value. Lynn should try to assure Wall Street that the company will be more disciplined in its management practices going forward. Vesania will no longer sacrifice net income to gain market share. The company will still grow its core markets, but it will do so more carefully while maintaining a profit discipline. Vesania should institute a more formal system of internal controls for the early detection and elimination of the aggressive accounting tactics used in the past. Vesania needs to inform Wall Street that short-term earnings will be hurt by the recent marketing activities. However, by following a more disciplined and steady growth plan, Vesania can hope to regain its long-term profitability.

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Carol spent 10 years at Coopers & Lybrand specializing in hospitals and not-for-profit organizations, in addition to having experiences in large commercial organizations. Following her years at Cooper & Lybrand, Carol was a senior financial executive at a major hospital corporation in Northern New Jersey, before taking her current position as CFO at the Roman Catholic Archdiocese of Newark.

“As the new chief financial officer of Vesania Networks, one of Lynn Holland’s tasks is to establish credibility with the investment community.”

When an institution relies on investment returns to fund operations and pension obligations, the integrity of financial information reported to analysts is obviously a concern. As the new chief financial officer of Vesania Networks, one of Lynn Holland’s



tasks is to establish credibility in reporting information to the investment community. While further deterioration in stock price will be painful, she has a cooperative chief executive officer and management team.

This would seem like the right opportunity to correct any lingering problems and start building a successful business plan. Lynn will need to coordinate any discussion of past business practices with legal counsel in light of the class action suits.

Obviously, any restatement of earnings would have to be of a material nature. Lynn should discuss with the external auditors which items should be included in the restatement.

The reclassifications are characterized as immaterial and therefore are not subject to any further discussion.

Assuming the business fundamentals are sound, the deteriorating outlook for the coming year can be categorized as a result of developments in emerging markets requiring closer review and tighter requirements for the extension of financing terms.

In conjunction with the management team, Lynn should develop changes regarding dealing with Wall Street. A uniform corporate culture supporting honest dialogue needs to be created. The CEO should advocate this approach and set the example. As mentioned before, if the company's business fundamentals are sound and a talented management team is in place, the market will eventually reward performance. Keeping track of the strategies to meet earnings projections is demoralizing and distracts management from real business issues. Quarterly earnings releases tend to take priority over more important matters. The company should accept that being a "value stock" for a while is not all that bad.

As to restructuring charges, Lynn should address the issue with the external auditors to learn their position on these charges as well as on writing down any reserves. If they can develop an agreed-upon framework, it should deter outside pressures to use the reserves to meet earnings projections.

Finally, the weaknesses in internal controls should be addressed immediately. Once efforts have been made to communicate the bad news to the public, and the management team has established credibility with all interested parties, it would be foolish to allow these weaknesses to remain and create opportunities for recurrent earnings problems.

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“Fraud starts with UNDUE PRESSURE to make the numbers, which are frequently extremely aggressive.”

Vesania Networks is a classic example of earnings management apparently crossing the line from acceptable to unacceptable (in other words, deliberate misstatement of financial statements). Vesania has a host of problems, including:

- A 75% decline in shareholder value.
- Lack of credibility with its shareholders.
- Class-action lawsuits.
- A whistle-blower lawsuit.

Earnings management covers a wide variety of acceptable and unacceptable (i.e., fraudulent) company actions. Some of the earnings management efforts at Vesania involve legitimate discretionary choices of, for example, when and in what amount to grant discounts to customers. Such decisions increase or pump revenue and recognize that revenue under generally accepted accounting principles. This, of course, is acceptable under GAAP. Other actions--such as (1) reducing the bad debt allowance, (2) building up reserves to use in bad times and (3) drawing against restructuring reserves to reduce expenses unrelated to the restructuring--appear to be questionable and perhaps even fraudulent.

Vesania suffers from a culture that promotes playing with the numbers. In addition, the company apparently has significant deficiencies in its control system both at transaction levels (e.g., as revenue recognition) and at higher levels (e.g., oversight of its financial reporting policies and controls via its audit committee).

What must the acting chief executive officer and the new chief financial officer do? They must immediately clean up the accounting mess and make the required restatements and related disclosures. They must recognize that misreporting doesn't typically start with dishonesty. Instead, fraud starts with UNDUE PRESSURE to make the numbers, which are frequently extremely aggressive (e.g., an unreasonable growth rate that in Vesania's situation is 3% to 5% faster than the industry). Fraud usually starts out small and in areas involving accounting estimates (e.g., bad debt allowance and estimated liabilities) in which management thinks that it is still close enough to GAAP. Eventually, actions go beyond acceptable earnings management practices and cross the line into fraudulent financial reporting. The CEO, CFO and Vesania's board of directors and audit committee must change the company culture and establish one that communicates an unrelenting insistence that numbers are not to be massaged. That is, an unrelenting insistence upon truthfulness as the foremost objective of Vesania's financial reporting.