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Reversing the Charges
**Nortel Board Finds
 Accounting Tricks
 Behind '03 Profits**

**A Telecom Star Manipulated
 Its Reserves, Hid Losses,
 An Investigation Discovers**

How to Empty the Cookie Jar

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 Staff Reporters of THE WALL STREET JOURNAL
July 2, 2004; Page A1

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Frank Dunn, the chief executive of **Nortel Networks Corp.**, pledged in 2002 to end the giant telecom-equipment maker's years of red ink. At the start of 2003, the company was no closer to that goal. In January, Nortel's executives told its board that the company would lose \$112 million in the year's first quarter.

Then the outlook suddenly improved. In mid-February, Nortel's expected quarterly loss -- based on the company's own definition of the term -- shrank to \$32 million, according to people familiar with the matter. A week later, the projected loss was revised to \$20 million. By March 30, when the quarter ended, Nortel had a profit of \$40 million, its first positive quarterly result in four years. Based on a bonus plan dubbed "Return to Profitability," nearly every employee received a cash award. After two more profitable quarters, senior executives were given millions of dollars in bonuses.

WRONG NUMBER

- **1999 to October 2002:** Nortel's sales and stock price soar, then collapse as customers slash spending.
- **July 2002:** CEO Frank Dunn says Nortel will be profitable by June 2003
- **April 2003:** Nortel reports first-quarter profit.
- **December 2003:** Nortel restates results from 2000 through 2Q of 2003.
- **April 2004:** Nortel fires CFO, controller and CEO Dunn, and says 2003 first-half reported profit will be restated to show a loss.



Sources: Thomson Datastream; WSJ research

But the profits turned out to be illusory. According to people familiar with the situation, Nortel's board has determined the company inaccurately employed an accounting maneuver to make it look profitable, when in fact it wasn't. In some cases, the dollar amounts of the many individual moves were so small they were almost impossible to detect.

After making the discovery, Nortel's board fired Mr. Dunn one evening in late April, along with Nortel's chief financial officer and controller. The board debated until 10 p.m. the wording of a press release. The next day, Nortel said the three men had been "terminated for cause." The company didn't provide a detailed explanation of the alleged accounting manipulation.

Once corporate Canada's crown jewel, Nortel soared alongside other telecom players such as Cisco Systems Inc. and Lucent Technologies Inc.; sales of its networking equipment tripled to \$30 billion in 2000 from \$10 billion in the mid-1990s.

After the telecom bubble popped, Nortel's stock collapsed and the company slashed its work force to 35,000 from 95,000. Nortel is now under investigation by the U.S. Securities and Exchange Commission, the U.S. Justice Department and the Ontario Securities Commission. The company is technically

in default with lenders and is expected soon to restate earnings, erasing the reported profits of the first half of 2003.

Nortel's woes show that the fallout from the telecom bubble -- one of the great speculative excesses in the history of business -- is still wreaking havoc. People close to the company believe that as Nortel struggled to meet ambitious earnings targets, it resorted to a series of accounting maneuvers to artificially transform its finances, almost entirely out of the public's view.



Frank Dunn

Board members don't yet know if any one person instigated the alleged wrongdoing, according to people familiar with their thinking, but they believe it was conducted at "senior levels." The three fired executives, Mr. Dunn, former Chief Financial Officer Douglas Beatty and former Controller Michael Gollogly declined both written and oral requests to comment on this account.

Thomas G. Heintzman, one of Mr. Dunn's attorneys, said the former CEO was not involved in any effort to manipulate the books at Nortel. "At the time he was dismissed, Mr. Dunn was told that he was being dismissed because the problems with the company's financial statements occurred while he was CEO," Mr. Heintzman said in a written statement.

Nortel says in its own statement that it is cooperating with investigators. Nortel says if "the board determines bonuses have been paid to individuals who have acted improperly, it fully intends to seek recovery." The company says it declined to comment further because of the pending investigations.

People with knowledge of the board's investigation say the alleged manipulation centered on the misuse of an accounting entry known as accrued liabilities. Accrued liabilities derive from the charges companies often take for matters such as merger costs, write-downs and, in Nortel's case, contractual liabilities.

For example, a company might take a charge if it missed a deadline on a \$10 million contract and reasonably believed the error would cost it \$1 million in the future -- through a customer refund, perhaps. The company would count the \$1 million future liability as an expense, which would reduce its earnings in the quarter. It would be entered on the balance sheet as a liability until it was paid. Over time, these liabilities can add up.

Under certain rules, companies can dip into their accrued liabilities and count the withdrawn sum as income. For example, if the company agreed to pay its customer \$600,000 for the missed deadline, instead of the \$1 million set aside, the company would be able to count the unused \$400,000 as profit in the quarter when the customer was paid.

This system can be abused two ways. Companies can exaggerate the liability or hold it on their books too long, in both cases hoping to use the reserves to plump earnings at a later date. This is known in the finance world as "cookie jar" accounting, which is among the most common financial frauds, accounting experts say. "It's probably one of the big three," says Robert Willens, a tax and accounting analyst at Lehman Brothers.

In the first and second quarters of 2003, the board has determined, Nortel emptied the cookie jar. Reserves were inappropriately taken off the balance sheet and added to the company's earnings. The board hasn't found a legitimate trigger for the reserves to be released.

Nortel also had overstated the size of its reserves, a move that gave it a larger pot to dip into. The company said in filings with the SEC in October 2003 that some of its reserves "were recorded in excess of the amounts that now have been determined would have been appropriate at the time of recording." Although taking inflated reserves would initially depress a company's net income, Nortel, like many other companies, dubbed the taking of reserves a "one time" or "special" event, which it encouraged investors to overlook. The "pro forma" earnings Nortel released until recently didn't include these charges.

Nortel had been selling telecom equipment for more than a century when it became a high-tech darling. During the stock-market boom, demand for its Internet and wireless gear soared. Nortel went on a \$30 billion acquisition spree and rolled out splashy advertisements featuring celebrities including Elton John. Nortel's stock price peaked at \$87 on the New York Stock Exchange in mid-2000, giving it a market capitalization of about \$270 billion, up more than tenfold from the mid-1990s.

But even as Nortel's revenue soared, something peculiar started happening to its financial results. It reported net losses every quarter but one from 1998 through 2002. Before 1998, Nortel had been profitable for 17 straight quarters, according to Reuters Fundamentals, an earnings database.

Behind the losses was a rash of charges. From 1989 until 1997, Nortel took a charge just once. In 24 quarters from 1998 until the end of last year, Nortel took charges in 19 of them, according to the Reuters database. An unknown number of these charges related to setting up reserve accounts that were later used to boost earnings, the board believes.

Mr. Dunn, who is now 50 years old, landed as Nortel's chief financial officer in 1999 after more than 20 years working his way up through the finance department. Subordinates were fearful of his temper, according to former colleagues; they often began conversations with the phrase, "Frank wants ..." Insiders say he kept close track of the company's finances after his promotion in late 2001, briefly reassuming the title of CFO in early 2002. Mr. Dunn's mantra was that he would return Nortel to the black.

Inflating reserve accounts had been a routine end-of-the-quarter game among finance executives at Nortel for years, several former finance executives say. The practice of holding extra reserves was so common that Nortel executives gave it a name: "hardness." In Nortel parlance, having hardness meant having reserves on hand that could be released at some later date to help the company meet Wall Street's profit targets.

Divisional finance chiefs closely guarded their own reserves, which they in turn used to meet internal targets, according to former executives. That meant even the top finance executives didn't have a full grasp of the extent of the reserve provisions.

Former finance officials say Nortel sometimes used balance-sheet releases to improve earnings. "It happened. I don't think it was anything really organized," says Mark Langford, an 18-year veteran of the company's finance department who was laid off in 2002 during a cost-cutting round. He says his group didn't use that tactic.

Investors used to ignore charges relating to reserves, especially if they occur amid otherwise very good or very bad years. Given that Nortel lost \$34 billion from 2000 to 2002, investors didn't pay much attention to several hundred million dollars in reserve-related losses.

But in the summer of 2002, some investors voiced concern to Nortel's executives because the company's accrued liabilities had ballooned to \$5 billion. Investors worried Nortel would collapse if they all came due at the same time. To deal with the concerns, Mr. Beatty, the controller at the time, began a review of the company's balance sheet that was continued by Mr. Gologly when he took the job.

As a result, finance executives found an estimated \$303 million of liabilities that were in some way inaccurate, according to people familiar with Nortel. The exercise was not disclosed to investors. It isn't known

exactly what was done about those liabilities, but some executives now at Nortel believe some were added to the company's earnings in the third and fourth quarter of 2002. Nortel reported losses in both quarters.

In the first half of 2003, the long-standing practice of dipping into reserves became more significant when it was used to turn losses into profits. Finance executives distributed a document showing the quarter's earnings targets, according to a copy viewed by The Wall Street Journal. As the weeks went on, that number kept improving until the expected loss turned into a profit. Each time the profit or loss figure changed, another number on the spreadsheet, labeled "balance sheet," changed too, suggesting that the increase in earnings was funded by Nortel's reserve accounts.

In the first quarter, Nortel made \$40 million in what it dubbed pro forma income. Nortel had long used this number -- its own measure of profit -- in earnings press releases. After investors broadly criticized that formulation for not conforming to standard accounting principles, Nortel, like many other companies, stopped reporting pro forma incoming in 2003. It still used that number internally for matters including calculating bonuses. At the time, Nortel's reported first-quarter net income was \$54 million.

Out of public view, Nortel included in its first-quarter profits about \$361 million in reserves. Roughly \$160 million of that, the company's board has determined, was inappropriately released. At the time, Nortel identified \$80 million of releases in a regulatory filing, saying they were no longer needed. When directors pressed executives at an April 2003 board meeting, they were told the remaining releases related to normal business operations and didn't need to be disclosed, people with knowledge of the meeting said.

Nortel performed an almost identical accounting exercise in the second quarter. Nortel's pro forma profits hit \$34 million as a result of the reserve releases. To the public, Nortel actually reported a net loss of \$14 million.

The size of the first quarter releases was relatively small compared with Nortel's revenue -- the company had sales of \$2.3 billion -- but they made the difference between a profit and a loss. Under accounting rules, unusual factors leading to such a swing must be disclosed. "If you make [a profit] by doing something that's out of the ordinary you need to tell people about that," says Charles Mulford, an accounting professor at the Georgia Institute of Technology.

Because of that profitable first quarter, most employees received payments equivalent to 10% to 25% of their annual salaries from Nortel's bonus plan. Top managers earned between two and four times their salaries after the company reported four quarters of cumulative pro forma profits. According to bonus plan documents, Mr. Dunn received approximately four times his \$900,000 annual salary. Mr. Beatty earned \$1.3 million and Mr. Gollogly took home \$300,000, according to people familiar with Nortel's compensation.

But in the executive suite, the reserve accounting was causing a rift. Some executives worried the reserves were being released inconsistently, a problem that could make the decisions harder to justify if that was necessary, according to people who have spoken to Mr. Gollogly.

In a decision that ultimately sparked Nortel's unraveling, the board pushed the company's executives to clean up the company's balance sheet and reduce confusion caused by years of accumulated reserve accounting. Mr. Gollogly, the controller, launched the effort in May 2003.

As a result of the house-cleaning, Nortel restated 3½ years of financial results in December 2003. The company announced it had discovered \$950 million in faulty reserves; some were inappropriately taken and others should have been released earlier. Nortel retroactively added them to past quarterly earnings totals, including the first two quarters of 2003 that are under question.

In the filing that detailed the restatement, Nortel's auditor, Deloitte & Touche, said the company had "material weakness" in its internal controls and specifically cited the balance-sheet-reserve accounts. While Nortel said at the time its reserves were artificially high, it didn't say they had been used to manipulate earnings.

Board members wanted to make sure Nortel didn't make another earnings restatement and hired former SEC enforcement director William McLucas, now a partner at Wilmer Cutler Pickering Hale & Dorr LLP, to figure out how the errors occurred. Mr. McLucas had previously been hired to investigate scandals at both Enron Corp. and WorldCom Inc.

The board's inquiry began in late December. By the spring, it discovered something it wasn't looking for: the alleged manipulation of the company's reserve accounts. Led by Chairman Lynton R. Wilson, who once ran Bell Canada, and Audit Committee Chairman John E. Cleghorn, the former CEO of Royal Bank of Canada, the board suspended Messrs. Beatty and Gollogly in March.

Some former employees and critics say board members, many of whom were former ambassadors and Canadian corporate leaders, should have spotted the accounting problems earlier.

Donald Thain, professor emeritus at Richard Ivey School of Business in London, Ontario, says the board members had impressive credentials but were stretched too thin. Many served on multiple boards.

"Unfortunately, they were unwilling, unable or didn't have the time to do the job that was necessary," Mr. Thain says.

People familiar with the board's thinking say the directors feel they were misled by the company's executives. A spokeswoman for Deloitte & Touche, the company's auditors, said confidentiality rules prevented the firm from commenting on client matters.

At the end of April, the board held an all-day meeting at the company's suburban Toronto headquarters, where the investigators presented their findings. At about 5 p.m., Messrs. Cleghorn and Wilson walked to "mahogany row," the corridor where Nortel's top executives have their offices, and found the chief executive at work at his desk. They fired him. The board delivered the same news to Messrs. Gollogly and Beatty by phone, these people say.

The board also suspended the finance chiefs of Nortel's four operating companies. Two finance chiefs declined to comment and two didn't respond to requests for comment.

William Owens, a Nortel director tapped to succeed Mr. Dunn, has vowed to get to the bottom of the accounting mess and, among other things, is giving additional training to Nortel's 1,500-strong finance department. Currently, Nortel is focused on putting out financial results for this year's first quarter, which are more than two months late.

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