

Major Case 3

MicroStrategy, Inc.

Background

MicroStrategy, Inc., incorporated in Wilmington, Delaware, in November 1989, has offices all over the United States and around the world. Its headquarters are in McLean, Virginia. In its early years, the company provided software consulting services to assist customers in building custom software systems to access, analyze, and use information contained in large-scale, transaction-level databases. MicroStrategy began concentrating its efforts on the development and sale of data mining and decision support software and related products during 1994 and 1995.¹

A larger part of the company's revenues in 1996 resulted from software license sales. The company licensed its software through its direct sales force and through value-added resellers and original equipment manufacturers (OEMs). The total sales through the latter two avenues comprised more than 25 percent of the company's total revenues. Since 1996, the company revenues have been derived primarily from three sources:

- Product licenses
- Fees for maintenance, technical support, and training
- Consulting and development services

The company went public through an initial public offering (IPO) in June 1998. From the third quarter of 1998, the company began to take on a series of increasingly bigger and more complicated transactions, including the sale of software, extensive software application development, and software consulting services.

In 1998 the company began to develop an information network supported by the organization's software platform. Initially known as Telepath but later renamed Strategy.com., the network delivers personalized finance, news, weather, traffic, travel, and entertainment information to individuals through cell phones, e-mail, and fax machines. For a fee, an entity could become a Strategy.com affiliate that could offer service on a co-branded basis directly to its customers. The affiliate shared with MicroStrategy the subscription revenues from users. By the end of 2004, MicroStrategy was the leading worldwide provider of business intelligence software.

The story of MicroStrategy reflects the larger problems of the go-go years of the 1990s. The dream of many young entrepreneurs was to create a new software product or design a new Internet-based network and capitalize on the explosion

in telecommunications network capacity and computer usage. Greed may have been the sustaining factor enabling the manipulation of stock value, as many chief executive officers (CEOs) and CFOs cashed in before the stock price tumbled. However, pressure to achieve financial analysts' estimates of earnings seems to have been the driving force behind the decision to "cook the books."

Restatement of Financial Statements

On March 20, 2000, MicroStrategy announced that it planned to restate its financial results for the fiscal years 1998 and 1999. MicroStrategy stock, which had achieved a high of \$333 per share, dropped over 60 percent of its value in one day, going from \$260 per share to \$86 per share on March 20. The stock price continued to decline in the following weeks. Soon after, MicroStrategy announced that it would also restate its fiscal 1997 financial results, and by April 13, 2000, the company's stock closed at \$33 per share. The share price was quoted at its lowest price during the unraveling of the fraud \$3.15 per share as of January 16, 2002.

The restatements (summarized in Table 1) reduced the company's revenues over the three-year period by about \$65 million of the \$312 million reported, or 21 percent. About 83 percent of these restated revenues were in 1999.

The company's main reporting failures were derived from its early recognition of revenue arising from the misapplication of AICPA *Statement of Position (SOP) 97-2*.² The SEC states in the Accounting and Enforcement Release: "This misapplication was in connection with multiple-element deals in which significant services or future products to be provided by the company were not separable from the up-front sale of a license to the company's existing software products." The company also restated revenues from arrangements in which it had not properly executed contracts in the same fiscal period in which revenue was recorded from the deals.

The company 10-K annual report filed with the SEC for the fiscal year ended December 31, 1998, states the following in item number 7 of Management Discussion and Analysis (MD&A):

Our revenues are derived from two principal sources (i) product licenses and (ii) fees for maintenance, technical support, education and consulting services (collectively, "product support"). Prior to January 1, 1998, we recognized revenue in accordance with Statement of Position 91-1, "Software Revenue Recognition." Subsequent to December 31, 1997, we began recognizing revenue in accordance with Statement of Position 97-2, "Software Revenue Recognition." SOP 97-2 was amended on March 31, 1998 by SOP 98-4 "Deferral of the Effective Date of a Provision of SOP 97-2." In December 1998, the AICPA issued SOP 98-9 "Modification

¹Information about the case can be found at Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 1351, December 14, 2000, *In the Matter of MicroStrategy, Inc.*, December 18, 2000; www.sec.gov/litigation/admin/34-43724.htm.

²Available at www.aicpa.org.

Table 1
Impact of Restatement on Revenue and Net Income

Reporting Period	Revenue (\$ in thousands)		Net Income (\$ in thousands)	
	Original	Restated	Original	Restated
Year ended:				
December 31, 1997	\$ 53,557	\$ 52,551	\$ 121	\$ (885)
Quarter ended:				
March 31, 1998	19,895	19,160	542	(193)
June 30, 1998	23,790	21,138	942	(1,133)
September 30, 1998	27,014	25,960	1,928	2,055
December 31, 1998	35,731	29,231	2,766	(2,984)
Year ended:				
December 31, 1998	106,430	95,489	6,178	(2,255)
Quarter ended:				
March 31, 1999	35,784	29,322	1,859	(3,804)
June 30, 1999	45,638	40,465	3,211	(3)
September 30, 1999	54,555	35,309	3,794	(12,774)
December 31, 1999	69,352	46,162	3,756	(17,162)
Year ended:				
December 31, 1999	205,329	151,258	12,620	(33,743)

of SOP 97-2, Software Revenue Recognition," which amends SOP 98-4, and is effective after December 31, 1998. Management has assessed these new statements and believes that their adoption will not have a material effect on the timing of our revenue recognition or cause changes to our revenue recognition policies. Product license revenues are generally recognized upon the execution of a contract and shipment of the related software product, provided that no significant company obligations remain outstanding and the resulting receivable is deemed collectible by management. Maintenance revenues are derived from customer support agreements generally entered into in connection with initial product license sales and subsequent renewals. Fees for our maintenance and support plans are recorded as deferred revenue when billed to the customer and recognized ratably over the term of the maintenance and support agreement, which is typically one year. Fees for our education and consulting services are recognized at the time the services are performed.

The majority of MicroStrategy's sales closed in the final days of the fiscal period, which is common in the software industry and was as stated by the company in its 10-K. The following is an excerpt from the company's 10-K for the fiscal year December 31, 1998:

The sales cycle for our products may span nine months or more. Historically, we have recognized a substantial portion of our revenues in the last month of a quarter, with these revenues frequently concentrated in the last two weeks of a quarter. Even minor delays in booking orders may have a significant adverse impact on revenues for a particular quarter.

To the extent that delays are incurred in connection with orders of significant size, the impact will be correspondingly greater. Moreover, we currently operate with virtually no order backlog because our software products typically are shipped shortly after orders are received. Product license revenues in any quarter are substantially dependent on orders booked and shipped in that quarter. As a result of these and other factors, our quarterly results have varied significantly in the past and are likely to fluctuate significantly in the future. Accordingly, we believe that quarter-to-quarter comparisons of our results of operations are not necessarily indicative of the results to be expected for any future period.

SEC Investigation and Proceedings

According to the SEC investigation, the problems for MicroStrategy began at the time of its IPO in June 1998 and continued through the announced restatement in March 2000. The software company materially overstated its revenues and earnings contrary to GAAP. The company's internal revenue recognition policy in effect during the relevant time period stated that the company recognized revenue in accordance with SOP 97-2. The company, however, had not complied with SOP 97-2, instead recognizing revenue earlier than allowed under GAAP.

The closing of a majority of the company's sales in the final days of the fiscal period resulted in the contracts department receiving numerous contracts signed by customers that needed (according to company policy) to be signed by MicroStrategy as

well. To realize the desired quarterly financial results, the company held open, until after the close of the quarter, contracts that had been signed by customers but had not yet been signed by the company. After the company determined the desired financial results, the unsigned contracts were signed and given an "effective date" in the last month of the prior quarter. In some instances, the contracts were signed without affixing a date, allowing the company to assign a date at a later time. GAAP and MicroStrategy's own accounting policies required the signature of both the company and the customer prior to recognizing revenue.

SEC regulations that were violated by MicroStrategy included reporting provisions, recordkeeping requirements, and the internal control provisions. The company was required to cease and desist from committing any further violations of the relevant rules, as well as take steps to comply with the rules already violated.

Role of the Auditor

The auditor of MicroStrategy in 1996 was Coopers & Lybrand, and Warren Martin was the engagement partner. After Coopers merged with Price Waterhouse and became known as PricewaterhouseCoopers (PwC), Martin continued as the engagement partner until April 2000. The SEC filed administrative proceedings against him on August 8, 2003, and suspended him from practicing before the commission for two years.³

Martin was in charge of the audit of MicroStrategy during the period of restatement and was directly responsible for the unqualified (i.e., unmodified) opinions issued on the company's inaccurate financial statements. The SEC charged him with a variety of violations of professional standards of practice, including lacking an attitude of professional skepticism, failing to obtain sufficient evidence to support revenue recognition, and demonstrating a lack of due care in carrying out professional responsibilities.

Role of Officers of the Company

The following officers came under investigation by the SEC: Michael Saylor, cofounder and CEO; Mark Lynch, the CFO; and Sanjeev Bansal, cofounder and chief operating officer (COO). The SEC filed administrative proceedings against Saylor, Lynch, and Bansal on December 14, 2000, charging that MicroStrategy "materially overstated its revenues and earnings from the sales of software and information services contrary to GAAP." Two other officials were cited for their role in drafting the revenue recognition policies that violated GAAP—Antoinette Parsons, the corporate controller and director of finance and accounting and vice president of finance; and Stacy Hamm, an accounting manager who reported to Parsons.⁴ The SEC considered that all these

³Securities and Exchange Commission, Accounting and Enforcement Release No. 1835, *In the Matter of Warren Martin, CPA*, August 8, 2003; www.sec.gov/litigation/admin/34-48311.htm.

⁴U.S. Securities and Exchange Commission, "SEC Brings Civil Charges Against MicroStrategy, Three Executive Officers for Accounting Violations"; www.sec.gov/news/headlines/microstr.htm.

officers should have been aware of the revenue recognition policies of the company. Lynch, as the CFO, had the responsibility to ensure the truthfulness of MicroStrategy's financial reports, and he signed the company's periodic reports to the SEC. Saylor also signed the periodic reports.

The CEO, CFO, and COO paid approximately \$10 million in disgorgement used to repay investors who were affected by this fraud, another \$1 million in penalties, and they agreed to a cease-and-desist order regarding violations of reporting, bookkeeping, and internal controls. The controller and the accounting manager agreed to a cease-and-desist order that prohibited them from violating Rules 13a and 13b of the Securities and Exchange Act. In a separate action, Lynch was denied the right to practice before the commission for three years.

On June 8, 2005, the SEC reinstated Lynch's right to appear before the commission as an accountant. Lynch agreed to have his work reviewed by the independent audit committee of any company for which he works.

Post-Restatement Through 2004

MicroStrategy discontinued its Strategy.com business in 2001. It now has a single platform for business intelligence as its core business. Total revenues consist of revenues derived from the sale of product licenses and product support and other services, including technical support, education, and consulting services. The company's international market is rapidly developing, and it has positive earnings from operations since 2002.

For the year ended December 31, 2004, the MD&A identified its revenue recognition policy as described in Exhibit 1.

In its early years, MicroStrategy stated its revenue recognition policy in a single paragraph, saying that it followed the relevant accounting policies. Now the company provides a detailed analysis in its MD&A, as well as the notes to financial statements. The company has implemented all the requirements of the SEC. PwC continues as the auditors for MicroStrategy, and the firm has given an unqualified (i.e., unmodified) opinion on both the company's financial statements and its internal control report under SOX.

Investors sued MicroStrategy and PwC in 2000, after the software maker retracted two years of audited financial results and its stock price plunged by 62 percent in a single day, wiping out billions of dollars in shareholder wealth.

A report filed in court by the plaintiffs said the audit firm "consistently violated its responsibility" to maintain an appearance of independence. It cites e-mail evidence of a PwC auditor seeking a job at MicroStrategy while he was the senior manager on the team that reviewed the company's accounting. PwC also received money for reselling MicroStrategy software and recommending it to other clients. The accounting firm was working on setting up a business venture with its audit client, according to the plaintiff's report.

Steven G. Silber, a PwC spokesman, said the company denies "all of their allegations about our independence and the work we performed." He added: "While we believe our defense against the class-action claim was strong and compelling, we ultimately made a business decision to settle in order to avoid the further costs and uncertainties of litigation."

Exhibit 1 Revenue Recognition

MicroStrategy's software revenue recognition policies are in accordance with the American Institute of Certified Public Accountants' Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended. In the case of software arrangements that require significant production, modification or customization of software, we follow the guidance in SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." We also follow the guidance provided by SEC Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements," and SAB No. 104, "Revenue Recognition," which provide guidance on the recognition, presentation and disclosure of revenue in the financial statements filed with the SEC.

We recognize revenue from sales of software licenses to end users or resellers upon persuasive evidence of an arrangement, as provided by agreements or contracts executed by both parties, delivery of the software and determination that collection of a fixed or determinable fee is reasonably assured. When the fees for software upgrades and enhancements, technical support, consulting and education are bundled with the license fee, they are unbundled using our objective evidence of the fair value of the elements represented by our customary pricing for each element in separate transactions. If such evidence of fair value exists for all undelivered elements and there is no such evidence of fair value established for delivered elements, revenue is first allocated to the elements where evidence of fair value has been established and the residual amount is allocated to the delivered elements. If evidence of fair value for any undelivered element of an arrangement does not exist, all revenue from the arrangement is deferred until such time that evidence of fair value exists for undelivered elements or until all elements of the arrangement are delivered, subject to certain limited exceptions set forth in SOP 97-2.

When a software license arrangement requires us to provide significant production, customization or modification of the software, or when the customer considers these services essential to the functionality of the software product, both the product license revenue and consulting services revenue are recognized using the percentage of completion method. Under percentage of completion accounting, both product license and consulting services revenue are recognized as work progresses based upon labor hours incurred. Any expected losses on contracts in progress are expensed in the period in which the losses become probable and reasonably estimable. Contracts accounted for under the percentage of completion method were immaterial for the years ended December 31, 2004, 2003, and 2002.

If an arrangement includes acceptance criteria, revenue is not recognized until we can objectively demonstrate that the software or service can meet the acceptance criteria, or the acceptance period lapses, whichever occurs earlier. If a software license arrangement obligates us to deliver specified future products or upgrades, the revenue is recognized when the specified future product or upgrades are delivered, or when the obligation to deliver specified future products expires, whichever occurs earlier. If a software license arrangement obligates us to deliver unspecified future products, then revenue is recognized on the subscription basis, ratably over the term of the contract.

License revenue derived from sales to resellers or OEM's who purchase our products for future resale is recognized upon sufficient evidence that the products have been sold to the ultimate end users provided all other revenue recognition criteria have been met.

Technical support revenue, included in product support and other services revenue, is derived from providing technical support and software updates and upgrades to customers. Technical support revenue is recognized ratably over the term of the contract, which in most cases is one year. Revenue from consulting and education services is recognized as the services are performed.

Amounts collected prior to satisfying the above revenue recognition criteria are included in deferred revenue and advance payments in the accompanying consolidated balance sheets.⁵

⁵Securities and Exchange Commission, MicroStrategy 2004 10-K Report, Available at www.sec.gov/cgi-bin/browser-edgar.

MicroStrategy's chief of staff, Paul N. Zolfaghari, said in a statement that PwC auditors "have consistently assured us that they have been in full compliance with all applicable auditor independence requirements."

On May 8, 2011, PwC agreed to pay \$55 million to settle a class action lawsuit alleging that it defrauded investors in MicroStrategy Inc. by approving financial reports that inflated the earnings and revenue of the company.⁶

⁶"Accounting Firm to Settle Suit over Audits of MicroStrategy," Available at <http://mailman.lbo-talk.org/2001/2001-May/008924.html>.

Online Resources

Your instructor may ask you to delve deeply into the accounting standards and SEC actions in answering questions in the case. The following Web sites provide extensive information that may help in that regard.

- AICPA (SAS 55 and SOP 97-2): www.aicpa.org/members/div/auditstd/index.htm
- Committee of Sponsoring Organizations (COSO):
- *Internal Control—Integrated Framework* (Executive Summary): www.coso.org/publications/executive_summary_integrated_framework.htm