

Cooking the Books: How Pressure to Raise Sales Led MiniScribe To Falsify Numbers --- Q.T. Wiles, the Former Chief Of Disk-Drive Company, Abrasively Drove His Staff --- Fake Cargo on Phantom Ship

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LONGMONT, Colo. -- Last October, as other computer-disk-drive companies were laying off hundreds of employees, **MiniScribe** Corp. announced its 13th consecutive record-breaking quarter. This time, however, the surge in sales sent a shiver of apprehension through **MiniScribe's** board.

"The balance sheet was scary," says William Hambrecht, one of the directors.

What worried Mr. Hambrecht was a sudden, three-month run-up in receivables to \$173 million from \$109 million, a 59% increase. Inventories were similarly bloated, swelling to \$141 million from \$93 million -- a dangerous development because disk drives can become obsolete from one quarter to the next.

Seven months later, the portents that had worried Mr. Hambrecht generated grim headlines: **MiniScribe's** spectacular sales gain had been fabricated. In fact, the company acknowledged, it didn't know whether it could produce accurate financial statements for the prior three years.

The news shocked Wall Street, whose rosy financial forecasts helped quintuple **MiniScribe's** stock price in just two years. After all, this was a company that, by all appearances, had risen from the dead under the direction of Q.T. Wiles, then the chairman of Hambrecht & Quist, a highly respected venture-capital firm that in 1985 had injected \$20 million into **MiniScribe**. Mr. Wiles's proven ability to resurrect ailing companies was already so renowned that he was known as "Dr. Fix-It."

"It looked for two or three years like Q.T. was a miracle worker -- at least from the outside," says Jim Porter, president of Disk/Trend Inc., a California-based market-research firm.

Instead, what was supposed to be the crowning achievement of a storied career has become an epitaph. Mr. Wiles has resigned from **MiniScribe** and from half a dozen other companies, including Hambrecht & Quist, and lives in near-seclusion. He repeatedly declined to be interviewed for this article; his lawyers, instead, supplied a 40-page summary of a seven-hour interview in which Mr. Wiles responded to questions from investigators hired by the company's outside directors.

Virtually all of **MiniScribe's** top management has been dismissed, and layoffs have shrunk world-wide employment to 5,700 from a peak of 8,350 a year ago. **MiniScribe** might have to write off as much as \$200 million in bad inventory and uncollectable receivables. And an audit team composed of outside directors, under the scrutiny of the Securities and Exchange Commission, is investigating **MiniScribe's** failure to provide reliable financial statements to public investors.

The audit report, expected to be released this week, is unlikely to disclose more than a summary of the team's findings. Yet interviews with current and former executives, employees, competitors, suppliers and industry analysts depict a corporation run amok. Mr. Wiles's unrealistic sales targets and abusive management style created a pressure cooker that drove managers to cook the books or perish. And cook they did -- booking shipments as sales, manipulating reserves and simply fabricating figures -- to maintain the illusion of unbounded growth even after the industry was hit by a severe slump.

MiniScribe isn't the only high-tech company to indulge in questionable practices. Datapoint Corp. almost went out of business seven years ago when its practice of booking shipments as sales got out of hand, and the computer-networking concern is still struggling to return to profitability.

More recently, a highflying California company, Ashton-Tate Corp., has been sued in a federal court in Los Angeles by shareholders accusing it of similar bookkeeping games; the company has denied any wrongdoing. And DSC Communications Corp., of Dallas, signed a consent agreement with the SEC this year in which it

agreed to restate 1984 and 1985 results that allegedly recognized sales prematurely.

But the temptation to fudge numbers is greatest when times are hardest, and when Quentin Thomas Wiles arrived at **MiniScribe** in mid-1985, times were rock-hard. The disk-drive maker had just lost its biggest customer, International Business Machines Corp., which decided to make its own drives. And with the personal-computer industry then slumping, **MiniScribe** was drowning in red ink.

Dr. Fix-It's prescription was to slice off a fifth of the work force and overhaul the company from top to bottom, chopping it into separate divisions grouped around different products or research efforts. Each division had its own staff and each division manager set his own budget, sales quotas, incentives and work rules.

The idea, Mr. Wiles has said, was to create accountability. In practice, **MiniScribe** became a chaotic Babel of 20 or more minicompanies under one corporate umbrella. "There was constant change, constant reorganization," says an employee who held 20 different positions at **MiniScribe** in 6 1/2 years.

Mr. Wiles also turned up the heat under his lieutenants. Four times a year, he would summon as many as a hundred **MiniScribe** employees to Palm Springs for several days of intense "dash meetings," at which participants were force-fed his idiosyncratic management philosophy. At one of the first such meetings he attended, says a former division manager, Mr. Wiles demanded that two controllers stand, "and then he fired them on the spot, saying to everyone, 'That's just to show everyone I'm in control of the company.'"

At each dash meeting, division managers had to present and defend their "dash books," Mr. Wiles's term for business plans that had to conform to a set formula. Invariably, say former participants, Mr. Wiles would find such plans deficient and would berate their authors in front of their peers. A former controller says Mr. Wiles would throw, kick and rip dash books that displeased him, showering his intimidated audience with paper while yelling, "Why don't you understand this? Why can't you understand how to do this?"

Mr. Wiles, according to his attorneys, is "fairly autocratic and very demanding of the people who work for him." Even that understates the case. In fact, Mr. Wiles's behavior drove away some of his most senior engineers and cast a pall over those who remained. John Squires, a **MiniScribe** founder, says he quit after his first dash meeting because he couldn't abide Mr. Wiles's "SWAT team" management style.

Mr. Wiles was so intimidating, adds a former manager, that he and the executives he brought with him became known as "the VC," derived from "venture capitalists" but alluding to the Viet Cong. Moreover, Mr. Wiles made no bones about his plans for the company. "He used to say that the faster he could sell **MiniScribe**, the better," recalls the former manager.

Then, something changed. In late 1986, the manager says, Mr. Wiles started singing a different song at the dash meetings: "All of a sudden he was saying, 'I no longer want to be remembered as a turnaround artist. I want to be remembered as the man who made **MiniScribe** a billion-dollar company.'" Sales objectives became the company's driving force, a point Mr. Wiles underscored in the interview with investigators, when he acknowledged that financial results became "the sole determinant" of whether bonuses were awarded.

"Basically," a former **MiniScribe** accountant says, "Q.T. was saying, 'This is the number we want to hit first quarter, second quarter, third quarter and so on,' and it was amazing to see how close they could get to the number they wanted to hit."

Hitting the number became a companywide obsession. Although many high-tech manufacturers accelerate shipments at the end of a quarter to boost sales -- a practice known as "stuffing the channel" -- **MiniScribe** went several steps beyond that. On one occasion, an analyst relates, it shipped more than twice as many disk drives to a computer manufacturer as had been ordered; a former **MiniScribe** sales manager says the excess shipment was worth about \$9 million. **MiniScribe** later said it had shipped the excess drives by mistake. The extras were returned -- but by then **MiniScribe** had posted a sale at the higher number. In his interview with investigators, Mr. Wiles said he wasn't aware of any such incidents.

Other accounting maneuvers, starting as far back as 1986, involved shipments of disk drives from **MiniScribe**'s factory in Singapore. Most shipments went by air freight, but a squeeze on air-cargo space toward the end of each quarter would force some shipments onto cargo ships -- which required up to two weeks for transit. On several occasions, says a former division manager, **MiniScribe** executives looking to raise sales changed

purchase orders to show that a customer took title to a shipment in Singapore, when, in fact, title wouldn't change until the drives were delivered in the U.S.

In a more dramatic version of this ruse, according to a former accountant, **MiniScribe** executives tried to persuade an audit team that 1986 year-end results should book as sales the cargo on a freighter that they contended had set sail in late December. The audit team declined to do so. Eventually, the cargo and the freighter, which didn't exist, were simply forgotten.

MiniScribe executives also found other ways to inflate sales figures. One was to manipulate reserves, the accounting entries designed to offset unrecognized losses, such as returns of defective merchandise or bad debts. Mr. Wiles acknowledged to investigators that creating adequate reserves "never did sufficiently take root in the **MiniScribe** organization." Despite this awareness, Mr. Wiles failed to take corrective action and said that the last time he looked closely at the issue was in late 1986.

The problem of inadequate reserves grew so great that private analysts began noticing it in 1988. Despite \$177 million in receivables, one says, **MiniScribe** was booking less than 1% in reserves; the rest of the industry, meanwhile, had reserves ranging from 4% to 10%.

To avoid booking losses on returns in excess of its skimpy reserves, defective drives would be tossed onto a "dog pile" and booked as inventory, according to Greg Fortune, a disk-drive failure-analysis technician. Eventually, the dog-pile drives would be shipped out again to new customers, continuing the cycle. Returns of defective merchandise ran as high as 15% in some divisions, Mr. Fortune estimates.

At a time of strong market demand, such ploys enabled **MiniScribe** to seem to grow almost exponentially, posting sales of \$185 million in 1986 and \$362 million in 1987. In early 1988, Mr. Wiles was confidently forecasting a \$660 million year, and he held fast to his rosy forecast even as disk-drive sales started slipping industrywide in late spring and nosedived in the autumn. Meanwhile, Mr. Wiles increased the pressure on his managers.

"Everyone wanted to do good by Q.T.," says a customer representative, describing how division reports would be doctored as they rose from one bureaucratic level to the next.

Before long, the accounting gimmickry became increasingly brazen. Division managers were told to "force the numbers," says a former marketing manager; he tells of one division controller who quit when ordered by a vice president to lie about financial results. In this tense atmosphere, wild rumors abounded. Workers whispered that bricks were being shipped just so a division could claim to have met its quota. Others joked that unwanted disk drives were being shipped and returned so often that they had to be repackaged because the boxes wore out.

Employees also joked about shipments to "account BW," an acronym for "big warehouse." But that wasn't just a joke. **MiniScribe** established several warehouses around the country and in Canada as "just-in-time" suppliers for distributors. The largest and most abused was in Los Angeles, where it served as a supply point for Cal-Abco Inc., a major electronics-parts distributor.

Yair Barzilay, a Cal-Abco partner, says his company wasn't invoiced until it received a shipment from the warehouse. **MiniScribe**, however, was booking shipments to the warehouse as sales. And because the "just-in-time" operation wasn't under Cal-Abco's control, the number of disk drives shipped was at **MiniScribe's** discretion. **MiniScribe** won't say how many unordered disk drives went to the warehouse, but a former employee puts their value at \$80 million to \$100 million.

By last fall, **MiniScribe's** suppliers began to sense that something was terribly amiss. Domain Technology, a supplier of the coated aluminum disks on which disk drives store information, says **MiniScribe** started falling behind in its payments; then, its orders dropped. Eventually, says Domain's president, David Pearce, **MiniScribe** was returning virtually all Domain shipments, saying they were defective -- a contention that he vigorously denies. "We took a \$7 million hit on that," he says -- a jolt that helped push Domain into bankruptcy proceedings in June.

Wall Street, which had so eagerly embraced Mr. Wiles's previous forecasts, also began to smell trouble. "The company was talking a really bullish game," says John Rossi, an analyst at Alex. Brown & Sons Inc. "But I really couldn't find any significant customers other than Compaq." In fact, several major anticipated orders on which

Mr. Wiles had been pinning his hopes -- principally from Apple Computer and Digital Equipment Corp. -- fell through in the fall.

So, by the time **MiniScribe** announced its 1988 results in mid-February, they simply confirmed the growing suspicions. The company reported a fourth-quarter loss of \$14.6 million and a drop in net income for the year to \$25.8 million from \$31.1 million despite a 66% increase in sales to \$362.5 million -- on paper, that is.

Scarcely a week later, Mr. Wiles abruptly resigned, telling board members that the company's problems were far more pervasive than he had realized. Friends say he was devastated by what his exhaustive, three-week examination of the company revealed. "He reacted like he'd been blindsided," Mr. Hambrecht says. Adds a former marketing manager: "It was almost like a fraternity party, with everybody huddling together to figure out how to keep the house dad from knowing what was going on."

The house dad may not have wanted to know. After investigators showed him several memos that had been distributed at a meeting he attended, Mr. Wiles acknowledged that they "indicated the opposite of what he had previously been told." He denied having seen them and noted that if he had seen one particular memo, "he would have certainly read it as saying 'somebody's cheating.'"

Investors say they, too, have been cheated, having seen the value of their stockholdings tumble from a high of \$15 a share to less than \$3. A dozen shareholder lawsuits have been filed in federal court in Denver in recent months, charging, in the words of the first of them, that **MiniScribe** "engineered phony 'sales'" to artificially inflate its stock to benefit insiders. In 1988, **MiniScribe** officers and directors sold 350,000 shares of company stock. The suits also charge, among other things, that Coopers & Lybrand, the company's auditor, "participated in the conspiracy" by "falsely" certifying the company's financial statements. Hambrecht & Quist also was named as a defendant. Both Hambrecht & Quist and Coopers & Lybrand deny any wrongdoing.

Robert Sparacino, the chairman of the audit committee of outside directors that has been delving into the allegations of wrongdoing, declines to say what the panel has found. All he does say is that "the incidents that occurred were not trivial."

Lead to a fall in output and a decrease in the supply of liquid assets. 8. In an open economy with perfect capital mobility and a flexible exchange rate an increase in international interest rates will lead to: (a). No changes in trade deficit

â€” If all prices and wages are fully flexible in the short run then the aggregate supply (AS) curve is vertical. It is possible to argue that this statement could be either TRUE or FALSE. With flexible wages and prices, the labour market will adjust to a point where labour demand is equal to labour supply (there is an equilibrium real wage w).