MCKESSON ACCOUNTING SCANDALS: 1937 AND 1999

On January 12, 1999, McKesson Corporation, a large health care supply firm, paid $12 billion to acquire HBO & Company, a leading producer of health care-related software. (Note: To avoid confusion, be aware that HBO & Company is not connected with HBO, the cable channel.) On April 22, 1999, the combined company, called McKesson HBOC, announced that preliminary calculations indicated that income for the year ended March 31, 1999, was $237.1 million. A few days later, a staff auditor from Deloitte & Touche, performing a routine confirmation of accounts receivable, was surprised to hear from a customer that a $20 million sale reported by the HBO division had never taken place. It was soon learned that $42 million in sales reported by HBO should not have been recognized. When this information was announced to the financial press by McKesson HBOC on April 28, 1999, the company’s stock price dropped from $65 5/8 to $34 7/16 in one day; this 47.5% drop represented a market value loss of $8.8 billion.

Further investigation revealed that the accounting improprieties at McKesson HBOC were much more widespread than originally suspected. On May 25, 1999, the company revealed that further earnings restatements would be announced in the future. On July 14, 1999, when McKesson HBOC filed its 10-K with the SEC, it was revealed that net income for the year ended March 31, 1999, was not $237.1 million, as announced earlier, but was actually $84.9 million. The final amount of overstated revenue in the HBO division was $327 million, which was spread over the preceding three years.

The HBO revenue overstatements, which appear to have been the work of top managers of HBO (five of whom were fired by McKesson HBOC on June 21, 1999), were accomplished in the following ways.

- **Side letters.** Great pressure was put on HBO salespeople in order for the company to meet its revenue targets. To get wavering customers to close deals, the salespeople would promise that the customer could cancel the deal in the future if it was unable to obtain financing, if its board of directors didn’t approve, or even if it just changed its mind. The terms of these conditional agreements were written up in letters that were kept in files separate from the sales “orders.”

- **Backdating.** In order to meet quarterly revenue targets, sales orders in the first couple of weeks of a new quarter were backdated so that they would boost reported revenue in the preceding quarter.

- **Advanced recognition of future sales.** At the time of an original software sale, HBO would sometimes recognize revenue for both that sale and for all future revenue expected to be generated through software upgrades. Often, these expected future upgrades did not even exist at the time the revenue was recognized.

For accountants and auditors, the McKesson HBOC case stirs memories of the famous McKesson & Robbins fraud of 1937. For fiscal 1937, McKesson & Robbins, the predecessor of McKesson HBOC, reported total assets of $87 million. It was later discovered that this $87 million included $10 million in nonexistent inventory and $9 million in fictitious receivables. The fraud was perpetrated by the top managers of McKesson & Robbins and involved phony purchases from and sales to dummy Canadian companies, which were actually just empty offices staffed by secretaries who forwarded mail.

The well-publicized McKesson & Robbins fraud spurred the auditing profession to adopt two auditing standards that are still followed today.

1. The physical existence of inventory must be confirmed through direct observation. This simple procedure applied in the McKesson & Robbins case would have revealed that the reported purchases from the Canadian suppliers were phony.
2. The existence and accuracy of reported receivables must be independently confirmed by contacting a sample of the parties who allegedly owe the money. Sixty-two years after the original McKesson & Robbins scandal, this simple procedure, applied by a staff auditor at Deloitte & Touche, uncovered the modern-day McKesson HBOC fraud.

QUESTIONS:
1. Why did McKesson HBOC’s stock price drop so much (47.5%) upon release of the news on April 28, 1999, that sales in the HBO division had been overstated by $42 million?
2. This overstatement of revenue at HBO & Company coincided with the period in which the company was an acquisition target. Is this a coincidence? Explain.
3. What common aspect of both the 1937 McKesson & Robbins case and the 1999 McKesson HBOC case made it difficult to discover the frauds?

SOURCES:
10-K Filing of McKesson HBOC for the year ended March 31, 1999.

SOFTWARE REVENUE FOR SOFTWARE COMPANIES
The nature of the computer software industry presents several sticky revenue recognition issues. The installation of software and the promise of software upgrades require software companies to consider when the earnings process is substantially complete. Are the revenue recognition criteria satisfied at the point of sale, when the software is installed, or after promised upgrades are delivered?

Beginning in 1997, the AICPA required software companies to allocate revenue over the entire earnings process. A common practice at the time was to recognize all revenue associated with a sale at the point of sale. With the support of the SEC and the FASB, this new rule, SOP 97-2, required software companies to attribute revenue from a sale to the various components of the sale. For example, if a software company sells a software package for $500 and agrees to install the software and deliver a free upgrade within a year, the AICPA requires the $500 selling price to be allocated over the software, the installation, and the upgrade. Revenue would be recognized as each of these items or activities was delivered to the purchaser. Under the old rules, the entire $500 would be recognized at the point of sale.

As one might expect, not all software companies supported this new rule. But Microsoft, the biggest software publisher in the world, backed the reporting change.

QUESTIONS:
1. What difficulties might be associated with allocating a software package’s purchase price over the entire earnings process?
2. Why might Microsoft be supportive of a rule that would cause software companies (like Microsoft) to slow the recognition of revenue?

SOURCE: