# ADAPSO Reunion Workshop: Accounting Issues

Moderators:
Larry Schoenberg and Martin Campbell-Kelly

Recorded: May 4, 2002
Washington, DC

CHM Reference number: X4314.2008

© 2002 Computer History Museum

# Table of Contents

# ADAPSO Reunion – Accounting Issues Workshop

## Conducted by Software History Center—Oral History Project

**Abstract:** A group of former CEO’s of computer software product and services companies discussed various ways in which accounting practices evolved in their industry and how these practices impacted their business decisions. They discussed sales tax, capitalization of software, valuation of intangible assets and revenue recognition. They talked about the chart of accounts, financial ratios and SIC codes. They spoke of participating in ADAPSO Roundtables and the concern not to be collusive on pricing or related matters. Raising capital without being able to show any balance sheet assets led to R&D partnerships and the successful attempt by ADAPSO to get FASB to permit capitalization of certain software development costs by the software vendors. They also discussed the differences in the accounting treatment between acquisition of other companies with their products and services from the treatment of internal development costs of products and establishing of new service locations, all favoring buying assets versus building them. They closed the session by reviewing various ways that the accounting practices did not represent fiscal reality but, unfortunately, influenced business management and investment decisions and required that they set up set up separate records for management planning and operational control.

**Participants:**

| Name | Affiliation |
|---|---|
| David Campbell | Computer Task Group |
| Doug Jerger | Jerger Associates, formerly Fortex Data Systems |
| Gary Durbin | CEO of Tesseract Corporation |
| Harris Miller | President of ITAA |
| David Grier | *Annals of the History of Computing*, Associate E-I-C |
| Jeff Yost | CBI Univ. of Minnesota, historian |
| Thomas Haigh | The Haigh Group, historian |
| Elizabeth Virgo | Consultant |

 © 2004 Computer History Museum 

## Introductions

**Larry Schoenberg:** I'm Larry Schoenberg. My company was AGS Computers. I was the person who headed up the ADAPSO group when we first started working on accounting issues and spent, I think, seventeen years working with the AICPA and the FASB, failing to get most things satisfactorily resolved. However, we did publish some position papers. It was only after I left that AICPA and FASB reversed their positions.

This topic is called accounting issues but I think it should be redefined as financially-related issues. And I think it's important, at least in a historical perspective, to realize that, when these issues first came up in ADAPSO, ADAPSO was dominated by individuals who were the CEOs or COOs of companies. So, although this was a functional area of operations, it was approached from the perspective of the CEO and COO, not that of senior financial people. Before we go further, it would be useful if every person here gave his name and background.

**Harris Miller:** I'm Harris Miller. I'm the current president of ITAA. Accounting and finance issues are back big time, partly because of FASB getting involved in stock options which are very controversial. And partly because of some revenue recognition issues that have become very visible over the last few years involving some pretty visible companies like Computer Associates and MicroStrategy and others. And, of course, Enron has put everything back on the table, resuscitating the issue that you all fought through a couple decades ago.

But, beyond that, I think almost everything is on the table. When I got involved with ITAA in the mid-1990s, a lot of our companies said, we don't need ITAA to help us understand accounting issues, we understand it all. I actually had the CEO of a major company—that later made headlines because of their accounting practices—tell me that.

I think that egos got out of control and people were a little bit high-handed about these issues. And I think now people are coming together to say, OK, we better figure out what is the smartest thing to do as opposed to the cleverest thing to do. And this whole attitude of give us a loophole, we'll drive a horse through it, is now swinging back the other way. People are saying that their audits and financial reports are being watched a lot more carefully, and we better, as an industry, get our act together because it is affecting investor confidence.

**Schoenberg:** I love your comment about being clever because that really has been an overwhelming characteristic of how things have been done. One of the first statements I ever made to the accountants was, "Don't tell me about 'conservative' because 'conservative' is another way of saying biased." And if you're biased, sooner or later, someone will turn it on its head and we have had plenty of examples of that. I could never have dreamt up some of the ideas that people have come up with. So, once the connection between economic reality and accounting disappears, it's over. The game is over.

**David Grier:** I'm David Grier. I'm the Associate Editor-in-Chief of the *Annals of the History of Computing*. So I am here more as an observer than a participant. I do have sort of an interesting connection though. My father ran the Burroughs Users Group for thirty-odd years and was affiliated with ADAPSO in the late 1960s and early 1970s. So I'm here to find out what the story is.

**Tom Haigh:** I'm Thomas Haigh. I'm a historian of business and technology, specifically computing. I'm completing my Ph.D. at the University of Pennsylvania and currently teaching at Colby College.

**Jeff Yost:** I'm Jeff Yost. I'm Associate Director of the Charles Babbage Institute and have a strong interest in the business history of software.

**David Campbell:** I'm David Campbell. I'm now Managing Director of a company called Innovation Advisors but, to make Larry Schoenberg feel young, I've had responsibility for running public companies in the software services business in five different decades. We did the IPO of Computer Task Group in 1969 and I ran it all through the 1970s, 1980s, and 1990s. And in 2000, I was CEO of another public company.

One of the things that's interesting is our industry's impact on financial statements and how they help investors. There was an era when balance sheets and tangible assets were how you reported the strength of a company and our industry changed things in a lot of ways. We changed it because we traded in intangible assets and people didn't understand much about that. We brought growth rates which were pretty extraordinary to the investment community. We were maybe the first industry that commonly thought in terms of double-digit growth rates. We created the first large market cap people-based companies—companies that had human assets that went down the elevator at the end of every day. A major battle that we had to fight was to get the investment community to realize that our companies really had value, even though at six o'clock at night everyone had gone home, and there was nobody there.

All of these issues dealing with accounting/financial reporting were related to needing to raise capital because we needed capital to fund the growth of the company. We needed capital and the accounting practices weren't designed for our kind of industry. And, frankly, it's a still-evolving art of how to represent the past and/or the future since all companies today are valued based on the forecasted future. And there is no financial representation that attests to a company's forecast of the future.

We still have significant disconnects in valuation models and in accounting models, so I think we are, frankly, still early in the evolving process of how investors get access to information to make decisions about the performance of companies. It's sort of an ever-evolving mystery and art.

**Miller:** We're involved with this whole value reporting initiative that companies are undertaking. We've put it on the back-burner for now because the ITAA Board is really uncomfortable with having new accounting rules. But we're continuing to have discussions about it with executives from NASDAQ as well as others. It's the same issue: how do you come up with a value for a company whose assets are intangible?

**Gary Durbin:** I'm Gary Durbin. I was CEO of Tesseract Corporation. In the 1970s and 1980s, software accounting issues became critical for us, even though I didn't have any particular interest in accounting and considered that the responsibility of my CFO. But we were raising money. And if you're going to raise money, these become critical issues because there weren't any standards. They were any which way you wanted to do it. So you ended up explaining to investors how you were doing it and why what you were doing was rational, either from the software capitalization point of view or how to measure the assets if they weren't capitalized. Or why your revenue recognition policies made sense. We spent a tremendous amount of time doing that simply because there were no standards. So I became involved, as well as my CFO, Lyn Jensen, in the work to try to create some standards.

**Schoenberg:** I think Tesseract was actually the first company to testify.

**Durbin:** Yes, we did testify at FASB. And preparing for that took a lot of work because we wanted to understand what was going on in the industry and try to present a good case. There were a number of companies who had strong positions and, in some cases, they wanted to change their position. I had a long talk with the CFO at MSA. They wanted the industry to tell them that the way they had had to do it in the past was wrong because, from their point of view, the accounting practices were limiting their ability to do R&D. And they were losing ground competitively because of it. So it was really significant for the industry, both for raising money in the early stages of a company, and for established companies in how they funded R&D.

**Doug Jerger:** I'm Doug Jerger. During the 1970s and 1980s, I was CEO of a company called Fortex Data Corporation. It was a small software company but we had big customers. Our big interest in the accounting issue came from talking to Continental Bank. This was our banker who looked at our financials and said, "You don't have any assets here, nothing of value, right?" Eventually, we had a $150,000 loan from the bank, which for us was a *big* deal, and it was all secured by our accounts receivable. That was the only thing they would lend against.

**Durbin:** Same for us.

**Jerger:** So the work that ADAPSO did was wonderful for us. In the first half of the 1990s, I was on the staff at ADAPSO/ITAA, and it was wonderful what Larry Schoenberg was doing with the accounting folks and the folks at FASB. He would disavow any knowledge of

 © 2004 Computer History Museum 

accounting and then kill them with his logic on the rationality or irrationality of the accounting principles. So, Larry, you really did do a wonderful thing for our industry in accounting.

**Schoenberg:** Thank you. Mentioning the issue of dealing with the bank, I remember many years ago going with Jay Goldberg, the founder of Software Design Associates, to a bank in New York City to attempt to get him a loan. They wouldn't lend him money on receivables because the receivables were based on services revenues. And I met Dave Campbell through a sales tax issue in New York State. What's sales tax have to do with accounting? Well, it was heavily connected to their perception of the business.

**Jerger:** We owe a great debt to a guy named Tony, our loan officer at Continental Bank, who worked with the construction industry. They didn't know which industry to put us in so they gave us to Tony. I called him one time, right after Christmas Day and said, "Tony, I'm in deep trouble and you've got to help. I've got to have some money because we've always covered payroll but with this one, we're in trouble." He said, "Are you sure?" I said, "Yeah." He said, "OK, you got it." That's when I went to the $150,000 level. He didn't really understand the business, but he liked us and decided it would be OK.

**Campbell:** To Larry's point, which is fascinating in terms of how accounting affects things, the sales tax issue came about because New York City got into deep trouble, and, therefore, New York State was in deep trouble, and they went looking for revenues that weren't then subject to sales tax. They found some programming services companies and they said, "At the end of this process, what does the customer get?" Well, it's a stack of cards, so they decided that you were the manufacturer of tangible property, and that was the basis for applying sales tax. *Retroactively*, because nobody had previously filed sales tax returns and, therefore, there was no statute of limitations.

So, we got an invoice in 1976 for $586,000 and we had a $400,000 net worth. Sales tax, like payroll tax, is the personal responsibility of the officers of the company. So it was a bill to the four of us who were the officers for more than the net worth of the company. They were saying that what we did was manufacture a tangible property. None of the *banks* thought it was tangible property. [*Laughter*]

It was an example of how things can be interpreted to meet an objective.

**Martin Campbell-Kelly:** I'm Martin Campbell-Kelly. I've been writing a history of the software industry, looking at the years 1955 to 1995, and accounting is one of the issues I've really not got to grips with in the book. Part of the background to the software industry is that one constantly reads about how difficult it was to finance a company where the assets could walk out the door. And yet, what we actually have is a thriving industry. And people got venture financing. When you look at the business press, you can't get a clear picture of the evolution of the accounting standards.  But you pick up some little articles in the press that give you a sense that things are changing and that this must somehow be resolving the problem.

**Schoenberg:** Elizabeth, I'm not sure whether your title was provocateur, raconteur...[*Laughter*]

**Elizabeth Virgo:** I'm Elizabeth Virgo and I'm a consultant.  The reason I'm here is because of a long link with Burt Grad.  Burt and I did valuation studies.  I don't know how many we did for you, Larry, but it was really at the start of this whole concept of accounting for intangibles.  Burt and I started doing that, I think about 1978.

**Schoenberg:** Excellent choice in date, that's exactly the year.

**Virgo:** I can remember going to one of the FASB meetings and sitting there, really quite amazed that people did not understand this concept of intangibles.  As I said, we evolved and developed processes for our clients, and some of the work was scrutinized by the IRS, which was equally interesting. [*Laughter*] This was my first choice of the workshops to attend.

**Schoenberg:** As I mentioned to some people who were here earlier, everyone who is here gets a stock option. Two people asked me, "What company?"  Who cares? [*Laughter*]

**Durbin:** It's all lottery tickets, anyway.

## Subjects to Discuss

**Schoenberg:** In preparing for this session, a list of subjects that ADAPSO addressed came up. I'll read them to you simply because it may trigger some thoughts in your mind.  One of the first things on the list was creating a chart of accounts for service bureaus.  Although I wasn't involved with that, one of the most important things that happened at one of the roundtables I was a member of—which was one of the earliest ones and still exists today, twenty-five years later—was an issue related to our participation in gathering industry data or financial numbers. Those of us who were in the business could not understand the survey.  So we sat down together—the CEOs, not the financial guys—and actually worked out a common standard.  You might say, "How could it be that you couldn't understand it?"  I'll give you an example.  You're in the labor business.  Are social security taxes direct cost or indirect cost?  This is not trivial in a labor business; it could amount to 10%.  Where do technical support people fall? Are they direct labor or are they administrative cost?

It's not important how we resolved it, but the fact is sitting down allowed us to create something that benefited everyone.  It doesn't matter if it was right or wrong.  There is no right or wrong.  It

 © 2004 Computer History Museum 

was a matter of creating a standard way of doing it. That kind of thing was really important and I believe the trade association provided the ability for people to get together and do it.

Financial ratios: this is the same kind of thing I just talked about but relates to things such as growth rate, employees, etc. One of the wildest ones I ever spent time with was, "What's the revenue per employee, and what is the turnover rate?" You know, in companies that are growing fast, the turnover rate varies tremendously whether you start with the number at the beginning of the year, the average number for the year, or whatever. And, I must say, Harris, one number you threw out in your talk this morning that amused many of us in the audience was the idea that the revenue per employee has gone down in the industry. Which, of course, is not true. We were looking at totally different data and statistics. But it's a good example. If the press or some analyst gets that data, they'll say the industry's less efficient that it used to be. So you've really got to be very careful how you use some of this stuff.

SIC codes: why are these relevant? SIC codes, the Standard Industrial Code, are the way the government categorizes companies for labor statistics. What we discovered was that companies which had evolved from different backgrounds did not identify themselves by the same SIC code, although anyone could see that they were in the same business. We still see it today. Not only are the SIC codes confusing but if you look at the people who do research on the industry and you look at the companies that they group together, it's a joke. I look at the *Business Week* and *Forbes* lists, and direct competitors are not listed in the same category! The most *direct* competitors. So, to someone running these companies, it's a pretty stupid set of discussions. But it turns out to be very important, and even more so in an historical sense. And those are the kinds of things that ADAPSO was involved in.

**Jerger:** We found that critical when we'd go on the Hill to talk about issues. They'd say, "Who are you guys?" And they'd pull out the SIC reports and couldn't see us anywhere. We'd say, "Wait, wait, we're really important, we're all over." They'd say, "Yeah, right."

## Roundtables and Workshops

**Schoenberg:** The ADAPSO Roundtables, I believe, were what kept many people in the association. A roundtable was a group of people who self-selected into an area of interest and met on a regular basis. The problem with roundtables was that they tended to get people who were pretty direct competitors in one place at one time. This raised some antitrust issues and, since Teddy Roosevelt, the U.S. has had relatively stringent antitrust laws.

So there were serious questions about whether the people in the roundtables were violating antitrust law. The presentations last night mentioned Milt Wessel, the former General Counsel of ADAPSO. He was a very seminal influence in ADAPSO, and lectured us constantly about antitrust. Well, I can say that over forty years, I've never heard anyone discuss pricing, which is considered the ultimate sin. But I must say I heard things discussed that one could reasonably conclude had the potential for being collusive. Even discussing financial ratios. Clearly, if you know someone's cost ratios, it doesn't take a genius to figure out that there is a connection between cost and price, although it's not a pure connection.

**Campbell:** Larry and I have been on a roundtable together for over twenty-five years, and one of the reasons they survived is because they are naturally adaptive, and so the issues today are totally different. Twenty-five years ago, it was how do you commission a paid salesman or whatever, and those things have changed dramatically. I never felt there was, frankly, even a hint of collusion relative to pricing but, one time, I found something that was on the edge of collusion. It was when you and I, Larry, were both looking at acquiring the same company and there was no reason to get into a bidding contest. The company of a third member of the roundtable was for sale. Either of us could have bought it and you ended up buying it. We never quite said, "Let's not get into a bidding contest." But I suppose you could say that it was a factor, and it's interesting whether competing on acquisition activities would come under the normal rules of price fixing.

**Miller:** We tried without success to get roundtables going when I started with ITAA in the mid-1990s. One of the reasons was that people said the information shared among the founders of the industry is now available from so many sources, they don't need to come together anymore. You can get industry analysts, you can get consultants, because the industry itself has matured. So the kind of basic things you guys were talking about in the 1960s and 1970s and early 1980s, you can now pay somebody to give you that information.

**Durbin:** What the ADAPSO meetings were for me was educational. I came from the technical side of the business. There were all these management issues that I was blind to, and here were people who were just a little further along than I was. Sometimes I could contribute, but the learning experience was great because there were so many people groping for solutions. It was new stuff and I think it was the *new* character of it that was so important.

**Campbell-Kelly:** For people who are not familiar with ADAPSO, we're not getting a picture of what the roundtables were. How many people were there? What subset of those people were meeting? How often were they meeting and were you formulating policy that was being passed up into the organization or were you exchanging war stories and knowledge-sharing?

**Schoenberg:** First of all, the typical group was about twelve to fifteen people. People who wanted to be in a roundtable submitted their name and were invited to join or those that were already in a roundtable added names of potential new members. I was a part of the first two that were formed because I thought it was so valuable I wanted to see other roundtables get started.

The very first one was primarily people from service bureaus. I was the only person that wasn't. And the second one was essentially focused around professional services. The subjects that tended to be discussed were common business issues where smaller groups worked better and, as you would imagine, most of these roundtables evolved into social groups of a sort. I don't ever remember discussing ADAPSO issues.

**Campbell:** That second roundtable was actually a mix. We had software products people like John Maguire from Software AG, and Dick Thatcher from Atlantic Data Systems, and Bob Cook with VM Software. So it was a blend of services companies and software companies, and sometimes it was useful to have cross pollination. But the structure of the meetings, even today, is that one person has the group for an hour to say, "Here's my problem." And you just sort of talk about that problem so that it provides very personal support.

Everybody was young, frankly. The software and services industry was being created and the people running companies were in their 30's and 40's. They were sort of young to be running public companies or large companies and it was great to be able to share experiences. It's interesting that at the first meeting we actually had an outside moderator to make sure we didn't have any collusion. Right?

**Schoenberg:** In fact, Gil Mintz, one of the partners in Broadview Associates, moderated both of the first two groups.

**Campbell:** After the first meeting, we said we could do this without a moderator and we went off on our own. But we did worry about it. We had to make up the rules as we went along to some extent.

**Jerger:** I think in the late 1980s, early 1990s, there were probably thirty-five or forty titular roundtables. Maybe fifteen to twenty active ones. Does that sound right?

**Campbell:** Yes.

**Schoenberg:** I certainly was aware of about fifteen.

**Jerger:** How often did they meet? I think it was quarterly.

**Campbell:** We meet every six months. We've been doing that for over twenty-five years.

**Miller:** The analogue that exists today, like the enterprise software roundtable which Rick Crandall runs, is not personal-based, it's criteria-based. You have to be a CEO of one of these large enterprise software companies. So, unlike the old roundtables that Larry and Dave were talking about, if you lose your CEO job you don’t get invited back. The new CEO gets invited.

**Campbell:** In the early years we maintained that rule. If you lost your job, you could come to one more meeting and then you were out. But after we had been meeting for about ten years, it happened the bonds had gotten strong enough that we started waiving the rules.

**Schoenberg:** There was no one with a job! [*Laughter*]

**Campbell:** It *did* evolve that way.

**Schoenberg:** I just realized that I misread the item in the list of topics that was given to me. It says in the note, "CFO Roundtables and Workshops." I didn’t even notice "CFO" because, when we started, the organization was totally dominated by guys who ran companies. At some point in time, it became more functionally-driven and, actually, the first group to form a functional roundtable was not CFOs, but lawyers. Well, it didn't work because the lawyers wouldn't meet together.

## Classification for Taxation

At any rate, the next item that's listed is classification of software for sales and use tax and property tax. All of these things that sound trivial, like how to reduce your taxes, were highly interconnected. We were concerned with what you might call accounting issues, but they were actually issues related to the perception of value in the companies. We had this fantastic need to demonstrate that software companies had value. To whom? There’s no simple answer to that question. To the world at large. Yes, people had trouble with banks; they had trouble in the financial markets. But it was as much a matter of having created something that everyone said had no value. So it was a real emotional thing and only over time did it become something pursued by the accountants. The three original people assigned by the trade association to work on the accounting issues were myself, the CEO of AGS, Jim Porter, the VP of Marketing at Informatics, and Bill Graves, the COO of MSA. There was no accountant in the group. As people were replaced in the group, they tended to get replaced with accountants.

**Durbin:** There was a lead guy at Arthur Young who took a big position on the issues.

**Schoenberg:** Yes, Frank O’Brien. Frank worked for Arthur Young and he represented Informatics and a few other companies. He was a brilliant guy. But we got co-opted. The sequence of what happened was that we put out a white paper proposing changes to the accounting rules. I don’t remember whether we sent it to the accounting groups but somehow the AICPA got hold of it. They called up and said, "You shouldn’t be doing this, so we’ll create a committee to work on it.  You can assign three people to it and we'll assign three people to it and we'll work on the rules."  And so that happened.

You know, any of us who have ever negotiated anything in our lives know that you should never negotiate with anyone but a decision-maker.  Well, we made that mistake big time.  We negotiated with the people on the committee, then the group as a whole negotiated with the FASB, then the FASB negotiated with the SEC and by the time it was done, we couldn't understand our own rules.  They were absolutely incomprehensible to us.   The political process did it.

## Treating Intangible Assets

**Campbell-Kelly:** One of the questions that I was unable to resolve in my book was that it's commonly stated that there was a problem with these intangible assets.  And yet as I looked around, you have movie companies, you have firms who make encyclopedias, you have pharmaceutical companies, who also have intangible intellectual properties.  If pharmaceutical companies are managing to account for intangible assets, then what was the problem in the software industry?  Can you elaborate on that?

**Durbin:** We were trying to raise money in the late 1970s.  When we went to the venture capital community, they had already been badly burned by software companies claiming to have assets and then discovering that there was absolutely nothing there.   This was because there were no standards for those valuations and for how costs were to be associated with the valuations and how those costs were to be tied into the revenues downstream.   And if the revenue streams could not be evaluated, how could you deal with write-downs, and so forth?  There were just absolutely no standards.  So the rule that the VC's had was: take the intangibles off the valuation.  We had this huge problem of trying to differentiate product companies from service companies.  The product companies really did have assets.  We had invested a lot of money.  But the service companies' assets were just people and a lot of the investors couldn't make that differentiation.  They wanted to put us in the service category.  We were trying to make it clear that there was this other category which was a product business, and then determine how to value what we had.

What the VCs said was, "We'll take it off the balance sheet.  We will not value at all the investments you've made.  We're simply going to look your current revenue position."  Well, if you've got an early stage company, that doesn't work.  It was very difficult to get those valuations.

**Miller:** I think it also has to do with the physical manifestation of the intellectual property.  In the pharmaceutical industry, the intellectual property is the formula for the pill, but yet you can show someone the pill—that's the physical manifestation.  In the software industry the intellectual property is the code and, as Dave said, the physical manifestation of it used to be a deck of cards. And that's really different. So I think people had difficulty with it psychologically.

In movies, the intellectual property is a script; the physical manifestation is something you can sit in a movie theater and watch. But if you can't show people how that intellectual property exists in the physical world, they don't understand how to value it. Even today, when we lobby on the Hill, they say, "Where is the Internet?" Well, you know, it's not something you can point to. I can point to the Root A server that VeriSign runs, but I can't point to that the way I can point to a pill factory, or a movie studio, or movie theaters where the movie studio's work is shown.

**Durbin:** The analogy of a computer being like a projector is very strong but we couldn't get there. Could not get there.

**Schoenberg:** First of all, you have to recognize that one of the motives of accountants in general is to report revenues at the end of the life of the company. [*Laughter*]

In fact, there was actually one standard which you would never use except when the company ended. And to give you a bizarre example like that, I'm involved with a company that is a spin-off of my original company. The company eventually sort of collapsed of its own weight and became a shell. Now here it is, many years later. You know how bad it is liquidating a company. How about if I told you the company has gone from zero to $80,000,000 and is reporting profits regularly? All because it's the end of the company. All these things from the tax reserves, or this or that reserve, are all starting to surface. You know there aren't any assets, but all the money is surfacing. With cash, I might add, in this case.

At any rate, what happened in those discussions was the movie analogy would come up and they would use several arguments against it. One argument would be the stability of the entity itself. So the longer it's been in business, the better the valuation. Many accounting rules, I find—even the ones they propose today—are tremendously favorable to the large companies at the expense of the small companies. Which also means stable companies versus growing companies.

The pharmaceutical analogy never came up. But as a general principle, the pharmaceutical companies expensed everything because they didn't care. They were so established that they didn't have to care. It's intriguing. If you listen to the companies who support more stringent financial standards, which usually means delaying revenue recognition and taking expenses early on, it's invariably the very profitable large companies. This is hardly a shock, because they gain from it *tremendously*. So the problem here was that we had small growing companies with very limited histories.

**Campbell:** There were some interesting debates within the industry relative to the accounting issues. For example, on the sales tax issue. Sales tax is defined state-by-state rather than by the federal government, and that creates the potential for mischief. The debate was: is there a difference between a professional services company doing a million dollar project for an insurance company and a software products company selling a million dollar product? Should they be treated differently for tax purposes? When the sales tax rate was 7% and the average operating profit of the companies was about 7%, it was not a trivial issue. We simply didn't think we could afford the tax. And we were fighting against whether there should be any tax just about the time, in the late 1970s, early 1980s, when the PC came to the world with shrink-wrapped software sold over the retail store counter for $20. Now what's the difference between a $200,000 database system and a $20 VisiCalc? It was amazingly interesting and complex to try to get definitions. We ended up helping define the sales tax laws in New York and California. Then those became the patterns for lots of other states. But within the industry it was sometimes, "Yeah, we'll give up the software product guys." [*Laughter*] And they would say the same about the professional services guys. It was who got to the table first to sign the thing. And it was very interesting stuff because it was all pivoting around these definitions.

**Durbin:** But then we software products guys outfoxed you because we figured out that we could do electronic delivery so there was nothing tangible. We went to complete electronic delivery, so that we didn't even have to send a tape. We got tripped up a little bit, though, when we started doing some international sales because we couldn't make electronic transmissions, and Canada caught us taking a tape into Canada. And we had to try to say, "No, no, the tape is only worth twenty dollars." [*Laughter*]

**Schoenberg:** Actually there were other conflicts, too. I remember Marty Goetz trying to get some tax credit.

**Campbell:** The investment tax credit, right?

**Schoenberg:** It was more than investment tax; it was some sort of a local tax on products. I don't remember even what it was but to get these tax credits, he had to suddenly shift the definition to call it tangible even though for other purposes, he would call it intangible.

In my mind, all these issues always come back to what I started with: there is an economic reality. When laws and accounting rules move away from measuring economic reality to gimmickry, sooner or later you get into trouble. I mean, like with stock options. I know it's a very sore subject and I can understand why, but to argue that stock options have no economic value is ridiculous. It's just patently absurd. That doesn't answer the question of how they should be accounted for, right? But I suggested twenty years ago to several companies, including one represented here today, that we should have the stock strike price rise each year.

And my thought was, not only was it economic reality, but, in fact, we would probably get around the problem of determining present value because it wouldn't have a present value.  Or it would be really *de minimis*.  I guess, by definition, it has to have some value, but it would go down humongously.

**Capitalization Practices**

**Durbin:** Larry, could you talk a little bit about the conflict between the members of ADAPSO?   You mentioned earlier about the difference between small companies like mine who were very early in the stage of things and had a strong interest in being able to show that the company had value and that we had real assets versus some of the more established companies.  MSA had never capitalized a cent of software and they were ambivalent about it. On the one hand, they wanted to see it become the way to do things so that they could capitalize in the future, but they didn't want to have to go back and restate a whole bunch of stuff.  And then you had IBM who had their own position.

What I found interesting when I went to the FASB was that their fundamental issue was: we're not going to do anything that makes IBM restate their balance sheet.  So their inclination was to simply codify in the standard whatever IBM had been doing because that was the easy way to go.

**Schoenberg:** You know, Gary, I was involved in the ADAPSO effort from the beginning.  I did not know until something like three years after the process started that IBM capitalized software.

**Durbin:** They had two billion dollars worth.

**Schoenberg:** It did not appear on their balance sheet; they never mentioned it.  Only when they started to realize that the wording being developed for the standards could affect them, did they suddenly pop up.  And they did something very clever.  They tried to get the definition of who was covered by the standards to be only the software industry.  The original draft didn't say software industry, it said software.  But if you look at the original capitalization ruling, you will see that it excludes hardware companies. It left open the question of what IBM is; it said for those companies in the computer services industry.

Another group that it excluded was users, for similar reasons, because they knew the users would capitalize it.  *We* did not know the users would capitalize it.  They knew it and they were getting all this back door input that we didn't really have.

It is definitely true that there were always conflicts between small and large companies in the trade association, but I can proudly say that, generally speaking, the larger companies—and certainly those that were involved in this decision—understood that they were representing a broader constituency. And a lot of the things we eventually fought through, including such things as how you had to adopt the standard, were focused around small companies.

I constantly raised the issue about the analysts. FASB said, "What do the analysts want?" Of course, this is a different time and we all know now what we think of analysts. [*Laughter*] But I thought that, even back then, when FASB said, "We asked independent people, the analysts."

And I went off the wall. Independent??!! Now, their motive was not the same as it is now. Their motive was predictability. They didn't care about whether you had good results or bad results. They only wanted to be able to predict them. So, naturally, anything that spreads revenue, anything that does something along those lines, is clearly in their self-interest. But they were pure of heart. [*Laughter*]

At any rate, the small company versus large company issue was there. It's still there, Gary. It's a big part of the problem. The rules that they have adopted are horrendous for small companies. Much worse than the rules we would ever had made. They're terrible. And their justification is: we can't measure them; there's no past history. Even in some of the most basic new rules about revenue recognition they have a thing like "collectability." Well, how do you demonstrate collectability if you haven't been in the business very long?

**Durbin:** On the capitalization issue, you're absolutely right that the accountants wanted to look at it backwards. During the time we were building software at Tesseract, we couldn't capitalize. If we could have, we might have had maybe a million dollars on our books at any point in time, and that was writing down at a very fast clip. But then we went through an acquisition and the accountants came back in and said, "Oh, now we're going to take a look at this." Twenty-five million dollars was the asset they put on the books in the acquisition because now we were part of a public company. A twenty-five million dollar asset just appeared out of nowhere, and we had never been able to take advantage of the value up until that point.

**Haigh:** I have a related question. I'm interested in this issue of how purchasers would be able to account for software; I'm wondering, did ADAPSO have a position on that? Did you find the customer's ability or nonability to capitalize or depreciate a big ticket software purchase would actually make any difference to your company?

**Durbin:** We tried that pitch because we were selling big ticket software products—software licenses for a couple of million dollars—in the mid 1980s and it didn't help.

**Schoenberg:** Well, the fact is, the buyer could capitalize it, period. What I don't know is how many did. I know it was common to capitalize software purchases, but common is not the same as prevalent. Many did it but maybe many didn't do it. I don't know. There was nothing to prevent you from capitalizing anything that was purchased.

**Jerger:** We had a smaller company, and our product cost about $300,000. It would get over a budget level and we'd get resistance. And we'd tell them to capitalize it. Usually it worked. [*Laughter*]

**Durbin:** Well, some of them would and some of them wouldn't. I don't think it ever made a difference in a deal that they could capitalize it. If we couldn't do the deal on the ROI, it didn't matter. Afterwards we'd get to the CFO and we'd tell him what games he could play and either he'd do it or not.

**Haigh:** So why was it much easier to handle the accounting on the customer side than it was for the suppliers?

**Schoenberg:** Because of the accounting rules. The accounting rules simply said, if you purchase something, you purchase something. Think about it as inventory that the customer has, OK? But the software company doesn't have inventory, it has a work in process.

**Jerger:** But if you paid cash for it, all of a sudden it became inventory.

**Schoenberg:** That's right. In fact, there's been all this talk lately about off balance sheet items. Well, a lot of the early off balance sheet accounting wasn't to make it look like you didn't have assets, it was to make it look like you *did* have assets—another perfect example of how dumb rules get turned on their head. The idea was that if you created a separate entity that you could buy the software from, then you could capitalize it. So we had the opposite of what you're seeing today, which is you keep it off your books because it looks like death. We had the opposite. Was it in the 1970s that they started the R&D partnerships?

**Durbin:** 1970s and early 1980s.

**Schoenberg:** OK, so here you were. You were spending money developing a product and the amount of dollars you were spending was very large relative to both your earnings and your net worth. So it was a material item. And if you did it yourself, it was an expense for that accounting period. If it was done by a group that was related to you but in some way could be defined as independent, it was capitalized.

**Durbin:** This is still going on. If you look at a couple of deals: PeopleSoft's deal with spinning out their R&D organization, and Rational setting up a company in conjunction with a VC to fund the web conversion of their portfolio products. Both of those have done exactly that to move the expense into this somewhat arm's length relationship and then buy it back and capitalize it when they buy it back.

**Schoenberg:** That's correct. In addition, when you run a company you always get to the issue of, well, I could save three cents for the next quarter. [*Laughter*] Or I could recognize the expense earlier. So you ask the question, "When do I need it the most?" And you discover you don't know. I eventually came to the conclusion that I would do it straight-up because you know who gets the most confused by playing these games? Not my shareholders. Me. *I* get confused because I don't know what I've done after awhile.

**Miller:** Larry, I'm going to have to run to our Software Division Board meeting. They're talking about accelerated depreciation and tax credits. [*Laughter*] Thank you all very much.

**Durbin:** What was amazing was that Tesseract was selling software to companies which, when they bought the product, capitalized an asset that was more than we had on our balance sheet.

**Financial Considerations in Investment Decisions**

**Campbell-Kelly:** Question. You make accounting sound a lot harder than writing software. [*Laughter*] How much of a distraction was it? Did it create a lot of friction in the development of the software industry?

**Durbin:** Yes, I think it did. I didn't know much about accounting. I knew that debits were to the window and credits to the door when I got into this. [*Laughter*]

**Schoenberg:** He was in a right-handed room. [*Laughter*]

**Durbin:** And, it was not something that I really wanted to get involved in. But my CFO brought these issues forward and all of a sudden these software accounting issues became survival issues. The accountants changed their mind about how we could treat the development of our software and the bank was going to call my credit line. I mean, that was how critical these issues were. All of a sudden I was on top of these issues big time and spending a lot more time dealing with them than I really wanted to. I wanted to be involved in software development and working on the next product and so forth. It ended up taking a lot of time and I ended up becoming expert on this very small aspect of accounting.

**Jerger:** I agree, but if what you're asking is, "Did it ever forestall someone from going ahead and developing new stuff?" I expect not. We went ahead and developed the stuff. We got angry as the devil about it and we went nuts trying to deal with it. But you had to develop new products, so you did. You never said, "Oh well, because of the accounting problem, I'm not going to do it."

**Durbin:** But it did affect investment.

**Jerger:** Oh, yes, it affected investment.

**Durbin:** For us, it slowed down the ability to raise money, big time. And that's the issue that drove me crazy.

**Campbell:** It had a big impact on investment decisions. For example, the impact on the decision to open a new office or buy a company was extraordinary. Both Larry and I, for example, did several dozen acquisitions. You could spend three million dollars in cash to open an office and get it to cash flow breakeven, or you could write a check to someone who had a business in that city and buy a cash flow breakeven business. One would think these were the same. The three million dollars you would spend to open an office was current expense in the five quarters or so before you got to breakeven status—a terrible cost. You could only afford to do two or three a year. But you could write checks for three million dollars to ten companies in the same month, and it didn't cost you a penny because that was all capitalized.

So, between writing the same three million dollar check and applying it in two different ways, there were totally different accounting treatments. And the investment community, which wanted to measure consistent earnings, would punish one and applaud the other and it wasn't logical. It wasn't necessarily good business practice.

**Schoenberg:** Martin, I think in some degree that this response is overstated. It's overstated because one person says that he had a problem with getting money. Dave Campbell talks about the investment community. Well, the question is, "What percentage of people developing software were constrained by either one of these factors?" I think that overall it was probably not a huge percentage. That is, many companies were either of a size or didn't have the public pressures—there wasn't the same kind of demand for short-term performance twenty years ago as there is now—so that they weren't affected. I think you're hearing from people who were more on the cusp. I don't think the impact was as general as they said, but I *would* disagree with Doug's statement because I know absolutely, as someone who ran a company, that we decided not to develop products because of the accounting implication.

**Jerger:** I don't believe that.

**Schoenberg:** Well, I simply said no to the development.

**Jerger:** The difference could be that you were a lot bigger company at that point than we were.

**Durbin:** For you and me, Doug, it was survival. We only built products that we absolutely had to have anyway.

**Schoenberg:** I'd like to add that it does not mean that the product was not developed. It means I refused to develop it in the context in which it was presented to me. I might have done something akin to what Dave talked about. I might have done something about setting it up as a separate entity. So I'm not implying that it stifled innovation. I'm implying that for those companies for which the reported numbers were significant, it definitely stopped some things from happening.

**Durbin:** I talked a long time with the CFO at MSA and he felt very strongly that the accounting practices were inhibiting them. And, clearly, MSA lost ground to new companies like PeopleSoft and Tesseract that came and took their markets away from them. And he said it was partly because of their inability to make the investments at the time that they should have.

## Valuation of Software and Services Companies

**Schoenberg:** One of the other items on the list was valuation. How valuation of software companies was impacted by accounting issues. Well, I think we're really discussing that. I personally think that one of the big differences is small versus large companies, established versus non-established, and whether you had a mix of products and services. At AGS, by the time we were done, we had a lot of software products as well as services, and it was much easier to handle. You set a budget of so much a year for this sort of thing and you didn't think about it again. That money was just gone.

But I do believe it was a major factor in acquisitions on both sides. It not only meant it was cheaper to buy than to build, but if people are buying companies, then people will create companies to be bought. And the cycle goes round and round.

**Campbell:** People could create private companies to be bought and public companies could buy them. That was one of the differences.

**Schoenberg:** Right. I always felt when I evaluated a product internally that no one included in that cost a multiplier for the probability of success. Have you ever wondered in software product companies who paid for the products that failed? You can never find who paid for the failures. They just sort of disappear from the face of the earth.

**Durbin:** And 80% failed.

 © 2004 Computer History Museum 

## Industry Cooperation

**Schoenberg:** At least. OK, does anyone else have some other issues? I guess we don't have anyone here to talk about the service bureau issues. I don't remember very much about them. I think their problems related to the fact that they were very small companies and it was an educational process. I think one of the things that all of us who were involved with ADAPSO in the early days can be very proud of is the amount of time and energy we put into helping other companies start competing against us. It was not uncommon for someone to get up and tell a competitor how to run a business. It's a pretty extraordinary idea.

I had a conversation with one of the historians here about the difference between people who joined the trade association and those that *didn't* join the trade association. The people who joined the trade association were essentially people who saw the world as not a zero sum game. They said to themselves, "Helping this guy is not hurting me, it's increasing the total pie." Whereas the people who didn't join tended to be people who saw the world as zero sum. If I help you, it's coming out of my pocket. I bet this is generically true with trade associations.

**Campbell:** But one of the things that was unique about this industry was that our real competitor was the customer doing it for themselves. And so to the extent that we could make the customer comfortable with giving an outside company responsibility for creating their payroll system, for creating their database, whatever, that was a major hurdle for us to overcome. So we all really did benefit from helping everyone trust that there was a real industry, that these were real companies, and that turning responsibility for a $1,000,000 or $5,000,000 project over to a pretty small outside firm was an appropriate action to take. That was a big deal for us which made it sensible for us all to help each other.

**Schoenberg:** And, of course, the ultimate reason you help someone is because you think some day it will be you. I helped Dave with the sales tax, but I wasn't just trying to help him survive, I was saying, my God, I could be next.

**Campbell:** When we had that sales tax meeting in New York, I invited a group of people that I knew would all be affected. And I literally handed out Xeroxed copies of the tax invoice to the company and said, "Guys, they got me, they're going to get you." We raised $100,000 at that meeting. And then we spent the money to fight the legislation and two years later we won. It was a long, long fight.

**Durbin:** We had the same fight in California. Because once New York had done this, then all the other states decided it was a good idea and they implemented some of the drafts of the New York legislation so it was even worse.

**Campbell:** There were actually words missing in some of the drafts that got picked up by other states. It was an amazing exercise in how legislation gets passed because, although you can question how much accounting impacts a business, taxes can be passed at any time and they truly influence business behavior.

**Durbin:** Well, the idea of making this *retroactive* for years! My heart fluttered when I found out.

**Jerger:** He was absolutely apoplectic when he heard that.

**Durbin:** When I saw Dave's invoice, I went, "Oh my God, if they did that here…"

**Schoenberg:** Well, it is amazing that tax is as large a line item as most of us ever find on a financial statement and yet very few people pay much attention to it.

Well, let's see, what we can bring together from this. I think the feeling that I always had was that it wasn't financial issues that were driving companies, which is, I guess, what Doug's been constantly trying to say.

**Jerger:** As a former accountant.

**Schoenberg:** The reason is he doesn't want to be liable. [*Laughter*] But as in all things that we ever deal with, when something is a problem because it's irrational, it comes out in ways you cannot possibly imagine or think about. I just had an experience with a company I won't mention because this is going to be on the public record, but we were at a 100% club meeting and the most senior people who ran operating units got up to talk. And each one of them said he couldn't have been there without the help of his CFO, and my stomach turned. My stomach actually turned. I said, "Oh my God!" I think it was only meant as social courtesy but imagine if it was meant literally. It's a *terrifying* thought. And so we can't really hide from the implications of allowing other people to control how we report our numbers to ourselves.

You know, my whole thing is that I don't produce accounting reports for the outside world. I produce them to help run the company. And that's how accounting should be. It should help you run the company, not be some goofy idea of how someone else should read them. I studied the background on accounting rules when I went to the FASB. Accounting rules were set up originally to help *creditors* not owners. To help creditors determine whether or not they could get their money back. It was done by foreign governments. So you can understand in that context why being conservative, or careful, I guess is a better word, would be a useful thing. They weren't meant to literally quantify the process that you were going through. That principle never changed even though the use of it totally changed,

**Jerger:** I get *CFO* magazine. If you read that, you see that they are promoting being part of the operating effort. So I'm not sure that what those people said was just a social courtesy. The CFO really impacts a lot sometimes. It annoys me as I flip through the magazine that they are doing too much that affects how a company decides to do things from an operating perspective. But they're also kind of stuck with it.

**Schoenberg:** You know of all the current problems with Arthur Andersen. I'm head of an audit committee where Arthur Andersen is the auditor and my first response was, "Listen, it's the goddamn company's numbers, not the auditors' numbers, don't give me this crap." But they've explained to me that, in some cases, the auditors have actually suggested procedures that might be beneficial to the company. I personally had never heard that before. I never had an accountant come to me and tell me, "You know, if you did this you'd get a different treatment." Never in my life.

**Jerger:** They're probably afraid to. [*Laughter*]

**Durbin:** Larry, to address the point that you were making earlier, I think it's a very, very important point that in the early period the accounting rules were of no help to somebody who was trying to manage the company and look to accountability. I have a product here. What was my investment in that, what is my return on that? How do I hold product managers accountable for the money they're spending on R&D? These are the kinds of things that I wanted to look at as a CEO and the accounting policies were completely contrary to that. My CFO said, "Well, we can do this for our internal management, but for reporting, we're going to have to do something completely different." So, the way you're looking at the business and the way anybody is going to look at it from the outside are going to be diametrically opposed.

**Schoenberg:** Well, our time is up. Thank you all very much. I learned plenty and I hope we recorded something that we can use in the future.