SEC Investigates Lernout & Hauspie Over Alleged Inflated Sales Figures

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Securities and Exchange Commission sleuths are investigating a startling surge in sales at Belgian software maker Lernout & Hauspie Speech Products NV. They may find that a key stop on the money trail is No. 5 Shenton Way in downtown Singapore.

The SEC probe, which L&H confirmed Thursday, apparently is focusing on the once highflying company's recent dramatic sales increases in Asia and its dealings with corporate customers to which it has financial ties. The modern high-rise at No. 5 Shenton Way is the official address of 15 firms that together paid L&H $57 million last year, nearly 17% of its world-wide revenue. L&H says these customers bought licensing rights to its speech-recognition software.

But at the Shenton Way building, there isn't any evidence of operations of the 15 L&H customers. Their address leads to a law office, where Tan Lee Chin emerges to meet a visitor. Ms. Chin, who is listed in Singapore government records as an officer of a number of the L&H customers, confirms that many of the companies are indeed registered at that address but declines to say more.

Interviews with L&H officials and a review of regulatory filings and documents provided by the company reveal that nearly all of L&H's revenue in the Asian city-state have come from the 19 companies. Nearly all of the companies were launched just last year, and L&H helped create all of those start-ups. L&H also recruited and trained their initial employees. None of the putative customers started last year has had any revenue, according to an outside L&H spokesman. In addition to sharing addresses, many of the customers have the same officers and nominee shareholders.

As L&H's stock price fell 29% Thursday, the company issued a short statement saying that it is cooperating fully with the SEC investigation. "We are determined to resolve these matters," Jo Lernout and Pol Hauspie, co-founders and co-chairmen of the company, said in the statement.
The company has directed all specific inquiries to the outside spokesman, who himself insisted on not being named. The spokesman said Thursday that all of the company's revenue and transactions in Asia "are real, and we are confident they will be validated as such."

The Singapore companies were linchpins in L&H's quest to become a world leader in the explosive market for speech-recognition and language software -- products that allow computers to recognize spoken words and turn them into text. L&H's software products dominate the U.S. retail market under such brand names as L&H Voice Express and Dragon NaturallySpeaking.

Last year, L&H reported that its worldwide revenue rose more than 60%, fueled by huge growth in Asia. In Singapore, sales soared to $80.3 million, from just $29,000 the prior year. With its U.S. sales flat, Singapore became the company's largest market.

But eight of the Singapore start-ups have had financial ties to a Belgian venture-capital fund that has close links to L&H, according to regulatory filings and documents provided by L&H. The venture outfit, Flanders Language Valley Fund, was the brainchild of L&H's two founders, Messrs. Lernout and Hauspie, who still exercise influence over the fund's affairs.

FLV Fund currently owns 49% stakes in four of the eight Singapore companies, according to documents from L&H and the fund. The other four companies received cash from FLV Fund in late 1999, which they used to pay their bills to L&H, the outside L&H spokesman says.

FLV Fund's involvement in the Singapore companies raises the possibility that L&H's fast sales growth may not be all that it appears. The revenue burst may have been at least partly self-funded -- that is, paid for by L&H affiliates. That is one of the allegations made in recent years by short sellers -- investors who bet on a company's stock falling -- and other critics, including certain brokerage analysts, market columnists and Internet chat-room participants.

L&H has joint headquarters in Ieper, Belgium, and Burlington, Mass., and its stock trades on the Nasdaq Stock Market and Europe's Easdaq market. In 4 p.m. Nasdaq trading, L&H's already-hammered shares fell $6.13, to $15.13, down 79% from a high of $72.50 in March.

The company's audit committee has launched its own investigation with the help of outside lawyers, L&H reiterated in its statement Thursday. After a Wall Street Journal story last month, the company also commissioned a special midyear audit by its outside accountants, aiming to allay investor concerns about its sales in Korea, which have shown spectacular growth similar to that in Singapore.

In late August, the company replaced its chief executive, Gaston Bastiaens, although L&H said the move wasn't related to questions about its Asian sales. John Duerden, the newly appointed CEO, said in Thursday's company statement, "We have not yet received the results of [the special] audit, but we look forward to its completion at the earliest possible date."

The SEC probe is another blow to a firm that had been hailed as one Europe's high-tech stars. L&H was started in 1987 by Messrs. Lernout and Hauspie, entrepreneurs who had a vision of computers that could understand the human voice. The duo became multimillionaires when the company became Belgium's first to go public on the Nasdaq in late 1995.

L&H has swallowed numerous technology start-ups and some of its key competitors, and for a time
appeared to dominate this lucrative and expanding market. At its peak earlier this year, the company briefly boasted a $10 billion market capitalization. Messrs. Lernout and Hauspie became celebrities in Belgium, a small country not known as a technology hotbed.

But short sellers and other critics have long said that L&H's growth was questionable. The company, they claimed, clouded its financial results through serial acquisitions and artificially boosted its growth through transactions with firms that have close ties to Messrs. Lernout and Hauspie. As recently as 1997, sales to such related entities accounted for nearly 22% of the company's revenue, excluding sales to Microsoft Corp., which owns a small stake in L&H.

Many investors monitor related-party dealings closely because in some cases, such transactions can be used to artificially inflate sales. It is difficult for outsiders to know if one party is benefiting unduly.

L&H's outside spokesman acknowledges that investors are concerned about the issue, but he says the company has reduced its dependence on related-party dealings. L&H thought it had put the matter behind it, after reporting last year that about 1% of its non-Microsoft revenue was from such transactions.

In explaining its growth in Singapore, L&H's outside spokesman says it was interested in expanding its products to numerous additional languages and applications but anticipated that the move would be expensive and risky. So, the spokesman says, the company decided instead to set up "franchise" arrangements, in which it would sell the exclusive rights to its technology for a specific application or language -- such as Urdu, commonly spoken in Pakistan.

The concept was that outside investors would take the risk of developing the application, and L&H would share 50-50 in future revenue, the L&H spokesman says. Meanwhile, L&H would receive upfront payments for the exclusive rights.

But rather than sell the rights to already-established companies, the L&H spokesman says it recruited outside investors to set up special-purpose entities.

Who were the investors? All the spokesman will say on this score is that there were at least 10 investors, that they came from Europe, the Mideast and Asia, and that they weren't officers or directors of L&H or under its influence. As part of the arrangement, L&H agreed to recruit and train five initial staff members for each of the start-ups, the spokesman says.

Documents supplied by L&H show that the first such agreements were struck in the second half of 1998 with seven start-ups based at the same address in Arendonk, Belgium. Those companies paid L&H $21 million, or 10% of its global revenue that year, for rights to languages such as Czech, Polish and Farsi, the language of Iran. L&H has never disclosed details of these deals to investors.

The arrangement went global in 1999, when L&H signed deals with the 19 Singapore companies, in addition to four more Belgian outfits. The L&H spokesman says the company chose Singapore, in part, because of the city-state's favorable tax treatment of high-tech start-ups and its strong laws protecting intellectual property.

In this fashion, L&H says it sold rights to languages such as Urdu, Malay, Taiwanese, Armenian, Arabic and Vietnamese. Seven of the customer companies also paid for the technology to develop "cross-language" versions of L&H software, which work by translating between language pairs that don't include English, such as Italian and Japanese. Another six customers licensed L&H material for what the
company calls "intelligent-agent" applications, which use language technology for improved searches of the Internet and other giant databases.

In total, the Asian and Belgian companies paid L&H $85 million in 1999, or about one-fourth of its total revenue of $344.2 million that year.

According to L&H's documents, most of the companies paid either $3 million or $4 million each for their rights. The fees don't seem to be closely related to the relevant potential market size. Armenian rights, for example, cost more than Polish, even though Poland's population of about 39 million is 10 times that of Armenia, and its economy is much more developed. The L&H spokesman says the licenses were priced similarly because the company wasn't sure about the potential market for a given language or application.

Although L&H declines to identify most of the investors in these start-ups, at least one is known: the FLV Fund. The fund, which is publicly traded in Europe, is based in the same Belgian city as L&H. The fund invests in the same sector as L&H: high-tech speech and language systems. And the group of investors who set up FLV Fund in 1995 included Messrs. Lernout and Hauspie.

That pair are no longer directors of the fund. But through a nonprofit foundation they control, they have nominated two of the 10 members of the board of the management company that directs the fund's investments. The management company, in turn, is headed by a former L&H director.

Messrs. Lernout and Hauspie spend a "portion of their time" on FLV Fund activities, according to L&H filings with the SEC. Because of these close links, L&H considers FLV Fund a related party in its public filings and has disclosed sales to certain other companies partly owned by FLV Fund.

In September 1999, FLV Fund made its first investments in Singapore, paying $8 million for 49% stakes in four of the entities that had licensed L&H software. The companies -- now called I-Merge Pte., I-Office Pte., I-Mail Pte., and I-News Pte. -- had become L&H customers in the first quarter of 1999, paying their $10 million fees the following quarter, according to documents provided by L&H.

Philip Vermeulen, managing director of FLV's management arm, says the fund's investment decisions "absolutely" are not influenced by L&H. The fund is run "solely with the interests of our shareholders in mind," Mr. Vermeulen adds.

The L&H spokesman says his company "absolutely did not influence FLV Fund's decision" to invest in the Singapore companies.

Because the investment by FLV Fund came after the four companies paid L&H, the Belgian software company didn't have to list these as related-party transactions in its SEC filings, the L&H spokesman says.

Paul R. Brown, chairman of the accounting department at New York University's Stern School of Business, says that under standard accounting practices, such a transaction "definitely" would have to be disclosed in the company's annual report. "Even if they weren't a related party then [when the four customers paid L&H], they are now, and investors should be told about it," Prof. Brown says.

In last year's fourth quarter, FLV Fund also invested $10 million for 49% stakes in four other Singapore start-ups that were customers of L&H. The L&H spokesman says the investment was used to pay the Belgian software company $8 million still owed by these four companies. The quartet of start-ups had
agreed in the third quarter of 1999 to pay L&H $16 million for software rights, according to documents provided by L&H.

But again, the L&H spokesman says, there was no need to disclose these as related-party dealings. In this instance, the reason that disclosure wasn't necessary was that FLV Fund disposed of the four stakes so quickly -- before the end of 1999, the L&H spokesman says.

Mr. Vermeulen, the managing director of FLV Fund's management arm, says the fund sold the stakes for $11 million to a Korean company, Human Interface Worldwide Co., on Dec. 24, 1999. From there, the path of the money gets tangled.

Human Interface was itself a start-up, incorporated just three weeks before the FLV Fund deal. Human Interface also was formed to commercialize L&H's speech-recognition technology. The Seoul-based company, which describes itself as a developer of speech-recognition computer chips for toys, has no revenue as yet.

But nine months after the transaction, FLV Fund hasn't received any payment from Human Interface, according to Johnny Kegels, an FLV Fund spokesman. Mr. Kegels says the fund expects to be paid by the end of this year. "Of course we will be paid," agrees Mr. Vermeulen, who blames Korean foreign-exchange regulations for the delay.

Although FLV Fund says it no longer owns the stakes in the four firms, Mr. Vermeulen remains an officer of all four. That's because "payment is not fully done," Mr. Vermeulen says. He adds that companies often have independent directors.

There seems to be some confusion about the deal at Human Interface. At first, three Human Interface officials, including its current chief executive, J.J. Cho, said in interviews that they knew nothing about the transaction. Mr. Cho and the other two officials also said their company had no stakes in the Singapore firms and didn't owe any money to FLV Fund. "We don't owe anything, even a dime, to FLV," said Mr. Cho. He added that he carefully reviewed the company's books when taking his post in July and no such debt was included.

In a subsequent interview, however, Mr. Cho said he had checked with Human Interface's majority shareholder and confirmed that the company did indeed owe money to FLV Fund. But Mr. Cho said he didn't have any more information about the transaction, adding that he was "going to find it out."

L&H has characterized the start-up companies as independent. But L&H also has agreements that allow it to acquire at least some and possibly all of these companies at any time, at a substantial premium over the amount the investors in the companies had paid, according to the L&H spokesman.

Such arrangements can be used to allow a company to overstate revenue and understate research-and-development expenses. If, for example, one of the companies is successful and L&H subsequently purchases it, L&H would have received credit in 1999 for the license fee paid by the now-acquired company. L&H would have avoided costly R&D expenses in the interim. And buying the company would allow it to write off much of the purchase price over a lengthy period, resulting in only a small dent in earnings, while leaving operating cash flow undiminished.

The L&H spokesman says the intent of this arrangement was not to hide R&D expenses or boost revenue. The primary reason for the buyback clauses, he says, is to protect L&H in case one of the
start-ups failed to develop the software in a proper and timely manner. Then, presumably, L&H could recover the rights through the buyback.

L&H has bought back licensees before. In 1997, the company was paid $5 million by a newly formed entity, Brussels Translation Group NV, for an exclusive license to develop L&H technology. BTG, which L&H's outside spokesman says is owned by investors based in Belgium, subsequently paid L&H another $30 million to help develop BTG's products.

Last year, when the work was completed, L&H bought BTG for $42 million, plus the assumption of $17 million in debt.

-- Robert Frank in Singapore contributed to this article.

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