

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 52409 / September 13, 2005**

**ACCOUNTING & AUDITING ENFORCEMENT**  
**Release No. 2309 / September 13, 2005**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-12036**

**In the Matter of**

**NCO GROUP, INC.,**

**Respondent.**

**ORDER INSTITUTING CEASE-AND-  
DESIST PROCEEDINGS, MAKING  
FINDINGS AND IMPOSING A CEASE-  
AND-DESIST ORDER PURSUANT TO  
SECTION 21C OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against NCO Group, Inc. (“NCO” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

### **III.** **Findings**

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that:

#### **A.**

##### Respondent

NCO is a Pennsylvania corporation headquartered in Horsham, Pennsylvania and is the world's largest provider of debt collection, accounts receivable management services, and other outsourced revenue cycle management services to a broad range of clients in the United States and overseas. Most of NCO's services to date have focused on the recovery of traditional delinquent accounts, that is, accounts more than 90 days past due. NCO generates approximately 70 percent of its revenue on a contingency fee basis. Founded in 1926, the company went public in 1996. NCO's common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and is quoted on the Nasdaq national market system. NCO's fiscal year ends December 31.

#### **B.**

These proceedings arise from NCO's use of two accounting practices that contravened generally accepted accounting principles (GAAP): a "one-day-after" policy for recording incoming checks from collections on delinquent accounts, and a methodology for recording anticipated fee revenue under a long-term services contract.

##### NCO's One-day-after Policy

In each of its periodic filings with the Commission NCO has represented that its "contingency fee revenue is recognized *upon collection of funds* on behalf of clients."<sup>2</sup> Despite its stated revenue recognition policy, NCO has consistently, since a time prior to going public, been applying an undisclosed "one-day-after" policy to its contingency fee revenues, by recognizing revenues from collections postmarked prior to the end of the reporting period and received in the mail from consumers on the first business day of a subsequent reporting period as though they had been received and earned in the prior reporting period.

NCO's rationale for this policy was twofold: *first*, that NCO was in "*constructive*" receipt of the payments when they were delivered to NCO's "*agent*," the U.S. Postal Service, by being placed in the mail; and *second*, that any payments received on the first

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<sup>1</sup> The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

<sup>2</sup> See "Notes to Financial Statements" sections of each of NCO's Forms 10-K and 10-Q, under the "Revenue Recognition" heading [emphasis added].

day of a new quarter must necessarily have been mailed, and therefore earned by NCO, during the prior quarter.

NCO's "one-day-after" policy contravenes GAAP because it accounts for contingent fees as revenue before the earnings process is complete. The majority of NCO's business has been collecting payments from debtors who have already defaulted on outstanding payment obligations owed to NCO's clients. NCO earns as fees a percentage of the amount it collects. Because NCO's fee is contingent, NCO's earnings process is not complete until NCO in fact receives the collections. Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* ("CON 5") (issued in December 1984), provides that "[i]f collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received." Staff Accounting Bulletin (SAB) 101 *Revenue Recognition in Financial Statements* (released in December 1999) counsels against and CON 5 precludes accounting for contingent fee payments from a subsequent reporting period as revenue in the prior period. CON 5 requires that revenue is generally realized or realizable and earned when the seller's price to the buyer is fixed or determinable, services have been rendered, and collectibility is reasonably assured. In cases in which revenue is contingent upon some specified future event, SAB 101 provides that such contingent revenue "should be recorded in the period in which the contingency is resolved." NCO's position that the company has earned fee revenue because it is in *constructive* receipt of payments once the *check is in the mail* does not meet the provisions of CON 5 and SAB 101.

NCO's policy of recording in a prior reporting period contingent fee revenue derived from a subsequent reporting period also amounts to recognizing a gain contingency, which is specifically prohibited under paragraph 17(a) of Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies* (issued in March 1975). In particular, the contingencies attending NCO's collections are not resolved until NCO actually receives the payment. Accordingly, NCO's "one-day-after" policy prematurely recognizes contingent fee revenue one business day before it is actually earned.

NCO has consistently applied the "one-day-after" policy over time. Therefore, NCO's quarter-to-quarter and year-to-year financial statements reflected trends in revenues and earnings with some consistency.<sup>3</sup> In order to comply with GAAP, as well as to comply with NCO's own publicly disclosed revenue recognition policy, retroactive correction of the policy would entail reversing out the "one-day-after" fee income from the end of a period but adding in fee income improperly recorded in the prior period. In other words, the impact of correcting the back end of the period would be offset, in whole or in part, by correcting the front end of the period. As a result, retroactive correction of this practice

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<sup>3</sup> Note, however, that because NCO's policy included one additional *business* day, periodically, if its quarter ended on a Friday, NCO received the benefit of weekend mail deliveries as well as the following Monday's deliveries. This occasional increase in revenue sporadically increased the amount of revenue recorded in certain quarters.

would not materially differ from NCO's previously reported financial statements as NCO would report 90 days of revenues and expenses on a quarter-to-quarter basis and 365 days of revenues and expenses on an annual basis. However, by eliminating the "one-day-after" policy altogether NCO has reported a material one-time reduction in pre-tax income. That is, by ceasing the "one-day-after" policy, NCO has reported 89 days of contingent fee revenues but 90 days of expenses for the quarter in which the correction was made. For the fourth quarter of 2004, the correction resulted in a one-time reduction of pre-tax income of 7.5 percent. Additionally, ceasing the one-day-after policy resulted in NCO reporting earnings per share of approximately 35 cents, thereby not meeting its earnings per share guidance of 38 cents to 42 cents.

#### NCO's Long Term Guarantee Contract

On September 27, 1999, NCO entered into a long-term collection contract with a large customer (the "Contract"). The Contract went into effect on January 1, 2000 and continued until December 31, 2002. Pursuant to the Contract, NCO guaranteed that it would collect set minimum amounts of money, with the contract minimums based on historical benchmarks. In return for making the required collections, NCO's customer agreed to pay NCO a base fee of 16.9 percent for each dollar NCO collected plus a bonus equal to 25 percent of each dollar NCO collected in excess of the minimum thresholds. For each dollar by which NCO fell below the minimums, NCO agreed to pay a penalty of 75 to 100 percent of the shortfall. At the time, the Contract required NCO to compare the projected minimum threshold amount to the actual collection amount and to collect any aggregate net bonus or pay any aggregate net penalty 45 days after the end of the first year of the contract and 45 days after each six-month period thereafter. These interim payments were to be applied to the final cash reconciliation of penalty and bonus payments between NCO and its customer, which was originally set to occur 150 days after December 31, 2002. After the final reconciliation NCO would not be required to pay any additional funds to the customer, but through its continued collection efforts, NCO was entitled to recoup 90 to 100 percent of any penalties paid. Additionally, where NCO was in a bonus position at the final reconciliation, NCO was entitled to incremental bonuses from collections received after the date of the final reconciliation.

NCO recognized the base collection fee it received from current period collections as current period revenue. NCO also recorded the ratable portion of bonuses net of penalties in the current period based on a collection curve derived from historical experience with this client. To justify its accounting for the bonus provisions of the Contract, NCO analogized to the percentage of completion accounting methodology outlined in Statement of Position ("SOP") 81-1 *Accounting for Performance of Construction and Certain Production Type Contracts (issued in July 1981)*. However, SOP 81-1 specifically applies to "construction-type" contracts and does not, by its terms, ordinarily apply to "service transactions," particularly debt collection services. NCO also based its analogy to SOP 81-1 on the long-term nature of the Contract, and took the position that the production of "cash" served as this accounting treatment's requisite "tangible property."

NCO's method of accounting for the Contract contravened GAAP. As described above, CON 5 and SAB 101 provide that contingent revenue may be recognized only upon elimination of the underlying contingencies. The base fees and bonuses provided for in the Contract represent contingent revenue. NCO was not entitled to record contingent fees and bonuses as income until it had collected sufficient contingent payments to meet pre-determined thresholds and the collection results were reconciled with the client. Collectibility of the bonuses was not reasonably assured until the pre-determined thresholds were met and the collection results were reconciled with the client. In October 2000, just after the close of NCO's third quarter, SEC staff released SAB 101 Frequently Asked Question ("FAQ") No. 28, *Fixed or Determinable Fees*, which specifically addressed service contracts like the Contract. FAQ 28 directly addressed this type of service contract and fee arrangement. FAQ 28 provides that companies who earn fees based on such collection contracts "must wait until collections occur before recognizing revenue." Therefore, once the minimum collection thresholds were met NCO was only allowed to record base fees and bonus revenue to the extent that collections occurred. NCO did not make any change in its method of accounting for the Contract when the staff released FAQ 28.

Contrary to NCO's analogy, SOP 81-1 does not apply to service contracts except for "services essential to the construction or production of tangible property, *such as design, engineering, procurement and construction management.*"<sup>4</sup> In fact, the Notes to SOP 81-1 expressly explain that the statement does not apply to service contracts except for contracts "essential to the construction or production of tangible property . . . ."

On February 11, 2003, NCO announced that it would revise its policy concerning the timing of revenue recognition under the Contract and would restate its financial statements for its 2000 and 2001 fiscal years and for each of its quarters during those years and in 2002 to correct the accounting for the bonus and penalty provisions of the Contract. NCO further announced that the restatement would employ the correct accounting methodology that would defer the recognition of all revenues until all contingencies related to that revenue had been eliminated.

NCO's method of accounting for the Contract had a material impact on NCO's revenues, net income, and diluted earnings per share. The restatement reduced NCO's 2001 revenue by approximately \$17.6 million or 2.5 percent and 2001 diluted earnings per share by \$0.41 or approximately 41.4 percent; it reduced NCO's 2000 revenue by approximately \$18.4 million, or 3.0 percent and 2000 diluted earnings per share by \$0.42 or 49.4 percent. NCO estimated that the restatement increased its 2002 revenue by approximately \$2.1 million or 0.3 percent and increased 2002 diluted earnings per share by \$0.05 to \$1.54.

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<sup>4</sup> SOP 81-1, paragraph 11, fn. 1 [emphasis added].

## Respondent's Conduct

Respondent NCO's "one-day-after" policy contravened GAAP because it accounted for contingent fee revenue before the earnings process was complete. NCO's earnings process was not complete until collections were received by NCO. Accordingly, the policy did not meet CON 5's requirement that if collectibility of assets received for services is doubtful, revenues and gains may be recognized on the basis of cash received. SAB 101 counsels and CON 5 requires that contingent fees are earned only upon receipt, and the policy also violated paragraph 17(a) of SFAS No. 5 that prohibits the recognition of gain contingencies.

Respondent NCO failed to properly account for the Contract and instead improperly analogized to SOP 81-1. SOP 81-1 was not applicable to this contract since the services provided did not involve the production or construction of tangible property, such as design, engineering, procurement and construction management. Moreover, NCO also failed to apply the appropriate accounting pronouncements for this type of contract (CON 5, SAB 101, and FAQ 28) that provide that contingent revenue be recognized as revenue in the period in which the underlying contingencies related to the bonuses are resolved.

Respondent's independent auditors were aware of, consulted with NCO concerning, and did not object to both the "one-day-after" policy and the method of accounting for the Contract and issued audit reports containing unqualified opinions on Respondent's consolidated financial statements.

### **C.**

Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act to file annual and quarterly reports with the Commission. The obligation to file such reports embodies the requirement that they be true and correct. See, e.g., SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979). Section 13(b)(2) of the Exchange Act requires issuers to make and keep books, and records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Additionally, this provision requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP or any other criteria applicable to such statements.

As a result of the conduct described above, Respondent NCO committed violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 thereunder.

**IV.**  
**Undertakings**

Respondent NCO has undertaken to maintain its elimination of its former “one-day-after” policy.

**V.**  
**Order**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent’s Offer.

Accordingly, it is hereby ORDERED that:

Respondent NCO cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder.

IT IS FURTHERED ORDERED that Respondent NCO shall comply with the undertakings enumerated in Section IV above.

By the Commission.

Jonathan G. Katz  
Secretary