PROTECTING YOUR COMPANY AGAINST CIVIL AND CRIMINAL LIABILITY

A PRACTICAL HANDBOOK FOR CEOs and CFOs

CONTENTS

PREFACE

The Sarbanes-Oxley Act of 2002 is the most major securities regulation to affect companies since the Securities Exchange Act of 1934. Right now there are about 15,000 listed companies, which have a total market value of approximately $37 trillion and are held by tens of millions of shareholders.

The Enron trial ended after four years of federal investigations and 108 days of sworn evidence. The prosecution based its case on evidence provided by executives below the top level, who themselves took plea deals, and on the Watkins letter, which exposed the fraudulent activities of the corporation in August 2001. Judge Lake invoked a common feature in white-collar prosecutions by giving the "ostrich instruction" to the jurors. This allows the jury to find a defendant guilty if they had sufficient notice of problems (like the Watkins letter), but deliberately refused to recognize or act on that information. Former WorldCom CEO, Bernard Ebbers, was convicted by way of a similar ruling.

Willful blindness satisfies the knowledge for a conspiracy conviction and the intent (scienter) element of a fraud conviction. The knowledge element refers to an offending party's knowledge of the wrongness of an act or event prior to committing it. Black's Law Dictionary defines fraud under common law as involving three elements: (1) a material false statement made with intent to deceive (also known as the element of scienter); (2) a victim's reliance on those statements; and (3) damages. If the breach of fiduciary duty has no wrongful intent, it is civil fraud, but if it does, it becomes criminal fraud. This treatise does not cover frivolous cases of civil fraud claims, such as the difficulties of Dave Thomas of Wendy's with an IPO where a footnote disclosure was found inadequate or Ron Howard's dissolution of his film company whereby investors claimed civil fraud because he walked away from the corporation. These cases cross the line of frivolity.

The ostrich instruction is a common feature in white collar crime prosecutions. United States v. Jewell, 532 F.2d 697 (9th Cir. 1976), sets forth the classic instruction in this area: "You may infer knowledge from a combination of suspicion and indifference to the truth. If you find that a person had a strong suspicion that things were not what they seemed or

that someone had withheld some important facts, yet shut his eyes for fear that he would learn, you may conclude that he acted knowingly." Judge Posner explained how the ostrich instruction should be understood, and its limitations, in United States v. Giovannetti, 919 F.2d 1223 (7th Cir. 1990):

> The most powerful criticism of the ostrich instruction is, precisely, that its tendency is to allow juries to convict upon a finding of negligence for crimes that require intent . . . The criticism can be deflected by thinking carefully about just what it is that real ostriches do (or at least are popularly supposed to do). They do not just fail to follow through on their suspicions of bad things. They are not merely careless birds. They bury their heads in the sand so that they will not see or hear bad things. They deliberately avoid acquiring unpleasant knowledge. The ostrich instruction is designed for cases in which there is evidence that the defendant, knowing or strongly suspecting that he is involved in shady dealings, takes steps to make sure that he does not acquire full or exact knowledge of the nature and extent of those dealings. A deliberate effort to avoid guilty knowledge is all the guilty knowledge the law requires.

Jurors were quoted after the trial as saying that for a man as knowledgeable as Enron Chairman Ken Lay was, he had to know what was going on at his own company. They found the high level of stock sales unusual, as well, compared to his recommendations at the same time to employees of the company to hold and buy stock.

Why has the last decade seen such an increase in white collar crime? It has been reflected in dozens of cases involving bribery, conflicts of interest, mail and wire fraud, and securities fraud, to name only a few. It is inconceivable that the perpetrators were not aware. It is the purpose of this book to raise the awareness level for business owners of all sizes so that their company can operate in a safe environment, free of concern of government investigations, and internal fraud or inefficiency. By studying the past, and researching what the federal government requires, business owners of all sizes can rest assured that their business is abiding by and following critical principles of strategy that will keep it profitable.

1

An Overview of Corporate Governance

Key Provisions of the Sarbanes-Oxley Act

Events Leading up to Sarbanes

A variety of corporate scandals led to the passage of the Sarbanes-Oxley Act, including the Enron failure. David Duncan, the former senior audit partner of Arthur Andersen LLP (Arthur Andersen), participated in the shredding of documents in the Enron case. Andy Fastow, the former CFO of Enron, set up a series of partnerships that were used for self-dealing and had the ultimate purpose of hiding debt transactions from the consolidated financial statements of Enron. He was assisted by Michael Kopper, who was involved in money laundering and wire fraud. Other Enron executives were either being investigated or indicted for securities fraud, making false statements to federal investigators, or fraudulent trading practices. With the collapse of Enron, $60 billion in market value was lost.

Bernard Ebbers, the CEO of WorldCom, had enjoyed the rising price of his holdings in WorldCom's stock. Ebbers came under increasing pressure from banks to cover margin calls on his WorldCom stock that was used to finance his other businesses. During 2001, Ebbers persuaded WorldCom's board of directors to provide him corporate loans and guarantees in excess of $400 million to cover his margin calls, but this strategy ultimately failed, and WorldCom became the largest corporate bankruptcy in history.

Beginning in 1999 and continuing through May 2002, the company used fraudulent accounting methods to mask its declining financial condition.

The fraud was accomplished primarily in two manners: (1) underreporting "operational costs" (one of five popular methods of corporate accounting fraud) by capitalizing these costs on the balance sheet rather than properly expensing them and (2) generating revenues with false accounting entries from "corporate unallocated revenue." WorldCom's internal audit department uncovered approximately $4 billion of the fraud in June 2002 during a routine examination of capital expenditures and alerted the company's external auditors. At the end of the day, it was estimated that the company's total assets had been inflated by around $11 billion.

Four former HealthSouth CFOs pled guilty after Sarbanes was passed to a variety of charges, including false certification of financial statements under the Sarbanes-Oxley Act, a federal offense punishable by up to twenty years in prison.

After the fact, when the SEC commissioned a study under Section 704 of the Sarbanes-Oxley Act, dozens of corporate governance scenarios were listed, which led to grand jury investigations and investigations by the FBI, Treasury, and SEC, and were followed by indictments and class-action lawsuits against some of the largest publicly held corporations in the world. Almost thirty different bills were proposed in 2002 in Congress before the final version of the Sarbanes-Oxley Act, named after Senator Paul Sarbanes from Maryland and Representative Michael Oxley from Ohio, was accepted and signed into law by President Bush in July 2002.

Corporate governance is defined as the relationship between corporate directors, officers, and providers of capital under the rule of law. Corporate directors are responsible to shareholders for the efficient use and stewardship of resources. Self-regulating corporate governance had failed, and the government stepped in to provide direction with the Sarbanes-Oxley Act of 2002. This act replaced the long-standing Financial Accounting Standards Board with a quasi-government (private but accountable to the SEC) body known as the Public Company Accounting Oversight Board. It was to be responsible for auditing and quality control of firms registered to audit publicly held corporations. Title II of the act covered Auditor Independence Issues, including prohibited services that were in the realm of conflicts. Title III included the all-important Section 302 Certifications, which brought the HealthSouth fraud to a complete halt.

Title IV included Section 404, which increased audit responsibilities and also increased corporate accountability for solid internal control system reporting. Corporate fraud and accountability in a variety of areas were covered by Titles IV to XI. The section shortly following provides a list of key changes to the ways listed corporations are governed post-Sarbanes-Oxley.

PCAOB

One of the first responsibilities of the Public Company Accounting Oversight Board (PCAOB) was to establish a Standing Advisory Group (SAG) of twenty-five members who were experts in financial disciplines, as well as independent and objective. Once the SEC had approved this rule for the SAG to take effect, it began a study of current auditing standards in order to begin issuing its own interpretations. Auditing Standard No. 2 followed, which has the rule of law behind it. To violate it is the same as violation of the federal Sarbanes-Oxley Act and carries up to the same maximum civil and criminal penalties. Auditing Standard No. 3 followed, whose topic was audit documentation. Auditing Standard No. 4 had a primary topic of interpretation of material weakness changes. Approximately 8 percent of listed corporations after the first year of Sarbanes compliance reported what are known as material weaknesses in internal controls structures.

This came as a total change from the prior way that audits and auditors were accustomed to operating. Their former self-regulating body, the Financial Accounting Standards Board (FASB) had previously issued the pronouncements utilized in reaching conclusions about presentation and disclosure on annual Form 10-Ks and 10-Qs, the quarterly financials. PCAOB recommended the control environment structure utilized by the Treadway Commission Report, called the Committee of Sponsoring Organizations (COSO), but it did not require its exclusive use in evaluating risk assessments related to internal control issues. Scoping and planning, identifying significant accounts, determining multi-location coverage, and many other topics were addressed in Auditing Standard No. 2 (AS2).

COSO had recommended that five components of internal control become a critical part of management's Section 404 assessment. The Control

Environment establishes an overall tone, and COSO found a group of sub-components that related to corporate governance that comprise this facet, some of which are covered in detail below. Risk Assessment, the second component, is a matter of establishing risks and ranking them. Control Activities are the policies used to ensure that directives are implemented. These could include top-level reviews and metrics. Information & Communication is a fourth component, involving meetings, training, and policy manuals. Finally, Monitoring is the process utilized to assess the quality of internal control and reporting of deficiencies.

Section 302 Certification

Section 302 of the act is a formal signature certification rule that requires CEOs and CFOs to certify in each Form 10-K and 10-Q that:

- The officer reviewed the report;
- Based on the officer's knowledge, the report does not contain any untrue statement of a material fact in order that the financial statements present fairly the company's financial condition and results of operations;
- The officer is responsible for maintaining an internal control system that has been designed to ensure that material information is reported;
- The officer has evaluated the effectiveness of the internal controls within ninety days prior to the report;
- In the report, conclusions about the evaluation are reached, as well as whether significant changes have occurred;
- The officer has disclosed to the audit committee all significant deficiencies in design or operation of the internal controls, as well as any fraud that involves management.

Section 302 Certification has caused the SEC to issue guidance to listed corporations that have led them in large part to establish disclosure committees. These comprise key corporate officers and operate under a charter. Their purpose is to review the quarterly and annual reports, proxy statements, registration statements, and press releases to ensure they are in full compliance with the currently mandated disclosure requirements applicable to their industry.

Section 404 Certification

Section 404 of the act states that the commission (SEC) shall prescribe rules requiring each annual report required under the Securities Exchange Act of 1934 to contain an internal control report, which shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

The internal control definition encompasses the internal control system, at both the process and company levels, that provides reasonable assurance that transactions are complete, accurate, and valid and that restricted access exists. Completeness refers to all recorded transactions accepted by the system (only once, with duplicate postings rejected); accuracy refers to key data elements for transactions input as correct; validity refers to transactions being authorized; and restricted access refers to confidentiality of data and segregation of duties.

Segregation of Duties

This is a key concept within the Sarbanes framework. A fundamental element of internal control is the segregation of key duties. No employee should be in a position to perpetrate and to conceal errors in the course of their responsibilities. There are four categories of incompatible duties:

- Custody of assets
- Authorization or approval of related transactions
- Recording or reporting
- Reconciliation or monitoring

An essential feature of segregation of duties is that control over the processing of a transaction should not be performed by the same individual who is responsible for recording and reporting the transaction. Potential

incompatible duties would exist if one individual performs duties in more than one category. A template reflecting the segregation of duties in process-level controls is normally utilized to determine whether conflicts exist.

For example, there may be fifteen types of process-level controls within a corporation, including revenue, accounts payable/purchasing, payroll processing, fixed assets, regulatory compliance, debt, investments, stockholders equity, and financial reporting. A matrix with the above four categories at the top, followed by the actual process flow (normally seven to twelve items exist in each process flow) will allow one to determine potential conflicts at a glance. A process flow chart is an advanced means to determine control weaknesses, but it is a much more complicated procedure to perform. Some companies utilize both narrative documentation and process flow charts, however.

Section 404 Documentation

To meet the requirements of Section 404, a variety of documentation is required. At a minimum are the walkthrough document, the Risk control matrix, and an audit program based upon the matrix described above. The walkthrough document is prepared for each process, usually with the assistance of the controller and the process owner, the head of the department responsible for the process. It is a narrative description of the process that assists in the risk assessment process. On a practical level, internal audit decides which key control points affect financial reporting, and those items become key controls. Key controls in the walkthrough are normally listed in bold type and referenced to the risk control matrix by a nomenclature.

The walkthrough contains a complete description of key control points in each process. Normally at least one key control point is discovered at each level. The System Control Chart in the Case Studies chapter on insurance anti-fraud controls illustrates the points at which key controls are located. A key control is defined as a control that affects financial reporting.

The risk control matrix is normally an Excel schedule prepared for each Company-level Control and each Process-level Control that contains, in sequence, the:

- Objective of the Internal Control
- Financial Statement Assertion
- Key control
- Test of the Key control
- Inherent Risk Description

Company-level Controls

Company-level controls were at the heart of the Enron failures. COSO has established an internal control framework widely utilized in North America that provides a basis for organizing a risk control matrix. In addition to the process-level controls, the controls surrounding the corporate environment must be evaluated. At a minimum company-level controls need to be evaluated at these levels:

- Control Environment & Activities
- Information & Communication
- Monitoring
- Risk Assessment

At the control environment level, the objectives (around which appropriate Key controls must be designed) include:

- Management is conservative in accepting business risk.
- Senior managers and operations meet frequently to review risk proposals.
- Management has established and communicated a Code of Ethics policy.
- Company policies and procedures are enforced.
- Managers are prohibited from overriding established controls.
- The human resources department is committed to training and retaining competent individuals.
- Job descriptions and performance evaluations are related to guidelines.
- The company has an effective and active board of directors and audit committee.
- Anti-Fraud Charter is established and in practice.

At the Organization level, the objectives include:

- Relevant reports are identified, processed, and reported by information systems.
- Information system platforms are subject to guidelines and review.
- Organization charts are utilized to communicate duties.
- A whistleblower hotline is established.

At the Monitoring level, the objectives include:

- Audit plan and results are communicated to the audit committee.
- Internal audit reports are reviewed by the Chief Accounting Officer.
- Code of Conduct has been distributed and signed off by employees.
- Internal Audit plans and policies are approved by the audit committee.
- Company accounting manual is widely distributed and updated.

At the Risk Assessment level, the objectives include:

- Entity-wide objectives are communicated to business segment managers.
- Strategies and budgets are consistent with entity-wide objectives.
- Activity-level objectives are linked to overall business strategy.
- Critical success factors for activity-level objectives are reviewed (that is, performance objectives are met).
- Non-routine significant changes are reviewed and approved in accordance with company guidelines.

Section 404 of the Sarbanes-Oxley Act is only two paragraphs, but it encompasses and requires a review of the information technology platform, finance platform and company-level controls of every publicly listed corporation. A variety of other rules apply to listed corporations, including but not limited to:

- Regulation S-X, which sets forth the form, content, and requirements for financial statements required to be filed under the Securities Act of 1933

- Regulation S-K, which sets forth the content of non-financial statement portions of registration statements under the Securities Act, for example, Management Discussion and Analysis of Financial Condition and Results of Operations
- SEC Staff Accounting Bulletin No. 99 on Materiality, which states that materiality may exist if a misstatement masks a change in earnings, hides a failure to meet analyst expectations, changes a loss into income, conceals an unlawful transaction, or affects a company's compliance with regulatory requirements. These would indicate elements of willful fraud and attempt to mislead investors.

Criminal Sanctions

Section 802 of the Act requires a five-year retention period from conclusion of the audit of all records that support conclusions, as well as documents that reflect differences of opinion on conclusions. This would include correspondence, memorandums, and electronic records that contain analyses or opinions as to conclusions about the review of a corporation's internal control system. Any person who knowingly destroys, conceals, or makes a false entry with the intent to obstruct justice shall be fined and/or imprisoned up to twenty years. The five-year retention period was modified according to SEC rules to seven years.

Section 1107 covers retaliation against whistleblowers and provides that any person who knowingly takes action harmful to any person who assists law enforcement regarding a federal offense (under Sarbanes-Oxley) will be fined and/or imprisoned up to ten years.

Section 1107 also raised penalties to twenty years and a $5 million fine for any individual who conspires to commit fraud offenses under the Sarbanes-Oxley Act. This would apply not only to CEOs and CFOs, but could potentially apply to controllers and anyone in a corporation who violates this federal law. Compliance with Generally Accepted Accounting Principles (GAAP) is not a defense if the financial statements do not fairly represent the financial condition of the company.

Other Miscellaneous Provisions

Section 101 establishes PCAOB, the Public Company Accounting Oversight Board, which replaces the FASB as far as pronouncements are concerned and has the authority to regulate all firms that audit financial statements of publicly held companies. The board of PCAOB has five members. An extensive staff has developed over the major cities of the United States consisting largely of former public company auditors. This body audits the firms responsible for issuing opinions on listed corporations.

Section 203 requires rotation of lead partners every five years on audit assignments.

Section 204 requires public accounting firms to report to the audit committee critical accounting policies, alternative treatments, and significant communications.

Section 301 of the act requires the SEC de-list any company that does not meet the new audit committee standard requirements. The audit committee must consist solely of independent directors. Prior to Sarbanes, "gray" directors often existed, who had consulting or other ties to the company and therefore a conflict of interest. As well, at least one financial expert must be appointed to each audit committee. Formerly it often occurred that there wasn't anyone with financial statement expertise on audit committees. Now, the audit committee financial expert is required by Section 407. This is someone who has experience in understanding and applying GAAP to financial statements, as well as experience with internal controls.

Section 301 also requires a majority of the board of directors to be independent. Employees and those who accept payments over a de minimis amount ($60,000 per annum) are defined as not independent.

Section 304 of the act states that the CEO and CFO must return any profits, bonuses, or other incentive compensation if an accounting restatement is required because of material non-compliance of the company.

Section 306 covers pension fund blackout periods, which are periods of more than three consecutive business days during which the ability of at least 50 percent of the U.S. participants or beneficiaries under all individual account plans are temporarily suspended. Executives and directors may not trade during blackouts.

Section 401(a) requires the SEC to adopt rules requiring disclosure of off-balance sheet transactions with unconsolidated entities that may have material impacts on financial disclosure. This includes contingent obligations as defined under FASB Interpretation No. 46, Consolidation of Variable Interest Entities over the disclosure threshold.

The SEC also established rules covering contractual obligations, including leases and debt requiring disclosure in the MD&A (Management Disclosure & Analysis) section of the financial statements.

Section 402 of the act states that loans after July 30, 2002, to officers may not be made. Credit may not be arranged, nor loans allowed.

Section 406 requires a Code of Ethics rule to be adopted by the SEC to be applied to all listed companies. The 10-K must disclose whether one has been adopted. If one has not been adopted, the company must explain why.

Section 408 requires SEC review of filings on listed companies every three years. The SEC must consider companies that have issued material restatements and companies that have experienced significant stock volatility.

Section 409 requires real-time disclosure of material changes. The SEC requires public companies to disclose these on a current basis.

Section 804 extends the time for filing of class-action suits (civil fraud) to five years after the incident.

Section 906 requires each periodic report (10-K, 10-Q) filed by an issuer with the SEC under the Securities Exchange Act of 1934 to be accompanied by a written statement by the chief executive officer and chief financial officer that the financial statements fully comply with the

requirements of section 13(a) or 15(d) of the SEC Act of 1934, and that information contained fairly presents, in all material respects, the financial condition and results of operations of the issuer. Since the exact form of filing is not prescribed, most companies utilize a certification after the signature page or as an exhibit.

Form of Certifications

A general policy that has been observed in the conduct of public companies is that the CFO often requires from division heads a "sub-certification" before he signs the final certifications. These take many forms and can depend on the nature of the industry, number of processes and sub-processes involved in the Section 404 compliance project, and the strategies adopted by individual audit committees. Certifications and sub-certifications can vary widely in form, depending on facts and circumstances, and are handled as a rule by specialists within the company, after consultation with outside auditors and counsel.

The Management View of Sarbanes-Oxley

The Sarbanes Steering Committee

Almost every listed company has made a decision to form a steering committee. The steering committee faces these decisions:

- Utilization of a framework and risk assessment procedures
- Scope of auditing
- Testing materiality thresholds
- Decisions on which business units and segments to cover
- Decisions on extent of key control testing at the corporate level
- Decisions on extent of key control testing at the process level
- Service organization factors: Is a SAS 70 Report required?
- Decision to flowchart or narrate the documentation processes
- Sample size matrix formations
- IT General Control testing matrix formation
- Coordination with audit committee

- Coordination with outside auditors
- Coordination with the joint venture department as to contemplated mergers/acquisitions and the requirements of Sarbanes due diligence.

Framework

The COSO framework is almost universally utilized in the United States in the finance realm of Sarbanes auditing. Alternative frameworks have developed in Canada and Britain, such as the Turnbull Report. These are the frameworks for assessing components of internal control, the period-end reporting process, estimates and judgments, and company-level controls, as well as the information technology (IT) audit scope. The IT organization of a publicly held company must document and assess its own significant processes (what we call general computer controls) in five major areas: IT environment, development of new IT platforms, change management of existing IT platforms, computer operations or logic, and information security integrity.

Enforcement of the Sarbanes-Oxley Act is treated in the same way as enforcement of the Securities Act of 1934. Therefore when a violation of information security occurs that creates false or fraudulent reporting, it is litigated in a federal court by the SEC. Since these matters are of a serious nature, the chief information officer (CIO) of a company must establish a proper framework.

ISO is the International Organization for Standardization. It is made up of some 140 national standards institutes from countries large and small in all regions of the world. ISO develops voluntary technical standards that serve to safeguard consumers and general users of products and services. ISO 17799 is a set of best practices in information security that some companies have adopted. It is an international standard and it is elective. It contains recommendations for information security management by defining a set of computer controls. It is extensive, and compliance can be very costly in a large entity with hundreds of IT platforms. Normally the procedure is to define the "critical" platforms upon which financial reporting is dependent and test those to a maximum extent. However, that number can still run to the level of forty to fifty testing areas in a multi-billion dollar company with

extensive segments and a variety of software platforms. ISO 17799 has as its intent the integrity and security of data.

Another popular IT platform that is often chosen is COBIT (Control Objectives for Information and related Technology), which is high-level framework developed by the IT Governance Institute. The institute was founded in 1998 to advance international standards in controlling an enterprise's information technology. A related association, The Information Systems Audit and Control Association (ISACA), is the leading global information systems, audit, control, security, and governance collection of professionals in the world today. COBIT is covered in a future chapter, but a brief list of its advantages includes:

- It is 100 percent compliant with ISO 17799.
- It is already researched and accepted globally and is thus a recognized framework.
- It is management-oriented and practicable.
- It reduces the cost of audit risk assessment, since the model is already established.
- It is flexible to individual company requirements.
- It was produced by a senior international project team under the guidance of a steering committee and researchers, and then subject to expert review.

The COBIT framework has thirty-four high-level objectives followed by several hundred more detailed objectives that can be tailored to corporate requirements, whether the company has $100 million in revenue or $100 billion in revenue. It considers the allocation of IT resources in the levels of acquisition, delivery & support, monitoring, information communication, and planning & organization. One has to be careful, though. A COBIT objective alone does not necessarily indicate a key control exists. *A key control is a control whose failure would lead to failure to prevent or detect an unauthorized activity that results in a material error on the financial statements.* When an IT key control does exist, PCAOB guidance indicates that automated controls (IT controls) are subject to less extensive testing than manual controls because of the nature of their operation. Often a test of one automated control is sufficient, since it would be redundant to test an

automated control a second time, as automated application controls will continue to perform for a given control in exactly the same manner until the program is changed. Entirely automated application controls (for example, computer aging of accounts receivable in order to determine the related allowance or edit checks) are generally not subject to breakdowns due to human failure; therefore, this feature allows the auditor to "baseline" or benchmark these controls.

Scope of Auditing—Testing Materiality

In Sarbanes auditing there are several key terms to define. A control deficiency occurs when the design or operation of a control does not allow management in the normal course of business to prevent or detect misstatements on a timely basis. Control deficiencies are further divided into design deficiency and operation deficiency categories. A deficiency in design exists when there is no control to meet a key objective or a flawed design that does not meet the objective. A deficiency in operation exists when the control does not operate, or fails during testing. A significant deficiency exists when a combination of control deficiencies adversely affects the company's ability to process external financial reporting data in accordance with GAAP so that there is a "more-than-remote likelihood" that a misstatement of the company's annual or interim financials that is more than inconsequential will not be prevented or detected.

In the research paper, "A Framework for Evaluating Control Exceptions and Deficiencies," Version 3, which is the supplement produced by a variety of international public accounting firms to expand on the standards issued in Auditing Standard No. 2 by PCAOB, we find the information we need to determine critical scoping numbers, the basis for our Sarbanes audit.

We need to determine our threshold for significant deficiency. We'll use these hypothetical numbers:

The company is forecast to make $400,000,000 in after-tax earnings. It's a stable company, so let's assume that is a reasonable figure to work from.

Using the "rule of thumb," we've identified our materiality as 5 percent of after-tax income, thus $20 million.

Therefore any error that could result in a misstatement of > $20 million will automatically be considered a material weakness. This is a significant deficiency (or combination of significant deficiencies) that results in a more-than-remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected, according to PCAOB. This number is also essentially the same as what our auditors have defined as financial statement materiality.

Now we need to determine what a significant account is and what would constitute a significant deficiency. Using the "Framework for Evaluating Control Exceptions and Deficiencies," we find that misstatements > 20 percent of overall annual financial statement materiality (the $20 million calculated above) are defined as "more than inconsequential" and therefore are classed as a significant deficiency.

20 percent x 20 million = $4 million

We have then taken this significant deficiency threshold of $4 million and used that as our scoping number. Any account (with a balance of less than $4 million or that does not have the potential to cause an error of $4 million or more) is determined to be immaterial in terms of testing and can be removed from the scope of key control testing. For example, in this scenario if a process existed that had an account balance of $ 2 million, it would not be included in key control testing.

In summary:

$400 million after-tax earnings
$20 million materiality level/material weakness threshold
$4 million significant account/significant deficiency threshold

This can tend to be what some have referred to as an analytical dream area. External auditors and internal audit often disagree, especially when it comes to the level of aggregating deficiencies by class of transaction. This is

required at the end-stage of evaluation. You can also mention to external auditors the legalese that they like:

> Considering the overall compensating controls (hypothetically described below, for example) and the *de minimis* magnitude of the potential error as described above, further mitigating controls provide additional assurance that this control deficiency results in no more than a *de minimis* impact to the financial statements. The following control strongly mitigates any potential error.

In other words, compensating controls that act at a high level of precision will mitigate the effect of significant deficiencies. This is recognized in AS2.

Decisions on Business Units

The next decision for management and the Sarbanes steering committee is the mapping of significant business processes that generate the significant accounts to ensure that they are all addressed. To ensure coverage, the PricewaterhouseCoopers approach utilizes four information processing control objectives: Completeness, Accuracy, Validity, and Restricted Access (CAVR).[1] Presentation and disclosure constitute a fifth objective under the category of Financial Statement Assertions. The CAVR approach provides the auditor a standardized means to measure each control activity. You should select the information processing objective(s) that best relates to your control activity. Each element of CAVR should be addressed in some combination of control activities for each objective.

The majority of listed companies have a variety of business units located within and outside the United States. Section 404 requires testing of a "large portion" of the company's operations, as stated in Appendix B of AS2. Many analysts utilize 75 percent as a ballpark number, which constitutes the equivalent. AS2 does not establish a specific percentage. Quantitative metrics from consolidated financials are the best source to determine significant locations. The 5 percent of pre-tax income metric is commonly

[1] Sarbanes-Oxley Act: Section 404 Practical Guide for Management, PricewaterhouseCoopers, July 2004.

used in the computation. Other metrics may have to be utilized if the company is operating at break-even or a loss.

The other judgment considerations are qualitative. If a location is responsible for derivative or foreign trading, for example, then those areas could easily result in a material misstatement without proper internal controls in place and should be included in testing. In summary, 70 percent to 75 percent of metric coverage should equate to an equal level of significant account and disclosure testing. A practical solution for entities representing 25 percent or less of metric coverage is to utilize a questionnaire that is distributed to the CFOs of those entities and that asks a variety of questions on company-level and process-level controls, and whether they are in place. However, minimal testing occurs unless the external auditor deems it necessary. Internal audit restricts its testing to controls at the 75 percent-level units and segments.

Key Control Testing

Key control testing directly relates to the risk matrix. For example, if a company-level control has as its objective to "ensure that the company has an active and effective board of directors," then the key control would be that the board is independent and has proper knowledge and experience. The test might be to review the latest 10-K and the biographies of the board members, including documenting the number of directors who are independent. The audit committee charter and membership would be reviewed as part of testing, as well as the number of times the board met during the last year. The inherent risk is that the board is not independent or experienced. This would be a high-risk test because if it failed, the failure would affect company-level controls.

There are normally at least ten to twelve tests in each category of company-level controls. The primary categories are the control environment, information, monitoring, and risk assessment. Control activities, according to the COSO model, would be a fifth category. Because each company's organizational structure is different, there is no "one-size-fits-all" model, and each risk control matrix must be created separately based on the facts and circumstances.

General computer controls and information security must be tested, as these are pervasive controls. The integrity of information processing is dependent on their proper functioning. In fact, spreadsheets now operate at such a level of complexity, with embedded macros and other formulas, that they are the equivalent of application-level software and should be subject to Sarbanes testing if their use affects the financial statements.

Information technology security comprises the access to the IT platforms. Security in this area consists of protecting the environment from outside intrusion and unauthorized access by persons within the company who, according to segregation of duties and principles, should not have full access.

SAS 70 Reports

Service Auditors Reports (SAS 70 Reports) are required for any corporation that engages in significant outsourcing of processes or functions, for example, payroll. SAS 70 Reports are divided into Type I and Type II reports. In a Type I report the auditor issues an opinion on a description of the entity's controls. In a Type II report the auditor actually tests for a minimum six-month period the internal controls and reports on effectiveness. A Type II report is utilized for Sarbanes testing purposes and is required to be obtained for all significant processes that support Section 404 assessment operating effectiveness.

If the Type II report has a qualified opinion, the reason for qualification must be determined, and it is possible that the internal control deficiencies may have to be remediated before year-end. If a Type II report is not available, then an agreed-upon procedures report may be utilized as an alternative. An agreed-upon-procedures report means any report that is on a financial statement and that is based upon agreed-upon procedures issued with respect to another party's written assertion in accordance with statements on standards for attestation engagements as promulgated by the AICPA. In summary, an inventory of service providers must be obtained; scoping decisions need to be made; and then planning in order to meet deadlines must begin if these reports are not currently available.

Effect on Mergers & Acquisitions

Before Sarbanes-Oxley merger activity, due diligence was primarily on areas that affected economics and not targeted to internal control studies. However, under Sarbanes the situation has changed. The only exception to development team considerations listed below would be if aggregate numbers of the target were less than 5 percent of key metrics so that the entity could be de-scoped. Sarbanes has granted a one-year grace period on reporting on new acquisitions.

Management is still required to disclose the extension, if it occurs, of reporting exclusion grace periods. If the company target is within Sarbanes guidelines, then the questions to be answered would include the ability of the target to comply with Sections 302 and 404 on a stand-alone basis. The practical method to determine whether a target is in compliance is to assess the effectiveness of the design and operation of its controls on an independent basis. Full assessment is complex and timely and likely will result in longer lead times and due diligence periods before acquisitions are closed.

Disclosure Committee

There normally is a committee of certain members of the management of the corporation and its subsidiaries that is known as the disclosure committee. The disclosure committee reports to, and is subject to the supervision and oversight of, the chief executive officer and the chief financial officer.

The membership of the disclosure committee usually consists of the senior vice president and CFO, senior vice president and treasurer, deputy general counsel and secretary, vice president of communications, chief audit executive, vice president of investor relations, and director of SEC reporting.

The committee should review the company's existing internal disclosure controls and procedures, document them, and evaluate their adequacy. Footnote disclosures and management discussion & analysis disclosures can

be reviewed every quarter through use of reporting services that update pronouncements that affect corporate reporting.

Purpose

The purpose of the disclosure committee is to provide assistance to the CEO and CFO in fulfilling their responsibilities relating to:

1. The certification of disclosures and reporting procedures established by the SEC and the Sarbanes-Oxley Act of 2002
2. Consideration of the materiality of information required to be disclosed in, and review and supervision of the preparation of periodic reports under the Securities Exchange Act of 1934 (the "1934 Act") and earnings releases
3. The design, establishment, maintenance, review, and evaluation of the effectiveness of "disclosure controls and procedures"

Responsibilities

The disclosure committee meets as frequently as circumstances require, and as the members deem necessary or appropriate, to carry out its responsibilities, including:

1. Assisting in the design, establishment, maintenance, review, and evaluation of the effectiveness of disclosure controls and procedures to ensure that material information is made known to the committee and is able to be provided, processed, summarized, and reported to the SEC on a timely basis
2. Considering materiality of information received regarding disclosure controls and procedures to determine disclosure obligations on a timely basis
3. Assisting in the preparation of each SEC periodic report and earnings release and evaluate the clarity, accuracy, and compliance of the information in those reports

Evaluation of Material Weaknesses

The majority of material weaknesses are reported on Form 10-K, and by companies with less than $500 million in revenue. Financial systems and procedures weaknesses are a majority of those disclosed, followed by personnel-related weaknesses for smaller companies. A significant percentage, relative to their number, of technology companies report weaknesses. Lack of qualified accounting personnel is a major cause of that arena of weakness. Revenue-recognition policy deficiencies, lack of segregation of duties, and inadequate period-end reporting are significant classes of weaknesses. Current asset weaknesses are also commonly reported. Derivative and income tax-related weaknesses constitute another major area. The risks of allowing weaknesses to be reported on a 10-K include the SEC's wide authority to take actions up to and including de-listing the corporation.

Private capital markets are also studying 10-K weakness disclosures. Moody's credit rating agency recently stated that it would assess the credit positions of companies whose auditors engaged in substantive auditing to "audit around" Category B material weaknesses. Category A material weaknesses include specific-account and transaction-level processes. Moody's states that Category A weaknesses can be audited around, where testing of account balances on a sample basis to validate is utilized. For example, the fee income of a title insurance company can be tested with random sampling in a variety of regions. This constitutes substantive testing versus Sarbanes testing. Category B material weaknesses involve company-level controls, including the financial reporting process. Moody's views these on a more serious level. It has issued a comment that rating committees may review unremediated Category B weaknesses, an enormous implication.

Therefore company-level controls are high-risk and should be tested early in the year so that time remains for remediation. According to PCAOB staff questions & answers, company-level controls include:

- Controls within the control environment, such as tone at the top, organizational structure, commitment to competence, human resource policies, and procedures

- Management's risk assessment process
- Centralized processing and controls, such as shared service environments
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs
- The period-end financial reporting process

The period-end financial reporting process normally involves a variety of objectives, including that transactions are accurately posted to the general ledger; transactions recorded as suspense are monitored and cleared; the month-end close is accurate and complete; inter-company transactions are netted and balanced; financial reports submitted to corporate are complete; and unusual variations and deviations are identified, researched, and resolved.

Strategies for Implementing Section 404

Identifying Significant Accounts

Significant accounts are identified both at the consolidated level and the individual account or disclosure level. An account is significant if there is a more-than-remote likelihood that the account could contain misstatements that individually, or when aggregated, could have a material effect on the financial statements.

All line items and footnotes in published financial statements should be considered significant accounts if they are greater than management's planning materiality. In addition, accounts that undergo significant activity (for example, cash flow) or have exposure (for example, loss reserves) are significant.

Planning Materiality

Planning materiality is concerned with whether a misstatement is likely to result in a material misstatement. Auditors use planning materiality to determine which items to examine. The starting point for the value of planning materiality is *reporting materiality*. Reporting materiality is based on pre-tax income. Planning materiality generally ranges from 50 percent to 75

percent of reporting materiality, based on how the risk is assessed (that is, a higher-risk entity would have a lower materiality). Auditors generally select for examination those account balances that equal or exceed the value of planning materiality at the financial statement level. Overall materiality levels should be documented.

Qualitative considerations also apply when considering the significance of an account. The composition of the account, susceptibility to loss due to fraud, volume of activity, and related-party transactions should be considered. PCAOB staff have indicated that the standard's reference to financial statements does not extend to the preparation of MD&A (Management Discussion & Analysis of Financial Condition and Results of Operations).

Identifying Assertions for Each Significant Account

CAVR:

- Completeness
- Accuracy
- Validity
- Restricted access

These are required by the PCAOB Auditing Standard No 2. Completeness indicates that all recorded transactions are accepted by the system, and duplicate posting is rejected by the system. Accuracy indicates that key data elements for transactions are correct, and changes in data are accurately input. Validity indicates transactions are authorized, and that they are not fictitious. Restricted access indicates that confidentiality exists; segregation of duties is ensured; and assets are protected.

Off-Balance-Sheet Arrangements

The final rules require disclosure of off-balance-sheet arrangements that either have, or are "reasonably likely" to have, a current or future material effect to investors on the registrant's financial condition. The "reasonably likely" disclosure threshold is consistent with the existing MD&A disclosure

threshold for other information. The SEC decided not to use the more demanding threshold set forth in the proposed rules, which would have required disclosure unless "the likelihood of either the occurrence of an event implicating an off-balance sheet arrangement, or the materiality of its effect, is remote."

Determining Business Units to Test

The PCAOB has not established specific percentages to determine coverage, but most monographs on the topic indicate that at least 60 percent to 70 percent of the company's operations and financial position constitutes sufficient coverage. If an individual unit contributes greater than 5 percent of annual revenues, 5 percent of pre-tax income, or 5 percent of total assets, it likely should be considered an important location. Quantitative metrics should be derived from consolidated financial statements filed with the SEC. Pre-tax income may not be applicable if the company has break-even operations or if significant inter-company transactions exist.

Testing at Business Units

Once the locations to test are targeted, then management must test controls over all relevant assertions for each significant account balance at an individually important location. Account balances over planning materiality should be tested. Company-level controls should also be tested at the location. The proper use of corporate documentation and accounting procedures should be tested at the location. If a location carries a specific risk, such as treasury management, that could result in a misstatement, then those specific areas should be examined at that location.

In summary, if an entity is part of 70 percent-level coverage, then it is an important location, and detailed tests of controls need to be performed. If an entity is part of a 25 percent-level coverage, then only evaluation of company-level controls is necessary. If an entity is part of the remaining 5 percent, it is considered an immaterial location.

Identifying Company-level Controls

Company-level controls are controls to monitor operations and oversee the control environment. They often have a pervasive impact on controls at the process, transaction, or application level. They include:

- Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as compliance manuals and fraud prevention, that apply to all locations and business units
- Risk assessment process
- Monitoring results of operations
- Internal audit
- Financial reporting process
- Board-approved policies that address specific business control and risk management practices
- Code of conduct
- Disclosure committee
- Period-end reporting

Service Organization Considerations

Management should consider outsourced operations that are deemed significant to its internal control over financial reporting. SAS 70 indicates that activities are considered part of a company's internal control structure if they affect the classes of transactions that are significant to operations, which would include significant accounting estimates and disclosures. If the activities are considered significant, then a Type II SAS 70 report must be obtained and evaluated.

A Type I report reviews designs of controls. A Type II report reviews whether the internal controls are operating effectively. The standard requires the auditor to assess both; therefore, a Type II report must be reviewed. A Type II report should cover CAVR points, as well as general computer controls. These are pervasive controls and will have an impact on financials. The IT control environment, program changes, access and computer logic or operations have to be part of the infrastructure study.

The date on the SAS 70 report should be within a reasonable time frame; otherwise, update procedures will have to be performed. If a Type II SAS 70 report cannot be obtained, then auditors need to perform tests of controls at the service organization.

An agreed-upon-procedures engagement is an alternative to an SAS 70 report. This is an engagement where the firm issues a report on findings based on the performance of specific procedures that are agreed to by the accountant and a third party. The scope of procedures can vary widely, based on the needs and what you believe is appropriate.

All five COSO components of internal control need to be covered if this alternative is adopted, which would include a review of the control environment, risk assessment, control activities, information and communication, and monitoring. The control environment includes anti-fraud considerations, which would encompass a code of conduct, a whistleblower program, oversight by the audit committee, and ongoing risk assessment. Control activities encompass performance metrics, development change programs, and safeguarding of assets and records. The segregation of duties is included within the control activity module. Information and communication refers to accounting systems and the reports generated from the systems. Monitoring is a function of internal audit, the audit committee and the disclosure committee.

Digital Security

In considering control characteristics, various issues are important. In the field of IT controls, the VISA credit card network service providers, including banks, processors, merchants, and others use what is known as the "Digital Dozen." Here is a list, which is a mix of preventive, detective, and corrective controls most likely achieving security in the 99 percent to 100 percent range:

- Install and maintain a working firewall to protect data
- Restrict physical access to data
- Encrypt data sent across public networks
- Do not use vendor-supplied defaults for passwords and security codes

- Track all access to data by unique ID
- Protect stored data
- Use and update anti-virus software
- Implement an information security policy
- Assign a unique ID code to each person with access
- Restrict access with "need to know"
- Keep security patches up to data
- Regularly test security systems and processes

Controls Subject to Assessment

The assessment of a company's internal control over financial reporting should be based upon procedures sufficient to evaluate its design and to test its operating effectiveness. Controls subject to assessment include but are not limited to:

- Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions included in the financial statements
- Controls related to the initiation and processing of non-routine and non-systematic transactions, such as accounts involving judgments and estimates
- Controls related to the selection and application of appropriate accounting policies that are in accordance with generally accepted accounting principles
- Anti-fraud programs and controls
- Controls, including information technology general controls, on which other controls are dependent
- Controls over the period-end financial reporting process, including but not limited to controls over procedures used to enter transaction totals into the general ledger; controls to initiate, authorize, record, and process journal entries in the general ledger; controls to record recurring and non-recurring adjustments to the financial statements; and controls that have a pervasive impact, such as those within the control environment, including the "tone at the top," assignment of

authority and responsibility, consistent policies and procedures, and entity-wide programs that apply to all locations and business units.

COBIT

COBIT provides benefits to managers, IT users, and auditors. Managers benefit from COBIT because it provides them with a foundation upon which IT-related decisions and investments can be based. Decision making is more effective because COBIT aids management in defining a strategic IT plan. IT users benefit from COBIT because of the assurance provided to them if the applications that aid in the gathering, processing, and reporting of information comply with COBIT, since it implies controls and security are in place to govern the processes. COBIT benefits auditors because it helps them identify IT control issues within a company's IT infrastructure.

COBIT covers four domains:

- Plan and Organize
- Acquire and Implement
- Deliver and Support
- Monitoring

There's not a one-size-fits-all approach when it comes to structuring IT controls, so the entire COBIT document should be referenced during evaluation and auditing phases. The four domains of COBIT cover all five components of COSO.

A sample control matrix, which could be utilized to meet IT objectives, would contain:

- Sub-process, for example, GL posting or review of journal entries
- Control objective (a description of the control)
- Description and frequency of the control activity
- Information processing objective (C,A,V,R)
- Assertions: completeness, existence, valuation
- Automated or manual control column
- Preventive or detective control column

Testing

Sarbanes testing is generally:

- Re-performance, which involves manual re-calculation, tracing, footing, or similar review
- Examination of evidence, such as exception reports
- Inquiry
- Observation

Inquiry and observation offer the lower levels of assurance, and re-performance and examination provide higher levels of authority. Inquiry on a stand-alone basis will not suffice for purposes of the standard. The majority of manual controls will be subject to a combination of tests. Most controls have a combination of manual and automated phases. Automated controls require a test of one, as they are either operational or not. Manual controls are normally tested based on a matrix such as the following:

Frequency — Manual Control	
Annually	1
Quarterly	2 quarters
Monthly	4 months
Weekly	10 weeks
Daily	30 items

In order to determine sample size, we need to look at the population over the course of the year. The company may perform the control only on a weekly basis, which would mean a test over ten weeks. However, if the item occurred multiple times within those weeks, a sample of up to thirty items should be tested. Periodic sampling is normally 25 percent of the population, up to thirty items.

Initial testing should be performed in each quarter, including the fourth quarter, for controls. Quarterly controls should be tested once in the first half of the year and once in the second half of the year. Once control deficiencies are identified, remediation takes place. The process owner

corrects the deficiency, whether it is operational or design, and retesting takes place according to the following Remediation Testing Table:

Frequency — Manual Control	
Quarterly	2 tests over 2 quarters
Monthly	2 tests over 2 months
Weekly	2 tests over 5 weeks
Daily	10 tests over 20 days
Multiple times per day	15 tests over at least 15 days

Methodology

Normally controls are tested on a pass/fail basis. A negligible exception rate may be tolerated, which can be defined as an error of one that, upon new sampling procedures being initiated to the population—that is, no exceptions found in the second sample—a proper conclusion is that the overall exception rate does not indicate a deficiency.

Evaluating the Impact

Definitions:

Internal control deficiency: exists when the design or operation of a control does not allow management to prevent or detect misstatements on a timely basis.

Significant deficiency: a combination of control deficiencies that adversely affect the company's ability to initiate, authorize, record, process, or report external financial data reliably utilizing GAAP so that there is a more-than-remote likelihood that a more-than-inconsequential misstatement will occur.

Material weakness: a combination of significant deficiencies that results in a more-than-remote likelihood of a material misstatement in the financial statements that will not be detected.

A scorecard type of matrix, which is a summary of significant deficiencies that are unremediated, is the next step. Remediation, however, can occur

via compensatory controls, which, according to PCAOB staff, operate at a level of precision that would prevent or detect a misstatement that was more than inconsequential or material, respectively.

The standard next indicates that aggregation should occur. For example, if a San Francisco plant has five internal control deficiencies in relation to the revenue process, they could potentially rise to the level of a significant deficiency. The focus should be on the size of the potential error that could occur in a more-than-remote likelihood situation. This is a matter of auditor's judgment. Therefore the final step is the assessment of deficiencies in aggregate with others of the same process. This is an iterative search for patterns.

Scenario A: Significant Deficiency

This is taken directly from the standard and illustrates the importance of compensating controls.

Example: Reconciliations of Inter-company Accounts are Not Performed on a Timely Basis

The company processes a significant number of routine inter-company transactions on a monthly basis. Individual inter-company transactions are not material and primarily relate to balance-sheet activity (for example, cash transfers between business units to finance normal operations). A formal management policy requires monthly reconciliation of inter-company accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed. As a result, detailed reconciliations of inter-company accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar differences between inter-company accounts. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Drawing only on these facts, the auditor should determine that this deficiency (that is, the company's failure to reconcile inter-company accounts on a timely basis) represents a significant deficiency for the following reasons: It would be reasonable to expect that the magnitude of a financial-statement misstatement resulting from this deficiency would be

more than inconsequential but less than material, because (1) individual inter-company transactions are not material, and (2) the compensating controls (which operate monthly) should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance-sheet accounts. However, the compensating detective controls are designed to detect material misstatements only. The controls do not address the detection of misstatements that are more than inconsequential but less than material. Thus there is a more-than-remote likelihood of a misstatement that is more than inconsequential, but less than material.

Scenario B: Material Weakness

The company processes a significant number of inter-company transactions on a monthly basis. Inter-company transactions relate to a wide range of activities, including transfers of inventory with inter-company profit between business units, allocation of research and development costs to business units, and corporate charges. Individual inter-company transactions are frequently material. A formal management policy requires monthly reconciliation of inter-company accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of inter-company accounts are not performed on a timely basis, and differences in inter-company accounts are frequent and significant. Management does not perform any alternative controls to investigate significant differences between inter-company accounts.

Using only these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: It is reasonable to expect that the magnitude of a financial-statement misstatement resulting from this deficiency would be material because individual inter-company transactions are frequently material and relate to a wide range of activities. Additionally, actual unreconciled differences in inter-company accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and *compensating controls are not effective, either because they are not properly designed or they are not operating effectively*. Taken together, the likelihood and potential magnitude of a financial-statement misstatement resulting from this internal-control deficiency meets the definition of a material weakness.

Deficiency Remediation Utilizing Bayes' Theorem

Bayes' Theorem is a probability theory that relates the conditional and marginal probability distributions of random variables. Bayes' Theorem tells how to update or revise beliefs in light of new evidence. In the example that follows, we are assuming the control deficiencies have at least one primary control in place, though it may not be operating at a high level. For example, in the matrix to follow, we'll look at two hypothetical deficiencies: the first deficiency is a lack of proper segregation of duties. It is partially remedied by a directive control, that is, the requirement to restrictively endorse a check upon receipt. The second matrix example has a primary control that is an authorization signature (sole signature from a manager level). What the auditors do is look within the system model for that process for compensating controls and utilize the stratagem of Bayes' Theorem to justify their position that in terms of a collection of controls, there is effectiveness at a high level that in fact remediates the control deficiency.

Utilization of an Excel Matrix to Illustrate Remediation of Control Deficiencies with Complementary Controls under Bayes' Theorem Principles

A corporation may have a hundred control deficiencies, but we will utilize this illustration on a prototype basis, with two deficiencies.

Complementary Controls Matrix

Objective	Deficiencies	Compensating Controls
Proper segregation of duties is in place.	Improper segregation of duties exists as one person maintains custody of cash, restrictively endorses the cash receipts, prepares bank deposits, and records the receipts.	The controller reviews the monthly Underwriting Income report and ties the deposits and Cash Receipts journal to the report. (f=monthly) TESTING PASSED

	REMEDIATIONSee following column.	As part of the month-end close process, the regional assistant controllers review the TB line items, looking for fluctuations that require further explanation, following up with the GL closers. (f=monthly). TESTING PASSED
Escrow savings accounts are properly controlled.	6 of 15 withdrawals from escrow IBAs tested did not have evidence of dual authorization.	All escrow transactions are processed through ITGA, which ensures that all transactions are captured, settled, and complete. This enables individual file ledgers, summary trial balances, and escrow reconciliations to be generated. (f=daily). TESTING PASSED
	REMEDIATIONSee following column.	Segregation of duties over cash receipting, endorsing checks, posting, and transporting deposits to the bank occurs within each branch. The escrow officer posts the receipts in the ledger; the escrow assistant restrictively endorses the checks and lists all the checks received; the

		receptionist prepares the bank deposit and compares the deposit ticket to the check listing; and another person transports the deposit (f=daily). TESTING PASSED

"Reasonable assurance" is the standard that internal controls should meet. This is intended to be a practical standard. There are inherent limitations in any internal control system that are such that absolute assurance is a cost-prohibitive standard. Reasonable assurance is a matter of auditor's judgment, but needs to be supported and documented with requisite expertise. The utilization of the System Control Model and Bayes' Theorem allows the Internal Audit function to do just that.

Risk Assessment

In risk assessment, worst-case scenarios are "gamed out" much as the intelligence agencies game out scenarios on a world front. If the threat happens, what are the worst consequences? How often could the event occur? And how certain are we as to the analysis? IT and finance both typically have risk control models in their Sarbanes-Oxley matrix.

If mitigating controls do not exist, you need to ask three questions:

- What can be done to reduce the risk?
- How much will it cost?
- Is the cost efficient?

For each general control and related risk, it's important that the internal auditor can show how the relevant policies/procedures/processes are:

- Created—evidence of the policy/procedure documentation
- Approved—evidence of sign-off/approval

- Implemented—test system/procedure to ensure that the policy/procedure is followed
- Reported upon—evidence of ongoing reporting (not just a one-time report produced for audit)
- Monitored/reviewed—evidence that the policy is enforced and is reviewed
- Improved—evidence of a process that includes a feedback loop for changes to be made in response to improvements

Definitions:

Preventive Controls: controls that protect vulnerabilities to avoid the occurrence of unwanted events and make an attack unsuccessful.
Detective Controls: controls that discover unwanted events or exceptions (Reports produced can include audit trails, checksums and intrusion detection reports.)

Corrective Controls: controls that remedy the circumstances that allow unauthorized activity.

Recovery Controls: controls that restore lost computing resources.

Some risks may be minor, and it may not be worthwhile to implement a control to counter them. Some risks may exist and not be remediated unless full and complete remediation of the source exists. For example, if you have an escrow operation, and your company has a directive that negative file balances more than thirty days old must be funded by corporate, then that policy either exists and is implemented, or it doesn't exist. Mitigating controls are not applicable to some risks.

Accepting the risk is one alternative. If you have one thousand branches and are concerned about lack of segregation of duties at the branches regarding cash controls, but a significant percentage of your branches have only one person authorized to handle funds, it is a *non sequitur* to have a segregation of duties deficiency at those branches, so the best you can do is have a corporate directive for immediate restrictive endorsement of funds.

Eliminating the risk is another alternative. With an IT platform you can embed IT controls that, for example, eliminate the possibility of duplicate payments or claims.

Sharing the risk is a third alternative. The cost to transfer realized risk may be mitigated by reinsurance of large-dollar amounts of potential claims, for example, in the insurance industry.

Finally, in controlling the risk, your company must establish sufficient authorization, preventive, or detective controls to work in combination that the real possibility of a control failure is extremely low.

Controls should meet a variety of characteristics:

- Their effectiveness should be a high percentile.
- Their mix should reach a high level on the theorem chart.
- They should provide evidence when control parameters are exceeded.
- An audit or management trail should occur.

Utilizing advanced techniques, internal auditors can protect their employers and clients now and in the future. Basel II requirements can be conformed to within reasonable levels of cost containment. Sarbanes-Oxley costs can be streamlined. Utilizing proven and accepted mathematical theorems, principles of auditing come to life in a brand new manner.

The net result is saving hundreds, possibly thousands, of personnel hours in Sarbanes-Oxley compliance costs. As well, the Basel II Accord is a global regulatory treaty that defines the global standards for enterprise risk management practices in the financial sector with the intent of risk mitigation. These areas of risk management can be addressed by the methodology presented here in a successful manner, resulting in significant savings in compliance costs through effective use of the internal audit function.

COBIT and Information Systems

Lessons Learned from Allfirst

The surest sign of an accounting fraud is financial transactions that bear no independent economic value. In the cases of HealthSouth, Adelphia, Tyco, Quest Communications, and Global Crossing, senior management actively participated in events that led to the deception of investors. However, in the Allfirst Bank case, as well as in the Nick Leeson disruption of Barings Bank in Singapore, which cost $1.17 billion, IT security controls and spreadsheet controls, as well as routine Sarbanes auditing would likely have either prevented these frauds from occurring or detected them at much earlier stages. Metric or performance reports should have been in place as compensating controls in the field of foreign exchange trading. Metric and performance reports in proper format have also been known to have prevented material weaknesses from being determined at large listed corporations.

Numerous control deficiencies led to the failure of the Allied Irish Bank subsidiary named Allfirst. The net loss after discovery was $691.2 million, which was created by an individual named John Rusnak, a foreign exchange trader who was involved in buying spot (current) and forward (future) contracts on Japanese yen. The difference is called arbitrage. Rusnak also speculated in currency options. These give the holder the right to buy (call) from the writer of the option, or to sell (put) to the writer, a quantity of currency for a different type of currency. He was betting that the yen would appreciate against the dollar during the exact period of time it was doing quite the opposite. He was eventually indicted by a grand jury of seven charges of fraud and falsifying bank documents and later pled guilty.

Rusnak summarized his work on a value at risk spreadsheet that had no audit controls whatsoever on it. The VaR spreadsheet utilized by this bank generated one thousand hypothetical exchange spot and volatility rates using Monte Carlo simulations and then calculated a resulting profit or loss statement. The VaR utilized the ten worst outcomes provided by simulation to provide a 99 percent statistical certainty of results. The problem was that he inserted false links into the spreadsheet, primarily in order to generate more than $500,000 in bonuses to himself. The VaR, whose purpose it is to

provide a maximum loss range for the portfolio, was in effect worthless, but it was accepted by management. The bank had set a VaR trading loss limit of $1.5 million, the maximum exposure they desired. Since a trader was responsible for calculation of his own VaR without any checks and balances, this left an open door for Rusnak to proceed. Hedging positions were utilized to make the VaR numbers positive rather than negative. The bank's risk management group did not confirm his numbers. Another oddity was that he captured Reuter's Exchange Rate input directly, rather than through a back office, allowing him to place false values on exchange rate calculations.

The currency market is estimated at over $1.5 trillion, and there is a separate Eurocurrency market. The markets are virtual—that is, no physical location houses them. Dealing rooms are connected electronically. Interest rates are set, and the Foreign Exchange Market (FOREX) establishes exchange rates. Rusnak's losses at the end of 1997 were $29.1 million. The options Rusnak wrote were false—they were utilized on the surface for hedging. A close look at his options would have raised red flags, as they had different expiration dates but the same premium, which is not logical. The trades were written on the opposite side of the bets he placed. By the end of 1999 his losses were at $41.5 million.

Allfirst's treasury had a standard operating procedure of confirming all trades, but this policy was not followed. Therefore options appearing on the books that purported to have value were worthless. When questioned, Rusnak produced false confirmations, which were not examined until the very end. He was also allowed to trade 365 days a year with no mandatory vacation. U.S. federal rules on foreign exchange traders require at least ten days of continuous time off so that rotation of responsibilities can occur.

Strong IT and finance internal controls and an annual audit at varying times during the year would have likely detected the fraud well in its early stages. Controls under the COSO framework would not have allowed the fraud to remain concealed for a period of years. IT security controls are a Sarbanes-Oxley mandate.

COBIT

The body of knowledge developed by COBIT on an open source basis is quite amazing. COBIT 4.0 was the product of several years of research and improvement to the 3.0 model developed in 2000. It is a breakthrough governance tool that uses non-technical language to help organizations focus on their information technology support of business objectives, including compliance with ISO 17799, COSO I, and COSO II. When Charles Schwab acquired U.S. Trust and became a financial holding company, senior management recognized the need for an improved IT governance structure and chose COBIT. Universities, public companies, and governments around the world utilize the COBIT standard. The COBIT framework contains thirty-four high-level Control Objectives, which are grouped into four domains: planning and organization, acquisition and implementation, delivery and support, and monitoring. Strategies and objectives are therefore linked. The delivery and support domain covers actual processing of IT transactions and therefore application controls.

Studies have reflected that medium-level public companies normally have one hundred to two hundred software programs running their IT platform, a combination of off-the-shelf programs and specifically developed software under a system development life cycle. The average lines of source code are approximately 30 million. It can be a daunting task to determine which of those software platforms are required to be compliant under Sarbanes-Oxley and then to produce test plans to achieve that objective.

System Development Life Cycle

The waterfall model is a popular version of the model for software engineering. Often considered the classic approach to the systems development life cycle, the waterfall model is a development method. Waterfall development has distinct linear goals for each phase of development. The advantage of waterfall development is that it allows for compartmentalized managerial control. A schedule can be set with deadlines for each stage of development, and a product can proceed through the process. The disadvantage of waterfall development is that it does not allow for non-paradigm thinking, creativity, or change once it is

set in motion. It is used by a variety of multi-national companies. SDLC auditing concentrates on assessment of risk and auditing those control points in the development process that are high-risk controls in the planning, implementation, development, quality production, and post-production stages of development of proprietary software.

IT processes, like finance processes, are evaluated at the entity level and at the process level. A joint effort is involved. Application testing of off-the-shelf programs would, for example, be a responsibility of the finance section of the Sarbanes team versus the IT section. COBIT has 215 detail control objectives that follow its high-level standards and best practices. COBIT guidelines are generic and thus must be tailored to individual needs. It can be used for a variety of audiences, but it must be tailored. If management is unfamiliar with the COBIT structure, the first step is for the internal audit group responsible for IT to develop a COBIT process model and use that as a baseline model to establish control objectives for internal and external certifications (including SAS 70).

Specifically, COBIT provides critical success factors that define the most important implementation guidelines to achieve IT control. It provides key goal indicators that define the most important management-oriented implementation guidelines, and it provides key performance indicators, lead indicators of the progress of the IT department.

The risk control matrix for IT is a joint development of the IT department, internal audit, and senior executives, such as the CIO (chief information officer). The first step is often a memorandum from the IT audit manager to assess the re-engineering of the IT function toward Sarbanes compliance. This letter would be directed to division managers across business units and segments. A preliminary survey would be utilized to list all thirty-four COBIT processes and ask respondents to indicate responsibility levels. If IT documentation is available in narrative form of the primary Sarbanes-Oxley-critical platforms, another part of internal audit could begin an assessment of risk levels according to the COBIT information criteria. As the risk matrix is in progress, another set of auditors could recommend tentative test plans based on perceived risks. Scope would be based on conferences with the external auditor.

IT Auditing

Key control IT testing can be broken down into several categories: IT application controls and IT general controls. Application controls can be further divided into security and reporting. Security would encompass objectives including password administration and authentication, and user access (utilizing the concept of "least privilege," which is similar to the government "need to know" standard: the user should have access only to those platforms that he requires); and changes to user access should be authorized and reviewed. Application controls also apply to the reporting area, which would include the complete, accurate, and valid recording to the consolidated financial statements. A detailed matrix should show the objectives, as discussed for example, tailored according to COBIT and then related to financial statement assertions (CAVR, presentation and disclosure), risk, a test of controls and a statement of inherent risk. Every reporting location and every Sarbanes-critical IT platform must be evaluated and tested with these matrixes in order to support the Section 302 Sarbanes Certification Report.

IT general controls are normally divided into up to five categories, including change management, security, data management, control environment, and computer operations. Examples of change management objectives around which a matrix should be developed include key objectives, such as: significant changes are tested at the unit, system, integration and user level; emergency change programs are approved, tested, documented, and monitored; software updates are applied and tested on a timely basis; and the SDLC methodology utilized to ensure application controls are accurate, complete, and valid is tested.

Security objectives around which a matrix should be developed include restricted access to processing areas; restrictive grant of user rights; computer virus/firewall/intrusion detection systems in place; password strength/security procedures in place; segregation of duties; monitoring and logging of security activity; LAN/Network security; VPN policies; and encryption procedures for critical data.

Data management objectives around which a matrix should be developed include accurate interface between systems (for example, legacy software to

Excel applications, which are then uploaded to general ledger software); database and table accuracy; and the complete, accurate, and valid conversion of data. LDAP directories, such as Microsoft's Active Directory, are servers that index data accessible via standard lookup functions. User authentication and access is often automated at these sites.

Control environment objectives around which a matrix should be developed include the IT organization segregation of duties and an IT backup plan utilizing RAID or another similar technology. Business continuity and disaster planning are not required objectives under Sarbanes, since they do not affect current financial reporting. However, backup of daily operations is inclusive with Sarbanes testing procedures.

Computer operations/logic objectives include third-party service contracts (security concerns), key system inventories with details as to level of complexity, interface with general ledger systems, user and reviewer information and key metrics, SAS 70 Reports, environmental (company) controls, escalation procedures in regard to exception reports, batch process review procedures, and record retention and storage processes.

Database Encryption

Recent cases in the public domain of security breaches, often involving hundreds of thousands or millions of pieces of data related to proprietary credit card information, could have been prevented by utilizing basic methods of encryption. In some cases where laptops containing sensitive files were stolen, it would have been relatively simple for the data to have been compressed and encrypted utilizing available software, eliminating that risk. E-mail, database files, and virtually any other type of file can be encrypted either before transmission or before storage. In this process the original content is translated by means of an algorithm. A key is needed to accurately decode.

There are two kinds of systems in cryptography today: *symmetric* and *asymmetric*. Symmetric cryptography utilizes a secret key, and asymmetric systems use a public key to encrypt and a separate private key to decrypt data. Asymmetric systems are also known as *public key* cryptosystems. Symmetric cryptosystems have the difficulty of keeping the data in the

secret key securely. An efficient solution is a public key cryptosystem, such as RSA, which is utilized in the PGP security tool. PGP Encryption is a program developed by Philip Zimmermann in 1991 that provides cryptographic privacy. For e-mail, PGP sends the key and the encrypted message simultaneously. It encrypts the key utilizing a public key algorithm such as RSA and encrypts the message using another secret key algorithm. When received, the secret key is decrypted first so that it can be used to decrypt the message. Distributing asymmetric keys is quite a bit easier than distributing symmetric keys. The public key can be distributed through any medium. RSA is named after Rivest, Shamir & Adleman, and is the most widely utilized asymmetric encryption process. RSA does not interpret plain text as a bit sequence, but as large numbers. The key itself is a number, and the larger it is, the more secure it will be.

RSA and DES have been the most significant algorithms utilized in modern cryptography. DES is the well-known Data Encryption Standard. It is a cipher that operates on sixty-four-bit blocks of data utilizing a fifty-six-bit key. It is a "private key" system. DES was invented by IBM and is the most widely used symmetric algorithm in the world. Double-length DES keys were the standard in the financial industry for a number of years. The Electronic Frontier Institute in February 2000 succeeded in cracking DES, and it was then considered obsolete. The next algorithm to emerge was Triple-DES. The Triple-DES algorithm works as follows: Encrypt with K1; decrypt with K2; encrypt with K3 and then decrypt with K3; encrypt with K2; followed by a decrypt with K1. DES is therefore applied three times.

The National Institute of Standards put out a proposal for a higher standard, which was to be called AES (Advanced Encryption Standard). The algorithm chosen was a cipher proposed by two Belgians. The National Security Agency (NSA) stated that this was secure enough for government and non-classified data. In June 2003, the U.S. government announced that AES may be used for classified information:

> The design and strength of all key lengths of the AES algorithm (that is, 128, 192, and 256) are sufficient to protect classified information up to the SECRET level. TOP SECRET information will require use of either the 192 or 256 key lengths. The implementation of AES in

> products intended to protect national security systems and/or information must be reviewed and certified by NSA prior to their acquisition and use.

This marks a milestone in that the public has had access to a cipher approved by NSA for top secret information.

For encrypting e-mails, the PGP (Pretty Good Privacy) program is often the standard. Phil Zimmerman also developed it, and further development has occurred in the corporate world. Every personal key utilized in PGP is protected with a *passphrase.* A personal key can be utilized only after this phrase is inserted. It is a password, but more than a password in that it is normally a complicated phrase. In order to exchange information and data with your correspondents, you must distribute a public key to them, which is done via email. If you receive a signed message, PGP notices the signature and adds a status message informing the recipient the e-mail has a valid signature. PGP keys of sufficient length, at least 2,048 bits or greater, are secure. Only the NSA would have the ability to decode a key of that length. Commercial programs such as MS Outlook have security levels at various points that can be chosen during setup.

Steganography

Steganography is the art of placing messages in images. The use of digital images for steganography exploits the weaknesses in the human visual system, which has a low sensitivity in random pattern changes. If you are concerned about corporate competition for top secret/sensitive data you are transmitting electronically, you might consider utilizing this process.

Steganographers do not use keys, as do cryptographers. Steganography is based on the principle of "hiding something in plain sight." The data may be as harmless as a picture of your mother. However, encryption is often combined with steganography. The text is stored, but on the chance it is discovered, it would have to be decrypted. Passwords for decryption would be communicated, for example, by telephone prior to sending the message. Steganography can be utilized as part of a layered security approach to corporate data that is categorized "sensitive and compartmentalized." This could include memoranda regarding possible acquisitions, settlements, and

other data that must remain secure. There are a variety of commercial software packages that allow one to embed images in JPEG files, without a third party even being able to recognize that an embedded image exists. CD-ROMs, photos, text files, and even compressed music files can contain hidden data. The information-hiding capacity of a color image can vary from 10 percent to 50 percent, depending upon the software utilized.

Steganography began with the ancient Greeks and Romans, and the original meaning of the word is "covered writing." In ancient Greece, text was written on wax-covered tablets. In one account Demeratus wanted to notify Sparta that Xerxes intended to invade Greece. To avoid detection, he removed the wax from the tablets and wrote a message on the wood. He then covered the tablets with wax again. The tablets appeared to be blank to all outside observers. Invisible inks were utilized as late in history as World War II. These inks darken when heated. Null ciphers have also been utilized. The real message is coded in what appears to be an innocent transmission. By taking, say, every seventh letter of the entire message, an entirely new message appears. J. Edgar Hoover was one of the first individuals to be concerned about espionage via microdots. Microdots are the size of a period and can contain the clarity of a one-page message.

An ABC news special broadcast the image that follows. Contained within this image, invisible to the naked eye, is another image embedded with steganography of a B-52 graveyard satellite photo over an Air Force Base. Steganalysis (the investigation of hidden information) was utilized by a security expert to extract the hidden photo. But as you can plainly see, there is no evidence to the naked eye that this image is anything other than what it appears to be.

Obviously steganography is of some concern to the government, since if one can hide 5 KB of information on a picture, as below, that hidden message could be utilized to transmit instructions to those with interests against that government, and an electronic image can be posted anywhere. The CIA and the Pentagon are funding steganalysis research at Carnegie Mellon. Stegdetect is a common tool used by analysts. Stegdetect can find hidden information in JPEG images using such steganography schemes as F5, Invisible Secrets, JPHide, and JSteg. It also has a graphical interface called Xsteg. The only possible visual sign of hidden data is the padding or

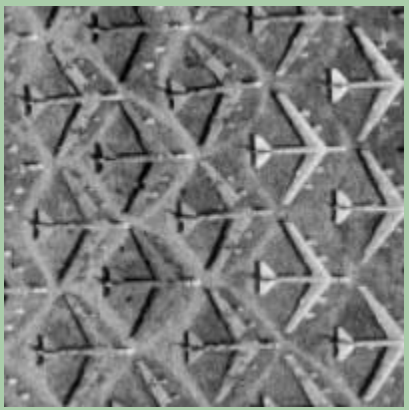
cropping of an image. As PCs become more advanced, the opportunity for greater security, as well as greater threats to security, increases.

A. COVER IMAGE [1]

B. ORIGINAL IMAGE FROM ABC

- During the broadcast, an Internet security consultant displayed a jpeg image, shown on the left.
- He asserts that it contains a hidden image of a B52.
- The broadcast showed fabricated images that were suggesting terrorist use of steganography. In fact, it was just a demonstration.
- Read about it in a posting on the Politech list or in an article by Duncan Campbell in Telepolis.

C. HIDDEN MESSAGE



D. STEGANOGRAPHIC DETECTION FRAMEWORK IN ACTION

- The following demonstrates the use of the Steganography Detection Framework:
- Stegdetect shows that there might be hidden information inserted by the JSteg tool.

	• Stegbreak verifies that a hidden message exists. The secret key to extract the hidden message is "abc." • The hidden message turns out to be an image. It is displayed on the left. • The image shows an aerial view of the "B-52 graveyard" at Davis-Monthan Air Force Base. Available via Terraserver.

[1] *Photos courtesy of Niels Provos, http://niels.xtdnet.nl/stego/abc.html*

Disclosure Requirements

Real-Time Disclosure

In the wake of Enron, when Ken Lay was telling shareholders to buy Enron stock while at the same time he was selling tens of millions of dollars of it, Congress included Section 409 of the Sarbanes-Oxley Act, requiring in effect, according to SEC rules subsequently passed, a four-business-day disclosure requirement for disclosures of material events. Form 8-K is utilized to disclose. In the EDGAR database available online, set up by the SEC, one can enter the company ticker symbol and immediately have access to all corporate filings of any listed company.

Material events requiring disclosure include significant changes to previously published financial data, events that create an acceleration in financial obligations, direct or off-balance-sheet material financial obligations, and material impairments of assets. As well, the election and removal of key executives are listed. The responsibility to provide these disclosures rests with the disclosure committee.

Before Sarbanes-Oxley, insiders did not have to report stock trades until ten days after the end of the month when it occurred. Now option grants are included within the real-time disclosure rules.

Whistleblower Protection

Section 301 of the Sarbanes-Oxley Act requires publicly-traded corporations to establish audit committees. These committees are then required to establish procedures for employee concerns (anonymous and non-anonymous) regarding questionable accounting practices. Internal reports to the audit committee are fully protected.

Interestingly with Enron, the Watkins letter was first sent on an anonymous basis. It was not taken seriously, and Lay seemed to rely on the comfort of opinions he had received from counsel and Arthur Andersen. Both of these firms had conflicts of interest that apparently jaded their views. An independent forensic investigation opinion was desperately needed, but it did not occur. If Ken Lay, at the point at which he had received the first anonymous letter from Watkins, had simply disclosed it to the board and asked for a separate board committee to be formed to investigate the allegations, the final result would have likely been much different for Lay himself. The other parties had deep involvement that could not be remedied at that point, but as chairman and CEO, he had one last opportunity before his acts crossed the line to set up an independent committee that should have reported directly to the board and the audit committee. The element of scienter (deliberate knowing) of securities fraud was crossed at this point. Non-disclosure of material related-party transactions is part of the definition of securities fraud. This group should have retained independent consultants who had no prior affiliation whatsoever with Enron, and a forensic audit should have occurred of the LJM, Raptor, Chewco, and other SPE entities. If this had been combined with an 8-K disclosure, Ken Lay would not have faced the fraud and conspiracy charges he later faced, in my opinion. The value of independent consultants cannot be overstated when issues of this manner arise.

Section 307 establishes new rules of conduct for counsel, as well. When the Watkins letter was read by an in-house lawyer, an antagonistic response was generated without going into the full value of the letter. Under Sarbanes-

Oxley it is now matter of federal law that counsel must report "evidence of a material violation of securities law" or "breach of fiduciary duties" to a corporation's CEO. If this does not achieve an action plan, it is further required for them to report to the audit committee. It would be a protected report. Therefore, counsel are viewed from this point forward as "mandatory whistleblowers" under Title 15 of the U.S. Code.

Rulemaking

Section 107 of the Sarbanes-Oxley Act states that the SEC shall have "oversight and enforcement authority over the Board." The SEC therefore can provide the board with additional operating rules and itself can inspect the board (PCAOB). In effect it has the same rule of law over PCAOB as it does the NASD and other self-regulating bodies. PCAOB is required to file proposed rule changes with the SEC, which the SEC may then amend, approve, or reject. PCAOB coordinates investigations with the SEC.

Compliance Dates

Compliance dates for Sarbanes-Oxley Act certifications under Section 404 vary with the type of reporting entity. Accelerated filers, which are seasoned U.S. companies with floats over $75 million under Exchange Act Rule 12b-2 have required compliance for fiscal years ending on or after July 15, 2005. Extensions have been granted for domestic issuers that are not accelerated filers. These companies must comply beginning with the annual report for the first fiscal year ending on or after December 15, 2007.

Microcap companies—small companies with limited revenue but that are public—are exempt from Section 404 compliance until fiscal years on or after June 15, 2010. These rules are complex and subject to change, and counsel should be obtained. A variety of companies who fall in the microcap category have decided to de-list – go private, in order to avoid the requirements of compliance with Sarbanes Oxley.

SEC Rules and Certifications

Section 906 of the Sarbanes-Oxley Act requires each periodic report containing financial statements filed with the SEC after July 29, 2002, to be accompanied by certifications of the CEO and CFO that state the periodic report complies with the Exchange Act and presents fairly the financial condition of the corporation.

A Section 906 reads as follows:

> Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002:
>
> In connection with the Form 10-Q of (registrant) for the period ended (dates), as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I (name of CEO) certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:
>
> (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
> (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.
>
> A signed original of this statement has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

The following contains SEC commentary on the Section 302 and 404 certifications and the exact form preferred by the SEC:

> The certification requirement that we are adopting today implements a Congressional mandate. We recognize that any implementation of the Sarbanes-Oxley Act will likely result in costs as well as benefits and have an effect on the economy. We are sensitive to the costs and benefits of our adoption of a rule that requires issuers to maintain

disclosure controls and procedures. We discuss these costs and benefits below.

The new certification requirement may lead to some additional costs for issuers. The new rules require an issuer's principal executive and financial officers to review the issuer's periodic reports and to make the required certification. To the extent that corporate officers would need to spend additional time thinking critically about the overall context of their company's disclosure, issuers would incur costs (although investors would benefit from improved disclosure). The certification requirement creates a new legal obligation for an issuer's principal executive and financial officers, but does not change the standard of legal liability.

Issuers are already required to maintain reporting controls and procedures for identifying and processing the information needed to satisfy their disclosure obligations under the Exchange Act. The new rules do not dictate that issuers follow any particular procedure. By allowing issuers to determine what procedures are necessary to meet the obligation of the rules, we are mitigating the costs associated with compliance. Some issuers may need to institute appropriate controls and procedures. Other issuers may need to enhance existing informal or ad hoc controls and procedures. These incremental costs are difficult to quantify. While we requested comment and supporting data in connection with the June Proposals on the cost of implementing, or upgrading and strengthening existing, reporting controls and procedures, we received no specific comment letters in response to that request.

The required periodic evaluation of reporting controls and procedures likely will result in costs for issuers. The new certification requirement likely will require issuers to create or strengthen internal controls to enable their senior executive officers to meet their certification obligations

under the new rules. Many issuers already regularly monitor and evaluate their controls and procedures. Because the size and scope of these internal reporting systems is likely to vary among issuers, it is difficult to provide an accurate cost estimate.

Conversely, the new rules are likely to provide significant benefits by ensuring that information about an issuer's business and financial condition is adequately reviewed by the issuer's principal executive and financial officers and the issuer's internal systems keep pace with the growth of the business.

We believe that investor confidence in corporate disclosure has suffered, in part, because of a belief that corporate officers may not devote sufficient attention to the preparation of their companies' periodic reports and to the disclosure controls and procedures that generate the data from which they are prepared.

The new rules should help to ensure that issuers maintain sufficient internal reporting controls and procedures to provide reasonable assurance that they can record, process, summarize and report the information that is required in all Exchange Act reports. To the extent that issuers do not maintain adequate controls and procedures, the new rules should lead to the development, or enhancement and modernization, of these controls and procedures. The required periodic evaluation of these controls and procedures should ensure that issuers devote adequate resources and attention to the maintenance of their internal reporting systems. Additionally, the required evaluation should help to identify potential weaknesses and deficiencies in advance of a system breakdown, thereby ensuring the continuous, orderly and timely flow of information within the company and, ultimately, to investors and the marketplace.

GENERAL INSTRUCTIONS: 10 Q Certification Controls and Procedures.

Furnish the information required by Item 307 of Regulation S-K (§229.307 of this chapter).

* * * * *

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this quarterly report on Form 10-Q of [identify registrant];

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to

us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: .....

_____

[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

GENERAL INSTRUCTIONS: 10 K Certification

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 10-K of [identify registrant];

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) Presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: .....

_____

[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 and 15d-14. The required certification must be in the exact form set forth above.

Section 404 Assertion:

In our opinion, management's assessment, included in "Management's Annual Report on Internal Control Over Financial Reporting" that the Company maintained effective internal control over financial reporting as of (date) based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating

> effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.
>
> A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

The Offshore Impact of Sarbanes-Oxley

The U.S. legislators who drafted the act most likely had little idea of the enormous effect it would have on public markets throughout the world. In the years since, the United Kingdom and Canada have passed their own versions of the Sarbanes law. On August 1, 2003, France adopted a law on financial security similar in intent to Sarbanes, and the Japanese Diet has produced J-SOX for Japan. Mergers and acquisitions have been affected by this law in the United States, and offshore Regulation S offerings have increased. Increased compliance costs in Europe will occur over a phase-in period according to an updated Eighth Directive that impacts all twenty-five member EU states with increased corporate governance. Worldwide

Sarbanes compliance and increased audit costs may shortly approach $50 billion.

Mergers, Acquisitions, and Regulation S

The primary opportunity for closely held corporations seeking additional capitalization used to be the IPO. Now with the SEC only deferring micro-cap exemptions for small companies to 2007, small business owners concerned with the costs of Sarbanes compliance have only one traditional route of capital infusion—the sale of shares to publicly held companies. According to statistics, the market premium for similar sales has recently decreased to about half of what it was prior to Sarbanes-Oxley. Increased due diligence costs, and the perceived liability of potentially weak internal control systems that need cost-compliant change have potentially caused this market dilution. An alternative has recently been brought to the attention of small business owners: Regulation S, an SEC exemption for sales of securities to people outside of the United States.

Regulation S was adopted by the SEC in 1990 and modified in 1996. Very few if any empirical studies of offerings under Regulation S have been done, partly because the information cannot be obtained from routine database sources. However, some investment bankers estimate up to 5 percent of all North American capital raised since 1990 has been accomplished via Regulation S offerings. One of the main advantages of these types of offerings is that data can be put together much more quickly.

Let's review the initial public offering (IPO) and how it is normally regulated. Jurisdictional variants exist, but generally the company seeking to go public hires an investment banking firm that will serve as its primary underwriters and manage the IPO. The underwriter in connection with company counsel and advisers prepare an elaborate business plan just before pricing the issue. The prospectus includes *pro forma* statements, estimates of value, and a history of the financial operations of the company. Since the entity is going public for the first time, extensive disclosure is required. Executive compensation is disclosed, as well as marketing plans. However, stricter guidelines of certain world jurisdictions are not always applicable, depending upon the situs chosen for the IPO. Many companies

that are onshore may well have never needed to be. Some advisers feel the U.S. market has reached a saturation point in any case with IPOs.

Regulation S requires an offshore offering not directed to any U.S. person, and requires certifications of such. Certificates are inscribed that transfers are subject to restrictions. No direct U.S. advertising is permitted. However, if a company is a U.S. issuer, SEC regulations stipulate if assets exceed $10 million and equity holders exceed 300, then under Section 12(g) SEC reporting including Sarbanes-Oxley compliance becomes effective. In February 1998, the SEC adopted amendments to Regulation S designed to prevent perceived abusive practices in connection with offerings of equity securities to domestic issuers, the Securities Act Release No. 33-7505 (February 17, 1998). In addition to extending the distribution compliance period to one year for such securities (and requiring purchasers to agree that hedging transactions with respect to such securities will be conducted in compliance with the Securities Act), the amendments classify such securities as "restricted securities" under Rule 144. As a result, for such securities to be resold in the United States or to U.S. persons without registrations, the requirements of Rule 144 must be met, including the one-year holding period.

In an effort to respond to questions regarding what constitutes an offer targeted at the United States, the SEC provided an interpretive release effective March 23, 1998, that gives further guidance in the areas where securities laws and electronic media interact. This SEC interpretation clarifies the SEC's requirements for the electronic delivery of documents under the federal securities laws, issuer liability for Web site content, and the requirements for conducting online offerings. This interpretation rules that Web postings will not come under U.S. regulation as long as there are precautionary measures that are "reasonably designed to ensure that offshore Internet offers are not targeted at the U.S."[2]

Going Public in Bermuda

The Bermuda Stock Exchange (BSX) was established in 1971. Today it is the world's largest offshore, fully electronic securities market. Unlike AIM

[2] Duke Law Review, www.law.duke.edu/journals/dltr/articles/2001dltr0007.html

in the UK or the European Neur Market, the BSX Mezzanine Market offers development-stage companies the opportunity to list on a recognized international exchange without having to commit to a full IPO. The Mezzanine Market supports an active domestic market that trades daily, Monday through Friday.

Trading on the BSX is executed through the Exchange's customized trading system (Bermuda Electronic Securities Trading). There is a light but effective regulatory environment, making it conducive to new listings, as it is bound neither by the European Union Listings Directive nor SEC regulations. The SEC recognizes the BSX as a "Designated Offshore Securities Exchange."

Bermuda has a reputation as a world-class center of commerce with a business-friendly environment, a stable economy, and a superb collection of talent and intellectual capital. Bermuda regulatory systems are based on British Common Law. The country has maintained a sterling reputation. Located just 700 miles from the U.S. eastern seaboard and less than seven hours from London, it is geographically independent and neutral.

The BSX Mezzanine Market

BSX offers growing e-commerce, high-tech, and development-stage companies the opportunity to list on a recognized international stock exchange at a much earlier stage than is currently possible in any other jurisdiction. This is largely because the BSX restricts Mezzanine Market investment to "qualified investors." This is defined as one whose investment is not less than $100,000 or meets another adequate suitability test. Subject to this restriction, a company does not have to have any minimum track record, market capitalization, free float, or profitability in order to qualify for a full public listing on the BSX's Mezzanine Market. However, once it is listed on the BSX, the company has all the profile and prestige of being a publicly listed entity, without having to conduct a retail IPO.

The company's visibility is enhanced, including full exposure on Bloomberg and Reuters. Worldwide recognition can be achieved, as the BSX represents a full public listing on a recognized stock exchange. This adds considerably

to the prestige of the firm when dealing with customers and suppliers and helps the company expand its market share. The corporate tax regime in Bermuda has no profits, income, or capital gain taxes. Listing fees are very reasonable, and the prospectus is often the same document as the private placement offering document.

Advantages of a listing on the BSX include:

- A listing on a recognized stock exchange is widely recognized as a prestigious mark of advancement for any company and adds significant marketability to its securities.
- "Listed" securities are more attractive to institutional investors outside the United States (who often limit the amount they can invest in "unlisted" securities).
- The BSX creates a mechanism for trading—representing an important "exit strategy" for institutional investors.
- A high market value based on future growth prospects can be attained.

In summary, the BSX has established a Mezzanine Market as a logical first step for issuers who wish to eventually list on another international market and create a clear "roadmap" for that listing. Private companies can then list on the Mezzanine Market at the earliest stage. This market can groom high-potential companies at an early stage so that they are ready to meet full international listing standards of the exchange they choose for their ultimate IPO on a recognized exchange, such as the London AIM.

The London AIM Market

Specifically tailored to growing businesses, London AIM combines the benefits of a public quotation with a flexible regulatory approach. AIM gives companies from all countries and sectors access to the market at an earlier stage of their development, allowing them to experience life as a public company. Since AIM opened in 1995, more than 2,200 companies have been admitted and more than £24 billion has been raised collectively.

An AIM quotation offers:

- A flexible regulatory regime
- Access to a unique, globally respected market
- Access to a wide pool of capital
- Enhanced profile—heightened interest in your company
- Increased status and credibility
- Currency for and easier rules on acquisition
- Eligibility for a range of tax benefits

The table below highlights the main differences in the admission criteria for the Main London Market and AIM:

Main Market	**AIM**
▪ Minimum 25% shares in public hands ▪ Normally 3-year trading record required ▪ Prior shareholder approval required for substantial acquisitions and disposals ▪ Pre-vetting of admission documents by the United Kingdom Listing Authority (UKLA) ▪ Sponsors needed for certain transactions ▪ Minimum market capitalization	▪ No minimum shares to be in public hands ▪ No trading record requirement ▪ No prior shareholder approval for transactions* ▪ Admission documents not pre-vetted by Exchange nor by the UKLA in most circumstances. The UKLA will vet an AIM admission document only where it is also a Prospectus under the Prospectus Directive ▪ Nominated adviser required at all times ▪ No minimum market capitalization

Case Studies of Anti-Fraud Controls

Typology of cases occurring within the insurance industry normally focuses on one of four categories: Use of Anonymous Asset Types, Concealment within Business Structures, Utilization of Cover Businesses or Legends, and Use of False Identities or Straw Men. Once the monies are obtained from these pretenses, offshore or laundering techniques are often applied to disguise the money's source.

We will study the types of cases written to a unified style, utilizing fictional names and locations. Each case study will be followed by a section called "Indicators," which are red flags branch managers and auditors should be aware of. Each case is based on a real set of similar circumstances that the financial intelligence unit of the insurance company then investigated and brought to light to authorities, normally resulting in criminal proceedings for charges as varied as money laundering and tax evasion. Almost all insurance companies in the United States have a special investigative unit they may call by several different names. The units serve to collect the data and brief enforcement authorities.

Anonymous Asset Types

Use of anonymous asset types has come into play in recent years, as it is the simplest. Criminals are aware that the less audit trail available, the less likely a financial investigation will either detect or prove beyond a reasonable doubt that a crime actually occurred.

Dave Sheinfeld was an American citizen who approached a bank in Europe and told the bank clerk he would like to open a new account. He said he had just closed out other accounts because of poor service and would like to deposit all withdrawn cash. Opening a gym bag, he told the clerk that $1,750,000, give or take a few hundred, was in the bag. The bank clerk subsequently opened the account, but the explanation of poor service he had been given in the past raised a flag of suspicion. This led to a series of amazing and startling discoveries.

After the customer left, the clerk contacted the FIU of his country. More than one hundred countries currently have FIUs—Financial Intelligence

Units. They belong for the most part to the Egmont Group. This is an elite intelligence force that meets once a year in a castle in Western Europe and has a common Web server and intelligence database to which more than one hundred nations subscribe. You may think if you open an account in the Cayman Islands or the Cook Islands or Vanuatu, that there is no one watching. You are wrong, as those countries have FIUs that are part of the Egmont Group. In the United States, the participating FIU is called FinCen in Washington, D.C. These groups talk daily, share a common database, and have access to virtually every financial transaction record you can imagine. The group has been effectively operating since 2000.

A month later Dave returned to his bank. This time he decided he would transfer the funds to an account in a tax haven country, Barbados. The bank clerk stalled him while officers from that country's FIU arrived to have a discussion with him. He indicated that the monies were the proceeds of an inheritance from his father, who owned large tracts land that had been sold to developers. As the conversation continued, discrepancies appeared. The local police were brought in, and his hotel room was searched.

In his hotel room seven different passports were found with various names, but Dave's picture was on each. Safety deposit box information at five different banks was located. In checking their law enforcement database, they discovered that Dave Sheinfeld in fact was deceased. He had passed away approximately three years ago. At this point he was placed in custody, and his funds were frozen.

Under questioning he told a very tangled, but apparently true story. Dave had taken out a $5 million life insurance policy on himself, with a relative named Todd Davies as the beneficiary. Dave had then decided to take a vacation in Haiti, where newspaper articles indicated he had been murdered. In Haiti, medical examiners are not even required to view a body before issuing a death certificate, providing three people swear a death has occurred. After having arranged for his own demise, the insurance was collected through Todd Davies, who was actually a distant cousin, as well as a co-conspirator. Todd reportedly received 20 percent as a "finder's fee" and turned the monies back over to Dave. Dave had been traveling overseas ever since then, living off sailboats and banking at convenient ports under different identities.

Indicators: Overseas death certificates are relatively easy to obtain and create hearsay problems in U.S. courts even when they are contested. When your documentation and witnesses are overseas, obtaining evidence is also difficult. Dave had pulled off the perfect crime—he was Dead On Arrival in Haiti. But he had not counted on the existence of foreign FIUs. The remaining monies that were located were turned over to the insurance company that had originally lost the funds, and Dave was charged with money laundering and several other matters and is awaiting a trial.

Concealment within Business Structures

Jack was a popular man about town and was a senior contract closer employed by Free and Clear Title Company in South Florida, under licensing by two different underwriters.

The underwriters had a provision in the agency agreement with Free and Clear that allowed them to audit annually or more frequently the escrow operations of the agent as necessary to protect their interests. The underwriters issued closing letters and were responsible for any misappropriation of funds, subject, of course, to their rights under subrogation.

An escrow check for $945,000 was disbursed to Lamar Thomason P.A., a Miami law firm. The check was intended to pay an outstanding mortgage on a home, but instead Jack diverted the check by having a courier of his choice deliver the check. His courier was Tom Menes, his accomplice, who drove up to the agency office in a newly-painted car with "Menes Courier Service" written on the side.

Menes proceeded to deliver the check to another bank, where he and Jack had established a Nevada company called "Lamar Thomason." After the endorsement was forged, the check was deposited. If the check had been deposited in a personal account, because of its magnitude, it would have been suspicious, and possibly the banking officer would have filed a Suspicious Activity Report with FinCen, a joint venture of the Treasury Department and CIA. However, as it was payable to a business entity, and the bank had been told that Lamar Thomason was a trading company involved in fruit delivery, it raised no red flags at the bank. The day after it

was cleared, $50,000 was withdrawn in cash, and the balance was then wire transferred to a Bahamas entity that had been previously established called "ABC Corporation." The ownership of ABC was divided equally between Jack and Tom.

By the time the real law firm inquired where the payoff check was, Jack was buying a new car. Tom had taken his share and left town. Jack continued in his position—dumbing down and keeping quiet. The agency manager reported the defalcation to the underwriter and the local police. The underwriter was required to cover the loss. The check was traced to the false flag entity that had been set up, and a report provided to the Florida Department of Law Enforcement. FDLE discovered that the Nevada company was co-owned by Jack and Tom. Jack was arrested and Tom is now considered a fugitive.

Indicators: The bank should have realized that impropriety was involved because of large-scale cash transactions, the rapid off-shore transfer after the funds were deposited, and the unrealistic wealth compared to the client's profile. The red flag to the agency should have been the need for a check personally delivered by courier instead of the more normal process of a wire payout directly to the lawyer's escrow account. As of this writing, the underwriter is seeking to determine how much of the funds are left in the Bahamas and their recourse under an Anton Pilar order, which is a freeze of the bank account in Nassau owned by ABC Company. The agent is out of business. It was later determined that the cost of this fraud to the perpetrators was only $950, the cost of forming the two companies.

Utilization of Cover Businesses or Legends

In the third case, we'll notice that the perpetrators use professionals. This can be understood by the motive that in utilizing another respectable business, in this case a law firm, the criminal funds will probably be viewed as originating from that firm and therefore legitimate.

This was a complex scheme headed by J.R. Smith with the assistance of a real estate lawyer who is now serving nine years in a federal prison. J.R. ran seminars about how houses can be purchased with little money down. At the same time he had an office in Savannah, Georgia, which would contract

for cheap homes and then simultaneously close, usually the same afternoon, without any good funds or money at risk, to his seminar investors for inflated prices, often double. Involved were 287 sales with a gross profit of $5.8 million. The lawyer handled all real estate closings for J.R. and received legal fees for each closing approximating $500 per closing, just under $150,000 in total.

In reality J.R. did not buy anything. Mortgage brokers working with J.R. helped investors get loans for up to 90 percent of the inflated selling prices. Local mortgage brokers who spent several months tape recording the scheme for the FBI were put on probation. The lawyer has pleaded guilty to bank fraud and conspiracy.

Daily resales generated almost 100 percent gross profit. The buyers did not suspect anything was amiss. When questioned about how he got involved in the business, J.R. stated he had been a corporate officer of a large insurance group in the past that had decided to sell one of its buildings at a low price—$225,000. He had a co-worker named Jeffrey go on the contract as seller of the building and marked the price up to $425,000. The building was marketed for the higher price through Jeffrey, and the closing occurred with a personal check delivered to the escrow agent for the initial purchase at $225,000. The funds in the bank were cleared the next day for the personal check by the funds received at the real closing the following day, when the building was re-sold for $425,000. The shareholders and officers of the company knew nothing of the higher sale on the second day. Because of his senior position, he was not suspected of any wrongdoing, and he used the capital thus obtained to begin his larger operation.

The lawyer, in testimony against J.R., later admitted, "You had two statements with the same buyers and the same sellers in a 24-hour period, showing two different prices. One of them was obviously not correct." Buyers and sellers were not supposed to see each other and compare notes on closing days. There were always two sets of closing statements for a J.R. deal. One had a low sales price and was given to the seller. The buyer and buyer's mortgage company were given the statement with the higher price.

At a minimum, an escrow operation should not disburse money until good funds are received. This would have been the key to preventing the

simultaneous closing. Good funds mean certified funds, wires, official bank check, ACH credit, or a check from an escrow or lawyer's trust account. Conditional funding—that is, not good funds—includes personal checks, credit cards, and drafts. If monies from the latter sources are received, as good practice, they should be located in a separate escrow account from which no disbursements are made until they clear. Each state in the United States has different rules on good funds, but in practice a strong internal control is not to disburse until good funds are received.

Indicators: To the buyers and sellers, the red flag should have been the transfer of assets at well below (or above) market rates. Normally J.R. accomplished a morning closing at one title company and an afternoon (simultaneous) closing at a second title company. The red flag to the title companies that allowed the closings to take place is the lack of good funds. Another red flag to the title company should have been the atypical account behavior (size and nature of J.R.'s business). J.R.'s admitted assets have been seized, but it is thought he may have significant amounts of money hidden, awaiting his release, as an analysis of his spending over the course of the scheme and his located assets account for only about half of the monies lost.

Utilization of False Identities or Straw Men

The use of false identities or straw men is a common siphoning technique for those who have access without proper segregation of duties to disbursable funds. An insurance company without strong internal controls or with internal control deficiencies is subject to defalcation losses through embezzlement.

Such was the case with Fitzgerald Insurance, a non-public insurance holding company located in Scotland. Charles, a longtime trusted employee, supervised the accounts payable division of the firm. Charles had decided, unknown to his employer, to accumulate savings in a faster manner than was legally possible. He was writing himself checks of $40,000 to $60,000 a month, and had been for over a year.

During a routine annual operational audit, a variance analysis was performed on a year-to-year basis, and it appeared that several categories of costs were far in excess on a percentage basis of budgeted amounts. The costs were in the areas of travel, office, and maintenance accounts. Because tens of millions

of dollars passed through these accounts, and five hundred to a thousand vendors were involved, a database was first created after suspicions arose. The database was in Excel format and listed vendors by category and address. It was further delineated into addresses by street and post office box.

When a data sort was applied, something quite unusual was noted—about 5 percent of the invoices were to post office boxes, and of those, close to 40 percent were to the same post office box, but with different names. The names were researched against state and national databases, but they turned out to be non-existent. Several of the companies were found to be located in offshore jurisdictions, making identification of owners highly difficult.

Upon examination of the related invoices, it was apparent that they were fictitious. No identifiable level of real business activity was noted. Missing documentation was noted in about a third of the invoices to the suspicious post office boxes. The accounts were not used to pay any of the normal running costs of a business that may be expected. They were fictitious.

The company names were designed to resemble established companies, but they had no real purposes other than to draw out funds in what would otherwise appear to have been payment of ordinary invoices. At this point Charles's assets were identified and a restraining order entered against them.

Indicators: The red flag indicators here should have been monitored on a monthly basis, and not an annual basis. The indicators included atypical account activity, account activity to the same vendor address for different vendors, and questionable rationale for disbursing funds.

In summary the most frequently observed indicators are:

- Lack of supporting business explanations
- Unusual levels of transaction activity
- Large and/or rapid fund movements within accounts
- Profiles of unrealistic wealth
- Atypical business behavior
- Uneconomical funds transfers to foreign jurisdictions
- False documentation

- Suspicious activity of associates
- Transfer of assets at non-market levels
- Overly complex movements of funds
- Use of company names to resemble established companies
- Illogical activity

A number of cases, of course, will not fall into these categories because the range of activities is not predetermined. However, a strong system of internal controls over all significant processes within an insurer's line of business, whether his company is private or public, will mitigate the circumstances that can lead to the types of cases discussed.

Synergistic Controls

Whether one is designing an anti-fraud system, complying with Section 404 of the Sarbanes-Oxley Act, or simply designing an internal control system, the "System Control Model" is a little-understood but essential tool. It reflects the common internal control points of a well-designed internal control system. A company may have twenty processes—payroll, revenue, cash disbursements, payables cycles, and so forth—and it may have five or six "key control" points within each cycle. Understanding this is the secret to designing or auditing a particular cycle for fraud indicators. The following chart illustrates the system control model applicable to all corporate structures:

System Control Model

CONTROL	DESCRIPTION
Transaction Authorization	Transaction Authorization Controls are used to ensure management authorizes all transactions entered into the system.
System Access & Edit Controls	System Access & Edit and Validation Controls are used to ensure only valid transactions are entered into the system by properly authorized personnel

System Calculates Correctly	Processing controls ensure valid transactions are processed correctly, and the resulting output has integrity and can be relied on.
Interface Reconciliations	Interface Controls ensure accurate and reliable data is passed from one application system to another.
System Monitoring	Management Monitoring Controls use system data to validate the integrity of processed data: for example, Suspense and Bank Reconciliations.
Management Analytics	Management Analytics uses system data to ensure the consistency and reasonableness of processed data.
Segregation of Duties	Segregation of Duties is a control used by management to ensure the functions of authorization, custody, recording, and reconciliation are properly segregated.
System Table Changes	System Table Changes and quality assurance over those processes are used to ensure the integrity of the application system.

Source: H.C. "Pete" Warner, CIA, St. Petersburg, Florida

Let's take a particular example. In the case of the title insurance industry, for example, you normally have hundreds of millions of dollars in cash escrow accounts and custodial escrow accounts. Let's say your Norton office in Kansas has several million dollars in an escrow savings account related to a railroad deal. The money was in the account for eight years before all the title issues were resolved and the closing could take place. If there are no strong authorization controls, referred to Transaction Authorization above, someone could close this account and transfer the

funds to personal use. A dual signature requirement to close any escrow account would be a strong transaction control. However, this is not always practical. How do you then ensure compliance?

Bayes' Theorem

This little-known statistical theory is the answer. It describes a "new probability" (control effectiveness) given a "prior" probability. Let's look at this chart:

Bayes' Theorem

Number of Synergistic Controls	Effectiveness of Primary 60%	Effectiveness of Primary 70%	Effectiveness of Primary 80%	Effectiveness of Primary 90%
1	60%	70%	80%	90%
2	84%	91%	96%	99%
3	93.6%	97.3%	99.2%	99.9%
4	94.7%	99.2%	99.8%	100%
5	99%	99.8%	100%	100%

To determine the effectiveness of a synergistic control, use the following equation, where E is the effectiveness of a single control.

Bayes' Theorem: E=1-((1-E1)*(1-E2)*(1-E3)…)

What this mathematical formula is telling us as auditors is that in addition to implementing primary controls, complementary or compensating controls effectively increase the percentage level of confidence in our internal control structure. In fact, with, for example, two compensating controls, the initial 60 percent effectiveness of the primary control is enhanced to 84 percent. Therefore in the case we're using, if in addition to one strong transaction control, there are two complementary controls, we have achieved 84 percent security for the asset being protected. These complementary controls could be segregation of duties and system monitoring of an overall trial balance reconciliation once a month. Without trial balance monitoring in the railroad escrow account example above, it could be five years before anyone noticed the money was gone.

At a minimum in designing internal control structures, you need for every category of risk at least one preventive (transaction control) and at least two system (segregation of duties) or detective (monitoring) controls, as in the above system model. This can be liberating to the process owners, who need to follow the process flowchart that is created around their process every month from a time perspective. It can also assure the auditor of a high confidence level. In the case of a fraud auditor, it is important to examine any process that *does not have* a design structure as listed, as this is an internal control weakness that is susceptible to fraud.

This theorem of synergistic security enables us to pinpoint areas of weakness that should be examined. Each process is viewed from the overall perspective of the System Control Model, and then internal control weaknesses indicate to us the processes that are subject to fraud and intense examination. For every threat category, you have an area to examine for red flags. Trend analyses are utilized to pinpoint variances over time that would go undetected if only the single year was being analyzed.

Discovery Sampling

You can utilize discovery sampling to determine if a weakness exists. Discovery sampling is sampling that will provide, within a given probability (confidence level), the sample size needed to locate at least one critical area in the population. The U.S. Army Audit Agency has a Web site with an excellent discovery sampling tool used to determine sample size. It is the common statistical sampling tool used in fraud auditing. The web site for USAAA is http://www.hqda.army.mil/aaaweb/.

For instance, if an auditor wanted to examine checks to see whether someone was making fraudulent payments to vendors, he or she would use random-number-generating software to select the serial numbers of checks to review. The auditor then would then use the USAAA statistical sampling software or refer to a basic discovery sampling table (see exhibit, below) available in any auditing textbook. Such a table consists of a probability matrix correlating the frequency of certain occurrences in a sample with approximations of the likelihood of their existence in the population.

Discovery Sampling Table

	Maximum percentage of sample containing signs of fraud							
	0.01	0.05	0.1	0.2	0.3	0.5	1	2
Sample size	Percentage of certainty that above percentage is accurate							
50		2	5	9	14	22	39	64
60	1	3	6	11	16	26	45	70
70	1	3	7	13	19	30	51	76
80	1	4	8	15	21	33	55	80
90	1	4	9	16	24	36	60	84
100	1	5	10	18	26	39	63	87
120	1	6	11	21	30	45	70	91
140	1	7	13	24	34	50	76	94
160	2	8	15	27	38	55	80	96
200	2	10	18	33	45	63	87	98
240	2	11	21	38	51	70	91	99
300	3	14	26	45	59	78	95	99+
340	3	16	29	49	64	82	97	99+
400	4	18	33	55	70	87	98	99+
460	5	21	37	60	75	90	99	99+
500	5	22	39	63	78	92	99	99+
800	8	33	55	80	91	98	99+	99+
1,000	10	39	63	86	95	99	99+	99+
1,500	14	53	78	95	99	99+	99+	99+
2,500	22	71	92	99	99+	99+	99+	99+

Note: Because of its minimal effect on sample size, population size is not included in the above table.

Source: From *Audit Sampling: An Introduction* (3rd ed.) by Dan M. Guy, D.R. Carmichael, and O. Ray Whittington, John Wiley & Sons, 1994.

If the auditor reviewed 120 of 6,000 checks and found no signs of fraud, he or she could be 70 percent confident that no more than one percent of all checks were fraudulent, or 91 percent confident that no more than 2 percent were.

COSO Framework

A chapter on the COSO framework is essential in any book on the topic of Sarbanes. Because of Sarbanes's reliance on controls, the Committee of Sponsoring Organizations of the Treadway Commission (headed by former SEC member James Treadway), developed a series of guidelines that we have touched on that are controls for financial processes. COSO published in September 2004 an updated approach called Enterprise Risk Management (ERM), or COSO II. It adds a strategic versus operational approach to the twenty-five-year-old COSO framework. Enterprise Risk Management is defined by COSO as "a process, effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."

The ERM model contains eight components: Internal Environment, Objective Setting, Event Identification, Risk Assessment, Risk Response, Control Activities, Information and Communication, and Monitoring. It was a needed expansion of COSO I, but will take a few years to be adopted by various organizations. For IT auditors, the framework utilized to comply with Sarbanes is called COBIT. It may seem a particularly uninteresting topic for some, but first let's look at a case with some history that illustrates what can occur (and what did occur) when no internal control framework is active in a corporation.

Case Study: Collapse of Barings Bank

The option and derivative market, driven by global economics, is estimated at $20 trillion. Nick Leeson was a trader with the Singapore branch of Barings Bank, which had a sterling reputation in Britain as the bank that had done business on behalf of the British government. Leeson was

responsible for bringing the bank to a state of bankruptcy in 1995, when it was unable to meet a SIMEX (Singapore International Monetary Exchange) market call. Following this, it was purchased for one pound by the Dutch insurance group ING. Derivative speculation cost the bank $1.4 billion. The events leading to the collapse of Barings Bank are a case study in inadequate internal controls and the absence of an effective internal audit function.

Leeson had some investment banking experience in London before joining Barings and was considered a rising star among its top traders. Leeson arrived in Singapore in 1992 with a position for Barings Securities (Singapore) Limited. He was considered the general manager with trading responsibilities, as well. Heading the back office of the securities subsidiary, he had a wide range of authority.

For most corporations subject to internal audit scrutiny, this arrangement alone should have raised red flags. He managed the office, traded, and controlled the back office. There was no segregation of duties whatsoever, a typical conflict. Smaller companies and banks often have conflicts, but they are remedied to an extent with monitoring controls, such as reconciliations and performance reports on a trend analysis basis. Barings was a worldwide bank with no shortage of personnel, but allowed this scenario to develop. Leeson's responsibilities included futures, options, and arbitrage. Futures provided for tremendously leveraged positive returns, or disastrous losses if the market went against the position. Leeson concentrated on positions revolving around the Nikkei 225, a group of top Japanese stocks.

Leeson utilized an account he named 88888 to speculate on his own behalf. But the trades went against him, and his positions increased as he attempted to win back losses. Account 88888 was a suspense account that was not reviewed or reconciled to real-world numbers. A truly professional trader simply cuts losses, but Leeson followed the opposite strategy. In fact, New York investment bankers noted right before Barings's collapse that Leeson had half the open interest in the Nikkei future. As money is lost in futures trading, margin calls develop. Leeson used the strategy that he was covering calls for clients when he placed requests for cash. This alone is a red flag, as institutions do not cover client margin calls. Most exchanges, in fact, prohibit this practice.

The question is how people at the top could not know when the bank was achieving speculative losses approaching $1.4 billion. They did not know, as is reflected in the now-famous quote from 1993 by Peter Barings, chairman, who said, "The recovery in profitability has been amazing following the reorganization, leaving Barings to conclude that it was not terribly difficult to make money in the securities market."

This statement refers to a merger that created Barings Investment Bank in 1993. Possibly more resources should have been allocated to internal audit, and less to acquisitions when the situation is viewed in retrospect. The risk management function was apparently not well audited. Leeson had sole control of authorization for trades and was responsible for booking them, as well. Leeson traded and settled the trades. When needed, he would produce false documentation, which was not strictly audited until Barings collapsed. In fact, until the end, he received huge bonuses, had an $8,000-a-month apartment, and was highly thought of within the organization. His bonuses were based on fictitious profits from arbitrage. Senior executives did not review performance metrics for his office because of their complexity. A lack of authorization controls, segregation of duties, and effective monitoring (detective) controls created the collapse of the bank that served the British Empire for centuries.

COSO Explained

AS2 utilizes the COSO report as its framework. According to the PCAOB Auditing Standard No. 2, the COSO framework identified three primary objectives of internal control: efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations. Operations and compliance that are directly related to presentation and disclosure in financial statements are encompassed in internal control over financial reporting. It is continually emphasized that management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. Sarbanes is not a perfect world. There are inherent limitations on the level of assurance that effective internal controls over financial reporting can provide.

Fraud-related controls are listed in AS2 and enumerated as including but not limited to:

- Controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements
- Company's risk assessment processes
- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, and the monitoring of the code by management and the audit committee or Board
- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee
- Adequacy of whistleblower provisions

AS2 also has a lot to say about understanding the design of controls related to each component of internal control over financial reporting:

- *Control Environment.* Because of the pervasive effect of the control environment on the reliability of financial reporting, the auditor's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of operating effectiveness considered necessary. Weaknesses in the control environment should cause the auditor to alter the nature, timing, or extent of tests of operating effectiveness that otherwise should have been performed in the absence of weaknesses.
- *Risk Assessment.* When obtaining an understanding of the company's risk assessment process, the auditor should evaluate whether management has identified the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect errors or fraud that could result in material misstatements. For example, the risk assessment process should address how management considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
- *Control Activities.* The auditor's understanding of control activities relates to the controls that management has implemented to prevent or detect errors or fraud that could result in material misstatement in the accounts and disclosures and related assertions of the financial statements. For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control

activities encompasses a broader range of accounts and disclosures than is normally obtained for the financial statement audit.

- *Information & Communication.* The auditor's understanding of management's information and communication involves understanding the same systems and processes that he or she addresses in an audit of financial statements. In addition, this understanding includes a greater emphasis on comprehending the safeguarding controls and the processes for authorization of transactions and the maintenance of records, as well as the period-end financial reporting process.
- *Monitoring.* The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, that management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements.

Company-level Controls

AS2 devotes an entire section to restating the importance of company-level controls, and defines them as follows:

- Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units
- Management's risk assessment process
- Centralized processing and controls, including shared service environments
- Controls to monitor results of operations
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs
- The period-end financial reporting process
- Board-approved policies that address significant business control and risk management practices

The standard goes on to state that testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting.

Identifying Significant Accounts under COSO

AS2 states that when deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including:

- Size and composition of the account
- Susceptibility of loss due to errors or fraud
- Volume of activity and complexity of the transactions processed through the account
- Nature of the account (for example, cash and suspense accounts are high risk)
- Exposure to losses represented by the account (for example, a claims account in an insurance operation)
- Likelihood of significant contingent liabilities arising from the activities represented by the account
- Existence of related party transactions in the account
- Changes from the prior period in account characteristics

AS2 goes on to state that the auditor of the financial statements of a financial institution might not consider trust accounts significant to the institution's financial statements because such accounts are not included in the institution's balance sheet, and the associated fee income generated by trust activities is not material. However, in determining whether trust accounts are a significant account for purposes of the audit of internal control over financial reporting, the auditor should assess whether the activities of the trust department are significant to the institution's financial reporting, which also would include considering the contingent liabilities that could arise if a trust department failed to fulfill its fiduciary responsibilities (for example, if investments were made that were not in accordance with stated investment policies).

When assessing the significance of possible contingent liabilities, consideration of the amount of assets under the trust department's control may be useful. For this reason, an auditor who has not considered trust accounts significant accounts for purposes of the financial statement audit

might determine that they are significant for purposes of the audit of internal control over financial reporting.

Identifying Controls to Test

AS2 states that after identifying significant accounts, the auditor should evaluate the following to identify the controls to be tested:

- Points at which errors or fraud could occur
- The nature of the controls implemented by management
- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective or whether more than one control is necessary to achieve a particular objective
- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:

    1. Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
    2. Whether there have been changes in the design of controls
    3. The degree to which the control relies on the effectiveness of other controls
    4. Whether there have been any changes in key personnel who perform the control
    5. Whether the control relies on performance by an individual or is automated
    6. The complexity of the control

2

Enron and Arthur Andersen: A Case Study

Enron Corporation and thirteen of its subsidiaries filed for Chapter 11 bankruptcy on December 2, 2001. This followed an October 16, 2001, announcement of a $635 million net loss and a restatement of 1997 to 2000 financials which included a $591 million reduction in net income and an increase in Enron's restated debt for the same period of $2.585 billion. Much of the third quarter 2001 loss was due to losses on transactions with LJM, a Special Purpose Entity (SPE) controlled by Enron's CFO and a handful of insiders. The balance of the loss was due to the write-down of joint venture investments, including Azurix and a bandwidth venture. Shareholders' equity was reduced by $1.2 billion because of the repurchase of 55 million shares of Enron stock from SPEs.

Selected Financial Data	FY 1997	FY 1998	FY 1999	FY 2000	First Qtr 2001	Second Qtr 2001	Third Qtr 2001
Net Income (Loss),Reported	$105	$703	$893	$979	$425	$404	($618)
Net Income (Loss),Restated	9	590	643	847	442	409	(635)
Debt, As Reported	6,254	7,357	8,152	10,229	11,922	12,812	12,812
Debt, As Restated	6,965	7,918	8,837	10,857	11,922	12,812	12,978

Three unconsolidated entities that should have been consolidated in the financial statements pursuant to generally accepted accounting principles (GAAP) created a significant write-down in the third quarter 2001, according to a GAO Study on Restatements. Accounting guidelines allowed for SPEs to report separately from the sponsoring company's financial statements in certain circumstances, including a provision that at least 3

percent of the SPE equity, a nominal sum in actuality, was provided by outside third-party investors. Accordingly, with the SPE being treated as an independent entity, mark-to-market accounting guidelines (or mark-to-model) provided for gains and losses in cash flow to be recognized by the sponsor, in this case Enron. Financial institutions often refer to this procedure as "monetizations." Enron established several SPEs: most notable were Joint Energy Development Investments LP (JEDI); Chewco Investments LP (Chewco); LJM Cayman LP (LJM1); and LJM2 Co-Investment LP (LJM2), which Enron referred to collectively as the LJMs.

JEDI was established in 1993 as a partnership between Enron and the California Public Employees' Retirement System (CalPERS) to invest in natural gas projects. In 1997, Enron wanted to expand JEDI, but Calpers was reluctant. Andrew Fastow, then CFO, created Chewco, setup in 1997 to buy out the interest of CalPERS investment in JEDI, which was valued at $383 million. The LJMs were private-investment limited partnerships that were formed in 1999. Fastow was (from inception through July 2001) the managing member of the general partners of the LJMs.

Specifically in the restatement, Enron concluded that, based on current information, the financial activities of Chewco, a related party that was an investor in JEDI, should have been consolidated beginning in November 1997, and the financial activities of a wholly owned subsidiary of LJM1, which engaged in transactions with Enron to permit Enron to hedge market risks of an equity investment in Rhythms NetConnections Inc., should have been consolidated into Enron's financial statements beginning in 1999.

Arthur Andersen was Enron's independent auditor from 1985 to 2001. On January 17, 2002, Arthur Andersen was discharged by Enron's board of directors. As of August 2002, the company did not have an independent auditor, and, based on discussions with independent auditing firms, Enron management believed that the retention of an auditor was not feasible.

According to a U.S. Department of Justice indictment against Arthur Andersen, Arthur Andersen allegedly advised Enron against using the term "nonrecurring" and documented its objections internally in the event of litigation, but did not report its objections or otherwise take steps to cure

Enron's public statement. The audit partner of Arthur Andersen responsible for Enron was separately indicted for destruction of documents while under notice of a pending investigation.

The Whistleblower Letter

The Department of Justice alleged that Arthur Andersen was put on direct notice of the allegations of Sherron Watkins, an Enron employee and former Arthur Andersen employee, regarding possible fraud and other improprieties at Enron. In particular, she noted the possibility of fraud in Enron's use of off-balance-sheet SPEs that enabled the company to camouflage the true financial condition of the company. Watkins had reported her concerns to a partner at Arthur Andersen, who thereafter allegedly disseminated them within Arthur Andersen, including to the team working on the Enron audit.

She alleged that the Raptor and Condor SPEs created the illusion of funds flow, including $800 million from merchant asset sales in 1999 through a monetization transaction with Condor that was in fact based on a promise of Enron stock. As a simplified explanation, let's assume that Enron sells electric generating equipment to an SPE for $800 million. Banks lend the SPE $750 million for the purchase with a fixed maturity and interest rate. Enron invests $45 million in equity of the SPE and sells shares for $5 million (10 percent) to outside investors. The bank loan is monetized and does not appear on the Enron balance sheet. If the book value of the asset sold to Enron was $500 million, then Enron can report in this fiscal year profit on the sale of $300 million. Enron has received cash of $800 million, less its equity investment of $45 million, or $755 million.

Waktins's next concern was overvaluation of the assets and what happens if they do not generate sufficient revenues to repay the bank loan. The answer is that Enron entered into separate agreements to promise the banks that loaned money to the SPE to provide treasury stock of Enron in sufficient amount to cover any projected deficit, should the Enron stock fall in value. The massive amounts of undisclosed obligations under this arrangement in the case of a falling stock price could substantially dilute the share price of Enron, which is exactly what happened when the stock price later in 2001 fell almost 75 percent, from $33.84 to $9.05, by November 7, 2001. In the

days surrounding the restatement, the stock continued a precipitous decline to 61 cents per share after the buyout from Dynegy fell through.

Watkins states in the letter, which was originally anonymous but was later followed by a personal meeting with Lay, the chairman of Enron, that she is concerned Enron will "implode in a wave of accounting scandals."

Her concern that Arthur Andersen has a conflict of interest is next disclosed: Arthur Andersen is acting in both a consulting capacity and as outside auditors with annual fees approaching $50 million.

Her concern has to do with the basic principle of accounting—that if you explain the presentation to a "man on the street," would you influence his investing decisions? Would he buy or sell the stock based on his knowledge of the facts? And the facts in this case had been (the letter was written in August 2001, prior to the restatement) that the data had been so buried in minor disclosure references that even analysts hadn't noticed the conflicts.

Watkins's concern that the "oddities" about the SPEs are questionable, including booking a $500 million gain from equity derivatives from a related party (Fastow controlled the SPEs as a general partner); the related party (SPE) is thinly capitalized with no party at risk except Enron; and it appears that Enron has supported income statement gains by contributions of its own shares. Watkins was also concerned that none of the SPE transactions is at arm's length and recommends that outside consultants be brought in to evaluate the multitude of SPE transactions.

Events Timeline

Watkins personally approached Lay after he took over as CEO after Jeffrey Skilling resigned for "personal reasons" on August 14, 2001. She indicated during the meeting he appeared to feel that the approval of Arthur Andersen, despite the conflicts, covered all bases. Following this meeting, events occurred rapidly:

- On October 12 an in-house lawyer at Arthur Andersen e-mailed the Enron partner in Houston to remind him of the firm's document-destruction policy. This, in effect, was the trigger to the obstruction of justice charge Andersen later faced.

- On October 16 the third-quarter loss and $1.2 billion reduction in shareholder equity were reported.
- On October 17 the SEC requested information from Enron because of the restatement.
- On October 24 CFO Andrew Fastow resigned.
- On November 8 Arthur Andersen received a federal subpoena for documents.
- On November 8 Enron restated financial statements.
- On November 29 a merger with Dynegy collapsed.
- On December 2 Enron, one of the world's largest energy conglomerates, filed for federal bankruptcy protection.
- On January 10 the Justice Department confirmed a criminal investigation had begun.
- On January 23 Kenneth Lay resigned as the CEO and the FBI began its investigation of document shredding.
- On January 24 Congressional hearings on document shredding by Arthur Andersen began. Andersen had destroyed two tons of documents.

Credit Rating Agency Actions

Moody's Investors Service Inc. (Moody's), and Standard and Poor's rated Enron. Each reacted differently to Enron's October 16, 2001, announcement of third-quarter losses. Standard and Poor's affirmed Enron's medium-grade rating, which indicated that Enron had adequate capacity to meet its financial commitments. However, its rating also indicated that adverse economic conditions or changing circumstances were more likely to lead to a weakened capacity to meet financial commitments. Moody's placed all of Enron's long-term debt on review for possible downgrade. Both firms continued to downgrade Enron's debt and commercial paper throughout October and November 2001. On December 3, 2001, the day after Enron filed for bankruptcy protection under Chapter 11, Standard and Poor's lowered Enron's rating to reflect its view that a default was likely. Moody's downgraded Enron's long-term debt ratings and senior unsecured debt to a low grade indicating that partial recovery might be possible.

Brief on Andersen Indictment

Deputy Attorney General Transcript
News Conference - Arthur Andersen Indictment
Thursday, March 14, 2002
DOJ Conference Center

MR. THOMPSON: Good afternoon -- again. On October 17, the Securities and Exchange Commission launched an inquiry into the financial collapse of Enron, which had been considered the nation's seventh largest corporation. The SEC's inquiry focused attention on the role of Arthur Andersen LLP, Enron's long-time auditor and one of the nation's big five accounting firms. The Justice Department established a task force in January to investigate all the matters that have arisen from that collapse. Today we are unsealing an indictment obtained last week from a federal grand jury in Houston, Texas charging the Arthur Andersen partnership with obstruction of justice, for destroying literally tons of paper documents and other electronic information related to the Enron inquiries.

The indictment catalogues allegations of widespread criminal conduct by the Arthur Andersen firm, charging that the firm sought to undermine our justice system by destroying evidence relevant to the investigations. It alleges that at the firm's direction, Andersen personnel engaged in the wholesale destruction of tons of paperwork and attempted to purge huge volumes of electronic data or information.

The indictment further explains that at the time Andersen knew full well that these documents were relevant to the inquiries and to Enron's collapse. The indictment alleges

that Andersen partners and others personally directed these efforts to destroy evidence.

As the indictment lays out, the destruction initiative began on or about October 10, 2001, as Andersen foresaw imminent government investigations and civil litigation. The destruction continued through the SEC's announcement that an investigation had been launched and only ended nearly one month later when the SEC officially served Andersen with a subpoena for Enron documents.

As charged in the indictment, on October 16th Enron issued a press release announcing a $618 million net loss for the third quarter of 2001.

The very next day, the SEC began its Enron investigation. By October 19th, Enron notified Andersen that the SEC was investigating the Enron special-purpose entities that Andersen, itself, had helped to establish, enabling Enron to camouflage the true financial condition of the company.

The next morning, Andersen's high-level management discussed the SEC inquiry on a conference call. On October 23rd, Andersen partners ordered their employees to destroy Enron documents in Andersen's offices in Houston. The indictment alleges that in urgent and mandatory meetings, Andersen partners and others told employees to immediately destroy documents related to Enron. Dozens of large trunks were brought in to haul documents from Andersen's office in Enron's building to Andersen's firm office in Houston, in order to destroy literally tons of documents, the indictment alleges. Employees were told to work overtime, if necessary, to finish the job of destroying documents. The shredder at the Andersen office in the Enron building ran virtually constantly.

The indictment charges that destruction of evidence extended far beyond Andersen's Houston-based Enron engagement team. This is the indictment of a firm, of a partnership. As the indictment clearly outlines, the obstruction effort was not just confined to a few isolated individuals or documents. This was a substantial undertaking over an extended period of time with a very wide scope. The Andersen firm instructed Andersen firm in Portland, Oregon; Chicago, Illinois; and London, England, to join in the shredding. In London, Andersen partners and others orchestrated a parallel, coordinated effort to destroy Enron documents within days of notice of the SEC inquiry. The shredding apparently stopped only after the SEC officially served Andersen on November 8th with the anticipated subpoena for documents related to the firm's work on Enron.

Obstruction of justice is a grave matter and one that this department takes very seriously. Arthur Andersen is charged with a crime that attacks the justice system itself by impeding investigators and regulators from getting at the truth. This indictment alleges just such subversion of our justice system by a firm responsible for upholding the standards of the accounting profession on which hundreds of millions of investors rely.

Now, when determining whether to charge an entity with criminal conduct, we consider many factors, including the seriousness of the alleged offense, the firm's history of wrongdoing, the pervasiveness of the wrongdoing, and the need to deter others from similar activity. Under these standards, we felt compelled to seek the indictment of the Arthur Andersen partnership.

Today's indictment charges Arthur Andersen with violating Section 1512 of Title 18 of the United States Code. The statute makes it a crime to, and I quote, "alter, destroy, mutilate or conceal an object with intent to impair

> the object's integrity or availability for use in an official proceeding."

The Appeal of Arthur Andersen

The aftermath of the conviction of Arthur Andersen was the dismantling of the firm and the simultaneous appeal, which eventually reached the U.S. Supreme Court.

According to the *Washington Post*: "The Supreme Court in May 2005 unanimously threw out the conviction of accounting firm Arthur Andersen, a symbolic victory for a nearly defunct company torn apart in a document-shredding case involving the fallen energy giant Enron. In a 9-0 opinion, the justices concluded that 'jury instructions at issue simply failed to convey the requisite consciousness of wrongdoing.' Chief Justice William Rehnquist wrote the opinion."

The successful appeal was largely academic, as by the time it occurred, Arthur Andersen no longer existed in an operating form. The Chicago-based firm has a staff of only a few hundred left, out of the 28,000 people who used to work there. Sixty billion dollars in market value had been lost in Enron shares; $2 billion in pension plans had been lost; and before 2005 even started, Andrew Fastow had pled guilty and agreed to forfeit most of his assets in a plea deal. Jeffrey Skilling had surrendered to authorities in 2004 and was facing nearly three dozen fraud and insider trading charges. Kenneth Lay had surrendered to federal agents and pled not guilty. Eleven criminal charges would be unsealed against him. Kenneth Rice, a former CEO on Enron's Internet Unit, pled guilty to securities fraud. Enron's investor relations chief pled guilty to aiding and abetting securities fraud. Class action lawsuits had descended on Enron and its principals.

Enron's Stock Price

Enron's stock traded on the New York Stock Exchange under the symbol ENE. After being de-listed from NYSE, Enron traded on the over-the-counter market under the ticker symbol ENRNQ. From May 2001 to October 2001 Enron's stock experienced a market decline from over $60 per share to under $30 per share. Enron's stock price fell further to $9.05

by November 7, 2001, just before restatement of earnings for 1997 through 2001. In the days surrounding the restatement announcement, its stock price fell from $9.05 to $8.63. But by November 28, 2001, it had dropped to 61 cents a share. As of September 13, 2002, the stock price, once above $90 a share, had closed at 16 cents per share. Based on historical analyst information, as of October 18, 2001, fifteen firms rated Enron a buy—twelve of the fifteen even considered the stock a strong buy. As late as November 8, 2001, the date of Enron's disclosure that nearly five years of earnings would have to be recalculated, eleven of fifteen continued to recommend buying the stock; three recommended holding; and only one recommended selling.

Lessons Learned

The Enron failure was one of the more dramatic failures of the century because of the extent of lost positions and capital, both in the market and in pension plans. While key officers were selling tens of millions in stock in 2001, the average employee who was locked into their 401(k) could do nothing. Enron was apparently on a "watch list" with the SEC, which has to be credited with quick enforcement once the problems arose. But why did corporate governance fail?

The basic motivation of the key executives, now all convicted, was to satisfy earnings objectives of Wall Street. Both profit and stock expectations were placed ahead of ethical considerations. In fact, it was later disclosed that Sherron Watkins was in danger of losing her position after her meeting with Ken Lay. He contacted the law firm to attempt to devise a means to demote her or move her out of the company permanently, but no way could be legally found to do so. Her letter to Ken Lay and to Arthur Andersen remain the "smoking gun" that may have had a lot to do with the conviction of key principals in both instances. No action plan was developed after receipt of her letter, which even had exhibits attached. The only action plan developed was to take no action.

New capital requirements for operational models Enron adopted in the 1990s set the groundwork for failure. Enron was no longer a physical distribution system for energy. It became involved in natural gas trading. In 1991, Skilling persuaded the audit committee to apply mark-to-market

accounting to Enron's trading books. This is widely used in capital markets, primarily where liquidity exists. Liquidity did not exist with Enron. Many of Enron's markets were far from liquid. Deregulation in the United States opened the gates for this scenario. In 1995, Enron opened an office in London to trade natural gas. Executive bonuses depended on the profitability of deals.

Corporate spending was not controlled. Between 1996 and 1997, Skilling doubled the staff of Enron, with a total of 15,555 employees on board. The corporation purchased a $41.6 million Gulfstream V jet for personal use, instead of a more reasonable lower level of business jet. Andrew Fastow had been hired in 1990 because he had experience in securitization deals at Continental Bank. Fastow was responsible for the off-balance-sheet financing ventures of Enron, including all of the SPEs, from which he personally made more than $45 million as general partner. Rather than use independent investors for outside equity partners for the SPEs, he chose insiders. Enron's board approved SPE deals without knowing the details of the roles played. In addition, Enron took gambles on international diversification on power and water projects that ultimately would be written down.

In one case an IPO profit that had been invested in by Enron treasury approaching $300 million was not realizable because of lockout provisions. Fastow began the LJM SPEs to "protect" these gains and recognize them as income. The structures became exceedingly complex. Four SPEs were set up initially to transfer forward interests to LJM, which then place a put option on the asset contained in the deal, which LJM then issued back to Enron. Enron basically booked income resulting from a rise in its own stock price. Mark-to-market accounting created phantom income based on the selling price. The balance sheet liabilities of LJM were not consolidated with Enron. Debt was hidden from stockholder view. And the trigger mechanism was set up that would ultimately collapse Enron—the SPEs. If Enron's stock fell, the SPEs would fail.

Once this information was disclosed via the *Wall Street Journal* and other sources of information, Enron's partners would no longer trade with the company. Trading revenue was the primary source of business. The White House declined a bailout, and earnings were restated. The demise of Enron, once the seventh-largest corporation in the United States, occurred over a

period of only months at the end of 2001, a classic case study in the absence of corporate governance provisions at the company level.

Timeline of Enron

According to the federal government, Kenneth L. Lay, Jeffrey K. Skilling, and Richard A. Causey, all former senior executives of Enron, engaged in a multi-faceted scheme to defraud in violation of the federal securities laws. From at least 1999 through late 2001, Lay, Skilling, Causey, and others manipulated Enron's publicly reported financial results and made false and misleading public statements about Enron's financial condition and its actual performance. As an objective and result of their scheme to defraud, Lay, Skilling, Causey, and others made millions of dollars in the form of salary, bonuses, and the sale of Enron stock at prices they had inflated by fraudulent means. Skilling and Causey made at least $103 million and $23 million, respectively, in illicit gains. SEC Bulletin No. 99 on materiality was apparently never read by the principals of Enron. This bulletin was actually utilized as a criminal exhibit in the trial. Materiality, according to the bulletin, cannot be measured on a percentage basis but is to be applied on a case-by-case basis, and an individual transaction can be material if it causes a change in "investor perception." In this timeline we will look step-by-step at what happened to Enron and the results of the massive fraud at this seventh largest company in the United States, as a case study and lesson text on the primary elements of securities fraud. The precise violations will be covered. I've examined more than five hundred documents in the public domain on Enron, and this data is an accurate portrayal of the government's successful case against the principals, in normally never-disclosed-before detail. Let's first look at Chairman Lay and examine the SEC action against Lay in federal court and the others using a real-time sequence. Lay secretly dumped massive amounts of his own Enron stock at the same time he falsely portrayed that all was well at Enron. Although defendants owed fiduciary duties to act in the best interests of their company and shareholders, their scheme to defraud revealed in the end a troika of executives who acted for their own personal gain, leaving in their wake a bankrupt company, employees on the street, and worthless stock in the hands of shareholders and investors they had fooled.

The commission (SEC) requested that the court permanently enjoin Lay, Skilling, and Causey from violating the federal securities laws cited herein, prohibit each permanently and unconditionally from acting as an officer or director of any issuer of securities that has a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 ("Exchange Act") or that is required to file reports pursuant to Section 15(d) of such Act, and order each to disgorge all ill-gotten gains, to pay civil penalties, and to have the amount of such penalties added to and become part of a disgorgement fund for the benefit of the victims of their unlawful conduct.

Jurisdiction and Venue

The Court received jurisdiction over this action pursuant to Sections 21(d), 21(e), and 27 of the Exchange Act [15 U.S.C. §§ 78u(d) and (e) and 78aa] and Sections 20(b), 20(d)(1) and 22 (a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77t(b), 77t(d)(1) and 77v(a)].

Skilling faced twenty-eight counts of fraud, conspiracy, insider trading, and lying to auditors. Lay faced six counts of fraud and conspiracy dating from Skilling's resignation forward.

In connection with the acts, practices, and courses of business alleged herein, Lay, Skilling, and Causey, directly or indirectly, made use of the means and instruments of transportation and communication in interstate commerce, of the mails, and of the facilities of a national securities exchange.

It was stated that Lay, Skilling, and Causey, unless restrained and enjoined by this court, will continue to engage in transactions, acts, practices, and courses of business as set forth in the Second Amended Complaint or in similar illegal acts and practices.

Defendants

Kenneth L. Lay resided in Houston, Texas. Lay served as the chairman of the board of directors of Enron (the "board") from its formation in 1986 until January 23, 2002. He was the chief executive officer (CEO) of Enron from 1986 until February 2001 and from August 14, 2001, until January 23,

2002. Lay resigned from the board on February 4, 2002. Lay presided as chairman at board meetings, where the board reviewed Enron's performance and financial condition. Lay, however, did not fully disclose to the board at various times certain negative information concerning Enron that he was aware of and possessed at the time he sold shares of Enron stock. Lay also attended meetings of the board's Finance Committee, the Audit and Compliance committees, and the Executive Committee, where the company's operations and financial condition were discussed. In his capacity as CEO, Lay had oversight of Enron's business units and supervised the senior executives and managers of these units. Lay regularly attended management meetings with these individuals and others, where the business and financial condition of Enron and its business units were discussed. Lay signed Enron's annual reports filed on Form 10-K with the SEC. Lay also signed quarterly and annual management representation letters to Enron's auditors, registration statements for the offer and sale of securities by Enron, and letters to shareholders accompanying Enron's annual reports to shareholders.

Jeffrey A. Skilling resided in Houston, Texas. He was employed by or acted as a consultant to Enron from at least the late 1980s through early December 2001. From 1979 to 1990, Skilling was employed by the consulting firm of McKinsey & Co., where he provided consulting services to Enron. In August 1990, Enron hired Skilling. He held various positions at Enron, and in January 1997, Enron promoted Skilling to president and chief operating officer (COO) of the entire company, reporting directly to Lay. In February 2001, Skilling became CEO of Enron and retained his position as COO. On August 14, 2001, with no forewarning to the public, Skilling resigned from Enron. Lay resumed the CEO position at that time. Along with Lay, Skilling attended meetings of the board's Finance Committee, the Audit and Compliance committees, and the Executive Committee, where the company's operations and financial condition were discussed. Skilling also had oversight of Enron's business units and supervised the senior executives and managers of these units. Skilling regularly attended management meetings with these individuals and others, where the business and financial condition of Enron and its business units were discussed. Skilling signed Enron's annual reports filed on Form 10-K with the SEC, and he signed quarterly and annual representation letters to Enron's auditors. Skilling also signed registration statements for the offer

and sale of securities by Enron, and letters to shareholders accompanying Enron's annual reports to shareholders.

Richard A. Causey resided in Houston, Texas. He was a certified public accountant and worked for Enron from 1991 through early 2002. From 1986 until 1991, while an employee of the accounting firm Arthur Andersen LLP ("Andersen"), Causey provided audit services to Enron on behalf of Andersen, Enron's outside auditor. In 1991, Enron hired Causey as assistant controller of Enron Gas Services Group. From 1992 until 1997, Causey served in various executive positions at Enron. In 1998, Causey was made chief accounting officer (CAO) of Enron and an executive vice-president. As Enron's CAO, Causey managed Enron's accounting practices and reported directly to Lay and Skilling. Lay, Skilling, and Causey, along with Enron's chief financial officer (CFO) Andrew S. Fastow, its treasurer Ben F. Glisan Jr., and others were the principal managers of Enron's finances. Causey also was a principal manager of Enron's financial disclosures to the investing public, and he regularly participated in conferences with investment analysts and in other public forums where he discussed Enron's financial condition. Causey signed Enron's annual reports on Form 10-K and its quarterly reports on Form 10-Q filed with the SEC, and signed quarterly and annual representation letters to Enron's auditors. Causey also signed registration statements for the offer and sale of securities by Enron.

Entities and Other Persons Involved

Enron Corp. is an Oregon corporation with its principal place of business in Houston, Texas. During the relevant time period, the common stock of Enron was registered with the commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange. Because it was a public company, Enron and its directors, officers, and employees were required to comply with federal securities laws, including rules and regulations requiring the filing of true and accurate financial information. Enron's stock price was influenced by factors such as Enron's reported financial information, its credit rating, and its ability to meet revenue and earnings targets and forecasts. Investors considered this information important in making investment decisions. Likewise, the information was important to credit rating agencies and influenced the investment-grade

ratings for Enron's debt, which were critical to Enron's ongoing business operations and ability to secure loans and to sell securities. During the time that defendants engaged in the fraudulent conduct alleged herein, Enron raised millions in the public debt and equity markets. Enron was the nation's largest natural gas and electric marketer, with reported annual revenue of more than $150 billion. Enron rose to number seven on the Fortune 500 list of companies. By December 2, 2001, when it filed for bankruptcy, Enron's stock price had dropped in less than a year from more than $80 per share to less than $1 per share.

Enron Energy Services (EES) was formed by Enron in late 1996 to provide energy products and services to industrial, commercial, and residential customers in both regulated and deregulated markets. In Enron's segment disclosures, EES's results were reported separately as Retail Energy Services. Accurate segment disclosure reporting is required under generally accepted accounting principles and SEC rules and regulations for those companies operating in multiple significant industries.

Enron Wholesale Services (Wholesale) was Enron's largest business segment in 2000 and 2001. Wholesale consisted of several business units, including Enron North America (ENA). ENA was the largest and most profitable business unit within Wholesale and included Enron's wholesale merchant energy business across North America. In Enron's segment disclosures, ENA's results were reported within the Wholesale segment.

Enron Broadband Services Inc. (EBS) was a wholly-owned subsidiary of Enron engaged in the telecommunications business. Its two principal business lines were bandwidth intermediation (the buying and selling of bandwidth) and content services (the delivery of high-bandwidth, media-rich content, such as video streaming, high capacity data transport, and video conferencing). EBS also made investments in companies with related technologies and with the potential for capital appreciation. In Enron's segment disclosures, EBS's results were reported separately as Broadband Services.

Numerous other Enron executives and senior managers engaged in the scheme to defraud with Lay, Skilling, and Causey. The others included, but were not limited to, former Enron employees named as defendants in other

Enron-related cases brought by the SEC in the Southern District of Texas: Fastow (SEC v. Fastow, H-02-3666); Glisan (SEC v. Glisan, H-033628); former ENA and EES CEO David W. Delainey, who reported to Skilling (SEC v. Delainey, H-03-4883); former ENA CAO Wesley Colwell, who reported to Causey and Delainey and managed the accounting for Enron's wholesale energy business (SEC v. Colwell, H-034308); and former Enron Global Finance managing director Michael Kopper, who reported to Fastow and conducted structured finance activities for Enron. Others assisted in various aspects of the scheme to defraud, including Merrill Lynch and certain of its employees (SEC v. Merrill Lynch, et al., HO-03-0946), J.P. Morgan Chase & Co. (SEC v. J.P. Morgan Chase & Co., H-03-2877), Canadian Imperial Bank of Commerce and certain of its employees (SEC v. CIBC, et al., H-03-5785); and Citigroup (In the Matter of Citigroup, Inc., SEC Administrative Proceeding, File No. 3-11192).

Factual Allegations

The Objectives and Roots of the Scheme to Defraud

The objectives of the scheme to defraud carried out by defendants and others were, among other things, (a) to falsely present Enron as a profitable, successful business; (b) to report recurring earnings that falsely appeared to grow by approximately 15 percent to 20 percent annually; (c) to meet or exceed the published expectations of industry analysts forecasting Enron's reported earnings-per-share and other results; (d) to maintain an investment-grade credit rating; (e) to conceal the true magnitude of Enron's losses, growing debt, and other obligations; (f) to artificially inflate Enron's stock price; and (g) to personally profit from the unlawful conduct, including gains from the sale of inflated Enron stock.

As a result of the scheme to defraud carried out by defendants and others, the descriptions of Enron's business and finances in public filings and public statements by defendants and others were false and misleading, and bore no resemblance to its actual performance and financial condition.

Lay, Skilling, Causey, and others planned and carried out various parts of the scheme to defraud. They and others set annual and quarterly financial targets, including earnings and cash flow targets ("budget targets"), for

Enron and each of its business units. The budget targets were based on the numbers necessary to meet or exceed analysts' expectations, not on what could be realistically achieved by legitimate business operations.

On a quarterly and year-end basis, Skilling, Causey, and others assessed Enron's progress toward its budget targets. Often, Enron did not meet the budget targets from business operations and had earnings and cash flow shortfalls that were at times in the hundreds of millions of dollars. Within Enron, these shortfalls were referred to variously as the "gap," "stretch," and/or "overview." When this occurred, the targets were met by unlawful means, including those described below.

Use of Special Purpose Entities and LJM Partnership to Manipulate Financial Results

As part of the scheme to defraud, Skilling, Causey, and others transferred assets and liabilities to Special Purpose Entities (SPEs). Under applicable accounting rules, Enron did not need to consolidate the SPE on its balance sheet if an independent investor had made a substantive investment in the SPE (at least 3 percent of the SPE's equity), had control of the SPE, and had the risks and rewards of owning the SPE assets. Through the use of SPEs, Enron would, among other things, record earnings and cash flows while hiding debt.

Creation of LJM Partnership

In June 1999, Skilling, Causey, and others sought and obtained the approval of the board for Fastow to create and serve as the managing partner of an investment partnership named LJM Cayman L.P. (LJM1). The board later approved Fastow's participation, as an equity and managing partner, in another even larger partnership used to fund SPEs by Enron named LJM2 Co-Investment, L.P. (LJM2) (the LJM entities are collectively referred to as LJM unless otherwise noted). These entities were created to invest in SPEs for Enron.

As Skilling, Causey, and others knew, LJM was not a legitimate independent third party because Fastow controlled LJM. This permitted Skilling, Causey, and others to use LJM as Enron's own vehicle for fraudulent means.

From approximately July 1999 through October 2001, Enron entered into fraudulent transactions with LJM. The transactions enabled defendants and others to manipulate Enron's reported financial results by, among other things: (a) improperly moving poorly performing assets off-balance sheet; (b) concealing Enron's poor operating performance; (c) manufacturing earnings through sham transactions; and (d) improperly inflating the value of Enron's investment portfolio by backdating documents.

"Raptor" Hedges

Beginning in the spring of 2000, Enron and LJM engaged in a series of financial transactions with four SPEs called Raptor I, Raptor II, Raptor III, and Raptor IV (collectively referred to as the "Raptors"). The Raptors were capitalized mainly with Enron stock. Skilling, Causey, and others used the Raptors to manipulate fraudulently Enron's reported financial results. They used Raptor I, among other things, to protect Enron from having to report publicly in its financial results decreases in value in large portions of its energy merchant asset portfolio and technology investments by purportedly hedging the value of those investments with an allegedly independent third party created by Enron and LJM, known as Talon.

However, Skilling, Causey, and others knew the Raptor I structure was invalid under applicable accounting rules because Talon was not independent from Enron, since LJM2's investment in Talon was not sufficiently at risk to qualify as outside equity. Causey and Fastow had an oral side-deal that LJM2 would receive its initial $30 million investment in Talon plus a profit of $11 million from Enron, all prior to Talon engaging in any of the hedging transactions for which it was created. Enron could then use Raptor I to manipulate Enron's financial statements, including by allowing Enron employees to arbitrarily select the values at which the Enron assets were hedged with Talon. Skilling was informed of and approved the deal.

The side-deal between Causey and Fastow was satisfied by Causey and others by manufacturing an illicit transaction between Enron and Talon that generated a $41 million payment to LJM2. Specifically, Causey and others caused Enron to purchase a "put" on its own stock from an entity involved in the Raptor structure, which had no business purpose for Enron, but

ensured that LJM2 received the complete return of its $30 million investment in the first Raptor structure, together with a profit of $11 million.

After satisfying the side-deal by providing LJM2 with a guaranteed return of and on its investment, Enron began to use Raptor I to hedge the value of Enron's assets. Enron employees manipulated the book values of Enron assets, many of which were expected to decline in value, before they were hedged, knowing that the Raptor I structure ensured that Enron would not suffer the financial reporting consequences of subsequent declines or large fluctuations in the value of those assets. Causey and others further used Raptor I fraudulently to promote Enron's financial position by back-dating the effective date of the Raptor hedge to Enron's advantage, capturing the all-time high stock value of one of the Enron assets, stock in a company named AVICI, at a time when they knew that value already had declined. The basic structure used in Raptor I, including the oral side-deal between Causey and Fastow, was repeated in the three successor fraudulent hedging devices known as Raptors II, III, and IV.

As with Raptor I, the Raptor successors were used to manipulate fraudulently Enron's reported financial results. These vehicles did not offer true economic hedges. Because the vehicles were dependent on the value of Enron stock, if the price of Enron stock declined, the hedging obligations of the Raptors could not be met, thus creating losses that would have to be reflected on Enron's financial statements.

Lay approved of the Raptors and understood they did not provide a true economic hedge, and were designed and used solely to manipulate Enron's financial statements. Lay was advised at various times in 2000 that the Raptors did not transfer economic risk and that a decline in Enron's stock price would impair the hedging ability of the Raptors. By no later than August 2001, Lay was aware that the Raptors were beyond salvage, and Enron's stock price had declined below the minimum required for the Raptors to meet their hedging obligations. As a result of the fraudulent use of the Raptors, Enron reported more than $1 billion in fictitious earnings on its books that should never have been recognized. Further, as set forth below, Lay made false and misleading public statements about the Raptors.

Manufacturing Earnings and Concealing Debt through Purported Sales to LJM

In addition to the fraudulent Raptor hedging devices, Skilling, Causey, and others used LJM for other transactions, including purported asset sales. These generated reported earnings and cash flow and moved poorly performing assets temporarily off Enron's balance sheet. Skilling, Causey, and others made undisclosed side agreements that guaranteed LJM against risk in certain of its transactions with Enron.

Cuiaba

One such transaction involved LJM's "purchase" of Enron's interest in a company that was building a power plant in Cuiaba, Brazil (the "Cuiaba project"). On September 30, 1999, when no true third-party buyer could be found, Skilling, Causey, and others caused Enron to "sell" a portion of Enron's interest in the Cuiaba project to LJM for $11.3 million. LJM agreed to "buy" this interest only because Skilling, Causey, and others, in an undisclosed side-deal, agreed that Enron would buy back the interest, if necessary, at a profit to LJM. Based on this purported "sale," which was in fact an asset parking or warehousing arrangement, Enron improperly recognized approximately $65 million in income in the third and fourth quarters of 1999, income that was needed to meet budget targets and earnings-per-share goals.

By 2001, the Cuiaba project was approximately $200 million over budget. Nonetheless, in the spring of 2001, Skilling, Causey, and others caused Enron to agree to buy back LJM's interest in the Cuiaba project at a considerable profit to LJM, pursuant to the undisclosed oral side-deal. Enron did not disclose the repurchase agreement in its second quarter 2001 financial reports because Skilling, Causey, and others did not want to announce the deal until after Fastow had sold his interest in LJM.

Nigerian Barges

In the fourth quarter of 1999, Enron engaged in a bogus asset sale to Merrill Lynch as part of an effort to meet budget targets. Enron "sold" Merrill Lynch an interest in electricity-generating power barges moored off the coast of Nigeria. When Enron was unable to find a true buyer for the

barges by December 1999, it parked the barges with Merrill Lynch so that Enron could record $12 million in earnings and $28 million in cash flow needed to meet budget targets.

Enron induced Merrill Lynch to enter into the Nigerian barge transaction by making a secret oral promise to Merrill Lynch that Merrill Lynch would receive a return of its investment plus an agreed-upon profit within six months. Skilling and Causey knew that the promise was concealed from Enron's auditors and the public. Because Merrill Lynch's equity investment was not sufficiently "at risk," Enron should not have treated the transaction as a sale nor recorded earnings and cash flow from the transaction. In June 2000, Enron delivered on its promise to Merrill Lynch by producing LJM as a buyer for the Nigerian barges, while secretly promising to take LJM out of the Nigerian barge deal at a profit plus a large fee. The Nigerian barge transaction is the subject of the SEC's action against former Merrill Lynch executives involved in the transaction.

Global Galactic

Between approximately July 2000 and September 2000, Causey, Fastow, and others reached an agreement on fulfilling the unlawful side-deals between Enron and LJM. Fastow and Causey memorialized and initialed the agreement which came to be known as the "Global Galactic" agreement. Among other things, Causey and Fastow reaffirmed the side-deals between Enron and LJM concerning the Nigerian barges and Cuiaba. In addition, Causey and Fastow agreed that the put on ENE stock in Raptor I would be backdated to August 3, 2000, which would cause $41 million to be disbursed from Enron to LJM. LJM would then "invest" approximately $6 million of the $41 million in a Raptor vehicle in order to increase the alleged outside equity.

Manufacturing Earnings by Fraudulently Manipulating Asset Values

Enron executives and senior managers, including Causey, engaged in a pattern of fraudulent conduct designed to generate earnings needed to meet budget targets by artificially increasing the book value of certain assets in Enron's large merchant asset portfolio. This portfolio included many interests in energy-related businesses that were not publicly traded and,

therefore, were valued by Enron, according to its own internal valuation models. Causey and others manipulated these models in order to produce results desired to meet earnings targets. For example, in the fourth quarter of 2000, under the direction of Causey and others, Enron personnel fraudulently increased the value of one of Enron's largest merchant assets, Mariner Energy, by $100 million in order to help close a budget gap.

Use Of Disguised Loans As Asset "Sales" To Hide Debt And Report Fictitious Earnings

As part of the scheme to manipulate Enron's financial results and inflate its stock price, Causey, aided and abetted by others, caused Enron to obtain loans from certain financial institutions and report the transactions as sales of assets to generate purported cash from operating activities. These transactions were sham asset sales. Under Financial Accounting Standards 125 and 140, Enron "sold" assets to various SPEs it had established with various financial institutions ("FAS 140 transactions"). Through FAS 140 transactions, Causey and others removed those assets from Enron's balance sheet and generated income and cash flow, while at the same time retaining control over the assets. From 1998 through 2001, Enron used FAS 140 transactions to obtain disguised loans, keeping more than $2.6 billion of debt off its balance sheet, generating more than $1 billion in earnings and $2 billion in operating cash flow.

As Causey and others knew, Enron provided the Canadian Imperial Bank of Commerce ("CIBC") with oral promises that its three percent "equity" in certain entities, including a vehicle known as "Hawaii 125-0," which was used by Enron repeatedly to move assets off-balance-sheet and record earnings, would be repaid. For example, in or about October 2000, Fastow provided such an oral promise to CIBC. As Causey and others knew, under FAS 140, these oral guarantees violated the off-balance-sheet accounting treatment of assets "sold" to the vehicles because CIBC's "equity" was not sufficiently at risk to qualify the vehicles as separate from Enron. Thus, the transactions did not qualify as asset sales, and Enron should have disclosed the loans as debt on its financial statements, not as earnings and cash flow.

Concealing EES Failures

In presentations to the investing public, Lay, Skilling, Causey, and others touted EES as a major reason for past and projected increases in the value of Enron's stock. However, defendants and others were warned of major problems at EES in early 2001. For example, on January 22, 2001, Lay met with several Enron executives to discuss the problem of uncollectible receivables of EES in the amount of $500 million. Lay and others engaged in a fraudulent scheme to hide the uncollectible receivables by transferring them to ENA. The concealment of EES losses in this manner materially affected EES' reported operating results.

In the spring of 2001, defendants and others were warned by EES management that EES was in extremely bad shape, was unlikely to meet its year end target of $225 million in income before interest and taxes (IBIT), and would require at least a year before becoming truly profitable. Enron hid the magnitude of EES' business failure from the investing public at the close of the first quarter 2001 by moving large portions of EES's business—which Lay, Skilling, Causey, and others knew at the time otherwise would have to report hundreds of millions of dollars in losses—into Wholesale, which was the Enron business segment housing most of the company's wholesale energy trading operations and income. As Lay, Skilling, Causey, and others knew, Wholesale would have ample earnings to absorb the losses that, in fact, were attributable to EES, while at the same time continuing to meet Enron's budget targets.

Lay, Skilling, Causey, and others falsely explained to the public that the change in segment reporting was solely a means to improve efficiency. As detailed below, defendants also falsely stated publicly that EES was continuing to perform profitably and as expected, despite their knowledge of the hidden losses.

EES-related losses recorded by ENA materially affected Enron and Wholesale's first quarter 2001 operating results. Had EES properly taken the losses, EES's IBIT for the first quarter of 2001 would have decreased from a positive $40 million to a negative $694 million and would have likely caused Enron to miss its highly touted estimated IBIT of $225 million.

Promoting EBS to Manufacture Earnings and Concealing Failure of EBS

In 1999, technology stocks traded at a premium compared to stocks of more traditional businesses. To take advantage of this market condition, Skilling and others sought to artificially pump up Enron's stock price by heavily promoting EBS, a costly telecommunications business that ultimately failed.

"Project Grayhawk"

Enron scheduled a high-profile presentation to analysts about its new EBS business for January 20, 2000. Knowing the presentation would cause an immediate increase in Enron's stock price, Skilling, Causey, and others constructed and approved a scheme to allow Enron to record and report approximately $85 million as a result of the spike in Enron's stock price as earnings from operations.

The scheme required a maneuver relating to Enron's recorded earnings from a partnership interest it held in a large energy investment named JEDI. The investment holdings of the JEDI partnership consisted, in part, of Enron stock. When Enron's stock price rose, the value of JEDI rose. However, in September 1999, JEDI hedged its Enron stock holdings through a transaction with Enron that fixed the value of the Enron stock held by JEDI at a set price. As a result of this hedge, an increase in the value of Enron stock held by JEDI did not increase JEDI's income, and therefore did not generate a corresponding increase in Enron's share of JEDI's income.

In anticipation of an increase in Enron's stock price from the January 20, 2000, analyst conference, however, Enron executed a series of transactions, known as "Project Grayhawk," that temporarily removed the JEDI hedge to allow JEDI's income to increase if the price of Enron's stock increased. After the price of Enron stock rose following the analyst conference, Enron and JEDI—through a new hedging arrangement—once again fixed the value of Enron stock held by JEDI, this time at a higher price.

Enron removed the original hedge to enable Enron to recognize earnings brought about by the dramatic increase in Enron's stock price as a result of its January 20, 2000, analyst conference. Skilling and others then improperly

publicly reported this gain as recurring operating income in its energy business. Skilling and others failed to disclose that the income resulted from the increase in Enron's own stock price caused by the false and misleading statements outlined below. Skilling, Causey, and others planned and approved the scheme.

January 20, 2000, Analyst Conference

At the January 20, 2000, analyst conference, Skilling and others knowingly made false and misleading statements about EBS. Skilling stated, among other things, that EBS "has already established the superior broadband delivery network"; that EBS has "built this network . . . and we are turning on the switch"; that the critical "network control software" was in Enron's possession and incorporated and used in its network; and that Enron valued the business at $30 billion, which Skilling called a "conservative" valuation. In Skilling's presence, EBS's co-CEO Joseph Hirko stated that EBS possessed advance network control software and that it was no "pipe dream." In reality, EBS had neither the claimed broadband network in place, nor the critical proprietary network control software to run it. The claims about EBS remained only unproven concepts and laboratory demonstrations, and Skilling was advised before the analyst conference that the network he publicly described would take years to complete and might never be realized. In addition, the valuation of the business was inflated by billions of dollars over internal and external valuations.

First Quarter 2000 Earnings from Enron's Own Stock

Skilling's and others' plan to boost Enron's stock price by aggressively touting EBS, and to record earnings from that boost, succeeded. On January 11, 2000, the date on which Enron purportedly altered the original hedge on the Enron stock in JEDI as part of Project Grayhawk, Enron stock traded at approximately $47 per share. After the analyst conference on January 20, 2000, Enron stock rose to approximately $67 per share. The fraudulent Project Grayhawk maneuver allowed Enron to recognize, through JEDI, approximately $85 million in earnings from the manufactured stock price. Skilling and Causey then misleadingly described these earnings in later presentations to analysts and in SEC filings as ordinary and recurring operating earnings from its energy business. Skilling

and Causey did not disclose Project Grayhawk to the investing public, nor did they disclose that approximately 20 percent of the earnings of Enron's energy business for the first quarter 2000 resulted solely from an increase in Enron's own stock price.

Concealment of EBS Failure

By late 2000, Skilling, Causey, and others knew that EBS was a struggling business that was a major loss producer. However, they took steps to hide this fact and falsify EBS' financial results. For example, during 2000, Enron structured a series of misleading, one-time financial transactions in EBS, known as Project Braveheart and Backbone Trust, that were designed to manufacture earnings and give the false impression that EBS would generate operating profits. Even with these transactions, EBS still was facing much larger than expected losses during the first quarter of 2001. In order to ensure that EBS did not record losses in the first quarter of 2001 that exceeded Enron's annual budgeted loss target for EBS, and in order to ensure that the quarterly budgeted loss target for the first quarter 2001 was met, Causey and others fraudulently reduced EBS' expenses for the first quarter of 2001. They did so by shifting numerous EBS costs off EBS's books, changing the depreciable life of certain of EBS's assets from five to ten years, and halving the bonus accrual for EBS employees.

Manufacturing and Manipulating Reported Earnings through Improper Use of Reserves

Third Quarter 2000 through Third Quarter 2001

During 2000 and 2001, the profitability of Enron's energy trading business, primarily based in Wholesale, dramatically increased for various reasons, including rapidly rising energy prices in the western United States, especially in California. If disclosed to the public, this sudden and large increase in trading profits, which exceeded $1 billion, would have made it apparent that Wholesale's revenues were tied to the market price of energy, meaning Enron was exposed to the risk of a decline in such prices. This would have revealed Enron as a speculative (and therefore risky) trading company. To conceal the extent and volatility of Enron's energy trading profits, Skilling, Causey, and others fraudulently hid hundreds of millions of dollars in trading profits in reserve accounts maintained on an internal Enron ledger

called "Schedule C." By early 2001, these reserves contained more than $1 billion in unreported earnings.

Skilling, Causey, and others then fraudulently used funds in the Schedule C reserve accounts to avoid reporting large losses in other areas of Enron's business. For example, in the first quarter of 2001, Skilling, Causey, and others improperly used Schedule C reserves to conceal from the investing public hundreds of millions of dollars in losses within Enron's EES business unit.

Second Quarter 2000

In mid-July 2000, weeks after the end of the second quarter 2000, Skilling, Causey, and others carried out a plan to publicly report a 34 cents earnings-per-share figure in the second quarter, as opposed to the 32 cents earnings-per-share figure predicted by analysts. Skilling and Causey were aware that Enron's performance for this quarter, even after Enron manipulated its budget targets, did not support a 34 cents earnings-per-share figure.

To achieve the fraudulent earnings-per-share figure, Skilling, Causey, and others caused a senior Enron executive to improperly release into earnings millions of dollars from a "prudency" reserve account in Enron's energy trading business. This release of reserves, which had no legitimate business purpose, artificially increased the second quarter earnings-per-share figure and Enron's stock price.

<u>"Prepays"-Use Of Disguised Loans To Fraudulently Inflate Cash Flows</u>

Enron, aided and abetted by certain financial institutions, manipulated its financial results through a series of structured transactions, called "prepays." Enron used prepays to report loans as cash flow from operating activities, rather than financing activities in its balance sheet. By using prepays as a means to increase its operating cash flow, Enron was able to match its so-called mark-to-market earnings (paper earnings based on changes in the market value of certain assets held by Enron) with operating cash flow. Enron used this tool to convince analysts and credit rating agencies that its reported mark-to-market earnings were real, that is, that the value of the underlying assets would ultimately be converted to cash. In addition, Enron failed to disclose that the prepays were actually debt and

failed to disclose the extent to which Enron was using prepays in its balance sheet during relevant periods. As of April 30, 2001, Enron's undisclosed prepays totaled $3.9 billion.

By no later than April 2001, by virtue of informative presentations on prepays to Lay by Fastow and others, Lay was aware of the use, importance, and magnitude of prepays to create cash flow; that the prepays were undisclosed debt; and that credit agencies were not told of the magnitude of Enron's prepay obligations.

Failure To Disclose Goodwill Impairment

In or about October 2001, Lay, Causey, and others failed to disclose the substantial impairment to the goodwill value attributable to one of its major assets, Wessex Water Services. Goodwill is an asset created when one entity acquires another entity. Goodwill is initially calculated as the excess of the sum of the amounts assigned to assets acquired over the amounts of liabilities assumed in an acquisition. By August 2001, Lay, Causey, and others undertook to determine the probable impact of a new goodwill rule on Enron, because goodwill losses would need to be disclosed to the market via SEC filings in the third quarter of 2001. The new rule was Statement of Accounting Standard No. 142, "Goodwill and Other Intangible Assets" (FAS 142). FAS 142 eliminated a company's ability to amortize or reduce goodwill gradually over a period of years. Instead, the new rule required a periodic assessment of the value of goodwill and any impairment loss.

By September 2001, as Lay and Causey knew, Enron's internal accountants had determined that the amount of goodwill attributable to Wessex Water Services ("Wessex") was approximately $700 million. Enron possessed a direct and indirect interest in Wessex, a water utility company purchased at a high cost of $2.4 billion. A rate cut imposed in April 2000 affected the future revenue of Wessex and made its post-acquisition value dubious at best. By the beginning of October 2001, Enron's internal accountants determined that Wessex's goodwill was impaired and that Enron would have to disclose the impairment unless Enron was able to assert that the company would once again pursue a water growth strategy backed by Enron. Enron's internal accountants had estimated that pursuing such a strategy would require Enron to expend between $1.5 and $28 billion.

Lay and Causey knew that Enron did not intend to pursue a water growth strategy and that Enron did not have the necessary capital for such a pursuit. Lay and Causey also knew that disclosure of the impairment would be unfavorable to Enron's financial statements and might have a negative impact on Enron's precarious credit rating. Nevertheless, on or about October 12, 2001, Lay, Causey, and others falsely claimed, including in representations to its auditors, that Enron was committed to developing a water growth strategy and failed to disclose an impairment of Wessex goodwill.

False and Misleading Representations to Investing Public

In furtherance of the scheme to manipulate Enron's financial results and inflate its stock price, Lay, Skilling, Causey, and others participated in the presentation of knowingly false and misleading statements about Enron's financial results, the performance of its businesses, the manner in which its stock was and should be valued, and the sale of personally held Enron stock. These statements were disseminated to the investing public in conferences, employee meetings, conference calls, press releases, interviews, SEC filings, and statements to members of the media.

First Quarter 2000 Analyst Conference Call

On April 12, 2000, Enron held its quarterly analyst conference call to discuss its earnings for the first quarter of 2000. Skilling and Causey were among the senior Enron managers who prepared for and participated in the call. Skilling knowingly made false and misleading statements. Skilling stated that Enron's Wholesale business recorded earnings of $220 million for the quarter; that those earnings were "attributable to increased earnings from Enron's portfolio of energy-related and other investments"; that "this was a pretty good quarter for the energy-related investment business in contrast to the drag it was over the last year"; and that the upswing in earnings in Wholesale was "basically the performance of the existing asset portfolios." Skilling omitted to disclose that approximately $85 million of the $220 million in earnings was unrelated to the operating performance of Enron's energy business. Rather, as Skilling knew, through "Project Grayhawk," these earnings were solely attributable to a scheme to generate earnings by manufacturing an increase in Enron's own stock price.

Fourth Quarter 2000 Analyst Conference Call

On January 22, 2001, Enron held its quarterly analyst conference call to discuss its earnings for the fourth quarter of 2000. Skilling and Causey were among the senior Enron managers who prepared for and participated in the call. Skilling knowingly made false and misleading statements including: "for Enron, the situation in California had little impact on fourth quarter results. Let me repeat that. For Enron, the situation in California had little impact on fourth quarter results." He further stated that "nothing can happen in California that would jeopardize" Enron's earnings targets for 2001 and that California business was "small" for Enron. In reality, as Skilling knew, Enron reaped huge profits in 2000 from energy trading in California and concealed hundreds of millions of dollars of those earnings in undisclosed reserve accounts for later use. Also, by late January 2001, as Skilling knew, California utilities owed EES hundreds of millions of dollars that EES could not collect, and these uncollectible receivables had been offset by large reserves concealed within Wholesale's books.

In support of Enron's claims that EBS continued to be successful and a positive factor contributing to Enron's stock price, a senior Enron manager misled analysts during the call about the source of EBS's earnings in the fourth quarter of 2000. After being directed by Skilling to answer a question about the source of EBS's earnings, the senior manager said that one-time, nonrecurring transactions such as sales of "dark fiber" and a "monetization," or sale, of part of EBS's nascent video-on-demand venture with the Blockbuster company accounted for only "a fairly small amount" of EBS's earnings. In truth, as Skilling, Causey, and others knew, the sale of projected future revenues from the Blockbuster video-on-demand venture, which Enron abandoned just two quarters later, accounted for $53 million of EBS's $63 million in fourth quarter 2000 earnings.

January 25, 2001, Analyst Conference

Enron held its annual analyst conference in Houston on January 25, 2001. At that conference, Skilling and others knowingly made false and misleading statements, including: (a) Skilling called all of Enron's major businesses, including EBS and EES, "strong franchises with sustainable high earnings power"; (b) Skilling said of EBS that "I think we have a solid

position. Our network is in place. We have customers and specific procedures and [devices] for the marketplace"; (c) Skilling asserted that Enron's stock, which was then trading at more than $80 per share, should be valued at $126 per share, attributing $63 of that alleged stock value to EBS and EES; and (d) Skilling stated that Enron was "not a trading business."

In reality, as Skilling knew, EBS was performing very poorly and had made little commercial progress in 2000; EBS personnel had recommended shutting down or selling EBS's network; EBS had few revenue prospects for the upcoming year; and EBS had an unsupportable cost structure that, without correction, could potentially lead to substantial losses well in excess of those Enron had publicly forecast. Skilling also knew that EES was an unsuccessful business, as well. Its modest earnings during 2000 largely resulted from one-time sales of investments unrelated to its retail energy contracting business; its existing retail energy contracts were overvalued by hundreds of millions of dollars; and it had hundreds of millions of dollars of uncollectible receivables that Enron was concealing within Wholesale.

March 23, 2001, Analyst Conference Call

Enron held a special analyst conference call on March 23, 2001, in an effort to dispel growing public concerns about Enron's stock, which had fallen from more than $80 per share to under $60 per share in less than two months. Skilling prepared for and participated in the call. Skilling knowingly made false and misleading statements and omitted to disclose facts necessary to make his statements not misleading. Among other things, he stated that "Enron's business is in great shape," and "I know this is a bad stock market but Enron is in good shape." He stated that Enron was "highly confident" of its income target of $225 million for the year for EES, and that EES was seeing the "positive effect" of "the chaos that's going on out in California."

Skilling further stated that EBS "is coming along just fine" and that the company was "very comfortable with the volumes and targets and the benchmarks that we set for EBS." He said that EBS's two profit-and-loss centers, intermediation and content services, were "growing fast" and that EBS was not laying off employees, but rather "moving people around

inside EBS" and that this was "very good news." In reality, as Skilling knew, EBS was continuing to fail. Senior personnel at EBS had reported internally that the unit had an unsupportable cost structure and unproven revenue model. One senior EBS executive estimated that Enron would need to write off (that is, record as a loss) approximately half of EBS's $875 million book value. EBS was laying off employees, and Skilling had told employees based in Portland, Oregon, that EBS would be centralized in Houston, and jobs would be cut because of a "total meltdown" in the broadband industry.

First Quarter 2001 Analyst Conference Call

Enron held an analyst conference call to discuss its first quarter 2001 results on April 17, 2001. Skilling and Causey were among the senior Enron managers who prepared for and participated in the call. Skilling made false and misleading statements in the call and omitted to disclose facts necessary to make his statements not misleading.

Skilling talked about continued "big, big numbers" in EES's energy contracting business. He falsely explained Enron's movement of EES's energy contract portfolio into Wholesale, omitting any reference to EES's large losses or their transfer to Wholesale and stated, "We have such capability in our wholesale business that we were—we just weren't taking advantage of that in managing our portfolio at the retail side. And this retail portfolio has gotten so big so fast that we needed to get the best—the best hands working risk management there." While Enron reported modest first quarter earnings for EES of $40 million, in reality, as Skilling and Causey knew, EES was facing losses approaching one billion dollars and had concealed those losses in Wholesale.

Skilling also made knowingly false and misleading statements, and omitted to disclose facts necessary to make his statements not misleading, about the success of EBS. He stated that "our network is now substantially complete" and that it "is just not the case" that Enron was reducing staff of EBS because it was getting out of the content services business. Skilling also stressed that the reported losses in the unit were on target and "anticipated" and that the unit's capital expenditures were being reduced because it was "able to get access to connectivity without having to build it." In reality, as Skilling knew, the cost-cutting measures at EBS were instituted because the

unit was continuing to fail and was incurring much larger than expected losses that could not be offset with projected future revenues.

A senior Enron manager made further false and misleading statements about EBS in the call, including that revenues from selling portions of EBS's content business, as opposed to recurring earnings from operations, were only "about a third" of EBS's overall earnings and that EBS had only done "a little bit" of such sales in the past two quarters. In reality, as Skilling knew, the sale of a portion of EBS's content business was the principal mechanism by which the unit had generated revenue in the last two quarters and accounted for the majority of EBS's earnings for the first quarter of 2001. Only a very small percentage of the unit's revenues in either quarter was due to operations that could be expected to recur. Moreover, EBS had been able to meet its target of $35 million in losses for the first quarter of 2001 only through the combined efforts of the sale of portions of its content services business and the manipulation of the accounting for many of its expenses and allocations under the supervision of Causey.

Second Quarter 2001 Analyst Conference Call

Enron held an analyst conference call to discuss its second quarter 2001 results on July 12, 2001. Skilling and Causey were among the senior Enron managers who prepared for and participated in the call. Skilling made knowingly false and misleading statements about the condition of Enron, including that Enron had a "great quarter." He further stated that EES "had an outstanding second quarter" and was "firmly on track to achieve our 2001 target of $225 million" in earnings; that losses in EBS were due to "industry conditions" and "dried up" revenue opportunities; and that Enron's "new businesses are expanding and adding to our earnings power and valuation, and we are well positioned for future growth." A senior Enron manager in the presence of Skilling and Causey also misled analysts about the movement of EES's losses into Wholesale, stating, "We just took the risk management functions and combined them because we just—we were trying to get some more efficiency out of management of the overall risk management function."

In reality, as Skilling and the manager knew, by the close of the second quarter of 2001, EBS had failed, and its increased losses were due to its

stopping the one-time sales of portions of its business that had previously been the only significant source of its earnings. EES was facing hundreds of millions of dollars in concealed losses. As a whole, Enron was less than five months from bankruptcy, and the accelerating pace of the company's decline was well known to Lay, Skilling, and Causey.

August 14, 2001: Skilling Leaves Enron

On July 13, 2001, Skilling unexpectedly told Lay he wanted to leave Enron because he could not do anything about Enron's declining stock price. On August 13, 2001, Skilling informed the board that he was resigning for personal reasons. On August 14, 2001, Enron issued a press release, with Lay's approval, that announced Skilling had resigned and stated that the resignation was for personal reasons. Lay took the title of CEO and continued his control and oversight of Enron.

On the same day, despite his knowledge of substantial problems at Enron as described above, Lay made the following false and misleading statements to securities analysts in a conference call: (a) "there are absolutely no problems that had anything to do with Jeff's departure… there are no accounting issues, no trading issues, no reserve issues… unknown, previously unknown problems, issues… I can honestly say that the company is probably in the strongest and best shape… that it's probably ever been in" and (b) regarding EES, "We've been doubling revenue and doubling income quarter on quarter, year on year for now about the last three years. We expect that to continue to grow very, very strong… most of us inside the company believe that the Enron Energy Services component could become as large or larger than our wholesale business within a five- or six-year period or so."

August 16, 2001, Employee Meeting

In an August 16, 2001, meeting, Lay made false and misleading statements to his own employees, fully aware that they were heavily invested in Enron stock, including in Enron's 401K plan. Lay stated: "Enron Energy Services just keeps banging away and just keeps growing at a tremendous rate… almost a doubling from second quarter last year to this year. And we've been kind of doing that systematically over the last four years…

tremendous growth. Of course, revenue is growing. But a very, very solid business."

August 20, 2001, Interview

Despite his knowledge of substantial problems at Enron, Lay made the following false and misleading statements in an August 20, 2001, interview with *Business Week Online*: (a) "There are no accounting issues, no trading issues, no reserve issues, no previously unknown problem issues," and (b) "There is no other shoe to fall… The company is probably in the strongest and best shape that it has ever been in. There are no surprises. We did file our 10-Q a few days ago. And if there were any serious problems, they would be in there." Lay also revealed his awareness of the legal implications of his conduct: "If there's anything material and we're not reporting it, we'd be breaking the law."

Lay Learns Of Additional Problems, August-September 2001

Lay became aware of additional negative information about Enron during the last two weeks of August 2001 and the first week of September 2001. In this time period, Lay was briefed by numerous Enron employees on Enron's mounting and undisclosed financial and operational problems, including overvaluation of Enron's assets and business units by billions of dollars.

As a result of Enron's deteriorating financial condition, Lay, Causey, and others privately considered a range of potential solutions, including mergers, restructurings, and even divestment of Enron's pipelines, assets that Lay considered to be the crown jewels of the company.

On or about August 23 and 28, 2001, Lay, Causey, and others participated in Management Committee meetings where reports were presented showing earnings shortfalls in virtually every Enron business unit, totaling approximately $1 billion. On September 6 and 7, 2001, Enron's Management Committee, including Lay and Causey, attended a retreat at The Woodlands resort near Houston, Texas. They discussed serious problems at Enron, including underperforming business units and troubled assets. Among other things, Lay, Causey, and others were involved in

discussions regarding the need to take at least a $1 billion charge in the third quarter of 2001 and that Enron had committed an accounting error in the amount of $1.2 billion.

Throughout September 2001, Lay, Causey, and other Enron executives engaged in a series of high-level meetings to discuss the growing undisclosed financial crisis at Enron and the likely impact on Enron's credit rating and stock price. Lay, Causey, and others learned that the total amount of losses attributable to Enron's assets and business units was at least $7 billion. Also at this time, Lay, Causey, and others learned that Enron's outside auditors changed their previous position regarding the accounting treatment of the Raptors. Enron's auditors determined that Enron's treatment of the Raptors violated clear accounting rules. Lay, Causey, and others were then faced with the prospect of restating Enron's earnings and admitting the error.

September 26, 2001, Employee Forum

Lay participated in an Enron employee online forum on September 26, 2001, and made the following false and misleading statements, including: (a) "The third quarter is looking great. We will hit our numbers. We are continuing to have strong growth in our businesses, and at this time I think we're positioned for a very strong fourth quarter"; (b) "We have record operating and financial results"; and (c) "The balance sheet is strong."

Lay also made false and misleading statements to his employees about his trading in Enron stock. Despite the fact that during the prior two months he had made net sales of more than $20 million in Enron stock to Enron, sales that he knew his employees did not know about, Lay falsely and misleadingly stated: "I have strongly encouraged our 16B officers to buy additional Enron stock. Some, including myself, have done so over the last couple of months and others will probably do so in the future … My personal belief is that Enron stock is an incredible bargain at current prices."

October 12, 2001, Call To Credit Rating Agency

On or about October 12, 2001, Lay made false and misleading statements to a representative of a prominent credit rating agency in a telephone call.

Among other things, Lay stated that Enron and its auditors had "scrubbed" the company's books and that no additional write-downs would be forthcoming. In fact, as Lay knew, Enron's international assets were being carried on Enron's books for billions of dollars in excess of their fair value. Lay also knew that he and other Enron employees had failed to disclose and would not report the $700 million Wessex goodwill impairment, and had falsely claimed to others, including Andersen, that Enron would pursue a growth strategy in the water business. In addition, as Lay knew, Enron's auditors had not completed their work regarding asset valuations or goodwill and had not yet provided a final opinion regarding the necessity of additional write-downs.

Third Quarter 2001 Earnings Release—October 16, 2001

By October 2001, Lay knew, among other things, that: (a) Enron had incorrectly accounted for the Raptor transactions, and that due to the massive accounting error, shareholders' equity needed to be reduced by $1.2 billion; (b) The Raptors were being terminated and, combined with other write-downs, this would result in an earnings charge of $1.01 billion; and (c) These two items were unrelated, and the $1.2 billion reduction to shareholders' equity was required, regardless of whether the Raptors were terminated. Despite this knowledge, Lay made false and misleading statements about these items.

On October 16, 2001, Enron issued an earnings release, reviewed and approved by Lay, that reported a "non-recurring" earnings charge of $1.01 billion, a majority of the charge relating to the unwind of certain vehicles. Lay did not disclose that the vehicles at issue were the Raptors. Lay knew that the characterization of the termination of the vehicles as "non-recurring" losses, that is, a one-time or unusual earnings event, was erroneous and inconsistent with Enron's past treatment of Raptor earnings as recurring operating earnings. Lay and others knowingly omitted any reference to the separate $1.2 billion equity reduction in the press release.

Enron had a conference call with analysts on October 16, 2001, to discuss the earnings release. Lay, Causey, and others prepared for and participated in the call. Lay made false and misleading statements in the call. Lay again falsely described the hundreds of millions of dollars in losses as "non-

recurring." Lay also falsely stated that "in connection with the early termination, shareholders' equity will be reduced by approximately $1.2 billion." Lay and Causey did not disclose that the vehicles unwound (as part of the $1 billion charge) were the Raptors, nor did he disclose that the $1.2 billion equity reduction was principally due to a significant accounting error.

In the same call, Lay made false and misleading statements regarding the valuation of Enron's international assets. In response to questions regarding the value of Elektro, a Brazilian power plant, which Enron carried on its books in excess of $2 billion, Lay stated that, "We may well have that asset and operate that asset for quite some time. It's not a bad asset, it's a good asset, just like a lot of the other assets in this portfolio." This statement was misleading, in that Lay knew that Elektro was overvalued by as much as $1 billion and classified internally as a "troubled" asset.

Lay further stated that Enron "and its outside auditors have recently completed our preliminary evaluation of goodwill." Lay represented that, based upon that review, "up to $200 million goodwill adjustment may be necessary, and will be recorded as required by the accounting principles in the first quarter of 2002." In fact, as Lay knew, the adjustment did not include the impaired Wessex goodwill of approximately $700 million, and Enron's auditors had not completed even a preliminary evaluation of goodwill.

Lay and other senior Enron managers hosted a series of meetings with analysts and large institutional investors after the announcement of Enron's third quarter earnings results. In these meetings, Lay and the senior managers falsely and misleadingly portrayed EES as rapidly increasing in profitability, quarter to quarter and year to year. Lay additionally distributed materials at the meetings that falsely and misleadingly described the value of Enron's international portfolio as $6.5 billion, when Lay knew this figure vastly overstated the true value of the international assets by billions of dollars.

October 23, 2001, Analyst Call

In an effort to calm deepening public concern regarding the decline in Enron's stock price, Lay and Causey prepared for and participated in an

Enron analyst conference call on October 23, 2001. In that call, Lay made the following false and misleading statements: "[we're] not trying to conceal anything. We're not hiding anything"; "We're really trying to make sure that the analysts and the shareholders and the debt holders really know what's going on here. So, we are not trying to hold anything back"; and "I'm disclosing everything we've found." In response to questioning, Lay again falsely stated that the $1.2 billion reduction to shareholder equity was a result of "unwinding" certain vehicles, failing to disclose that the cause of the equity write-down was principally due to a massive accounting error.

October 23, 2001, Employee Meeting

By October 2001, in addition to other problems known to Lay as described above, Lay knew that Enron had serious liquidity issues. Lay knew that Enron had been forced to offer its prized pipelines as collateral for a $1 billion bank loan. He also knew that the only source of liquidity was a $3 billion bank line of credit, which, if drawn, would highlight Enron's worsening financial situation. Despite this knowledge, on October 23, 2001, Lay made false and misleading statements to his employees during an all-employee meeting. Lay falsely stated, "Our liquidity is fine. As a matter of fact, it's better than fine, it's strong…" Three days later, Lay authorized the draw-down of the entire $3 billion line of credit.

Lay also made misleading statements about Enron stock and its prospects. Lay misleadingly stated, "as sad as the current market price is—and I've certainly lost a substantial portion of my net worth and my family's net worth—at current prices the market value [of Enron] is about $17 or $18 billion. It was $2 billion when we started in '85. But I also know that many of you who were a lot wealthier six to nine months ago are now concerned about the college education for your kids, maybe the mortgage on your house, maybe your retirement… But we're going to get it back." Lay also stated that he thought a fair price for Enron stock was in the $50-$60 range and "that doesn't mean we can't get back up to the $80s or $90s in the not-to-distant future." At the time, Enron stock was trading at approximately $19.79 per share. Lay did not disclose that he had substantially reduced his personal exposure to the declining stock price, having sold over $65 million of Enron stock in 2001. Lay also knew, and failed to disclose, that he had no reasonable basis to forecast an increase in Enron's stock price.

November 12, 2001, Analyst Call

Lay participated in an analyst conference call with analysts on November 12, 2001. During the call, Lay made the following false and misleading statements: "We don't have anything we're trying to hide… I'm disclosing everything we've found." Lay failed to disclose all of the negative information about Enron that he was well aware of by this point in time.

Collapse of Scheme

For a time, the scheme to defraud succeeded and supported Enron's stock price and its credit rating. In early 1998, Enron's stock traded at approximately $30 per share. By January 2001, even after a 1999 stock split, Enron's stock had risen to more than $80 per share, and Enron had become the seventh-ranked company in the United States, according to the leading index of the Fortune 500. Until late 2001, Enron maintained an investment-grade credit rating. However, the scheme quickly collapsed after Enron's announcement on October 16, 2001, revealed enormous losses. On October 22, 2001, Enron announced that it was the subject of an SEC investigation. The next day, Lay authorized Enron to enter into merger discussions with Dynegy Inc. On October 29 and November 1, 2001, the two leading credit rating agencies downgraded Enron's credit rating. On November 8, 2001, Enron announced its intention to restate its financial statements for 1997 through 2000 and the first and second quarters of 2001 to reduce previously reported net income by an aggregate of $586 million. On November 9, 2001, Enron filed an 8-K with a merger agreement signed by Lay announcing a merger between Enron and Dynegy, which falsely stated that Enron's prior public filings were true and accurate. On November 21, 2001, Enron's credit rating was downgraded to "junk" status. On December 2, 2001, Enron filed for bankruptcy, making its stock, which was trading at more than $80 per share less than a year earlier, virtually worthless.

False and Misleading Filings With The SEC

In furtherance of the scheme to manipulate Enron's financial results and inflate its stock price, Lay, Skilling, and Causey filed and caused to be filed with the SEC false and misleading reports of Enron, including:

- Annual and Quarterly Reports
- Form 10-Q for the Third Quarter 1999 (filed on or about November 15, 1999); Form 10-K for the Fiscal Year 1999 (filed on or about March 30, 2000)
- Form 10-Q for the First Quarter 2000 (filed on or about May 15, 2000)
- Form 10-Q for the Second Quarter 2000 (filed on or about August 14, 2000); Form 10-Q for the Third Quarter 2000 (filed on or about November 14, 2000); Form 10-K for Fiscal Year 2000 (filed on or about April 2, 2001)
- Form 10-Q for the First Quarter 2001 (filed on or about May 15, 2001)
- Form 10-Q for the Second Quarter 2001 (filed on or about August 14, 2001)
- Registration Statements
- Form S-3 filed on or about April 4, 2000
- Form S-3 filed on or about June 15, 2000
- Form S-3 filed on or about July 19, 2000
- Form S-3 filed on or about January 26, 2001
- Form S-3 filed on or about June 1, 2001, and Amendment dated July 13, 2001
- Form 8-K dated November 9, 2001

The reports caused to be filed by Lay, Skilling, and Causey contained, among other things, materially false and misleading financial statements that overstated Enron's actual revenues and earnings, understated Enron's actual debt and expenses, and contained materially false and misleading management descriptions and analyses of Enron's business.

Defendants' Illegal Gains

As officers and/or directors of Enron, Lay, Skilling, and Causey each owed a fiduciary duty to Enron and its shareholders to act solely in the best interests of Enron and its shareholders. Lay, Skilling, and Causey also signed employment and/or consulting agreements with Enron in which each acknowledged this fiduciary duty and agreed that each owed a duty of

trust and confidence to Enron, and that personal use of confidential information on Enron was prohibited. The employment and/or consulting agreements signed by Lay, Skilling, and Causey were in effect during the time period relevant to the Second Amended Complaint.

Lay, Skilling, Causey, and others made illegal gains from the scheme to defraud in the form of salary, bonuses, and other forms of compensation. During 2001, Lay received a salary of $1 million, a bonus of $7 million, and $3.6 million in long-term incentive payments, all proceeds of the scheme to defraud. Between 1998 and 2001, Skilling received at least $14 million in salary and bonuses, all proceeds of the scheme to defraud. Between 1998 and 2001, Causey received more than $4 million in salary and bonuses, all proceeds of the scheme to defraud. Moreover, as detailed below, the defendants and others also made additional illegal gains by selling large amounts of Enron stock at the inflated prices they engineered.

Defendants' trading in Enron stock also occurred while they were in possession of material non-public information, including information about Enron's actual financial position and the performance of its business units as described above, that the stock price was inflated, and that Enron and its executives and senior managers, including defendants, had supplied and were continuing to supply materially false and misleading information to the investing public, including, but not limited to, Enron's publicly reported financial results and public statements of Enron's executives and senior managers. Defendants knew or were reckless in not knowing that the information they possessed was confidential and that trading while in possession of that information was a breach of a fiduciary duty or similar relationship of trust and confidence that they owed to Enron and its shareholders.

By selling shares of Enron stock at the market price, defendants represented that the market price was a reliable way to value their shares, vouching for the integrity of Enron's financial statements and the public statements they and others made about Enron's financial condition. This representation was false and misleading, as the market price was not a reliable indicator of value because that price had been materially distorted by defendants' release of inaccurate information. Defendants intended that

Enron and the market rely on the accuracy of the stock market price as a fair way to value their shares. A true picture of Enron as of the dates of defendants' stock sales was far different from that represented in Enron's financial reports and defendants' public statements, leading defendants to receive unduly excessive value for their Enron shares.

Lay's Illegal Gains From Sales of Enron Stock

Lay profited from the scheme to defraud, in part, by selling large amounts of Enron stock at prices that did not reflect the true value of Enron stock. In 2001, Lay sold more than $70 million in Enron stock to repay cash advances on an unsecured Enron line of credit. In addition, Lay amended two pre-existing program trading plans to enable him to sell an additional $20 million in Enron stock. Lay's gains and losses avoided from the sales constitute illegal gains resulting from the scheme to defraud.

Lay's Sales of Enron Stock Back To Enron

Lay's unsecured line of credit allowed him to borrow up to $4 million (later increased to $7.5 million) directly from Enron. In May 1999, at Lay's request, Enron permitted Lay to repay amounts due on the line of credit in shares of Enron stock, to be valued at the closing price on the date he gave notice of his intent to repay. Lay preferred this method of repayment because, among other things, he could avoid disclosure of his stock sales at the time the sales occurred. All repayments by Lay were through sales of Enron stock to the company.

From January 25, 2001, to November 27, 2001, Lay took advances on his line of credit in the total amount of $77,525,000. Thereafter, despite having other assets at his disposal, Lay repaid balances on the line of credit by selling $70,104,762 worth of Enron stock to the company twenty times, at prices he knew did not reflect accurately Enron's true financial condition. For example, after learning of Enron's undisclosed plan to hide more than $500 million in EES losses in ENA, Lay sold 1,086,571 shares of Enron common stock back to the company, in eleven transactions, for a total of $34,081,558. Following Skilling's resignation on August 14, 2001, at a point when Lay was learning more about Enron's deteriorating financial condition, Lay sold 918,104 shares of Enron common stock back to the

company, in five transactions, totaling $26,066,474. As Lay learned more negative information following Enron's third quarter earnings release on October 16, 2001, Lay sold 362,051 shares of Enron stock back to the company, in four transactions, totaling $6,050,232. The transactions executed by Lay are set forth in the table titled Ken Lay Line of Credit that follows beginning on page 145.

Lay's sales of Enron stock were not reported by Lay to the SEC on a Form 5 or otherwise revealed publicly until February 2002, more than two months after Enron filed for bankruptcy protection.

Had Lay disclosed the substantial sales of his Enron stock at the time the sales occurred, this fact would have had a significant detrimental impact on the share price of Enron stock. By avoiding public disclosure of his stock sales, and even giving the impression to his employees and others that he was buying Enron stock, Lay was able to use artificially priced Enron shares to reduce his line of credit balance and avoid significant losses that he would have suffered had he retained his Enron shares.

In addition to the benefit Lay obtained from the Enron stock sales at inflated prices, Lay took advances on his line of credit in the amount of $7.5 million, an amount drawn in six advances between October 24 and November 27, 2001, while he knew Enron's financial condition was crumbling.

Lay's Sales of Enron Stock Pursuant to Amended 10b5-1 Plan

Under Rule 10b5-1 of the Exchange Act, if a stock-trading plan is entered into by a person before he becomes aware of material non-public information, such a plan can provide an affirmative defense to insider trading. However, any amendment to a plan is considered a new plan, and no affirmative defense is available if the amendment occurs after becoming aware of material non-public information.

On November 1, 2000, Lay established two program sales plans pursuant to Rule 10b5-1 of the Exchange Act. One plan was for Lay and his wife (the "Lay Plan"), and the other plan was for a family partnership (the "Partnership Plan"). Under the Lay Plan, Lay could sell 3,534 shares of Enron stock every trading day at the

market price from November 1, 2000, through January 31, 2001, and 1,500 shares every trading day from February 1, 2001, through January 31, 2002. Under the Partnership Plan, Lay could sell 500 Enron shares each trading day from November 1, 2000, through January 31, 2002.

On February 1, 2001, Lay amended the Lay Plan, increasing the sales to 2,500 shares each day. On May 1, 2001, Lay amended the Partnership Plan, increasing the sales to 1,000 shares each day. Lay terminated both plans effective July 31, 2001.

At the time Lay amended both plans, he was in possession of material non-public information concerning Enron, as described above. Thus, Lay cannot use the affirmative defense provided under Rule 10b5-1.

From February 1, 2001, through the termination date of July 31, 2001, under the Lay Plan, Lay sold 295,000 Enron shares at prices ranging from $43.66 to $80.81, for total proceeds of approximately $17,329,630. From May 1, 2001, through the termination date of July 31, 2001, under the Partnership Plan, Lay sold 64,000 shares at prices ranging from $43.65 to $63.07, for total proceeds of $3,278,510. The transactions executed by Lay are set forth in the table below.

Skilling's Illegal Gains from Sales of Enron Stock

Skilling sold shares of Enron stock that generated total proceeds of $62,626,401.90 as follows:

Trade	Date	Shares	Sale Price(s)	Gross Proceeds
A	April 25, 2000	10,000	$73.875 $73.9375	$738,893.75
B	April 26, 2000	86,217	$74.00 $73.875 $72.50	$6,338,183.00
C	August 30, 2000	15,000	$86.125	$1,291,875.00

D	September 1, 2000	60,000	$87.00 $86.875 $87.25	$5,220,000.00
E	September 5, 2000	11,441	$85.00	$972,485.00
F	November 1, 2000	72,600	$83.2406 $83.0625	$6,041,023.50
G	November 2, 2000	20,000	$82.3381	$1,646,762.00
H	November 7, 2000	46,068	$82.5872	$3,804,627.13
I	November 15, 2000-June 19, 2001	10,000 per week, 31 weeks per plan	$84.00 to $49.90	$20,985,247.42
J	September 17, 2001	500,000	$31.5061 $31.0822	$15,587,305.10

Causey's Illegal Gains from Sales of Enron Stock

Causey sold shares of Enron stock and generated total proceeds of $10,316,807.83 as follows:

Trade	Date	Shares	Sale Price(s)	Gross Proceeds
A	January 21, 2000	45,000	$72.00	$3,220,000.00
B	September 28, 2000	80,753	$87.8829	$7,096,807.83

False and Misleading Statements to Enron's Accountants

On or about the dates set forth below, Skilling, Causey, and others, while agreeing that they were "responsible for the fair presentation of the financial statements," falsely represented to Enron's accountants that, among other things, (a) the statements and representations made in Enron's

financial statements were true; (b) Enron properly recorded or disclosed in its financial statements all agreements to repurchase assets previously sold; (c) Enron properly recorded or disclosed in its financial statements guarantees, whether written or oral, under which Enron was contingently liable; (d) Enron's unaudited quarterly financial data fairly summarized, among other things, the operating revenues, net income, and per share data based upon that income for each quarter; (e) there was no material fraud or any other irregularities that, although not material, involved management or other employees who had a significant role in Enron's system of internal control, or fraud involving other employees that could have a material effect on the financial statements; (f) there were no material liabilities or gain or loss contingencies (including those that might exist relating to oral guarantees) that were required to be disclosed in accordance with SFAS No. 5; (g) all related-party transactions, including sales, were properly recorded and disclosed; (h) no events occurred subsequent to the balance sheet date that had a material effect on the financial statements and that should have been disclosed in order to keep those financial statements from being misleading; (i) Enron made available to the accountants all financial records and related data; (j) Enron's system of internal controls was adequate and had no significant deficiencies; and (k) the accounting records underlying Enron's financial statements accurately and fairly reflected, in reasonable detail, the transactions of Enron, well knowing that these statements were false. Skilling, Causey, and others made the false representations in representation letters to Enron's accountants.

Claims for Relief

First Claim

Violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5] (All Defendants)

The following details the government's cause of action based on criminal statutes.

As set forth more fully above, Lay, Skilling, and Causey, directly or indirectly, by use of the means or instrumentalities of interstate commerce,

or by the use of the mails and of the facilities of a national securities exchange, in connection with the purchase or sale of securities: have employed devices, schemes, or artifices to defraud, have made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or have engaged in acts, practices, or courses of business which operate or would operate as a fraud or deceit upon any person.

By reason of the foregoing, Lay, Skilling, and Causey violated and aided and abetted violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

Second Claim

Violations of Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)] (Lay)

The following details the government's cause of action based on criminal statutes.

Lay, by engaging in the conduct described above, directly or indirectly, in connection with the offer or sale of securities, by the use of the means or instruments of transportation or communication in interstate commerce or by the use of the mails: with scienter (the element of fraud that crosses the line from civil to criminal, since it involves the elements of knowing, deliberate intent), employed devices, schemes, or artifices to defraud, obtained money or property by means of untrue statements of material facts or omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or engaged in acts, practices, or courses of business which operate or would operate as a fraud or deceit upon the purchasers of such securities.

By reason of the foregoing, Lay violated Section 17(a) of the Securities Act.

Third Claim

Violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] (All

Defendants) and Exchange Act Rules 12b-20 (All Defendants), 13a-1 (Causey & Skilling), 13a-11 (Lay), and 13a-13 (Causey) [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, 240.13a-13]

The following details the government's cause of action based on criminal statutes.

By engaging in the conduct described above, Lay, Skilling, and Causey knowingly and substantially caused Enron to file materially false and misleading reports and filings with the Commission.

By reason of the foregoing, Lay, Skilling, and Causey aided and abetted violations by Enron of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 (Causey and Skilling), 13a-11 (Lay), and 13a-13 (Causey).

Fourth Claim

Violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A), 78m(b)(2)(B)] and Exchange Act Rule 13b2-1 [17 C.F.R. § 240.13b2-1] (All Defendants)

The following details the government's cause of action based on criminal statutes.

By engaging in the conduct described above, Lay, Skilling, and Causey aided and abetted Enron's failures to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflected Enron's transactions and dispositions of its assets, in violation of Section 13(b)(2)(A) of the Exchange Act, and further aided and abetted failures to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that Enron's corporate transactions were executed in accordance with management's authorization and in a manner to permit the preparation of financial statements in conformity with Generally Accepted Accounting Principles in violation of Section 13(b)(2)(B) of the Exchange Act.

By engaging in the conduct described above, Lay, Skilling, and Causey,

directly or indirectly, falsified and caused to be falsified Enron's books, records, and accounts subject to Section 13(b)(2)(A) of the Exchange Act in violation of Exchange Act Rule 13b2-1.

By reason of the foregoing, Skilling and Causey aided and abetted violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and violated Exchange Act Rule 13b2-1.

Fifth Claim

Violations of Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)] (Skilling/Causey)

The following details the government's cause of action based on criminal statutes.

By engaging in the conduct described above, Skilling and Causey knowingly circumvented or knowingly failed to implement a system of internal financial controls at Enron, and knowingly falsified books, records, and accounts of Enron.

By reason of the foregoing, Skilling and Causey violated and aided and abetted violations of Section 13(b)(5) of the Exchange Act.

Sixth Claim

Violations of Exchange Act Rule 13b2-2 [17 C.F.R. § 240.13b2-2] (Skilling/Causey)

The following details the government's cause of action based on criminal statutes.

By engaging in the conduct described above, Skilling and Causey, directly or indirectly, made or caused to be made false and misleading statements or omitted or caused others to omit to state material facts necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading to Enron's independent accountants and Enron's auditors in connection with audits and examinations of

Enron's required financial statements and in connection with the preparation and filing of documents and reports required to be filed with the Commission, in violation of Exchange Act Rule 13b2-2.

By reason of the foregoing, Skilling and Causey violated and aided and abetted violations of the Exchange Act Rule 13b2-2.

The SEC then requested that there be granted a Permanent Injunction restraining order, which enjoined Lay, Skilling, and Causey from violating the statutory provisions set forth; prohibiting each permanently and unconditionally from acting as an officer or director of any issuer of securities that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of such Act; and ordering each to pay disgorgement of illegal gains, and civil penalties.

The SEC also requested pursuant to Section 308 of the Sarbanes-Oxley Act of 2002, there enter an order providing that the amount of civil penalties ordered against Lay, Skilling, and Causey be added to and become part of a disgorgement fund for the benefit of the victims of the violations alleged under the SEC's complaint. In the end, Skilling was found guilty of nineteen of twenty-eight counts of fraud and conspiracy, and Lay was found guilty of one count of conspiracy, three counts of security fraud and two counts of wire fraud. He was also found guilty of two separate federal bank fraud charges that were heard in a separate bench trial related to making false statements to banks, where he signed loan forms (U1) agreeing not to use the loan proceeds to buy stock on margin.

The following exhibits were compiled by the government and illustrate how Lay utilized a line of credit from Enron to engage in trading, particularly during the critical 2001 year. Lay realized $11,971,326 of Enron trading profit in 2001, as the detail below illustrates, and an additional $1,948,590 of Enron trading profit from his family partnership account.

Ken Lay Line of Credit
Table of Advances and Repayments in 2001

Date	Transaction	Amount Shares	Price	Sales Proceeds
01/25/01	Advance	$4,000,000		
02/01/01	Repayment	50,814	$78.79	$4,003,635.06
03/23/01	Advance	$1,100,000		
04/05/01	Advance	$950,000		
04/19/01	Advance	$1,950,000		
04/27/01	Repayment	63,152	$63.50	$4,010,152.00
05/03/01	Advance	$4,000,000		
05/14/01	Repayment	68,182	$58.75	$4,005,692.50
05/23/01	Advance	$4,000,000		
05/25/01	Repayment	75,491	$53.00	$4,001,023.00
06/11/01	Advance	$4,000,000		
06/12/01	Repayment	79,423	$50.37	$4,000,536.51
06/15/01	Advance	$4,000,000		
06/19/01	Repayment	86,665	$46.18	$4,002,189.70
06/22/01	Advance	$4,000,000		
06/22/01	Repayment	89,126	$44.88	$3,999,974.88
06/26/01	Advance	$4,000,000		
06/26/01	Repayment	90,518	$44.19	$3,999,990.42
06/27/01	Advance	$4,000,000		
06/27/01	Repayment	85,616	$46.72	$3,999,979.52
06/28/01	Advance	$4,000,000		
06/28/01	Repayment	82,747	$48.34	$3,999,989.98
06/29/01	Advance	$4,000,000		
07/26/01	Repayment	85,720	$46.84	$4,015,124.80
07/27/01	Advance	$4,000,000		
08/21/01	Repayment	110,706	$36.25	$4,013,092.50
08/21/01	Advance	$4,000,000		
08/23/01	Repayment	108,254	$36.95	$3,999,985.30
08/24/01	Advance	$4,000,000		
08/24/01	Repayment	110,041	$36.35	$3,999,990.35
08/28/01	Advance	$4,000,000		
08/30/01	Repayment	112,706	$35.50	$4,001,063.00
08/31/01	Advance	$4,000,000		
09/4/01	Repayment	114,346	$35.00	$4,002,110.00
09/06/01	Advance	$4,000,000		
10/23/01	Repayment	76,995	$19.79	$1,523,731.05

10/24/01	Repayment	103,614	$16.41	$1,700,305.74
10/24/01	Advance	$3,500,000		
10/25/01	Repayment	33,672	$16.35	$550,537.20
10/25/01	Advance	$1,500,000		
10/26/01	Repayment	147,770	$15.40	$2,275,658.00
10/26/01	Advance	$2,000,000		
11/01/01	Advance	$1,000,000		
11/09/01	Advance	$525,000		
11/27/01	Advance	$1,000,000		
Totals:		**$77,525,000**	**1,775,558**	**$70,104,761.51**

Lay Plan Sales

Date	Number of Shares	Sale Price	Cost Price	Gross Proceeds	Net Profits
02/01/01	2,500	$78.83	$16.75	$197,075	$155,200
02/02/01	2,500	$78.77	$16.75	$196,925	$155,050
02/05/01	2,500	$80.49	$17.00	$201,225	$158,725
02/06/01	2,500	$80.81	$17.00	$202,025	$159,525
02/07/01	40	$80.00	$17.00	$3,200	$2,520
02/07/01	2,460	$80.39	$16.75	$197,759	$156,554
02/08/01	2,500	$80.38	$16.75	$200,950	$159,075
02/09/01	2,500	$80.77	$16.75	$201,925	$160,050
02/12/01	2,500	$79.98	$16.75	$199,950	$158,075
02/13/01	2,500	$79.76	$16.75	$199,400	$157,525
02/14/01	2,500	$80.72	$16.75	$201,800	$159,925
02/15/01	2,500	$77.60	$16.75	$194,000	$152,125
02/16/01	2,500	$76.36	$16.75	$190,900	$149,025
02/20/01	2,500	$76.28	$16.75	$190,700	$148,825
02/21/01	2,500	$74.85	$16.75	$187,125	$145,250
02/22/01	2,500	$72.58	$16.75	$181,450	$139,575
02/23/01	2,500	$71.06	$16.75	$177,650	$135,775
02/26/01	2,500	$70.57	$16.75	$176,425	$134,550
02/27/01	2,500	$70.36	$16.75	$175,900	$134,025
02/28/01	2,500	$69.50	$16.75	$173,750	$131,875
03/01/01	2,500	$67.78	$16.75	$169,450	$127,575
03/02/01	2,500	$69.00	$16.75	$172,500	$130,625
03/05/01	2,500	$70.48	$16.75	$176,200	$134,325
03/06/01	2,500	$69.86	$16.75	$174,650	$132,775
03/07/01	2,500	$69.30	$16.75	$173,250	$131,375
03/08/01	2,500	$70.40	$16.75	$176,000	$134,125

03/09/01	2,500	$69.65	$16.75	$174,125	$132,250
03/12/01	2,500	$64.92	$16.75	$162,300	$120,425
03/13/01	2,500	$61.75	$16.75	$154,375	$112,500
03/14/01	2,500	$61.43	$16.75	$153,575	$111,700
03/15/01	2,500	$64.63	$16.75	$161,575	$119,700
03/16/01	2,500	$65.50	$16.75	$163,750	$121,875
03/19/01	2,500	$62.27	$16.75	$155,675	$113,800
03/20/01	2,500	$62.28	$16.75	$155,700	$113,825
03/21/01	2,500	$59.57	$16.75	$148,925	$107,050
03/22/01	2,500	$53.93	$16.75	$134,825	$92,950
03/23/01	2,500	$57.72	$16.75	$144,300	$102,425
03/26/01	2,500	$61.32	$16.75	$153,300	$111,425
03/27/01	2,500	$60.50	$16.75	$151,250	$109,375
03/28/01	2,500	$58.83	$16.75	$147,075	$105,200
04/02/01	2,500	$57.50	$16.75	$143,750	$101,875
04/03/01	2,500	$55.90	$16.75	$139,750	$97,875
04/04/01	2,500	$54.11	$16.75	$135,275	$93,400
04/05/01	2,500	$54.88	$16.75	$137,200	$95,325
04/06/01	2,500	$54.75	$16.75	$136,875	$95,000
04/09/01	2,500	$54.53	$16.75	$136,325	$94,450
04/10/01	492	$57.20	$16.75	$28,142.	$19,901
04/10/01	2,008	$58.31	$16.75	$117,086	$83,452
04/11/01	2,500	$59.69	$19.06	$149,225	$101,575
04/12/01	2,500	$57.40	$19.06	$143,500	$95,850
04/16/01	2,500	$58.24	$19.06	$145,600	$97,950
04/17/01	2,500	$60.75	$19.06	$151,875	$104,225
04/18/01	2,500	$61.57	$19.06	$153,925	$106,275
04/19/01	2,500	$61.32	$19.06	$153,300	$105,650
04/20/01	2,500	$60.87	$19.06	$152,175	$104,525
04/23/01	2,500	$60.94	$19.06	$152,350	$104,700
04/24/01	2,500	$62.18	$19.06	$155,450	$107,800
04/25/01	2,500	$62.06	$19.06	$155,150	$107,500
04/26/01	2,500	$63.21	$19.06	$158,025	$110,375
04/27/01	2,500	$62.98	$19.06	$157,450	$109,800
05/01/01	2,500	$63.12	$19.06	$157,800	$110,150
05/02/01	2,500	$61.77	$19.06	$154,425	$106,775
05/03/01	2,500	$58.79	$19.06	$146,975	$99,325
05/04/01	2,500	$58.86	$19.06	$147,150	$99,500
05/07/01	2,500	$58.67	$19.06	$146,675	$99,025
05/08/01	2,500	$57.00	$19.06	$142,500	$94,850
05/09/01	2,500	$57.21	$19.06	$143,025	$95,375
05/10/01	2,500	$58.35	$19.06	$145,875	$98,225

05/11/01	2,500	$57.54	$19.06	$143,850	$96,200
05/14/01	2,500	$58.52	$19.06	$146,300	$98,650
05/15/01	2,500	$58.08	$19.06	$145,200	$97,550
05/16/01	2,500	$57.25	$19.06	$143,125	$95,475
05/17/01	2,500	$55.02	$19.06	$137,550	$89,900
05/18/01	2,500	$53.75	$19.06	$134,375	$86,725
05/21/01	2,500	$55.16	$19.06	$137,900	$90,250
05/22/01	2,500	$55.06	$19.06	$137,650	$90,000
05/23/01	2,500	$55.68	$19.06	$139,200	$91,550
05/24/01	2,500	$55.11	$19.06	$137,775	$90,125
05/29/01	2,500	$53.41	$19.06	$133,525	$85,875
06/01/01	2,500	$52.66	$19.06	$131,650	$84,000
06/04/01	2,500	$53.88	$19.06	$134,700	$87,050
06/05/01	2,500	$54.08	$19.06	$135,200	$87,550
06/06/01	2,500	$52.79	$19.06	$131,975	$84,325
06/07/01	2,500	$50.63	$19.06	$126,575	$78,925
06/08/01	2,500	$50.20	$19.06	$125,500	$77,850
06/11/01	2,500	$51.17	$19.06	$127,925	$80,275
06/12/01	2,500	$50.92	$19.06	$127,300	$79,650
06/13/01	2,500	$50.63	$19.06	$126,575	$78,925
06/14/01	2,500	$48.83	$19.06	$122,075	$74,425
06/15/01	2,500	$47.78	$19.06	$119,450	$71,800
06/18/01	2,500	$46.00	$19.06	$115,000	$67,350
06/19/01	2,500	$44.93	$19.06	$112,325	$64,675
06/20/01	2,500	$46.11	$19.06	$115,275	$67,625
06/21/01	2,500	$45.15	$19.06	$112,875	$65,225
06/22/01	2,500	$44.21	$19.06	$110,525	$62,875
06/25/01	2,500	$44.79	$19.06	$111,975	$64,325
06/26/01	2,500	$43.66	$19.06	$109,150	$61,500
06/27/01	2,500	$45.45	$19.06	$113,625	$65,975
06/28/01	2,500	$47.47	$19.06	$118,675	$71,025
07/02/01	2,500	$48.81	$19.06	$122,025	$74,375
07/03/01	2,500	$48.80	$19.06	$122,000	$74,350
07/05/01	2,500	$49.66	$19.06	$124,150	$76,500
07/06/01	2,500	$50.07	$19.06	$125,172	$77,522
07/09/01	2,500	$49.40	$19.06	$123,500	$75,850
07/10/01	2,500	$49.44	$19.06	$123,600	$75,950
07/11/01	2,500	$49.00	$19.06	$122,500	$74,850
07/12/01	2,500	$49.54	$19.06	$123,850	$76,200
07/13/01	2,500	$49.48	$19.06	$123,700	$76,050
07/16/01	2,500	$49.50	$19.06	$123,750	$76,100
07/17/01	2,500	$49.64	$19.06	$124,100	$76,450

07/18/01	2,500	$49.40	$19.06	$123,500	$75,850
07/19/01	2,500	$48.91	$19.06	$122,275	$74,625
07/20/01	2,500	$48.66	$19.06	$121,650	$74,000
07/23/01	2,500	$47.49	$19.06	$118,725	$71,075
07/24/01	2,500	$44.76	$19.06	$111,900	$64,250
07/25/01	2,500	$43.83	$19.06	$109,575	$61,925
07/26/01	2,500	$45.35	$19.06	$113,375	$65,725
07/27/01	2,500	$46.05	$19.06	$115,125	$67,475
07/30/01	2,500	$46.25	$19.06	$115,625	$67,975
07/31/01	2,500	$45.98	$19.06	$114,950	$67,300
Totals:	**295,000**			**$17,329,634**	**$11,971,324**

Partnership Plan Sales

Date	Number of Shares	Sale Price	Cost Basis	Gross Proceeds	Net Profits
05/01/01	1,000	$63.07	$20.78	$63,070	$42,290
05/02/01	1,000	$61.78	$20.78	$61,780	$41,000
05/03/01	1,000	$58.73	$20.78	$58,730	$37,950
05/04/01	1,000	$58.86	$20.78	$58,860	$38,080
05/07/01	1,000	$58.67	$20.78	$58,670	$37,890
05/08/01	1,000	$57.00	$20.78	$57,000	$36,220
05/09/01	1,000	$57.13	$20.78	$57,130	$36,350
05/10/01	1,000	$58.35	$20.78	$58,350	$37,570
05/11/01	1,000	$57.53	$20.78	$57,530	$36,750
05/14/01	1,000	$58.55	$20.78	$58,550	$37,770
05/15/01	1,000	$58.08	$20.78	$58,080	$37,300
05/16/01	1,000	$57.25	$20.78	$57,250	$36,470
05/17/01	1,000	$55.05	$20.78	$55,050	$34,270
05/18/01	1,000	$53.75	$20.78	$53,750	$32,970
05/21/01	1,000	$55.14	$20.78	$55,140	$34,360
05/22/01	1,000	$55.06	$20.78	$55,060	$34,280
05/23/01	1,000	$55.67	$20.78	$55,670	$34,890
05/24/01	1,000	$55.11	$20.78	$55,110	$34,330
05/25/01	1,000	$53.81	$20.78	$53,810	$33,030
05/29/01	1,000	$53.41	$20.78	$53,410	$32,630
05/30/01	1,000	$52.95	$20.78	$52,950	$32,170
05/31/01	1,000	$53.03	$20.78	$53,030	$32,250
06/01/01	1,000	$52.66	$20.78	$52,660	$31,880

06/04/01	1,000	$53.88	$20.78	$53,880	$33,100
06/05/01	1,000	$54.08	$20.78	$54,080	$33,300
06/06/01	1,000	$52.79	$20.78	$52,790	$32,010
06/07/01	1,000	$50.63	$20.78	$50,630	$29,850
06/08/01	1,000	$50.19	$20.78	$50,190	$29,410
06/11/01	1,000	$51.17	$20.78	$51,170	$30,390
06/12/01	1,000	$50.91	$20.78	$50,910	$30,130
06/13/01	1,000	$50.64	$20.78	$50,640	$29,860
06/14/01	1,000	$48.83	$20.78	$48,830	$28,050
06/15/01	1,000	$47.80	$20.78	$47,800	$27,020
06/18/01	1,000	$46.00	$20.78	$46,000	$25,220
06/19/01	1,000	$44.93	$20.78	$44,930	$24,150
06/20/01	1,000	$46.11	$20.78	$46,110	$25,330
06/21/01	1,000	$45.15	$20.78	$45,150	$24,370
06/22/01	1,000	$44.22	$20.78	$44,220	$23,440
06/25/01	1,000	$44.78	$20.78	$44,780	$24,000
06/26/01	1,000	$43.65	$20.78	$43,650	$22,870
06/27/01	1,000	$45.45	$20.78	$45,450	$24,670
06/28/01	1,000	$47.47	$20.78	$47,470	$26,690
06/29/01	1,000	$49.25	$20.78	$49,250	$28,470
07/02/01	1,000	$48.80	$20.78	$48,800	$28,020
07/03/01	1,000	$48.80	$20.78	$48,800	$28,020
07/05/01	1,000	$49.66	$20.78	$49,660	$28,880
07/06/01	1,000	$50.06	$20.78	$50,060	$29,280
07/09/01	1,000	$49.40	$20.78	$49,400	$28,620
07/10/01	1,000	$49.41	$20.78	$49,410	$28,630
07/11/01	1,000	$49.00	$20.78	$49,000	$28,220
07/12/01	1,000	$49.54	$20.78	$49,540	$28,760
07/13/01	1,000	$49.48	$20.78	$49,480	$28,700
07/16/01	1,000	$49.50	$20.78	$49,500	$28,720
07/17/01	1,000	$49.64	$20.78	$49,640	$28,860
07/18/01	1,000	$49.39	$20.78	$49,390	$28,610
07/19/01	1,000	$48.91	$20.78	$48,910	$28,130
07/20/01	1,000	$48.66	$20.78	$48,660	$27,880
07/23/01	1,000	$47.48	$20.78	$47,480	$26,700
07/24/01	1,000	$44.76	$20.78	$44,760	$23,980
07/25/01	1,000	$43.87	$20.78	$43,870	$23,090
07/26/01	1,000	$45.31	$20.78	$45,310	$24,530
07/27/01	1,000	$46.04	$20.78	$46,040	$25,260
07/30/01	1,000	$46.25	$20.78	$46,250	$25,470
07/31/01	1,000	$45.98	$20.78	$45,980	$25,200

Totals:	**64,000**	**$3,278,510**	**$1,948,590**

3

Cases and Topics of Note

The Section 704 Report

A Study of the Major Types and Classes of Corporate Fraud

For purposes of this study, the SEC staff reviewed and analyzed the actions filed by the commission during the study period that were identified in the commission's annual reports as "Issuer Financial Disclosure" cases. These cases typically involve violations of generally accepted accounting principles (GAAP) in an issuer's financial statements or inadequate disclosures in the MD&A or elsewhere in the issuer's filing. All references to companies herein and/or restatements refer to dates that are in correlation with the filing of the Section 704 report and not subsequent.

The Sarbanes-Oxley Act calls for the study of "enforcement actions by the Commission involving violations of reporting requirements imposed under the securities laws, and restatements of financial statements." The U.S. General Accounting Office (GAO) issued a report in October 2002 studying restatements. In this report, the GAO discussed the inherent difficulty in identifying restatements, the foremost reason being the lack of a comprehensive, authoritative database of restatements.[1] Because of the inherent limitations in identifying all relevant restatements, the staff determined that it would study all enforcement matters related to issuer financial reporting during the study period, regardless of whether the matter resulted from or was related to an issuer restatement. The staff identified 135 issuers that filed restatements relating to the accounting and reporting issues identified in the enforcement matters.

The Sarbanes-Oxley Act directs the commission to "identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or

inappropriate earnings management. …" To this end, the staff summarized the accounting and reporting issues identified in each enforcement matter and classified them into four major fraud categories: (1) revenue recognition, (2) expense or cost recognition, (3) acquisition or merger related, and (4) "other" conduct, including related party transactions, and improper accounting for foreign payments in violation of the Foreign Corrupt Practices Act (FCPA). The staff further divided each of these categories into subcategories for purposes of this analysis.[2] The staff also reviewed and classified enforcement matters involving auditor misconduct.

The report contains case highlights illustrating examples of the accounting issues being discussed. Each of these highlights indicates whether the issuer restated its financial statements or made other amendments to its filings pertaining to the enforcement matter being discussed.[3]

Results of Study—Areas of Reporting Most Susceptible to Fraud

The study identified several areas of reporting in the 227 enforcement matters reviewed that have been susceptible to fraud and other improper conduct: (1) improper revenue recognition, (2) improper expense recognition, (3) improper accounting in connection with business combinations, and (4) "other" conduct, including inadequate disclosures in Management Discussion and Analysis (MD&A) and elsewhere in issuer filings, failure to disclose related party transactions, inappropriate accounting for non-monetary and roundtrip transactions, improper accounting for foreign payments in violation of the Foreign Corrupt Practices Act (FCPA), improper use of off-balance-sheet arrangements, and improper use of non-GAAP financial measures.

Improper Revenue Recognition

Under GAAP, revenue should not be recognized until it is realized or realizable and earned. Issues concerning revenue recognition have dominated financial fraud cases. A March 1999 report sponsored by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, Fraudulent Financial Reporting: 1987-1997 An Analysis of U. S. Public Companies, indicated that more than half of financial reporting frauds in that study involved overstating revenue. When it enacted Section

704 of the Sarbanes-Oxley Act, Congress specifically required the commission to study the role of revenue recognition in enforcement matters during the study period.

The commission's accounting enforcement matters reflect the prevalence of revenue recognition as a tool for fraud. Of the 227 enforcement matters studied, 126 involved improper revenue recognition. An analysis of these enforcement matters revealed that 106 involved fraud charges (Section 17[a] of the Securities Act of 1933 ["Securities Act"] 5 and/or Section 10[b]) of the Securities Exchange Act of 1934 ["Exchange Act"], with the balance covering reporting, books and records and/or internal controls violations of the Exchange Act, respectively). Of the 126 enforcement matters involving improper revenue recognition, ninety-four issuers restated their financial statements.

Specifically, the study found that fifty-five chairmen of the board, seventy-five CEOs, seventy-seven presidents, eighty-one CFOs, twenty COOs, ten CAOs, and twenty-two VPs of finance were charged in such enforcement matters. In addition, the commission charged forty controllers for their involvement in these enforcement matters.

Discussion of Representative Cases and Description of Issues

As explained more fully below, the study identified three major problem areas for improper revenue recognition, including: (1) improper timing of revenue recognition (including the existence of contingencies that would preclude revenue recognition until the contingency is resolved), (2) fictitious revenue, and (3) improper valuation for purposes of revenue recognition.

Improper Timing of Revenue Recognition

The study found that eighty-one enforcement matters involved improper timing of revenue recognition. Accounting principles require that revenue should be recognized only once it has been both earned and realized. These revenue recognition cases commonly involved an issuer accelerating revenue from future periods to the current period. These enforcement matters included the following types of improper conduct: (1) holding books open after the close of a reporting period; (2) improper recognition

of the following transactions involving third parties: "bill and hold" sales, consignment sales, side letter agreements, and other contingency sales; and (3) improper recognition of revenue from multiple-element or bundled contracts.

Holding Books Open After Close

The study identified twenty-five enforcement matters involving the failure of issuers to close their books properly at the close of a reporting period. Generally, a company's books for any reporting period should include revenues realized in that period only.

Case Highlights

Sirena Apparel Group Inc.: The commission alleged that the company's CEO and CFO materially overstated Sirena's revenue by $3.6 million (or 13 percent) and earnings by $1.3 million (or 30 percent). The complaint alleged that the CEO and CFO instructed Sirena personnel to hold open the March 1999 fiscal quarter until Sirena had reached its sales target for that period, by resetting the date on Sirena's computer clock to March 30 or March 31. This manipulation allowed the April shipments to be recorded as March revenue. The CEO and CFO also ordered Sirena personnel to create false shipping records to conceal their scheme. On June 25, 1999, Sirena filed for bankruptcy. On August 16, 2000, the company filed a Form 15 with the commission suspending its duty to file reports under the Securities Exchange Act of 1934. The company did not restate its financial statements relating to this matter.

Sensormatic Electronics Corporation: The commission charged the company and three senior officers with several different accounting frauds, including recording revenue in one quarter from products shipped in the next quarter. At the end of each quarter, Sensormatic turned back its computer clock that recorded and dated shipments so that out-of-period shipments, and consequently revenue, would be recorded in the prior quarter. On or about October 11, 1995, the company filed amended financial statements for the fiscal quarter ended March 31, 1995.

Bill-and-Hold, Consignment Sales, and Other

Contingency Sales

There were forty-nine enforcement matters involving premature recognition of revenue during the study period, including bill-and-hold sales, consignment sales, side letter agreements, and other contingency sales. The accounting for these transactions generally failed to meet the criteria under GAAP for recognizing revenue because the seller had not actually assumed the risks and rewards of ownership; the terms of the sale were modified; or the revenue was otherwise not realized (or realizable) and earned.

Case Highlights

Sunbeam Corporation: This action involved, among other things, allegations that Sunbeam engaged in accounting fraud by improperly recognizing bill-and-hold and contingency sale transactions. The Commission alleged that Sunbeam gave financial incentives to its customers to write purchase orders before they needed the goods, offered to hold the product until delivery was requested, and typically covered related costs. The commission alleged that Sunbeam improperly recorded contingent sales as revenue. Just before the close of a quarter, Sunbeam allegedly booked revenue and income from purported sales to wholesalers, who incurred no expenses, accepted no ownership risks, and had the right to return unsold products. On or about November 12, 1998, the company filed amended financial statements covering the period October 1, 1996, through March 31, 1998.

McKesson HBOC Inc.: The commission brought fraud charges against senior management for engaging in a massive fraud to inflate revenue and net income by hiding contingencies—such as rights to cancel or, in some cases, continuing negotiations of relevant terms—related to software sales contracts in side letters. On or about July 14, 1999, McKesson filed amended financial statements covering the period April 1, 1996, through March 31, 1999.

Multiple Elements of Bundled Contracts

Some enforcement matters involving revenue recognition present more complex issues, including improper accounting for multiple element or bundled contracts. The study identified three enforcement matters involving multiple-element or bundled contracts.

Case Highlights

Xerox Corporation: The commission alleged that Xerox used a variety of accounting schemes involving its lease arrangements. Under these arrangements, the revenue stream from Xerox's customer leases typically had three components: the value of the equipment, the value of Xerox's obligation to service the equipment over the life of the lease, and financing revenue that Xerox received on deferred payments. Under GAAP, Xerox could recognize revenue from the equipment at the beginning of the lease if certain requirements were met, but was required to recognize revenue from servicing and financing over the course of the entire lease, or as those services were performed and that revenue earned. According to the complaint, Xerox relied on accounting actions to improperly shift finance and service lease revenues to the equipment, so that a greater portion of lease revenues could be recognized immediately. On or about July 11, 2002, Xerox filed amended financial statements covering the period January 1, 1997, through December 31, 2000.

MicroStrategy Inc.: The commission alleged that MicroStrategy engaged in the premature recognition of revenue in connection with multiple-element deals in which significant services or future products to be provided by MicroStrategy were not separable from the upfront sale of a license to its existing software products. MicroStrategy allegedly negotiated a $4.5 million transaction to provide software licenses, consulting and development services, and a stock purchase warrant to a buyer. The services were, in part, to develop software applications for the MicroStrategy software. The overwhelming majority of the software licenses purchased by the buyer were for use with software applications that were not yet developed. Although the product and service elements were interdependent, MicroStrategy accounted for the software product element as though it were separate from the service and warrant

obligations. MicroStrategy recognized the entire $4.5 million received in the transaction as software product license revenue, allocating no revenue to the extensive service obligations or the warrant. On or about April 13, 2000, the company filed amended financial statements covering the period January 1, 1997, through December 31, 1999.

Fictitious Revenue

The study found that eighty enforcement matters involved fictitious revenue. The manipulation of revenue was accomplished through, among other means, the falsification of sales documents, side agreements with customers that were not recorded, and top-side adjustments by senior management.

Case Highlights

Cendant Corporation: The commission alleged that for more than twelve years CUC senior management made topside adjustments that artificially inflated operating income at the company by directing changes to CUC's quarterly results. Defendants allegedly reviewed and managed schedules listing fraudulent adjustments to be made to CUC's quarterly and annual financial statements. As a result of these inappropriate topside adjustments and other fraud, pre-tax operating income reported to the public by CUC was inflated by an aggregate amount of more than $500 million for the period 1995 through 1997 alone. On or about September 29, 1998, the company filed amended financial statements covering the period January 1, 1995, through June 30, 1998.

Regal Communications Corporation: The commission alleged that Regal's upper management falsified the company's filings. Allegedly, the CFO caused the accounting staff to record fictitious business revenues and receivables into the company's general ledger. To further the scheme, the CEO allegedly supported the fictitious entries with false or misleading sales documents and bank records. The CFO and CEO then paid many of the false receivables with the company's money, which had been funneled through their own private companies in order to give the appearance of legitimate transactions. The alleged fraud inflated Regal's revenues and receivables, and consequently caused Regal's recorded income and assets to be materially

overstated in commission filings. The company declared bankruptcy in September 1994 and did not file a restatement.

Improper Valuation of Revenue

In addition to improper timing of revenue recognition and fictitious revenue, the study found that another problem area involved the improper valuation of revenue. Unlike the contingent sales situations discussed above, a sale does occur, but there may be terms, such as rights of return, that affect the appropriate value of revenue recognized from the sale. Improper accounting practices in this area involve the failure to take these terms into account in accordance with GAAP. There were twenty-one enforcement matters relating to improper valuation of revenue.

Case Highlights

Insignia Solutions PLC: The commission found that, because Insignia generally permitted rights of return, it recognized allowances for estimated future returns and exchanges. In order to implement this policy, Insignia endeavored to keep track of inventory held by its principal distributors and resellers. The commission found that the fraudulent revenue recognition scheme involved the circumvention of this system for monitoring inventory in the hands of Insignia's distributors and resellers. The sales manager, at the direction of the sales vice president, signed side letter agreements with a distributor and the reseller that allowed liberal return rights for certain shipments. The supervisors instructed a subordinate to report only 10 percent of the inventory held by the reseller. This practice had the effect of decreasing Insignia's allowance for product returns, thereby increasing reported revenue. On or about February 28, 1997, the company filed amended financial statements covering the period January 1, 1996, through June 30, 1996.

Analysis and Conclusions

The study found that revenue recognition is an area that is highly susceptible to financial reporting violations. Of the 227 enforcement matters during the study period, 126 involved some form of improper revenue recognition. The majority of these enforcement matters involved

improper timing (eighty-one of 126 enforcement matters) and fictitious revenue (eighty of 126 enforcement matters). These violations were accomplished primarily through the falsification of documents, such as sales invoices or side letters, and/or topside adjustments. At least one representative of senior management was charged in 104 of the 126 enforcement matters. This conduct was undertaken for a variety of reasons, including attempting to meet analysts' expectations or creating the illusion of a financially healthy company.

Improper Expense Recognition

The study identified 101 enforcement matters involving improper expense recognition. Improper expense recognition encompasses a wide variety of accounting practices usually intended to understate or defer expenses, and therefore overstate net income. One such practice, which is intended to enable an issuer to meet earnings expectations, involves setting up "cookie-jar" reserves in one quarter (and initially overstating expenses) and improperly netting those excess reserves against expenses in future periods, with the effect of increasing income in these periods.

An analysis of the 101 improper expense recognition enforcement matters revealed that approximately seventy-eight involved fraud charges (Section 17[a] of the Securities Act and/or Section 10[b] of the Exchange Act), with the balance covering non-fraud reporting, books and records, and/or internal controls violations (Sections 13[a], 13 [b][2][A] and [B], and/or 13[b][5] of the Exchange Act, respectively). In these seventy-eight enforcement matters, the commission charged 290 parties with committing fraud in connection with the reporting violations.

The study found that senior management was implicated in seventy of the 101 enforcement matters involving expense recognition. Specifically, the commission charged thirty-two chairmen of the board, forty-seven CEOs, forty-six presidents, fifty-four CFOs, sixteen COOs, eight CAOs and eighteen VPs of finance. The commission also charged thirty controllers for violations based on improper expense recognition.

Of the 101 enforcement matters involving improper expense recognition, seventy issuers restated their financial statements.

Discussion of Representative Cases & Description of Issues

Generally, under the accrual method of accounting, an expense should be recorded during the accounting period in which it was "incurred" even if the issuer prepays the expense or does not pay for the expense in cash until a later accounting period.

Companies typically have accounting and bookkeeping systems designed to generate financial statements in conformity with accrual accounting. However, as discussed below, in order to achieve the desired accounting result, companies have used practices in contravention of GAAP to manipulate their reported expenses and net income. These practices include: (1) improper capitalization or deferral of expenses or failure to record expenses or losses, (2) overstating ending inventory values, (3) improper use of restructuring and other liability reserves, (4) understating bad debts and loan loss liabilities, and (5) failure to record asset impairments.

Improper Capitalization/Deferral—Failure to Record Expenses or Losses

When recording expenditures on their books, companies should classify the costs as assets or expenses. Improper capitalization and deferral occurs when companies capitalize current costs that do not benefit future periods. Improperly capitalizing or deferring expenses generally causes a company to understate reported expenses and overstate net income in the period of capitalization or deferral.

During the study period, forty-nine enforcement matters involved the failure to properly record expenses. Fifteen of these cases involved the company's outright failure to accrue an appropriate expense or loss.

Case Highlights

WorldCom Inc.: The most prominent example of a company improperly capitalizing expenditures involved WorldCom. In its amended complaint against WorldCom, the commission alleged that WorldCom overstated the income reported in its financial statements by approximately $9 billion. One way that WorldCom allegedly accomplished this overstatement was to

reduce improperly its operating expenses by re-characterizing certain expenses as capital assets. Specifically, senior officials at the company directed accounting managers to transfer certain "line costs," which should have been reported as current operating expenses, to its capital asset accounts. This transfer caused the company to materially understate expenses and overstate net income, which allowed the company to report earnings that were in line with analysts' estimates. On July 21, 2002, the company and certain of its subsidiaries filed for bankruptcy.

Waste Management Inc.: The commission alleged that Waste Management, a hazardous waste services company, improperly inflated its operating income and other measures of performance by deferring the recognition of current-period operating expenses into the future and by netting one-time gains against current- and prior-period misstatements and current-period operating expenses. Senior management increased reported operating income by understating operating expenses—making repeated fourth quarter adjustments to improperly reduce depreciation expense on its equipment cumulatively from the beginning of the year, using a non-GAAP method of capitalizing interest on landfill development costs, failing to accrue properly for its tax and self-insurance expenses, improperly using purchase accounting to increase its environmental remediation reserves (liabilities), improperly charging operating expenses to the environmental remediation reserves, and failing to write off permitting and/or project costs on impaired or abandoned landfills. On or about March 31, 1998, the company filed amended financial statements covering the period January 1, 1992, through September 30, 1997.

Livent Inc.: The commission charged Livent, a theatrical entertainment company, with fraudulently capitalizing pre-production costs by transferring them to fixed asset (rather than expense) accounts. The commission alleged that Livent also deferred expenses by transferring expenses from current productions to shows that had not yet opened or that had longer amortization periods. In addition, Livent allegedly removed certain expenses from its general ledger, literally erasing them from the books, and re-entered them in subsequent quarters. On or about November 18, 1998, the company filed amended financial statements covering the period January 1, 1996, through March 31, 1998.

Overstating Ending Inventory

During the course of any accounting period, issuers that sell products have a certain amount of merchandise available for sale to customers. At the end of an accounting period, issuers may either count their physical inventory or rely on their books and records to determine how much of this merchandise cost should be allocated as "inventory" (an asset) and how much should be allocated as "cost of goods sold" (an expense). Companies have improperly increased their net profits by allocating more costs to inventory than cost of goods sold, thus artificially increasing their ending inventory values and decreasing their current expense for inventory.

In twenty-five enforcement matters that involved overstatements of ending inventory, several common themes were present. Specifically, companies (1) improperly increased physical ending inventory counts; (2) recorded bogus inventory "in-transit" to warehouses, often overseas; or (3) failed to write-down obsolete inventory or inventory whose market value had declined.

Case Highlights

Rite Aid Corporation: The commission alleged that Rite Aid overstated its net income by managing the value of its inventory. Specifically, senior management allegedly failed to record $8.8 million in shrinkage of its physical inventory due to loss or theft. The CFO also made adjusting journal entries to lower the reported cost of goods sold. On three separate occasions during 1999 and 2000, Rite Aid filed amended financial statements relating to this matter.

MiniScribe Corporation: The commission alleged that MiniScribe increased the value of its inventory by recording fictitious transfers of non-existent inventory from its headquarters in Colorado to overseas locations. MiniScribe also allegedly repackaged scrap and obsolete inventory parts that should have been written off and improperly included the costs in its ending inventory. The company also allegedly counted in inventory the costs of certain merchandise it purchased without recording the corresponding amounts owed as liabilities. On or about January 2, 1990, the company filed amended financial statements covering 1986 and 1987.

Improper Use of Restructuring and Other Liability Reserves

Recording a reserve on a company's books generally involves recognizing an expense and a related liability or contra-asset. Reserves are properly set up for a wide variety of estimated future expenditures; major categories of reserve liabilities relate to restructuring charges, environmental clean-up costs, or expected litigation costs. In establishing reserves, issuers should comply with GAAP by recording reserves only where a liability exists. Once a reserve is established, payments made by the issuer properly related to the reserve are offset against the reserve and not reported as an expense in the current period.

Reserves may be improperly used by issuers to manage earnings. These companies typically create excess reserves (by initially over-accruing a liability) in one accounting period and then reduce the excess reserves in later accounting periods. The reversal of the reserve creates net income that can be used to meet earnings shortfalls. Of the 101 enforcement matters involving improper expense recognition, seventeen involved improper use of reserves.

Case Highlights

Xerox Corporation: Xerox allegedly manipulated its reserves in order to meet market earnings expectations. Specifically, the commission alleged that Xerox maintained $396 million in cookie-jar reserves, which it periodically released into earnings to artificially improve its operating results. Xerox also improperly set up a $100 million reserve in connection with an acquisition and then used the reserve to cover expenses unrelated to the acquisition. On or about July 11, 2002, Xerox filed amended financial statements covering the period January 1, 1997, through December 31, 2000.

Sunbeam Corporation: The commission alleged that Sunbeam created cookie-jar reserves in 1996 to increase Sunbeam's reported loss, and reversed these excess reserves into income during 1997 to artificially inflate earnings. On or about November 12, 1998, the company filed amended financial statements covering the period October 1, 1996, through March 31, 1998.

W.R. Grace & Co.: The commission alleged that W.R. Grace, a packaging, specialty chemical, and health care services company, recorded liabilities,

through the deferral of income, in order to build cookie-jar reserves. W.R. Grace later used these reserves to meet earnings estimates. W.R. Grace did not restate its consolidated financial statements relating to this matter. All public companies sell products or services, and these sales often are made on a credit basis. For these credit sales, companies record revenue and corresponding accounts receivable for the money owed by customers. If, at a later date, certain receivables are determined to be uncollectible, companies must record an expense for the estimated bad debts. If a company fails to make a reasonable estimate of its uncollectible receivables, it will understate its accrual for bad debt and will overstate net income. Nineteen enforcement matters in the study involved the understatement of bad debt expense or loan losses.

Allegheny Health Education and Research Foundation (AHERF): The commission alleged that AHERF, a health care provider in Pennsylvania, masked its severely deteriorating financial condition by failing to increase its bad debt reserves to account for uncollectible accounts receivable of approximately $100 million. AHERF did not file amended financial statements with the commission relating to this matter.

Failure to Record Asset Impairments

Most non-financial assets are typically carried on the books at historical cost, less accumulated depreciation. Asset-values should be written down, and a corresponding expense or loss recorded, if the asset is impaired. GAAP includes different impairment standards for different types of assets. If the permanently impaired asset-values are not written down, the company's expenses or losses will be understated and net income overstated. Five enforcement matters involved the failure to record asset impairments.

Case Highlights

New Jersey Resources Corporation (NJR): The commission alleged that NJR, an energy company, failed to recognize an impairment of the carrying value of its oil and gas properties resulting in an overstatement of the company's net income by $6.3 million. On or about April 28, 1994, the company filed amended financial statements covering the period October 1, 1992, through September 30, 1993.

Analysis and Conclusions

The study found that expense recognition is very susceptible to manipulation of the issuer's financial statements. Of the 227 enforcement matters during the study period, 101 included improper expense recognition practices. Unlike the area of improper revenue recognition, the conduct found in improper expense recognition often involves a more subtle manipulation of expenses and reserves to increase overall income and meet analyst expectations. Of the 101 improper expense recognition enforcement matters, forty-nine involved the improper capitalization or non-recognition of expenses, resulting in the understatement of expenses and the overstatement of income. In addition, twenty-five of the 101 enforcement matters involved the overstatement of inventory, and nineteen involved the understatement of bad debts or loan losses. At least one member of senior management was charged in seventy of the 101 enforcement matters.

Merger/Acquisition Reserves and Valuations

Besides improper recognition of expenses and revenue enforcement matters, the study identified twenty-three enforcement matters in which companies used improper accounting in connection with business combinations. The study found that these types of violations involved improper valuation of assets, improper use of merger reserves, and premature merger recognition. Additionally, some companies failed to disclose the liabilities associated with a business combination. An analysis of the twenty-three enforcement matters revealed that about 17 involved fraud charges (Section 17[a] of the Securities Act and/or Section 10[b] of the Exchange Act), with the balance covering reporting, books and records, and/or internal controls violations (Sections 13[a], 13[b][2][A] and [B], and/or 13[b][5] of the Exchange Act, respectively). In these twenty-three enforcement matters, seventeen issuers restated their financial statements.

The study found that senior management was implicated in fourteen of the twenty-three enforcement matters involving improper accounting for business combinations. Specifically, the study found that seven chairmen of the board, eight CEOs, nine presidents, one COO, eight CFOs, and one VP of Finance were charged in such enforcement matters. In addition, the commission charged two controllers for their involvement in these enforcement matters.

Improper Asset Valuation

When valuing assets in the merger and acquisition context, amounts should be assigned to assets based on their fair values. Enforcement matters involving improper asset valuation include: overstating asset values, improperly valuing consideration given for the asset, and rolling over the historical value without requiring proper independent evidence to substantiate the value assigned to the asset.

Case Highlights

Chester Holdings Ltd.: The commission alleged that officers and directors of the issuer overstated the value of consideration paid for five acquisitions of assets and businesses and overstated the value of the assets acquired in the issuer's financial statements. For example, the officers claimed that the issuer acquired a knitting company for $14 million in stock when the fair value of the assets was worth no more than $4.9 million. On or about October 16, 1992, the company filed amended financial statements covering the period July 1, 1991, through June 30, 1992.

Improper Use of Merger Reserves

In connection with an acquisition, a company usually incurs costs to integrate (and/or exit) business activities. Such expected costs are shown as a liability accrued at the time of the acquisition. In later accounting periods, if the remaining liability reserve is determined to be too high, the company should generally reduce it in that accounting period. If accounted for improperly, the initial accrual and/or later reserve reductions can be used to manage or smooth earnings. Reserve reductions can also be improperly netted against current operating expenses (thus understating such expenses).

Case Highlights

Cendant Corporation: The commission alleged that senior management intentionally overstated their merger reserves and then instructed that amounts in the merger reserves be reversed in later periods. These reversals were offset by corresponding increases in revenues or decreases in

operating expenses. As a result of the improper reserve reversals and other fraud, the company overstated its pre-tax operating income by more than $500 million over a three-year period. On or about September 29, 1998, the company filed amended financial statements covering the period January 1, 1995, through June 30, 1998.

Kimberly-Clark Corporation: The commission alleged that Kimberly-Clark improperly accounted for merger-related restructuring reserves. The company took a $1.44 billion charge in relation to an acquisition. Periodic reevaluations of its reserve balance determined that the original estimate for certain of its merger-related reserves was too high. Instead of reducing the reserve as required by GAAP, the company reallocated excess amounts to other merger-related programs or to new programs. The company also allegedly released into earnings certain amounts of its merger-related reserves without adequate support. On or about December 31, 1999, the company filed amended financial statements covering the period January 1, 1996, through December 31, 1998.

Analysis and Conclusions

The study determined that accounting for business combinations has provided opportunities for issuers to manipulate their financial statements. Of the 227 enforcement matters during the study period, twenty-three involved improper accounting for business combinations. The two most prevalent methods of improper accounting in this area were improper asset valuation (eight of twenty-three) and improper use of merger reserves (eight of twenty-three). At least one member of senior management was charged in fourteen of the twenty-three enforcement matters.

Other Areas of Improper Accounting

Overview of Findings

The study found that other improper accounting practices included inadequate disclosure in the company's Management Discussion and Analysis (MD&A) or elsewhere in the issuer's filings, failure to disclose related party transactions, improper accounting for non-monetary and roundtrip transactions, improper accounting for foreign payments in

violation of the FCPA, the improper use of off-balance-sheet arrangements to conceal debt, and the improper use of non-GAAP financial measures. Of the 227 enforcement matters studied, 137 included one or more of these types of violations. An analysis of these 137 enforcement matters revealed that 104 involved fraud charges (Section 17[a] of the Securities Act and/or Section 10[b] of the Exchange Act), with the balance covering reporting, books and records, and/or internal controls violations (Sections 13[a], 13[b][2][A] and [B], and/or 13[b][5] of the Exchange Act, respectively).

The following chart summarizes the principal other improper accounting practices used by issuers involved in commission enforcement matters during the study period.

Improper Accounting Practice	**Number of Enforcement Matters Involving Each Practice**
Inadequate Disclosures in MD&A and Elsewhere	43
Failure to Disclose Related Party Transactions	23
Improper Accounting for Non-monetary and Roundtrip Transactions	19
Improper Accounting for Foreign Payments in Violation of the FCPA	6
Improper Use of Off-Balance-Sheet Arrangements	3
Improper Use of Non-GAAP Financial Measures	2

Inadequate Disclosures in MD&A and Elsewhere in Issuer Filings

The securities laws require issuers to include an MD&A section in their filings. The MD&A section discusses the issuer's financial condition and results of operations to enhance investor understanding of financial statements. Inadequate disclosure matters may involve situations where the issuer's financial statements are in conformity with GAAP, but fail in some material way to present an accurate picture of the issuer's financial condition. The study found that forty-three enforcement matters involved inadequate financial disclosure in the MD&A. Of these, twenty issuers

restated their financial statements or elsewhere in the issuer's filings.

Case Highlights

Edison Schools Inc.: The commission alleged that a private manager of elementary and secondary public schools failed to disclose significant information regarding its business operations. The commission alleged that Edison failed to disclose that a substantial portion of its reported revenues consisted of payments that never reached Edison. These funds were instead expended by school districts (Edison's clients) to pay teacher salaries and other costs of operating schools that were managed by Edison. The commission did not find that Edison's revenue recognition practices contravened GAAP or that earnings were misstated. However, the commission nonetheless found that Edison committed violations by failing to provide accurate disclosure, thus showing that technical compliance with GAAP in the financial statements will not insulate an issuer from enforcement action.

Failure to Disclose Third-Party Transactions

Under the securities laws and GAAP, companies must disclose related-party transactions. Additionally, transactions with board members, certain officers, relatives, or beneficial owners holding 5 percent or more of a company's voting securities that exceed $60,000 must be disclosed in the management section of the annual report.

Failure to disclose related-party transactions hides material information from shareholders and may be an indicator of weaknesses in internal control and corporate governance procedures. The study found twenty-three enforcement matters included the failure to disclose such transactions. Of these, twelve issuers restated their financial statements.

Case Highlights

Adelphia Communications Corporation ("Adelphia"): The commission alleged that Adelphia engaged in numerous undisclosed related-party transactions with board members, executive officers, and entities. Transactions resulted in the channeling of company funds and stock into entities controlled by senior management, the payment for timber rights that reverted to senior

management, the construction of a golf course on land owned or controlled by senior management, and the payment of personal loans. The commission alleged that Adelphia failed to disclose the existence of these transactions or misrepresented their terms in its financial statements. More than $300 million of company funds were diverted to senior management without adequate disclosure to investors. On June 25, 2002, the company and certain of its subsidiaries filed for bankruptcy.

Rite Aid Corporation: The commission alleged, among other things, that the CEO sought to enrich himself at the expense of shareholders by failing to disclose both his personal interest in leased property for Rite Aid store locations and several transactions where he funneled $2.6 million from Rite Aid to a partnership that he and a relative controlled. On three separate occasions during 1999 and 2000, Rite Aid filed amended financial statements relating to this matter.

Most business transactions involve exchanges of cash or other monetary assets or incurrence of liabilities for goods or services. The amount of monetary assets exchanged or liabilities incurred generally provides an objective basis for measuring the cost of non-monetary assets or services received by an enterprise, as well as for measuring gain or loss on non-monetary assets transferred from an enterprise. Exchanges that involve few or no monetary assets or liabilities are referred to as non-monetary transactions. In general, under GAAP, accounting for non-monetary transactions should be based on the fair values of the assets (or services) involved, which is the same basis as that used in monetary transactions.

Additionally, the commission has brought enforcement actions recently against issuers who engaged in improper accounting through the use of "roundtrip transactions." These transactions involve simultaneous pre-arranged sales transactions often of the same product in order to create a false impression of business activity and revenue. The study found nineteen enforcement matters involving the improper accounting for non-monetary and/or roundtrip transactions.

Case Highlights

Critical Path Inc.: The commission found that Critical Path improperly

reported as revenue several transactions, the largest of which was a barter transaction. In this transaction, a software company agreed to buy out a periodic royalty obligation for $2.8 million and buy another $240,000 of software, in exchange for Critical Path's agreement to buy approximately $4 million of software and services from the software company. The commission alleged that Critical Path recorded a $3.09 million sale to the software company improperly as revenue for the third quarter. The company failed to establish the fair value of either the software it received from, or the software it sent to, the software company. Furthermore, the commission found that Critical Path did not ensure that the value ascribed to the software Critical Path was receiving reasonably reflected its expected use of the software, as required under GAAP. On April 5, 2001, Critical Path restated its financial results for the third quarter of 2000.

Unify Corporation: The commission alleged that Unify fraudulently recognized revenue on transactions that it knew involved barter transactions. Under GAAP, it was improper for Unify to recognize revenue on barter transactions because Unify's revenue was contingent on Unify's performance of its obligation to the customer. The commission alleged that, in several instances, Unify's CEO and CFO engaged in "roundtripping," by causing Unify to provide funds its customers needed to buy Unify products, with no reasonable expectation that the customers would ever repay the funds. In some instances, Unify allegedly made an investment in another company, which then used most or all of the invested funds to purchase Unify products. In others, Unify contracted for services from other companies through so-called funded development agreements. However, the companies provided no such services, and simply used funds from Unify to buy Unify products. As a result of this conduct, Unify overstated its revenue over four fiscal quarters in amounts ranging from 61 percent to 150 percent per quarter. Unify filed various amendments during December 2000 and the first half of 2001 to restate its financial statements relating to this matter.

Quintus Corporation: The commission alleged that the CEO of Quintus, among other things, caused Quintus to improperly recognize $3 million in revenue on a barter transaction, which was contingent on Quintus's agreement to purchase $4 million of products from its customer. Quintus announced that it would restate its financial statements for the fiscal year ended March 31, 2000, and for the three-month periods ended December

31, 1999, and June 30, 2000. On February 21, 2001, Quintus and certain of its subsidiaries filed for bankruptcy.

Homestore.com Inc. ("Homestore"): The commission charged three former executives of Homestore with arranging fraudulent roundtrip transactions for the sole purpose of artificially inflating Homestore's revenues in order to exceed Wall Street analysts' expectations. The essence of these transactions was a circular flow of money by which Homestore recognized its own cash as revenue. Specifically, the commission alleged that Homestore paid inflated sums to various vendors for services or products; in turn, the vendors used these funds to buy advertising from two media companies. The media companies then bought advertising from Homestore either on their own behalf or as agents for other advertisers. Homestore recorded the funds it received from the media companies as revenue in its financial statements, in violation of applicable accounting principles. In March 2002, Homestore filed amended financial statements for the fiscal year ended December 31, 2000, and for the three quarters ended September 30, 2001.

Improper Accounting for Foreign Payments

The FCPA was passed in 1977 to combat corrupt business practices such as bribery. The commission includes FCPA enforcement matters as issuer reporting cases because they frequently involve the improper accounting by issuers for payments to foreign government officials. Of the six enforcement matters involving improper accounting for foreign payments, one issuer restated its financial statements.

Case Highlights

BellSouth Corporation: The commission alleged that BellSouth violated the FCPA by authorizing payments to local officials through their subsidiaries in Venezuela and Nicaragua. Senior management at BellSouth's Venezuelan subsidiary allegedly authorized over $10 million in payments to six offshore companies, which were improperly recorded as bona fide services. In addition, the commission alleged that management at the Nicaraguan subsidiary authorized payments, recorded as "consulting services," to a wife of a Nicaraguan legislator, who presided over a hearing that allowed

BellSouth to increase its ownership. BellSouth consented to a civil penalty of $150,000. in settlement of this civil action without admitting or denying the Commission's allegations.

International Business Machines Corporation (IBM): The commission alleged that IBM had a $250 million contract to integrate and modernize the computer system of a commercial bank owned by the Argentine government. IBM-Argentina allegedly entered into a subcontract with an Argentine corporation for $22 million, which funneled approximately $4.5 million of these funds to several directors of the government-owned commercial bank. IBM recorded the expenses as third-party subcontractor expenses. IBM-Argentina's former senior management overrode IBM's procurement and contracting procedures and hid the details from financial personnel. Management provided the procurement department with fabricated documentation and stated inaccurate and incomplete reasons for hiring the Argentine corporation.

Improper Use of Non-GAAP Measures

When improperly used, non-GAAP financial measures that include or exclude unusual expenses or gains may provide a misleading financial picture. The commission has recently issued a cautionary release on non-GAAP financial measures, has brought two antifraud enforcement actions in this area, and has proposed rule-making pursuant to the Sarbanes-Oxley Act. Of the two enforcement matters involving improper use of non-GAAP financial measures, one issuer restated its financial statements or disclosures.

Case Highlights

Ashford.com Inc. (Ashford): The commission alleged that Ashford misstated its pro-forma results by improperly deferring $1.5 million in expenses under a contract with Amazon.com. The commission also alleged that Ashford.com incorrectly classified certain marketing expenses as depreciation and amortization expenses, which materially understated the company's true marketing expenses. Moreover, because Ashford allegedly excluded depreciation and amortization from its non-GAAP financial results, Ashford's expense misclassification improved its non-GAAP financial

results. In its Form 10-K for the fiscal year ended March 30, 2001, Ashford re-classified the expenses in question.

Notes

[1] The staff used a number of methods to determine whether a restatement relating to one of the identified enforcement matters occurred. The staff initially reviewed commission internal documents to attempt to determine whether there had been a restatement. The staff then reviewed the commission's online Electronic Data Gathering, Analysis and Retrieval System (EDGAR) to determine whether the issuer made any amended filings during or after the period of the identified accounting or reporting issue. The commission's EDGAR database, however, dates back only to filings made in 1993 and after. Therefore restatements relating to accounting issues that preceded 1993 could not be identified using EDGAR. In addition, not all documents filed with the commission by public companies were available on EDGAR. Companies were phased in to EDGAR filing over a three-year period, ended May 6, 1996. As of that date, all public domestic companies were required to make their filings on EDGAR, except for filings made on paper because of a hardship exemption. Also, issuers do not always file amended Forms 10-K and 10-Q when there is a restatement. Depending upon the timing of the restatement, an issuer may include the restated financial statements for earlier periods in a current periodic filing or in a Form 8-K. Next, the staff performed keyword searches on the LexisNexis Research System. The staff then analyzed these amendments and LexisNexis hits to determine whether they related to a restatement for the particular accounting or reporting issue identified in the enforcement matter.

[2] Revenue recognition was further divided into the following subcategories: (1) fictitious sales or transactions, (2) improper timing of revenue recognition, and (3) valuation issues, such as sales returns.

[3] As previously mentioned, most enforcement matters included in the study identified multiple accounting or reporting issues. The issuer may have restated for one or more, but not all, of the identified issues. A statement in the case highlights indicating that the issuer restated its financial statements means that the issuer restated for at least one of the issues identified in the study; however, it may not necessarily mean that the issuer restated for the accounting or reporting issue being discussed in that particular highlight.

Federal National Mortgage Association Restatement

The Federal National Mortgage Association ("Fannie Mae") is one of the major current examples of restatements in a long history of civil action restatements. It is a lesson text. The SEC in May of 2006 filed an action against the company alleging it was engaged in a financial fraud (civil fraud without the element of scienter) involving multiple violations of GAAP. Eleven billion dollars in restatements were involved, and $30 billion loss of market value. A summary of allegations by the SEC follows. Between 1998 and 2004 Fannie Mae, a shareholder-owned government-sponsored enterprise, misstated its results of operations and issued materially false and misleading financial statements, according to the Securities and Exchange Commission.

The company's misconduct took varied forms. In some instances the company acted negligently, and in other instances recklessly. At the end of 1998, senior management manipulated the company's earnings in order to receive bonuses they would not otherwise have received, in violation of Section 10(b) of the Exchange Act.

The most current restatements expected for the years ended December 31, 2003, and 2002, and for the quarters ended June 30, 2004, and March 31, 2004, are expected to approximate a $1.1 billion reduction of previously reported net income.

Fannie Mae was chartered by Congress to expand the flow of mortgage funds by creating a secondary market for residential mortgages by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage

financing. It performs this function by buying and guaranteeing residential mortgage loans and mortgage-related securities, which it finances by issuing mortgage-related securities, debt securities and equity securities.

Overview of the Violations Alleged by the SEC

From 1998 through the second quarter of 2004, Fannie Mae issued financial reports that were materially false and misleading, primarily because of its failure to comply with the Statement of Financial Accounting Standard (SFAS) 133. In addition the company violated other standards, including SFAS 91. The violations resulted from insufficient accounting systems and related personnel, a lack of internal controls, and a desire to meet published expectations of industry analysts.

As a consequence, Fannie Mae implemented a series of non-GAAP policies, procedures, and practices that falsely portrayed the company's earnings. These non-GAAP policies, procedures, and practices included, but were not limited to (1) improper accounting for loan fees, premiums, and discounts; and (2) improper hedge accounting.

SFAS 91 requires companies to recognize loan fees, premiums, and discounts as an adjustment over the life of the applicable loans, to generate a "constant effective yield" on the loans. Because of the possibility of loan prepayments, the "life" of a loan or a group of loans is, necessarily, the product of estimation. The likelihood of prepayments fluctuates with the market. Consequently, estimated prepayments change. SFAS 91 requires that changes to the amortization of fees, premiums, and discounts caused by changes in estimated prepayments be recognized as a gain or loss in the current period's income statement, in its entirety. Fannie Mae refers to this amount as the "catch-up" adjustment.

Fannie Mae failed to record the full SFAS 91 catch-up amount for 1998. In the fourth quarter of 1998, Fannie Mae's accounting models and systems calculated that an approximate $439 million catch-up adjustment, in the form of a decrease to net interest income, was required at year-end. Rather than book this amount consistent with SFAS 91, senior management of the company directed employees to record only $ 240 million of the catch-up amount in that year's income statement. By not recording the full amount

of the calculated catch-up adjustment, Fannie Mae understated its expenses and overstated its income by a pre-tax amount of $199 million. The unrecorded catch-up amount represents 4.3 percent of 1998 earnings before taxes (EBT) and 4.9 percent of 1998 net interest income (NII) for the company's fiscal year 1998.

The company's management made two additional adjustments in the fourth quarter of 1998 that had the effect of offsetting nearly half of the $240 million catch-up adjustment. The first of these offsetting adjustments was caused by Fannie Mae's change from a non-GAAP to a GAAP treatment on its accounting for tax credits and depreciation expense related to low-income housing tax credits. The change in treatment resulted in Fannie Mae recognizing two years' worth of credits at year-end 1998, which had the net after-tax effect of recognizing $108 million in additional income.

The second adjustment was made after year-end and just prior to Fannie Mae closing its books for 1998. This is referred to as a topside adjustment. The company recognized in income the reversal of aged credit items totaling $3.9 million, describing them as "miscellaneous income." These items came from a suspense account that had a credit balance of more than $26 million before the $3.9 million reversal. For the most part, the credit balance in this account related to net interest income. This amount existed in a suspense account from at least as early as 1994; yet there was no reversal of the credit balances in this suspense account until the $3.9 million reversal for 1998.

Management's decisions to book an amount significantly less than the total calculated catch-up amount and to institute the two accounting adjustments in the fourth quarter of 1998 resulted in the company not only exceeding Wall Street expectations, but also hitting the EPS target necessary to trigger maximum bonuses.

Under the company's Annual Incentive Pool for 1998, an EPS figure of $3.13 would trigger minimum bonuses; an EPS figure of $3.18 would trigger the target bonus; and an EPS figure of $3.23 would trigger maximum bonuses.

Without these improper adjustments, management could have received substantially smaller bonuses or no bonuses at all. For example, prior to the eleventh-hour reversal of suspense items, EPS for the year was $3.2285. While this figure exceeded Wall Street estimates of $3.22, it fell short of the $3.23 EPS figure required to trigger maximum bonus payouts. After the $3.9 million reversal of suspense items, EPS for the year was $3.2309, which triggered a maximum bonus pool for management totaling $27.1 million. If Fannie Mae had recorded the full catch-up amount as initially calculated, its EPS would have been $3.10 for year-end 1998, a figure below the minimum threshold for bonuses.

At the direction of senior management, $158 million of the $199 million in unrecorded interest expense from 1998 was placed into the company's financial statements during 1999. The company recorded additional interest expense of between $7 million and $22 million a month throughout 1999. Additionally, the company's calculated catch-up at year-end 1999 was $84 million of interest income, which was not recorded. As a result, Fannie Mae publicly issued materially false and misleading financial statements on January 13, 2000, for the year ended December 31, 1999.

Prior to 2000, the company had an unwritten policy of only booking SFAS 91 Catch-up when it exceeded a "threshold" of $100 million of NII for the year. Following the company's failure to record the full amount of calculated catch-up at year-end 1998, the company developed a written policy whereby the threshold was calculated as a percentage of either NII or guaranty fees under the rubric of accounting for estimation error. The policy, which violated GAAP in several respects, allowed the company to continue to decrease the likelihood of large SFAS 91 adjustments.

The policy used a "precision threshold" to determine the amount of catch-up Fannie Mae would record at the end of the year. This precision threshold was an amount equal to one percent of NII or 2 percent of guaranty fees for the period. Under this policy, Fannie Mae was able to reduce the amount of catch-up recorded in any given period, as no adjustment would be recorded if the catch-up calculation fell within the threshold, and the company would only record catch-up that exceeded the precision threshold.

There is no support for the use of a threshold in SFAS 91 or in the FASB implementation guide for SFAS 91 developed to assist companies in complying with the standard. SFAS 91 specifically requires that an adjustment be made when there is a difference between actual and expected prepayments, or a change in expected prepayments, of the loans resulting in a difference from the previous amortization calculation.

Under SFAS 91, the amount of catch-up is to be determined based on the company's best estimate of the calculated catch-up amount, not the best estimate tempered by a threshold. Not only did Fannie Mae's use of a threshold violate GAAP, but so did its use of a full-year time horizon, rather than a quarterly basis, as provided in SFAS 91. This practice of using a full-year time horizon for calculating the catch-up adjustment continued until 2003.

Implementation of this policy led to misstatements of SFAS 91 amortization in all periods from the fourth quarter 2000 through the second quarter 2004. On at least one occasion, Fannie Mae booked income when it was within its policy threshold, with the effect of meeting its earnings targets. The company recorded its entire catch-up position of $19.8 million as part of its fourth quarter 2001 financial results, despite being within the calculated precision threshold established by the company's policy. Prior to recording this adjustment, which was done in January 2002, shortly before Fannie Mae closed its books for 2001, EPA for the fourth quarter was $1.3827, and analysts were expecting EPS of $1.39. After the catch-up adjustment, which was not justified by the policy, Fannie Mae's quarterly EPS was at $1.40.

In the third quarter of 2002, Fannie Mae's calculated catch-up was $80 million over its policy threshold. To comply with its stated policy, management should have ensured that a catch-up adjustment of $80 million was recorded to income. Instead, management changed the methodology used to calculate the catch-up amount. This change in methodology improperly reduced the calculated catch-up adjustment by $37 million.

Improper Hedge Accounting

In June 1998, the FASB released SFAS 133 requiring that, after January 1, 2001, derivatives be accounted for at fair market value. The standard essentially provides that derivatives must be revalued every reporting period, and changes to value must be reported in the income statement. To achieve hedge accounting in compliance with SFAS 133, a company associates each derivative contract with the specific liability, asset, or forecasted transaction being hedged.

Prior to the implementation of SFAS 133, derivatives were generally carried at book value on a holder's balance sheet. By requiring that they be carried at ever-changing market values, the new standard created the potential for increased earnings volatility. This posed a significant challenge to Fannie Mae's goal of avoiding volatility in its financial statements.

As Fannie Mae uses debt to finance the acquisition of mortgages and mortgage securities, it uses derivative instruments to hedge against the effect of fluctuations in interest rates on its debt costs. Because financial instruments react differently to interest rate movements, it is often difficult to perfectly hedge a debt issuance with an offsetting derivative. To the extent instruments do not perfectly offset each other, SFAS 133 generally requires companies to measure and record this "ineffectiveness" in their income statements. This process is commonly referred to as the "long-haul" method. Thus, consistent with the standard, earnings volatility associated with the use of derivatives is minimized to the extent hedge relationships are "effective." Significantly, SFAS 133 allows for special exceptions, known colloquially as the "short-cut" and "matched terms" methods (or the "perfect effectiveness" method) of hedge accounting. These narrow exceptions allow qualifying companies to avoid the burdensome requirement of measuring and recording hedge ineffectiveness. Given the size of its portfolio, Fannie Mae did not have the systems or personnel necessary to perform long-haul accounting. Moreover, the long-haul method would result in the income statement volatility that senior management wanted to avoid. The company disregarded the requirements for the "short-cut" method based on erroneous interpretations and unjustified reliance on materiality. This failure led to the company publicly issuing materially false and misleading financial statements for the periods covering the first quarter 2001 to the second quarter 2004. The vast majority of the anticipated restatement of at least a $1.1 billion reduction of

previously reported net income is the result of Fannie Mae's improper hedge accounting.

Other GAAP Violations-Reporting and Internal Controls Accounting for Loan Loss Reserves

GAAP requires an assessment of the loss exposure inherent in a loan portfolio and adjustments reflecting management's estimate of losses in the portfolio be made on a quarterly basis. Between 1997 and 2003, Fannie Mae performed no quantitative assessment, and instead relied on management's qualitative judgment in determining the appropriate loan loss reserve (LLR). The failure to establish and implement an appropriate model for determining the size of the LLR was a violation of GAAP.

The company maintained an unjustifiably high level of LLR in case it was needed to compensate for possible future changes in the economic environment. This approach is not consistent with GAAP, which requires that the estimate of loss reserves be based on losses currently inherent in the loan portfolio. At year-end 2002, Fannie Mae's LLR was overstated by at least $100 million. This overstatement resulted in a $100 million understatement of earnings before tax, which represented 1.6 percent of 2002 EBT, and eight cents of additional EPS on the year-end 2002 EPS figure of $4.52.

System Realignment Adjustments

Fannie Mae utilized several systems calculate, record, and track premium and discount data on its loans and securities. At certain times, the premium and discount amortization system would be manually adjusted to match the loan and securities databases, resulting in a realignment. These realignments produced a difference in accumulated amortization, which should have been adjusted for in the current period or may have required restatement of prior periods under GAAP. Rather than consistently follow the appropriate accounting guidance, Fannie Mae used three different methods to account for the realignment adjustments, two of which were improper under GAAP.

APB 207 governs the treatment of accounting errors and states that a company should determine the impact of the error on prior periods, as well as the impact of correcting those prior periods on the current period. Any material impact must be reported as a prior period adjustment, and then disclosed in the current period's financial statements.

Rather than apply this accounting guidance, Fannie Mae immediately recorded smaller realignments in the income statement but deferred large adjustments and recognized those as income statement items over future periods. The inconsistent accounting treatments utilized by the company allowed it to avoid volatility in its financial statements from the required system realignment adjustments.

Finite Insurance Transaction

In May 2001, Fannie Mae's office of the chairman suggested that the company undertake an initiative to shift current income to future periods. One such initiative involved employees in the company's credit policy group entering into a finite insurance contract in January 2002. The company recognized the approximate $40 million premium under the contract as an expense, and recorded as income the loss recoveries from the insurer in subsequent periods. GAAP requires that an insurance contract result in a transfer of risk to the insurer in order for the premium paid to be recorded as an expense; otherwise, the premium is to be recorded as a deposit on the balance sheet. This contract did not have sufficient risk transfer to qualify. Improperly treating the approximate $40 million premium as an expense lowered the company's earnings by $13.5 million in each of 2002 and 2003, and approximately $8 million in 2004.

Valuation of Aircraft Asset Backed Securities

In the second quarter of 2003, having determined that its investments in aircraft asset backed securities (ABS) had suffered an other than temporary impairment, Fannie Mae reduced the value of its investment and recorded an expense of $83.5 million. The amount of the write-down was based on values obtained from an internal discounted cash flow model instead of available market prices. GAAP, specifically SFAS 115, indicates that quoted

market prices should be used to determine the amount of asset impairment. Market prices at the time indicated that the value of these securities was $45 million lower than the amount to which Fannie Mae wrote down its aircraft ABS. Under GAAP, the company's adjustment should have been made according to this market price, and thus was understated. Failure to record the entire expense amount resulted in the company overstating its income by $45 million in 2003. The $45 million in unrecorded expense represented 3.2 percent of quarterly earnings before tax in the second quarter of 2003, and $.03 on 2003 EPS of $7.91.

In a recent five-year period, 919 financial statement restatements were announced by 845 public companies. Obviously several factors in this case and others have caused this and other U.S. companies to use questionable practices, including corporate pressure to meet quarterly earnings projections and the existence of executive compensation incentives, along with complex corporate financing arrangements.

OMB Circular A-123

Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control,* defines management's responsibility for internal control in federal departments and agencies. In December 2004, OMB revised the Circular A-123 and introduced Appendix A, which prescribes a strengthened process to assess the effectiveness of the internal control over financial reporting. It is effective beginning in fiscal year (FY) 2006. Performance and Accountability Reports (PARs) are due forty-five days after the end of the fiscal year. Twenty-four federal agencies listed at the bottom of this section are covered and require management assurance statements.

OMB A-123 was enacted to place federal reporting agencies on a par with the level of internal control required under the Sarbanes-Oxley Act of 2002. Entities that are excluded from this circular include certain groups, such as the National Security Agency. The circular contains guidance for process owners who are most knowledgeable about the key processes and systems to allow them the responsibility for documenting those processes and identifying key controls.

The circular allows management discretion in respect to both the breadth and the depth of the scope of financial reporting. At a minimum, the breadth encompasses the annual and quarterly entity-wide financial statements and accompanying notes. Management has discretion to determine what other financial reports are key to the department/agency and expand the scope to include those reports. The depth of financial reporting constitutes the boundaries of where the financial reporting processes meet the operating processes on an entity-wide basis, as well as the extent of coverage at the component unit and multiple locations.

The circular specifically addresses internal control over financial reporting. Operational program controls need to be considered only when there is an overlap. For example, an agency may award many grants over the course of the year. Operational program controls related to awarding grants would include monitoring, program reports, program audits, and other such operational control activities that ensure that federal monies are being spent as intended. One may consider that these are not necessarily financial reporting controls, but they can be and often times are. To the extent that these control activities affect financial reporting, the circular indicates they should be included within the universe of activities.

Agencies can utilize Type II SAS 70 reports during the assessment. Management must consider whether such a report exists and whether it is sufficient in scope. A Type II SAS 70 report is required of all federal entities that cross-service other federal entities per OMB Memorandum M-04-11.

Management is required to provide only *reasonable assurance* that internal control over financial reporting was operating effectively as of the date of the assessment. Management must evaluate the corrective actions taken on control weaknesses and determine whether previously reported material weaknesses exist. In cases where the agency has developed interim compensating measures that have enabled it to get an unqualified or qualified opinion on its financial statements, the A-123 assessment process should document and test those compensating measures used for financial reporting.

Testing of controls is based on risk. According to OMB A-123, once all key controls have been tested once and a baseline established on the operating effectiveness of those controls, not all key controls must be tested every year, with the exception of annual testing of the effectiveness of information security policies, procedures, and practices. Rotation testing of other key controls may occur.

A-123 allows agencies to submit a plan as to why it may require more than one year of testing to establish a baseline, and under certain conditions it may still be considered compliant with A-123 as long as full compliance occurs on or before September 2008, and this is reviewed and accepted by OMB. For example, Agency A identifies ten key business processes that are material to financial reporting. The agency cannot test all of the processes end-to-end in year one, and elects to test six in the first year. Overall, Agency A should report a scope limitation for its assurance statement on internal control over financial reporting. Simultaneously Agency A develops a sufficient plan that includes a full scope test of the four remaining business processes in tandem with risk-based testing on the other six in the second year and submits this updated plan to OMB. Agency A accurately reports a scope limitation in its annual assurance in year one. Under these circumstances OMB will consider the agency in compliance with Appendix A of Circular A-123. This provision will sunset after the fiscal year 2008 reporting cycle.

The annual assurance statement is reported in the PAR in the MD&A section. The assurance statement is reported in a separate section entitled "Management Assurances." A summary of material weaknesses and corrective actions should be included in an exhibit accompanying the assurance statement. The initial assurance statement for fiscal year 2006 will cover controls in place from October 1, 2005, to June 30, 2006.

Corrective action plans are required for all material weaknesses, and progress against plans should be periodically assessed and reported to agency management. A summary of the corrective action plans for material weaknesses shall be reported to OMB and the Congress through the PAR. The summary discussion shall include a description of the

material weaknesses and status of corrective actions with target completion dates.

OMB Circular A-123 requires the twenty-four agencies identified in the CFO Act to provide an additional assurance on internal control over financial reporting. These agencies are:

- Department of Agriculture
- Department of Commerce
- Department of Defense
- Department of Education
- Department of Energy
- Department of Health and Human Services
- Department of Housing and Urban Development
- Department of the Interior
- Department of Justice
- Department of Labor
- Department of State
- Department of Transportation
- Department of the Treasury
- Department of Veterans Affairs
- Environmental Protection Agency
- Federal Emergency Management Agency
- General Services Administration
- National Aeronautics and Space Administration
- National Science Foundation
- Nuclear Regulatory Commission
- Office of Personnel Management
- Small Business Administration
- Social Security Administration
- Agency for International Development

Health South: A Test of the Sarbanes-Oxley Act

HealthSouth was an accounting fraud that allegedly occurred for approximately fifteen years, but then the scope increased in the late 1990s going in to 2001. The company's history dates to 1984, when Richard Scrushy, along with partners, pooled a limited amount of capital to form HealthSouth Corporation, an outpatient rehabilitation center in Arkansas. Only two years later the company went public, and in 1997 corporate headquarters were moved to Birmingham, Alabama.

In August 2002, Scrushy resigned as CEO, and Bill Owens, chief operating officer, became the head of HealthSouth. In the latter part of August Scrushy announced he would spin off the surgical centers and become chief executive officer of the newly established entity. Investors, lenders, and bondholders did not react well to this announcement, and in October Scrushy stated it did not make sense at this time to proceed with this transaction. From 1996 to 2002, Scrushy had collected $206 million from sales of HealthSouth stock. In September 2002, the SEC confirmed it was investigating Scrushy related to these sales.

Shortly thereafter, in February 2003, the FBI confirmed a probe of HealthSouth for securities laws violations. The following month the SEC suspended trading of HealthSouth stock and alleged overstated earnings by $1.4 billion since 1999. That same month the former CFO, Weston Smith, pleaded guilty in federal court to securities fraud and a variety of other charges, including *false certification of financial records.* This was referring to the certification required under Section 302 of the Sarbanes-Oxley Act of 2002, punishable by up to $5 million in fines and twenty years in prison.

The same month, HealthSouth investors filed class-action suits. In the last week of March, the NYSE suspended trading of HealthSouth stock. On the last day of March, the board of directors removed Scrushy as CEO and requested his resignation from the board. Following this scenario, more than a dozen officers entered guilty pleas to charges, including securities fraud. The Department of Justice Release follows on the next page.

Department of Justice

FOR IMMEDIATE RELEASE CRM
TUESDAY, NOVEMBER 4, 2003 (202) 514-2008
WWW.USDOJ.GOV TDD (202) 514-1888

Government Seeks More Than $278 Million in Forfeiture

WASHINGTON, D.C. — Assistant Attorney General Christopher A. Wray of the Criminal Division, U.S. Attorney Alice H. Martin of the Northern District of Alabama, Carmen S. Adams, Special Agent in Charge of the FBI-Birmingham Field Office, and Internal Revenue Service Commissioner Mark W. Everson announced today that Richard M. Scrushy, a former chief executive officer and chairman of the board of HealthSouth Corp., has been charged in an 85-count indictment stemming from a wide-ranging scheme to defraud investors, the public and the U.S. government about HealthSouth's financial condition.

Scrushy, 51, of Birmingham, Alabama, surrendered at FBI Headquarters in Birmingham. The case has been assigned to the Honorable Karon O. Bowdre, U.S. District Court Judge.

The indictment was returned by a federal grand jury in Birmingham last Wednesday and unsealed this morning. The indictment charges Scrushy with conspiracy, mail, wire and securities fraud, false statements, false certifications and money laundering. The indictment also seeks forfeiture of more than $278.7 million in property which Scrushy derived from proceeds of the alleged offenses, including several residences, boats, aircraft and luxury automobiles.

"As alleged, instead of telling the public the truth, Richard Scrushy and his accomplices lied—they cooked HealthSouth's books and Scrushy personally vouched for false financial statements with the SEC to cover up their scheme," said Assistant Attorney General Christopher Wray. "These charges show that the government has important new tools to hold executives accountable for corporate fraud, and we won't hesitate to use them where the evidence warrants it."

"CEOs owe a fiduciary duty to investors, and the vast majority uphold that duty. However, for those who do not, our message is that no executive is above the law and through our forfeiture efforts we will work to show that crime doesn't pay," stated U.S. Attorney Alice H. Martin.

HealthSouth Corporation, founded in 1984, was the nation's largest provider of outpatient surgery, diagnostic imaging and rehabilitative healthcare services, with approximately 1,800 locations in all 50 states, Puerto Rico, the United Kingdom, Australia and Canada. Scrushy served as chairman of the Board of Directors from 1984 through early 2003, and as chief executive officer of the company during that time, except for periods in late 2002 and early 2003. Scrushy and other HealthSouth executives received salaries, bonuses, stock options and other benefits that were tied, directly or indirectly, to the company's financial performance. From 1996 through 2002, Scrushy received approximately $267 million in compensation from HealthSouth, including $7.5 million in base salary, more than $53 million in bonuses, and stock options valued at more than $206 million when exercised.

Scrushy controlled HealthSouth while CEO and Chairman of the Board, and personally participated in the preparation of financial statements and other financial documents. The indictment alleges that Scrushy caused HealthSouth to falsify financial statements, making the company appear more successful than it actually was.

The indictment alleges that between 1996 and 2003, internal reports by HealthSouth's corporate accounting staff showed that the company routinely failed to produce sufficient net income to meet the expectations of Wall Street securities analysts, the market and its own internal budgets—a failure that Scrushy and others allegedly referred to as "not making the numbers." According to the indictment, Scrushy and others devised a scheme to inflate HealthSouth's earnings by making false and fraudulent entries in HealthSouth's books and records, and to cover up the accounting fraud with false financial filings and statements. The indictment alleges that the scheme added approximately $2.7 billion in fictitious income to HealthSouth's books and records during the course of the conspiracy. The indictment further alleges that Scrushy paid himself and others in the form of salaries, bonuses and stock options as a result of the fraudulently inflated results.

According to the indictment, Scrushy and his accomplices would meet to discuss HealthSouth's actual financial performance and the need to falsify those internal results before they were publicly reported. The indictment states that Scrushy, through his accomplices, caused members of the corporate accounting staff to falsify the company's books and records. The fraud allegedly included false entries in income statement and balance sheet accounts, including property, plant and equipment accounts, cash accounts and accounts receivable, among others. According to the indictment, the co-conspirators referred to those methods as "filling the hole" or "filling the gap."

As part of the conspiracy, Scrushy and other co-conspirators allegedly signed and filed false statements with the Securities and Exchange Commission, and sought to conceal the fraud by controlling the internal distribution of actual financial results and providing false information to federal and state tax authorities. The indictment also alleges that Scrushy sought to control his co-conspirators, HealthSouth employees and the company's Board of Directors by, among other things, threats, intimidation, electronic and telephonic surveillance, and reading their e-mails. To further control others at HealthSouth, Scrushy allegedly obtained large

compensation packages for co-conspirators and offered them other incentives to keep them from discussing the fraudulent scheme, including, at one point in early 2003, an offer to take care of a co-conspirator's family if the co-conspirator would take the blame for HealthSouth's financial overstatements.

The indictment alleges that Scrushy knowingly signed false statements to the SEC, including a false 10-Q form for the third quarter of 2002, in violation of the recently enacted Sarbanes/Oxley law. Scrushy also allegedly continued the scheme through false representations to HealthSouth's stockholders and the rest of the investing public through press releases that misstated HealthSouth's financial condition. In June 2000, for example, Scrushy appeared in a HealthSouth State of the Company videotape, stating that "we have remained committed to prudent fiscal policy and the integrity of our balance sheet," and boasting that HealthSouth had an outstanding balance sheet. In early 2003, Scrushy boasted at a company managers meeting that HealthSouth did not have the same type of problems as WorldCom and Tyco.

The money laundering counts of the indictment allege that Scrushy knowingly engaged in financial transactions using criminally derived property, including the purchase of land, aircraft, boats, cars, artwork and jewelry, among other items. The indictment seeks forfeiture of all such gains derived from criminal activity, totaling $278,727,674.35, including: several residences in the state of Alabama and property in Palm Beach, Florida; a 92-foot Tarrab yacht called Chez Soiree, a 38-foot Intrepid Walkaround watercraft and a 42-foot Lightning boat; a 1998 Cessna Caravan 675, together with amphibious floats and other equipment, and a 2001 Cessna Citation 525 aircraft; diamond jewelry; several luxury automobiles, including a 2003 Lamborghini Murcielago, a 2000 Rolls Royce Corniche, and two 2002 Cadillac Escalades; and paintings by Pablo Picasso, Marc Chagall, Pierre-August Renoir, among others.

If convicted of all the charges, Scrushy faces a possible maximum sentence of 650 years in prison and more than $36 million in fines, in addition to the forfeiture.

Carmen Adams, Special Agent in Charge of the Birmingham FBI Field Office, stated: "The HealthSouth investigation is unprecedented in its size and scope for the Birmingham FBI. The indictment of Mr. Scrushy marks a great and necessary step forward in restoring the community's trust and confidence in its corporations and business leaders. This indictment is the result of the tireless efforts of scores of investigators and support personnel from the FBI, SEC, IRS and Postal Inspectors who have followed and uncovered the evidence of a very complex scheme to defraud and diligently moved this case forward."

"The IRS will use its financial expertise to help the government hold accountable those executives who engage in fraud," said IRS Commissioner Mark W. Everson. "Our investigation supports the Department of Justice seizure actions against Mr. Scrushy, involving a staggering sum of money, over a quarter of a billion dollars, which he accumulated during a seven-year period."

The HealthSouth investigation is continuing. The investigation is being conducted by the FBI-Birmingham Field Office, the Internal Revenue Service-Birmingham Division and the U.S. Postal Inspection Service. The prosecution is being handled by U.S. Attorney Alice H. Martin and Assistant U.S. Attorneys with the White Collar Section and Asset Forfeiture Section of the U.S. Attorney's Office for the Northern District of Alabama, and the Fraud and Asset Forfeiture and Money Laundering Sections of the Criminal Division of the Department of Justice in Washington, D.C. The investigation is being overseen by the Corporate Fraud Task Force, established by President Bush in July 2002 to investigate and prosecute allegations of fraud and other illegal conduct by executives at U.S. corporations. The Task Force is headed by Acting Deputy Attorney General Robert McCallum.

Sixteen individuals have been charged with crimes in connection with the HealthSouth investigation since it began in March 2003. The government has secured 14 guilty pleas from those individuals, including former HealthSouth Chief Financial Officers Aaron Beam, Michael Martin, William Owens, Weston Smith, Malcolm

> McVay and Vice President of Finance Emery Harris. All 14 of these defendants are cooperating with the government in this prosecution and the ongoing investigation. A defendant is presumed innocent of the charges and it will be the government's burden to prove a defendant's guilt beyond a reasonable doubt at trial.

The Associated Press reported on April 25, 2003, that an assistant vice president for finance, Kelly Coleman, reported that the contemplated corporate spinoff was a cover plan to remove the fraud from public attention. This had involved a UBS banker's presentation to the board of a briefing to "spin" the surgery division. The restructuring was said to be necessary due to "explosive growth."

The Fraud Unravels

According to documents filed, the fraud involved credits to the contractual adjustment—a contra revenue account. The offsets to these were charges to various asset accounts, including property, plant and equipment, goodwill, and inventory. Falsification of invoices was used to back up the entries. This scheme also enabled the company to obtain loans and credit from AmSouth Bank in Birmingham by overstating earnings and reflecting ability to repay.

The Sarbanes-Oxley Act criminal sanctions under Section 1107 raised the individual penalties to $5 million and twenty years, and the corporate penalties to $25 million for false certification of financials. A single Sarbanes-Oxley count carries very heavy weight. It consists simply of one signature penned on a public report. Just days after the law took effect in July 2002, Weston Smith, then the CFO, refused to sign off on an allegedly doctored quarterly report, a 10Q. This touched off a temporary panic, but he eventually agreed to sign the report. Apparently because of a concern with the implications of what he had done, a few months later he struck a deal with prosecutors.

Prosecutors believe it was the new law that brought down HealthSouth. CEOs and CFOs have always signed financial statements, but under Sarbanes-Oxley there is a personal affidavit that the numbers are accurate.

Weston also agreed to cooperate with the FBI and to secretly tape conversations with Scrushy. A federal judge later heard the tape. Bill Owens also made tape recordings of conversations with Scrushy. Scrushy maintained throughout the trial that he was an "idea man" and left the details to others, which at the end of the day the jurors apparently believed, finding no reasonable doubt to convict him. He had previously refused to testify before Congress without an immunity deal. However, fifteen other guilty pleas from executives and the cessation of the fraud were the consequences of the Sarbanes-Oxley Act. This was its purpose, and it was successful in that objective.

SEC BULLETIN NO. 99 expresses the view of the Securities and Exchange Commission that exclusive reliance on quantitative benchmarks to assess materiality in preparing financial statements and performing audits of the financial statements is not appropriate.

SEC BULLETIN NO. 99 — MATERIALITY

THIS CONSTITUTES ONE OF THE MOST SIGNIFICANT PRONOUNCEMENTS OF THE SECURITIES AND EXCHANGE COMMISSION AND SHOULD BE FULLY READ AND UNDERSTOOD BY EVERY MEMBER OF SENIOR MANAGEMENT, INCLUDING BOARD AND AUDIT COMMITTEE MEMBERS.

II. SEC STAFF ACCOUNTING BULLETIN:
NO. 99 — MATERIALITY
SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 211
[Release No. SAB 99]
Staff Accounting Bulletin No. 99

AGENCY: Securities and Exchange Commission

ACTION: Publication of Staff Accounting Bulletin

SUMMARY: This staff accounting bulletin expresses the views of the staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.
DATE: August 12, 1999

FOR FURTHER INFORMATION CONTACT: W. Scott Bayless, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant (202-942-4400), or David R. Fredrickson, Office of General Counsel (202-942-0900), Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103

SUPPLEMENTARY INFORMATION: The statements in the staff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jonathan G. Katz
Secretary
Date: August 12, 1999

Part 211 - (AMEND) Accordingly, Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 99 to the table found in Subpart B.

STAFF ACCOUNTING BULLETIN NO. 99

The staff hereby adds Section M to Topic 1 of the Staff Accounting Bulletin Series. Section M, entitled "Materiality," provides guidance in applying materiality thresholds to the preparation of financial statements filed with the Commission and the performance of audits of those financial statements.

STAFF ACCOUNTING BULLETINS

TOPIC 1: FINANCIAL STATEMENTS

* * * * *

M. Materiality

1. Assessing Materiality

Facts: During the course of preparing or auditing year-end financial statements, financial management or the registrant's independent auditor becomes aware of misstatements in a registrant's financial statements. When combined, the misstatements result in a 4% overstatement of net income and a $.02 (4%) overstatement of earnings per share. Because no item in the registrant's consolidated financial statements is misstated by more than 5%, management

and the independent auditor conclude that the deviation from generally accepted accounting principles ("GAAP") is immaterial and that the accounting is permissible.[1]

Question: Each Statement of Financial Accounting Standards adopted by the Financial Accounting Standards Board ("FASB") states, "The provisions of this Statement need not be applied to immaterial items." In the staff's view, may a registrant or the auditor of its financial statements assume the immateriality of items that fall below a percentage threshold set by management or the auditor to determine whether amounts and items are material to the financial statements?

Interpretive Response: No. The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission[2] of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that—without considering all relevant circumstances—a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material. The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations. Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important. In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.[3]

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is —

a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. [4]

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.[5] Court decisions, Commission rules and enforcement actions, and accounting and auditing literature[6] have all considered "qualitative" factors in various contexts.

The FASB has long emphasized that materiality cannot be reduced to a numerical formula. In its Concepts Statement No. 2, the FASB noted that some had urged it to promulgate quantitative materiality guides for use in a variety of situations. The FASB rejected such an approach as representing only a "minority view," stating —

The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment. [7]

The FASB noted that, in certain limited circumstances, the Commission and other authoritative bodies had issued quantitative materiality guidance, citing as examples guidelines ranging from one to ten percent with respect to a variety of disclosures.[8] And it took account of contradictory studies, one showing a lack of uniformity among auditors on materiality judgments, and another suggesting widespread use of a "rule of thumb" of five to ten percent of net income.[9] The FASB also considered whether an evaluation of materiality could be based solely on anticipating the market's reaction to accounting information.[10]

The FASB rejected a formulaic approach to discharging "the onerous duty of making materiality decisions"[11] in favor of an approach that takes into account all the relevant considerations. In so doing, it made clear that —

Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment.[12]

Evaluation of materiality requires a registrant and its auditor to consider *all* the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material; as stated in the auditing literature:

As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements.[13] Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are —

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate[14]
- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- whether the misstatement changes a loss into income or vice versa
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability
- whether the misstatement affects the registrant's compliance with regulatory requirements
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements
- whether the misstatement has the effect of increasing management's compensation — for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
- whether the misstatement involves concealment of an unlawful transaction.

This is not an exhaustive list of the circumstances that may affect the materiality of a quantitatively small misstatement.[15] Among other factors, the demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements as material. Consideration of potential market reaction to disclosure of a misstatement is by itself "too blunt an instrument to be depended on" in considering whether a fact is material.[16] When, however, management or the independent auditor expects (based, for example, on a pattern of market performance) that a known misstatement may result in a significant positive or negative market reaction, that expected reaction should be taken into account when considering whether a misstatement is material.[17]

For the reasons noted above, the staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements, for example those pursuant to actions to "manage" earnings, are immaterial.[18] While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, it presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements.[19] The staff believes that investors generally would regard as significant a management practice to over- or under-state earnings up to an amount just short of a percentage threshold in order to "manage" earnings. Investors presumably also would regard as significant an accounting practice that, in essence, rendered all earnings figures subject to a management-directed margin of misstatement.

The materiality of a misstatement may turn on where it appears in the financial statements. For example, a misstatement may involve a segment of the registrant's operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatement but also the significance of the segment information to the financial statements taken as a whole.[20] "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity"[21] is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. In assessing the materiality of misstatements in segment information - as with materiality generally - situations may arise in practice where the auditor will conclude that a matter relating to segment information is qualitatively material even though, in his or her judgment, it is quantitatively immaterial to the financial statements taken as a whole.[22]

Aggregating and Netting Misstatements

In determining whether multiple misstatements cause the financial statements to be materially misstated, registrants and the auditors of their financial statements should consider each misstatement separately and the aggregate effect of all misstatements.[23] A registrant and its auditor should evaluate misstatements in light of quantitative and qualitative factors and "consider whether, in relation to individual line item amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole."[24] This requires consideration of -

The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole ....[25]

Registrants and their auditors first should consider whether each misstatement is material, irrespective of its effect when combined with other misstatements. The literature notes that the analysis should consider whether the misstatement of "individual amounts" causes a material misstatement of the financial statements taken as a whole. As with materiality generally, this analysis requires consideration of both quantitative and qualitative factors.

If the misstatement of an individual amount causes the financial statements as a whole to be materially misstated, that effect cannot be eliminated by other misstatements whose effect may be to diminish the impact of the misstatement on other financial statement items. To take an obvious example, if a registrant's revenues are a material financial statement item and if they are materially overstated, the financial statements taken as a whole will be materially misleading even if the effect on earnings is completely offset by an equivalent overstatement of expenses.

Even though a misstatement of an individual amount may not cause the financial statements taken as a whole to be materially misstated, it may nonetheless, when aggregated with other misstatements, render the financial statements taken as a whole to be materially misleading. Registrants and the auditors of their financial statements accordingly should consider the effect of the misstatement on subtotals or totals. The auditor should aggregate all misstatements that affect each subtotal or total and consider whether the misstatements in the aggregate affect the subtotal or total in a way that causes the registrant's financial statements taken as a whole to be materially

misleading.[26]

The staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement. As noted above, assessments of materiality should never be purely mechanical; given the imprecision inherent in estimates, there is by definition a corresponding imprecision in the aggregation of misstatements involving estimates with those that do not involve an estimate.

Registrants and auditors also should consider the effect of misstatements from prior periods on the current financial statements. For example, the auditing literature states,

Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements.[27]

This may be particularly the case where immaterial misstatements recur in several years and the cumulative effect becomes material in the current year.

2. Immaterial Misstatements that are Intentional

Facts: A registrant's management intentionally has made adjustments to various financial statement items in a manner inconsistent with GAAP. In each accounting period in which such actions were taken, none of the individual adjustments is by itself material, nor is the aggregate effect on the financial statements taken as a whole material for the period. The registrant's earnings "management" has been effected at the direction or acquiescence of management in the belief that any deviations from GAAP have been immaterial and that accordingly the accounting is permissible.

Question: In the staff's view, may a registrant make intentional immaterial misstatements in its financial statements?

Interpretive Response: No. In certain circumstances, intentional immaterial misstatements are unlawful.

Considerations of the Books and Records Provisions Under the Exchange

Act

Even if misstatements are immaterial,[28] registrants must comply with Sections 13(b)(2) - (7) of the Securities Exchange Act of 1934 (the "Exchange Act").[29] Under these provisions, each registrant with securities registered pursuant to Section 12 of the Exchange Act,[30] or required to file reports pursuant to Section 15(d),[31] must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant and must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.[32] In this context, determinations of what constitutes "reasonable assurance" and "reasonable detail" are based not on a "materiality" analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.[33] Accordingly, failure to record accurately immaterial items, in some instances, may result in violations of the securities laws.

The staff recognizes that there is limited authoritative guidance[34] regarding the "reasonableness" standard in Section 13(b)(2) of the Exchange Act. A principal statement of the Commission's policy in this area is set forth in an address given in 1981 by then Chairman Harold M. Williams.[35] In his address, Chairman Williams noted that, like materiality, "reasonableness" is not an "absolute standard of exactitude for corporate records."[36] Unlike materiality, however, "reasonableness" is not solely a measure of the significance of a financial statement item to investors. "Reasonableness," in this context, reflects a judgment as to whether an issuer's failure to correct a known misstatement implicates the purposes underlying the accounting provisions of Sections 13(b)(2) - (7) of the Exchange Act.[37]

In assessing whether a misstatement results in a violation of a registrant's obligation to keep books and records that are accurate "in reasonable detail," registrants and their auditors should consider, in addition to the factors discussed above concerning an evaluation of a misstatement's potential materiality, the factors set forth below.

- **The significance of the misstatement**. Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.
- **How the misstatement arose**. It is unlikely that it is ever

"reasonable" for registrants to record misstatements or not to correct known misstatements — even immaterial ones — as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. On the other hand, insignificant misstatements that arise from the operation of systems or recurring processes in the normal course of business generally will not cause a registrant's books to be inaccurate "in reasonable detail."[38]

- **The cost of correcting the misstatement**. The books and records provisions of the Exchange Act do not require registrants to make major expenditures to correct small misstatements.[39] Conversely, where there is little cost or delay involved in correcting a misstatement, failing to do so is unlikely to be "reasonable."
- **The clarity of authoritative accounting guidance with respect to the misstatement**. Where reasonable minds may differ about the appropriate accounting treatment of a financial statement item, a failure to correct it may not render the registrant's financial statements inaccurate "in reasonable detail." Where, however, there is little ground for reasonable disagreement, the case for leaving a misstatement uncorrected is correspondingly weaker.

There may be other indicators of "reasonableness" that registrants and their auditors may ordinarily consider. Because the judgment is not mechanical, the staff will be inclined to continue to defer to judgments that "allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way."[40]

The Auditor's Response to Intentional Misstatements

Section 10A(b) of the Exchange Act requires auditors to take certain actions upon discovery of an "illegal act."[41] The statute specifies that these obligations are triggered "whether or not [the illegal acts are] perceived to have a material effect on the financial statements of the issuer . . . ." Among other things, Section 10A(b)(1) requires the auditor to inform the appropriate level of management of an illegal act (unless clearly inconsequential) and assure that the registrant's audit committee is "adequately informed" with respect to the illegal act.

As noted, an intentional misstatement of immaterial items in a registrant's financial statements may violate Section 13(b)(2) of the Exchange Act and thus be an illegal act. When such a violation occurs, an auditor must take steps to see that the registrant's audit committee is "adequately informed" about the illegal act. Because Section 10A(b)(1) is triggered regardless of whether an illegal act has a material effect on the registrant's financial statements, where the illegal act consists of a misstatement in the registrant's financial statements, the auditor

will be required to report that illegal act to the audit committee irrespective of any "netting" of the misstatements with other financial statement items.

The requirements of Section 10A echo the auditing literature. See, for example, Statement on Auditing Standards No. ("SAS") 54, "Illegal Acts by Clients," and SAS 82, "Consideration of Fraud in a Financial Statement Audit." Pursuant to paragraph 38 of SAS 82, if the auditor determines there is evidence that fraud may exist, the auditor must discuss the matter with the appropriate level of management. The auditor must report directly to the audit committee fraud involving senior management and fraud that causes a material misstatement of the financial statements. Paragraph 4 of SAS 82 states that "misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users."[42] SAS 82 further states that fraudulent financial reporting may involve falsification or alteration of accounting records; misrepresenting or omitting events, transactions or other information in the financial statements; and the intentional misapplication of accounting principles relating to amounts, classifications, the manner of presentation, or disclosures in the financial statements.[43] The clear implication of SAS 82 is that immaterial misstatements may be fraudulent financial reporting. [44]

Auditors that learn of intentional misstatements may also be required to (1) re-evaluate the degree of audit risk involved in the audit engagement, (2) determine whether to revise the nature, timing, and extent of audit procedures accordingly, and (3) consider whether to resign.[45]

Intentional misstatements also may signal the existence of reportable conditions or material weaknesses in the registrant's system of internal accounting control designed to detect and deter improper accounting and financial reporting.[46] As stated by the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, in its 1987 report,

The tone set by top management - the corporate environment or culture within which financial reporting occurs - is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.[47]

An auditor is required to report to a registrant's audit committee any reportable conditions or material weaknesses in a registrant's system of internal accounting control that the auditor discovers in the course of the examination of the registrant's financial statements. [48]

GAAP Precedence Over Industry Practice

Some have argued to the staff that registrants should be permitted to follow an industry accounting practice even though that practice is inconsistent with authoritative accounting literature. This situation might occur if a practice is developed when there are few transactions and the accounting results are clearly inconsequential, and that practice never changes despite a subsequent growth in the number or materiality of such transactions. The staff disagrees with this argument. Authoritative literature takes precedence over industry practice that is contrary to GAAP.[49]

General Comments

This SAB is not intended to change current law or guidance in the accounting or auditing literature.[50] This SAB and the authoritative accounting literature cannot specifically address all of the novel and complex business transactions and events that may occur. Accordingly, registrants may account for, and make disclosures about, these transactions and events based on analogies to similar situations or other factors. The staff may not, however, always be persuaded that a registrant's determination is the most appropriate under the circumstances. When disagreements occur after a transaction or an event has been reported, the consequences may be severe for registrants, auditors, and, most importantly, the users of financial statements who have a right to expect consistent accounting and reporting for, and disclosure of, similar transactions and events. The staff, therefore, encourages registrants and auditors to discuss on a timely basis with the staff proposed accounting treatments for, or disclosures about, transactions or events that are not specifically covered by the existing accounting literature.

Footnotes

1 American Institute of Certified Public Accountants ("AICPA"), Codification of Statements on Auditing Standards ("AU") § 312, "Audit Risk and Materiality in Conducting an Audit," states that the auditor should consider audit risk and materiality both in (a) planning and setting the scope for the audit and (b) evaluating whether the financial statements taken as a whole are fairly presented in all material respects in conformity with generally accepted accounting principles. The purpose of this Staff Accounting Bulletin ("SAB") is to provide guidance to financial management and independent auditors with respect to the evaluation of the materiality of misstatements that are identified in the audit process or preparation of the financial statements (i.e., (b) above). This SAB is not intended to provide definitive guidance for assessing "materiality" in other contexts, such as evaluations of auditor independence, as other factors may apply. There may be other rules that

address financial presentation. See, e.g., Rule 2a-4, 17 CFR 270.2a-4, under the Investment Company Act of 1940.

2 As used in this SAB, "misstatement" or "omission" refers to a financial statement assertion that would not be in conformity with GAAP.

3 FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information ("Concepts Statement No. 2"), 132 (1980). See also Concepts Statement No. 2, Glossary of Terms - Materiality.

4 TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also Basic, Inc. v. Levinson, 485 U.S. 224 (1988). As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . ." TSC Industries, 426 U.S. at 450.

5 See, e.g., Concepts Statement No. 2, 123-124; AU § 312.10 (" . . . materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations."); AU § 312.34 ("Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material."). As used in the accounting literature and in this SAB, "qualitative" materiality refers to the surrounding circumstances that inform an investor's evaluation of financial statement entries. Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB.

6 See, e.g., Rule 1-02(o) of Regulation S-X, 17 CFR 210.1-02(o), Rule 405 of Regulation C, 17 CFR 230.405, and Rule 12b-2, 17 CFR 240.12b-2; AU §§ 312.10 - .11, 317.13, 411.04 n. 1, and 508.36; In re Kidder Peabody Securities Litigation, 10 F. Supp. 2d 398 (S.D.N.Y. 1998); Parnes v. Gateway 2000, Inc., 122 F.3d 539 (8th Cir. 1997); In re Westinghouse Securities Litigation, 90 F.3d 696 (3d Cir. 1996); In the Matter of W.R. Grace & Co., Accounting and Auditing Enforcement Release No. ("AAER") 1140 (June 30, 1999); In the Matter of Eugene Gaughan, AAER 1141 (June 30, 1999); In the Matter of Thomas Scanlon, AAER 1142 (June 30, 1999); and In re Sensormatic Electronics Corporation, Sec. Act Rel. No. 7518 (March 25, 1998).

7 Concepts Statement No. 2, 131 (1980).

8 Concepts Statement No. 2, 131 and 166.

9 Concepts Statement No. 2, 167.

10 Concepts Statement No. 2, 168-69.

11 Concepts Statement No. 2, 170.

12 Concepts Statement No. 2, 125.

13 AU § 312.11.

14 As stated in Concepts Statement No. 2, 130:
Another factor in materiality judgments is the degree of precision that is attainable in estimating the judgment item. The amount of deviation that is considered immaterial may increase as the attainable degree of precision decreases. For

example, accounts payable usually can be estimated more accurately than can contingent liabilities arising from litigation or threats of it, and a deviation considered to be material in the first case may be quite trivial in the second. This SAB is not intended to change current law or guidance in the accounting literature regarding accounting estimates. See, e.g., Accounting Principles Board Opinion No. 20, Accounting Changes 10, 11, 31-33 (July 1971).

15 The staff understands that the Big Five Audit Materiality Task Force ("Task Force") was convened in March of 1998 and has made recommendations to the Auditing Standards Board including suggestions regarding communications with audit committees about unadjusted misstatements. See generally Big Five Audit Materiality Task Force, "Materiality in a Financial Statement Audit — Considering Qualitative Factors When Evaluating Audit Findings" (August 1998). The Task Force memorandum is available at www.aicpa.org.

16 See Concepts Statement No. 2, 169.

17 If management does not expect a significant market reaction, a misstatement still may be material and should be evaluated under the criteria discussed in this SAB.

18 Intentional management of earnings and intentional misstatements, as used in this SAB, do not include insignificant errors and omissions that may occur in systems and recurring processes in the normal course of business. See notes 38 and 50 infra.

19 Assessments of materiality should occur not only at year-end, but also during the preparation of each quarterly or interim financial statement. See, e.g., In the Matter of Venator Group, Inc., AAER 1049 (June 29, 1998).

20 See, e.g., In the Matter of W.R. Grace & Co., AAER 1140 (June 30, 1999).

21 AUI § 326.33.

22 Id.

23 The auditing literature notes that the "concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles." AU § 312.03. See also AU § 312.04.

24 AU § 312.34. Quantitative materiality assessments often are made by comparing adjustments to revenues, gross profit, pretax and net income, total assets, stockholders' equity, or individual line items in the financial statements. The particular items in the financial statements to be considered as a basis for the materiality determination depend on the proposed adjustment to be made and other factors, such as those identified in this SAB. For example, an adjustment to inventory that is immaterial to pretax income or net income may be material to the financial statements because it may affect a working capital ratio or cause the registrant to be in default of loan covenants.

25 AU § 508.36.

26 AU § 312.34

27 AU § 380.09.

28 FASB Statements of Financial Accounting Standards ("Standards" or "Statements") generally provide that "[t]he provisions of this Statement need not be applied to immaterial items." This SAB is consistent with that provision of the Statements. In theory, this language is subject to the interpretation that the registrant is free intentionally to set forth immaterial items in financial statements in a manner that plainly would be contrary to GAAP if the misstatement were material. The staff believes that the FASB did not intend this result.

29 15 U.S.C. §§ 78m(b)(2) - (7).

30 15 U.S.C. § 78l.

31 15 U.S.C. § 78o(d).

32 Criminal liability may be imposed if a person knowingly circumvents or knowingly fails to implement a system of internal accounting controls or knowingly falsifies books, records or accounts. 15 U.S.C. §§ 78m(4) and (5). See also Rule 13b2-1 under the Exchange Act, 17 CFR 240.13b2-1, which states, "No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

33 15 U.S.C. § 78m(b)(7). The books and records provisions of section 13(b) of the Exchange Act originally were passed as part of the Foreign Corrupt Practices Act ("FCPA"). In the conference committee report regarding the 1988 amendments to the FCPA, the committee stated,
The conference committee adopted the prudent man qualification in order to clarify that the current standard does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.
Cong. Rec. H2116 (daily ed. April 20, 1988).

34 So far as the staff is aware, there is only one judicial decision that discusses Section 13(b)(2) of the Exchange Act in any detail, SEC v. World-Wide Coin Investments, Ltd., 567 F. Supp. 724 (N.D. Ga. 1983), and the courts generally have found that no private right of action exists under the accounting and books and records provisions of the Exchange Act. See e.g., Lamb v. Phillip Morris Inc., 915 F.2d 1024 (6th Cir. 1990) and JS Service Center Corporation v. General Electric Technical Services Company, 937 F. Supp. 216 (S.D.N.Y. 1996).

35 The Commission adopted the address as a formal statement of policy in Securities Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981), 21 SEC Docket 1466 (February 10, 1981).

36 Id. at 46 FR 11546.

37 Id.

38 For example, the conference report regarding the 1988 amendments to the FCPA stated,
The Conferees intend to codify current Securities and Exchange Commission (SEC) enforcement policy that penalties not be imposed for insignificant or technical infractions or inadvertent conduct. The amendment adopted by the Conferees

[Section 13(b)(4)] accomplishes this by providing that criminal penalties shall not be imposed for failing to comply with the FCPA's books and records or accounting provisions. This provision [Section 13(b)(5)] is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement.

Cong. Rec. H2115 (daily ed. April 20, 1988).

39 As Chairman Williams noted with respect to the internal control provisions of the FCPA, " thousands of dollars ordinarily should not be spent conserving hundreds." 46 FR 11546.

40 Id., at 11547.

41 Section 10A(f) defines, for purposes of Section 10A, an "illegal act" as "an act or omission that violates any law, or any rule or regulation having the force of law." This is broader than the definition of an "illegal act" in AU § 317.02, which states, "Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."

42 AU § 316.04. See also AU § 316.03. An unintentional illegal act triggers the same procedures and considerations by the auditor as a fraudulent misstatement if the illegal act has a direct and material effect on the financial statements. See AU §§ 110 n. 1, 316 n. 1, 317.05 and 317.07. Although distinguishing between intentional and unintentional misstatements is often difficult, the auditor must plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements in either case. See AU § 316 note 3.

43 AU § 316.04. Although the auditor is not required to plan or perform the audit to detect misstatements that are immaterial to the financial statements, SAS 82 requires the auditor to evaluate several fraud "risk factors" that may bring such misstatements to his or her attention. For example, an analysis of fraud risk factors under SAS 82 must include, among other things, consideration of management's interest in maintaining or increasing the registrant's stock price or earnings trend through the use of unusually aggressive accounting practices, whether management has a practice of committing to analysts or others that it will achieve unduly aggressive or clearly unrealistic forecasts, and the existence of assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties. See AU §§ 316.17a and .17c.

44 AU §§ 316.34 and 316.35, in requiring the auditor to consider whether fraudulent misstatements are material, and in requiring differing responses depending on whether the misstatement is material, make clear that fraud can involve immaterial misstatements. Indeed, a misstatement can be "inconsequential" and still involve fraud.

Under SAS 82, assessing whether misstatements due to fraud are material to the financial statements is a "cumulative process" that should occur both during and at

the completion of the audit. SAS 82 further states that this accumulation is primarily a "qualitative matter" based on the auditor's judgment. AU § 316.33. The staff believes that in making these assessments, management and auditors should refer to the discussion in Part 1 of this SAB.

45 AU §§ 316.34 and 316.36. Auditors should document their determinations in accordance with AU §§ 316.37, 319.57, 339, and other appropriate sections.

46 See, e.g., AU § 316.39.

47 Report of the National Commission on Fraudulent Financial Reporting at 32 (October 1987). See also Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 8, 1999).

48 AU § 325.02. See also AU § 380.09, which, in discussing matters to be communicated by the auditor to the audit committee, states,
The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements....

49 See AU § 411.05.

50 The FASB Discussion Memorandum, Criteria for Determining Materiality, states that the financial accounting and reporting process considers that "a great deal of the time might be spent during the accounting process considering insignificant matters . . . . If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial." This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management. Management and the auditor would need to consider the various factors described elsewhere in this SAB in assessing whether such misstatements are material, need to be corrected to comply with the FCPA, or trigger procedures under Section 10A of the Exchange Act. Because this SAB does not change current law or guidance in the accounting or auditing literature, adherence to the principles described in this SAB should not raise the costs associated with recordkeeping or with audits of financial statements.

http://www.sec.gov/rules/acctrps/sab99.htm

Backdating Stock Options: Sarbanes-Oxley Implications

Federal prosecutors recently delivered their first indictment against a California company for the practice of backdating stock options. At this time, close to one hundred companies are being investigated, and the total impact may reach 2,000 companies before the day is over. Executives and directors from six companies have left as a result of the practice. Plaintiff lawyers have filed billions of dollars in lawsuits. In this chapter we'll look at what's happening and the remedies.

David Yermack of New York University was the first analyst to document unusual patterns in executive stock options in 1997. This research was followed by Erik Lie's papers at the University of Iowa. He estimates that close to 29 percent of 7,774 U.S. companies backdated option grants from 1996 to 2002. Backdating per se is not illegal if there is a window or range permitted in the compensation package, but the practice that is being referred to is failing to disclose and properly account for backdated options. That is illegal. It is costing companies millions of dollars in auditor fees, counsel fees, tax liabilities, and investigative fees. The practice was flawed, and considering the magnitude of the implications, which include derivative and class action suits, could cost affected companies tens of millions of dollars to settle. A restatement virtually guarantees an SEC investigation and a variety of lawsuits.

One Pennsylvania law firm alone just filed thirty-four suits as a result of backdating. Institutional investors are joining in the filing actions as plaintiffs. The Department of Justice has investigators at more than sixty companies. And Erik Lie, whose university research began this media attention to the problem, has stated that he is confident the number of companies involved is "much higher." His studies have noted a sharp decline in prices immediately before unscheduled awards, followed by a sharp reversal immediately afterward. This would indicate an amazing

ability to predict stock prices on the part of compensation committees, or would alternatively indicate that the awards are timed after-the-fact.

Backdating Issues

Stock option plans for the most part do not specifically prohibit the grant date from preceding the decision date. However, it is well known that shareholders dislike the dilutive effect generated by a large number of outstanding options, particularly if they are issued at a substantial discount level to top executives. Excess in this respect could cause a breach of fiduciary duty. And accounting rules require a charge to earnings for grants that are in-the-money. If a company did not record compensation expense, that would be a violation of GAAP.

Stock options are normally granted at-the-money at a regular anniversary date. These options were granted at below-market prices on largely unscheduled dates, creating an intrinsic value upon vesting that is properly recorded as executive compensation. Companies have under-withheld income taxes and underpaid payroll taxes. The financials therefore also do not contain proper tax reserves.

Tax Issues

Tax issues are very complex. Section 162(m)—Audit Techniques for IRS agents contains a listing of compensation audit principles. Agents are advised that statutory stock options require shareholder approval within twelve months before or after adoption by the board of directors. Verification that the employer has not cancelled loans advanced to exercise options or restricted stock is also recommended; otherwise, the reductions are additional compensation. As to stock option transfers, the IRS is investigating more than forty companies where executives transferred option awards to family-controlled partnerships, obviously related persons.

Equity-based plans have also been affected by Code Section 409A, which established a new scheme for federal taxation of deferred compensation. It applies to stock options, stock appreciation rights, and restricted stock awards. Companies had until December 31, 2006, to amend their plans. If 409A requirements are not met in form or substance, all deferred

compensation is includible in gross income. Exemptions from 409A include statutory options, such as incentive stock options which are "fair market value" options. Compensation committee minutes must be very precise. The IRS has issued a notice that contains detailed valuation guidelines that are acceptable for public companies, including the value based on the last sale before the grant and an average thirty-day pricing valuation model.

Also, at-the-money options are considered performance-based compensation and therefore not considered for the $1 million cap on executive compensation required by Section 162(m) of the Internal Revenue Code. In-the-money options, on the other hand, do not qualify for tax deductions—a lot of disadvantages, overall.

Enter Sarbanes-Oxley

After the passage of the Sarbanes-Oxley Act, option grants must be reported within two business days. Before this, they could be reported within forty-five days after the fiscal year and option exercises by the tenth of the month after the exercise.

Spring-loading is not covered by Sarbanes-Oxley. This is the practice of timing option grants right before good news is to be released or after expected bad news. But wait—isn't this a definition of insider trading? The SEC is divided, but you can take it to the bank that when derivative suits against executives and boards are filed and tried, the juries won't have much trouble on the decision. This is material, non-public information. It sounds to many like classic insider trading.

Stock Ramifications

A Silicon Valley firm last year announced that its board had formed a sub-committee to investigate backdated options after an SEC inquiry had begun. As a result, three top executives, including the CEO, resigned. The stock price dropped 25 percent upon the news of the events. Because of inability to restate in a timely manner due to huge requirements for investigative costs and time, the shares were de-listed earlier this year. The market capitalization of another large company suffered a $13 billion loss since an SEC inquiry began.

Derivative Lawsuits

Aside from the criminal investigations that have sprung up by U.S. attorneys' offices and the Department of Justice, one law firm alone recently filed ten suits on behalf of investors. Eight of these were derivative actions, and two class actions. Derivative suits normally charge boards of directors with breach of fiduciary duty, gross negligence, and violations of certain provisions of the Securities and Exchange Act of 1934. The filings usually contain language to the effect that the backdated stock options allowed the holders to obtain extraordinary and improper profits.

Most litigation will likely involve derivative suits, since under Rule 10-b(5) in a class action, the stock price has to fall to demonstrate investor loss. Derivate suits are civil and filed by shareholders seeking to enforce rights, as opposed to class actions, which are large groups of plaintiffs. The other advantage to a derivative suit is that plaintiffs are not required to wait sixty days to file an action.

Large institutional investors are mobilizing to file derivative suits, since they have the resources to make sure that corporations are held accountable.

Remediation

A number of issues can be addressed to remediate. Severance compensation in connection with change-in-control transactions can be discontinued. Benefits can be capped for reasonableness. The annual shareholder meeting can be established as the grant date for stock options. Guidelines can be followed to ensure options are at-the-money when awarded. Preventive controls can be established in the finance and accounting departments, as well as oversight of the compensation committee.

In other words, corporations need to enact Sarbanes-Oxley-type internal controls over the processes related to executive compensation. This will vary on a case-by-case basis and will involve a number of personnel hours and effort. However, the alternative, as we have reviewed, is untenable. The audit committee should review the results of remediation efforts. In cases where backdating has occurred, a new sub-committee reporting to the audit

committee and board of directors needs to be established, consisting of forensic experts. The Justice Department recently released the Thompson Memorandum, which in general terms states that if mistakes were due to careless behavior and not willful intent, and a company self-regulates and voluntarily discloses, criminal penalties will not apply.

In deference to those companies that are instituting their own internal investigations, this is quite commendable. For companies that may be ultimately affected, there are various considerations. Financial statements need be adjusted for potential reserves for below-market options that were exercised. Compensation expense needs to be recorded. Materiality is a consideration; therefore, SEC Bulletin No. 99 must be considered. Prompt notification of authorities—stock exchanges and the SEC—must occur in order to reach settlement scenarios. Executives involved should consider a repayment of profits to the corporation. Section 409A penalty tax studies need to be made. A multi-disciplinary task force needs to be funded and established to address the issues from various reference points. It may be accurate that close to 30 percent of publicly held companies evaluated that granted options to top executives between 1996 and 2005 manipulated the grants.

Backdating Stock Options: Corporate Remediation

As of August 17, 2006, the *Wall Street Journal* posted a study of eighty-seven companies that have initiated probes or announced restatements or had executive resignations or Department of Justice inquiries into their stock options practices. The SEC has filed civil charges against executives of public companies, alleging that they engaged in a decade-long fraudulent scheme to grant undisclosed, in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of their stock. These complaints have alleged that former executives collectively realized millions of dollars of ill-gotten compensation through the exercise of illegally backdated option grants and the subsequent sale of related common stock.

In a separate matter, U.S. attorneys' offices have unsealed criminal complaints charging executives with conspiracy to violate the anti-fraud provisions of the federal securities laws, wire fraud, and mail fraud. It has

been alleged that backdated option grants and secret option slush funds were "deceits of the highest order" upon shareholders. Executives, according to the SEC, have repeatedly used hindsight to select dates when the closing price of their common stock was at or near a quarterly or annual low. The complaints further allege that under well-settled accounting principles, in effect at the time, companies that granted in-the-money options were required to record a corresponding compensation expense and disclose such amounts in filings with the commission. The executives have also been charged with violations of the Sarbanes-Oxley officer certification provisions of the federal securities laws. Injunctive relief, civil penalties, disgorgement, with prejudgment interest, and officer and director bars against each of the defendants have been requested.

How the Backdating Occurred

It is helpful to review how the practices originated in order that remediation of one's own internal control policies can effectively take place. The executives directed and controlled the option grant process and initiated the backdating schemes. Among other things, they specifically selected the backdated grant dates by interfacing with the compensation committee. Grant documents with false grant dates were approved by the compensation committee. Unscheduled grants were the modus operandi. A spreadsheet contained lists of proposed grantees. At some point, the executives "cherry-picked" the grant date by looking back at their historical stock prices and, with the benefit of hindsight, chose a grant date that corresponded to a date on which the common stock was trading at a relative low. The master list was then submitted to the Compensation Committee for approval.

Unanimous written consent forms pertaining to the proposed grant were sent to Compensation Committee members for signature. It was known among the executives that these dates were the "low-ball" look-back dates they had previously chosen. Compensation Committee members were generally not aware of an impending grant prior to receiving the master list. The committee members then signed, but did not date, their copies of the consents and returned them. Based upon their involvement in the option grant process, each of the defendants knew, or was reckless in not knowing, that the unanimous written consents were false because the "as of" dates

that were inserted into the consents and reflected in the company's books and records did not represent the true grant dates.

The executives knew that no corporate action to approve the options grants had actually occurred on the "as of" date. They knew this because they were the ones who had picked the grant dates by use of the look-back tables, with the benefit of hindsight. They had examined historical trading prices and selected a date with a low trading price. Options with backdated dates in effect also accelerated the vesting schedule because the company used the backdated date for vesting purposes, not the date of the actual Compensation Committee approval. A large number of grants were grants at or near the lowest price for the fiscal quarter or year. In an article published by the *Wall Street Journal*, the patterns of stock options grants were analyzed, and astronomically high odds, some approaching one in six billion, were determined to exist that such grants would have fallen on dates just ahead of sharp gains in the related corporate stock price by chance.

The secret backdating schemes allowed the defendants to disguise the fact that the company was paying higher compensation to executives and employees by awarding them in-the-money options, and to avoid having to expense the in-the-money options as compensation expense, thus avoiding reductions to the company's net income and EPS. In addition, certain large institutional investors have long been opposed to stock option plans that allowed grants of options at below the fair market value of the underlying stock at the time of the grant. This is the basis for the tens of billions of dollars of derivative suits filed in recent weeks against related corporations by law firms on behalf of large institutional investors.

The California Public Employees' Retirement System (CalPERS) is the largest U.S. public pension fund, with more than $200 billion in total assets. Its membership has recently written an open letter to the chairs of the compensation committees of a number of portfolio companies related to inquiries on employee stock option backdating practices. Their letter contains implications of allegations, including lack of oversight by the board of directors, weak internal controls, weak internal and external audit practices, poor accounting, significant income tax consequences for persons implicated for backdating options, and problems with the executive compensation plan administrator.

Senator Chuck Grassley of Iowa, chairman of the U.S. Senate Committee on Finance, has publicly stated: "It's one thing for an executive to make big profits because he's improved his company, but it's a whole different thing to make big profits because he's playing fast and loose with the dating of stock options. Outside the corporate suite, Americans don't get to pick and choose their dream stock price. The market dictates the price."

The CFA Institute recently published an open letter to the SEC stating, "In the case of Post-Dating, senior executives (and possibly directors) used inside information or post-closing market prices to determine when to retroactively set the effective date of share-based awards in order to enhance the return of such awards. This practice also appears to have involved falsified accounting, may circumvent financial reporting requirements for 'variable' option grants, may conflict with governance requirements related to the pricing of stock options, and may ultimately lead to criminal and tax penalties against companies engaged in these activities, thereby harming shareowner value even more."

Remediation

In the real world, the best stance is one of remediation before any investigation by third parties begins. Materiality thresholds need to be considered according to SEC Bulletin No. 99 and Sarbanes-Oxley thresholds. If the materiality threshold is not breached, then no restatements will occur. If a restatement occurs, it almost guarantees an SEC investigation and the finding of a material weakness by one's third-party auditors. Material weakness findings can cause the loss of significant blocks of market capitalization upon disclosure.

The problems are not restricted to information technology companies. Their excess returns in the studies performed by the academics at the University of Iowa and others were what brought initial attention to the issue, but the scope is beyond IT companies. It is estimated that close to 3,000 companies are involved. In many of these cases undoubtedly management has retained its integrity, and the element of scienter does not exist. The rest of the public companies need to study and research adequate Sarbanes procedures to ensure they are not affected in the future. The

Sarbanes-Oxley Act changed the reporting requirements on incentive stock options to two trading days effective in August of 2002. Grant patterns on excess return post-option pricing began largely in the mid-1990s. One company alone has close to two million documents that need to be examined to determine the extent of the backdating issues. I understand investigative, forensic and related professional costs in this one case alone are targeted and budgeted for $70 million. This does not include defense or settlement costs for related class-action and derivative lawsuits.

Without going into specific detail, what is referred to as the "tone at the top" must be re-established by compensation committees throughout the world today. Directors and particularly audit committee and compensation committee members need to be re-educated as to governance requirements that comply with both the spirit and the letter of the law. Compensation programs should not be driven by competitive surveys, but by superior performance over the long term. Full disclosure is necessary in proxy statements. Independent directors are a major necessity. Experts have to be added to compensation committees. If they are not there, then third parties must be hired who are expert consultants. Issues of incentive compensation, dilution, performance options and structures, repricing, and a variety of tax and governance issues have to be addressed. Steps have to be taken to ensure that board and committee evaluations of compensation are equitable, and it would be advised to refrain from using company resources to satisfy legal and tax liabilities for executives who are implicated in wrongdoing. This could lead to further derivative suits. Independent detailed investigations on a case-by-case basis with strong board of director backing need to be undertaken. The implications of Sarbanes need to be fully understood and addressed. Lying to auditors is now a federal offense. Insider manipulation is now not being tolerated by the market, nor by enforcement authorities who have oversight. Justice officials have made it clear that executives can face possible prison time for backdating stock options. Serious change and corporate governance must now follow.

Defending Against Class Action Suits

In April of 1998 Cendant disclosed a restatement of 1997 results, including a reduction in net income of $100 million due to various accounting irregularities. Then on July 14, 1998, Cendant announced a further

restatement of financial results for 1995, 1996, and 1997, including all quarters, due to recognition of fictitious revenues and cookie-cutter reserve mismanagement. At the end of August, Cendant filed an SEC report indicating a reduction in operating income of $500 million, a reduction in net income before taxes of $297 million, and the effect on earnings per share. As a result, the market price of the stock decreased from a high of $35 in April to $11 per share in August. Normally a 10 percent drop in stock price following an adverse announcement is enough to trigger a class action suit within seventy-two hours. Here the drop was precipitous—69 percent.

Fifty lawsuits were filed in the U.S. District Court, which were consolidated by the judge with several institutional investors as the lead plaintiffs. Hundreds of thousands of documents were produced by Cendant, Ernst & Young, and the various defendants. An investment banking firm and a forensic team were retained as expert witnesses. Cendant settled for $2.8 billion. Ernst & Young settled for $335 million. This settlement was followed by even larger valuations in the cases of WorldCom ($6.2 billion) and Enron ($7.1 billion, pending final court approvals).

Enron directors agreed to settle class action against them for $168 million as their proportionate share of the settlement. Insurance covered most of the cost, but left them with terms that required the directors to personally pay $13 million. WorldCom directors had a settlement requiring them to pay their proportionate share, $54 million, leaving them $18 million owed on a personal liability basis. The directors in the settlement admitted no wrongdoing.

Backdating Stock Options

The backdating scandal we are currently reading about in the *Wall Street Journal* may, according to academics, affect up to 3,000 publicly held companies. Defense attorneys, plaintiff attorneys, and expert witness are beginning to mobilize. This potentially massive arena of litigation and expert testimony has occurred because of the practice in the last ten years of publicly held companies granting to key executives stock options that were in-the-money but not properly recorded as compensation expense, thus violating GAAP, and misstating tax liabilities, as well, over every

quarter since the practice began. In other words, dates were assigned to the options using hindsight that were earlier dates than the actual grant date. The SEC has just begun an investigation into approximately eighty companies, and the list is expanding daily. The DOJ and U.S. attorneys' offices are making logistic decisions as to how to allocate predicted case load. Several criminal charges have been filed. At a minimum, companies that are involved will face civil charges by the SEC, massive restatements, and therefore the virtual guarantee of class action and derivative suits. The suits have as their basis that the companies in question and their top executives, as well as boards of directors, have engaged in breaches of fiduciary duty, gross mismanagement, unjust enrichment, and violations of the SEC Act of 1934. Back-dated options have allowed the defendants to reap millions of dollars in unlawful windfall profits at the expense of the company. One law firm alone recently filed thirty-four derivative suits. It's the largest area of civil litigation in history that is beginning to unfold before our very eyes.

Shareholder Derivative Suits

Shareholder derivative suits are increasingly filed in connection with class action suits. A primary concern is that directors and officers will find themselves without coverage for defense costs, awards for plaintiff's attorneys' fees, and a monetary settlement. Director & officer insurance policies sometimes exclude payments for non-civil litigation, as where certain types of fraud that involve scienter exist. Even if it does, usually the coverage does not begin until an indictment is brought. Another area that contains elements of peril is that often payments are made on a first-come, first-served basis—in other words, in the order that claims are filed. This can often lead to a shortage in the case of a settlement.

There is an upward trend in filings of derivative suits, which are filed primarily in state courts, as opposed to class action suits, filed in federal district courts. State courts often permit plaintiffs to recover on non-unanimous verdicts (required in the federal system), and some state laws permit lower standards of findings for recovery purposes. These stand-alone derivative suits are normally for breach of fiduciary duty, proxy violations, excessive compensation, and breach of the duty of care or duty of loyalty.

The business judgment rule supports active decisions of the board of directors, but it does not cover these breaches. The business judgment rule is the primary guidance for directors' conduct. If a director exercises a duty of loyalty and a duty of care or diligence in making business decisions, then the courts will not second-guess his decisions, unless negligence is involved. For example, breach of the duty of care does not cover unintelligent decisions, ill-advised actions, or illegal breach of federal laws. Failure to question management representations is another example of this type of breach.

One solution to adequate D&O coverage is a Side A-only policy, which can protect directors and officers from losses not normally indemnified. These policies typically provide coverage even under adverse conditions, including corporate bankruptcy, when the limits of the traditional policy have been exhausted, and in cases where the normal policy excludes payments. Some states do not permit corporate indemnification of unsuccessful defense against derivative suits, and in these cases, as well, a Side A-only policy will provide coverage.

The Private Securities Litigation Reform Act of 1995 provided modifications and a safe harbor for corporations in one aspect of derivative suits—the forward-looking statement. Tenuous inferences are not permitted in plaintiff pleadings. Allegations must include specificity as to falseness or why the statements made by the company were misleading. Under the safe harbor provisions of the Reform Act, a company is not liable for projections that are inaccurate if such statements are properly identified and accompanied by a cautionary statement that indicates that actual results could differ from projected results. Liability also does not exist if the plaintiff does not prove the forward-looking statement was made with knowledge that it was misleading. Forward-looking statements are often made orally at analyst conferences, so this provides some measure of assurance to the corporate public relations department. However, for the option backdating practice, there is no safe harbor.

Trading Models

The economic basis of these settlements is an area of adversarial tests. In a monograph in the early 1990s, several authors criticized the use of trading models to estimate aggregate damages in class action suits, claiming that the results were not reliable and often overstated damages by as much as 74 percent. *Daubert* grounds have been challenged on a variety of proposed models. In *Daubert* the U.S. Supreme Court directed federal courts to consider four factors in evaluating expert testimony under Federal Rule of Evidence 702: (1) the general acceptance of the economic model, (2) potential rate of precision error, (3) peer review or publication, and (4) whether the theory has been tested. In finding that various proposed trading models do not meet these standards, the court is concerned about whether the model has been tested and whether the model has been accepted by professional economists.

The Journal of Legal Economics is a good starting point for obtaining solid valuation models. It is a double-blind, refereed journal. Each manuscript is reviewed by at least three qualified individuals, in addition to the editor. It was conceived as a forum for contributing authors, both from the profession of lawyers and from the quantitative professions of accounting, economics, and finance, to offer constructive insights to colleagues. It is designed to be a useful research tool for application, as well as theory.

In theory, the "out-of-pocket" loss is the measure of damages in open-market class suits. A defrauded buyer can recover his share of class members' damages, less applicable attorney fees, which can range from 15 percent to 30 percent. However, since this actual trading data is buried in repositories, models have been chosen to produce tangible results. The Private Securities Litigation Reform Act of 1995 leaves it open for the court to select the most reliable method of damages proof that is available. Two-trader models also exist, which assume, probably correctly, that there are passive investors and there are traders. Traders, of course, have a higher probability of acquiring and selling shares, and thus this model utilizes parameters for damage estimates with the damages estimated using depository record data. One-trader models often significantly overstate damages by 90 percent to 98 percent. Assumptions can therefore lead to bias. Three-trader models also exist, which involve high-activity investors, low-activity investors, and intraday-traders, who do not utilize overnight positions. Often these traders can account for up to one-third of all trading activity.

Recommendations

One strategy that is sometimes effective is the formation of a special litigation committee (SLC) that has the substance and form of independence. The committee has the responsibility of retaining forensic teams to review thousands of pages of documents and interview hundreds of witnesses. One corporation alone has 2 million documents to review and expects to pay $70 million just to receive a findings report. The purpose of the committee is to provide the court with the "business judgment rule" confidence to dismiss the derivative action. However, this procedure is not as simple and straightforward as it sounds.

Delaware and other states permit the board of directors to respond to suits by appointing an SLC comprising independent directors. As long as the SLC is in process, the derivative suit is stayed. However, when the adversarial process that is under way continues, motions are often filed that question the true objectivity of the SLC. Delaware courts often slam the door to the SLC by ruling against them and letting the suit proceed. SLC members having significant social ties to the defendants in terms of past or future relationships is one disqualification. Another is a public statement by the head of an SLC at any time prior to the issuance of the report that illustrates bias. It is hard to believe this would occur, but in specific cases it has, and it has destroyed the company's defenses from the beginning.

Directors often share institutional and social connections based on board service. This makes it particularly difficult to find objective third parties. Warren Buffet explained it this way: "Why have intelligent and decent directors failed so miserably? The answer lies not in inadequate laws—it's always been clear that directors are obligated to represent the interests of shareholders—but rather in what I'd call 'boardroom atmosphere.' It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision."

Therefore a tremendous litigation explosion in class action and derivative lawsuits has occurred. One CEO in the backdating scandal fled the country over a personal $57 million in allegedly ill-gotten gains. A very lucrative litigation niche has opened both for plaintiff and defense lawyers and expert witnesses. Board membership requests are being declined in record numbers because of the perception of risk of being a director in this environment. However, corporate governance provisions are being taken much more seriously, and since Sarbanes-Oxley mandates them, these recent revelations almost guarantee its place in history.

Corporate Governance Post-Sarbanes-Oxley

This section will address aspects of corporate governance after the passage of the Sarbanes-Oxley law. We'll look at repricing issues for stock options, restricted stock grant usage, valuation of employee stock options, compensation issues, audit committee issues, and merger and acquisition issues. Some of these have been directly affected by Sarbanes, and some have evolved independently of the law.

Employee Stock Options

Employee stock options were formerly disclosed via an estimate of the fair value granted on a pro forma basis in footnotes to the financial statements. On December 16, 2004, FASB 123R mandated that all stock compensation be expensed beginning June 30, 2005, for most public companies. Smaller public companies and private firms had until the first annual reporting period after December 15, 2005. Companies must now recognize the fair value of options payments, utilizing the Black-Scholes-Merton or an equivalent formula, as compensation expense over the vesting period. The Black-Scholes-Merton model has been frequently criticized, as it fails to incorporate the full effects of employee early exercise. Therefore the valuation of employee stock options is a critical matter for boards of directors and compensation committees in order to avoid breaching fiduciary duties.

An ESO valuation firm must be carefully chosen, as under the Sarbanes-Oxley Act, the company CFO and CEO are attesting on a real-time basis as to the accuracy of the financials, including compensation expense. Earnings

misstatements are therefore fraught with peril. Histories of employee exercise and forfeiture and empirical data must be a solid basis for the model. The Black-Scholes-Merton model utilizes a constant interest rate, but the exposure draft recommended the use of interest rates based on zero-coupon U.S. Treasury bonds with different maturities. Blackout periods must also be factored into the model. A custom approach for each corporation is the only solution. Statistical flaws will at a minimum open the board to shareholder suits. A wrong model could misstate by tens of millions the proper level of compensation expense.

Underwater Options

The volatility in the stock market in recent years has created large positions in underwater options. Underwater options are those options whereby one's exercise or strike price, the price at which shares may be purchased, is below market price at the time the block of options vest. When this occurs, the options become "underwater" or worthless. Unfortunately, accounting rules have changed to cause repricing plans to become extremely expensive. FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation," creates an accounting charge equal to the spread between the market price and the exercise price, which is the intrinsic value. At all reporting dates prior to exercise or forfeiture, mark to market accounting will apply, and a variable charge is required. Fixed accounting is available only under strict parameters. Replacement awards cannot occur until six months and one day after the cancellation of the former option grant. No side agreements, formal or informal, may exist in the interim period. Therefore the employee is exposed to various levels of risk during that time frame. Price fluctuations and the continuance of employment are the two primary risks faced.

Restricted Stock Options

Microsoft is one of the first companies to stop utilizing stock options as a result of the complex valuation rules and the repricing issues. Restricted stock options were formerly provided only to top executives, those with seven- and eight-figure compensation plans. However, in light of developments, corporations are following a more realistic approach that involves the assumption that a more level market return on share value

should encompass restricted stock issuance. Restricted is a reference to the vesting schedule. Microsoft's vesting schedule is 20 percent per year. After five years, all of the shares are owned outright, assuming the employee is still with the corporation and that there are no performance-related incentives that also had to be met. Performance incentives could include revenue targets or EPS targets.

The normal ratio of restricted stock to former option grants is in the 25 percent range because the restricted stock will have value regardless of the stock price. Ten thousand shares of $20 stock are worth $200,000. Restricted stock cannot go underwater, as can options. Several years ago a major business school did a study and found that nearly 50 percent of all option grants were underwater—in effect worthless as of that point in time. Restricted stock that has vested has value equal to the share price. When restricted stock vests annually or on schedule, the corporation realizes expense, and the employee realizes income.

Audit Committee Issues

The Sarbanes-Oxley Act of 2002 has imposed requirements that affect the audit committee. Either the charter or the policies of the audit committee need to be modified to reflect these changes. To begin with, it is a good idea for the committee to review the filings of their firm with PCAOB. These are matters of public information. The PCAOB reviews the quality of the work produced by the Big Four, as well as the thousands of other firms that are registered. These reports, with some proprietary information redacted, are available for public view on the site of the PCAOB.

An important calendar date for audit committees is the five-year term maximum for the audit partner and planning for his replacement. Another section of Sarbanes-Oxley, 206, requires a moratorium on hiring in certain positions individuals who have participated in the company audit over the prior year.

Sarbanes further requires total independence of directors on the audit committee. This refers to their not being affiliated with the company in any respect, as being an officer, and also refers to consulting compensation that would taint independence. Interlocking directorships continue to be

prohibited by the Clayton Act. On January 13, 2006, the FTC also announced revised thresholds for interlocking directorates, which were effective immediately. Section 8 of the Clayton Act prohibits a person from serving as a director or officer of two competing corporations if certain thresholds are met. The prohibition against interlocking directors applies if a corporation has more than $10 million (as adjusted) in capital, surplus, and undivided profits; however, if either corporation has less than $1 million (as adjusted) in competitive sales, then the prohibition does not apply.

The audit committee also needs to have authority to engage independent counsel and forensic experts, as necessary, to carry out its duties. Usually when special circumstances arise, a sub-committee is formed with these individuals present on it. Reports are issued back to the audit committee, and ultimately to the board of directors.

The audit committee should be able to receive confidential, anonymous submission by employees of the company regarding questionable auditing matters. Some companies provide encrypted communication and log files as part of the services and can provide this service for the committee.

The audit committee has the responsibility to ask auditors whether any person has taken action to fraudulently affect the financial statements. Section 3 of Sarbanes uses broad language in providing that a violation of Sarbanes, any rule or regulation of the SEC under Sarbanes, or any rule of the Public Company Accounting Oversight Board will be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934. Under the Sarbanes-Oxley Act, lying to auditors is a federal offense.

Each audit committee must have at least one financial expert. The committee further has responsibilities to ensure document retention policies in accordance with SEC rules are followed.

Compensation Committee Issues

Under the Sarbanes-Oxley Act, Section 304, the compensation committee has the responsibility to monitor the repayment of compensation, either

bonus or equity-based, from officers in the case of restatements due to misconduct.

Insider trading policies should be reviewed to determine that directors and officers cannot trade during blackout periods, and that the thirty-day notification rule about a pending blackout period is adequately communicated to all interested employees.

Extensions of credit may not be renewed under Sarbanes, and the company, specifically the committee, is required to determine that officers can finance or leverage out of their loan arrangements at the expiration of their current loans.

Insider trading reporting is now required for directors, officers, and 10 percent or more shareholders on Form 4 within a two-business-day period. Arrangements should be handled to establish control policies with brokerage houses to immediately report to in-house counsel all insider-trading transactions.

Conflicts of interest with investment banking houses should be reviewed. Changes should be made to resolve any outstanding issues. Investment banks that promote a stock while publishing analysis of the same stock are an example of a major conflict of interest that affects investors. Nine-figure settlements often follow such violations.

Merger and Acquisition Issues

In the United States, "poison pills," the anti-takeover strategy, seem to be in decline in the wake of the governance reforms of Sarbanes-Oxley. But in Canada, where the pills last for three years and are shareholder-approved, the strategy is growing stronger.

Poison pills are unique in anti-acquisition strategy in that they discourage corporate raiders from paying an inflated price (and subsequently reaping profits from dismantling whole divisions and selling them piecemeal). The poison pill strategy is based on shareholder rights in the corporate charter. When a takeover bid begins to purchase 10 percent to 20 percent or more of a company's stock, the board of directors issues preferred stock to

common shareholders. The common shareholders are permitted (if the takeover occurs) to redeem their shares for a very high price or convert them into the stock of the controlling company—the takeover company. Therefore there is a high expense left with the takeover corporation—either in the payment of buying stock back at inflated prices or paying huge dividends.

Normally poison pills are not effective unless combined with a staggered board of directors, elected over a period of more than one year. In the 1990s the majority of companies had some form of poison pill strategy. Courts have upheld the legality, beginning with a landmark 1985 decision (*Moran v. Household International,* 500 A.2d 1346). The arguments against them are primarily a concern that shareholder value can be limited by retaining entrenched management, but that is not a legal issue. As long as the provision is in the corporate charter, they can be utilized to defend against unwarranted intrusion via hostile takeover bids.

In conclusion, Sarbanes-Oxley has changed the landscape and the way directors and committee members must think and plan in order to defend their positions while sustaining and maximizing shareholder value, their primary mission objective. Checklists of issues raised by the act are now mandatory for consideration and implementation by boards throughout the United States, and foreign companies are subject to the Sarbanes-Oxley law via their listings on U.S. exchanges.

Conclusion

The new regime under Sarbanes-Oxley, as well as Basel, requires directors to create an audit trail to prove they have carried out due diligence on the required information. It is not enough just to put in place the required measures—they must be tested, proven, and then certified in annual and quarterly filings. The information in this book will empower directors, senior management, and educators with a combination of narrative and case study that allows them to stay updated in the world today in the esoteric field of Sarbanes-Oxley.

The Canadian Securities Administrators developed a Canadian equivalent to Sarbanes-Oxley, recognizing its benefits and its applicability to the Canadian marketplace. As with the Sarbanes-Oxley Act, the aim is to improve the quality and reliability of financial reporting and maintain the confidence of the public. Multilateral Instrument 52-111 (Reporting on Internal Control over Financial Reporting) is Canada's equivalent to Section 404 of the Sarbanes-Oxley Act.

The new UK regime, set out in the Companies (Audit, Investigations and Community Enterprise) Act of 2004, requires companies to adopt more stringent information security measures to ensure the accuracy and integrity of their records. Included in the sections of the act brought into force is a requirement that directors issue a statement in the auditor's report, confirming that they provided the auditors with all of the relevant information needed to properly prepare the report. Directors who fraudulently or negligently allow the statement to go into the report commit an offense under the act punishable by fine or imprisonment.

Central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries have endorsed the publication of the new capital adequacy framework commonly known as Basel II. Basel II updates 1988 standards, and has a proposed phase-in period of 2007 to 2011. The

eleven largest U.S. banks will have to adopt Basel II, and other large banks may voluntarily join the standard, bringing to about twenty the number of banks subject to the revised standard (compared to 15,000 publicly held companies and non-U.S. companies with more than 300 shareholders subject to Sarbanes). The 1988 accord set capital requirements without regard to creditworthiness and thus is considered by many out-of-date. Initially applying only to the G10 countries, Basel I eventually was adopted in up to 100 countries and became an international standard.

The challenge is often stated as to how much in capital reserves can be considered a sufficient hedge against catastrophic losses. Low levels of capital can put depositors at risk. On the other hand, if capital requirements are too stringent, efficient utilization of resources cannot occur. Market transparency is also enhanced by additional financial disclosure and internal control frameworks under Basel II. Operational risk assessment is the basis of the new standard. Technology failure, fraud, and extreme risks, such as those posed by a rogue trader, are included in this methodology. Banks are required to establish risk management structures that create full financial disclosure under Basel II. The U.S. Congress has legislation under way to control the implementation of Basel II in the United States.

Basel II defines operational risk in terms of failed or inadequate internal control policies. Sarbanes defines risk in terms of control objectives and the resultant key controls that affect material financial reporting. The frameworks are similar but different. A great deal more latitude is provided international banks under Basel II to prioritize their risk assessment matrix. However, banks are required to document processes and controls in much the same way as under Sarbanes. Internal and external auditors are needed to provide the analysis necessary to achieve these goals. Prevention of disclosure failure and the mitigation of risk are goals under both Basel and Sarbanes.

The PCAOB and the SEC have set guidelines for auditors under Sarbanes. Management choices increase under Basel II, but the priorities remain goal-oriented, and companies, with banks to follow, must comply with these regulatory bodies on schedule. It is imperative to study cases and methodologies and ultimately learn from the successes and failures of the past. Whenever cost-effective solutions can be derived, whether from

mathematical permutations or the design of internal control systems based on experience and case studies, the directive to proceed has been issued, and those corporations that will succeed will need to apply on a practical level the knowledge base so far developed.

Appendix A

Foreign Corrupt Practices Act

CONTENTS

Foreign Corrupt Practices Act

Anti-Bribery Provisions

United States Department of Justice
Fraud Section, Criminal Division
10th & Constitution Avenue, NW (Bond 4th Fl.)
Washington, D.C. 20530
phone: (202) 514-7023
fax: (202) 514-7021
internet:
www.usdoj.gov/criminal/fraud/fcpa/fcpa.html
email: FCPA.fraud@usdoj.gov

United States Department of Commerce
Office of the Chief Counsel for International Commerce
14th Street and Constitution Avenue, NW
Room 5882
Washington, D.C. 20230
phone: (202) 482-0937
fax: (202) 482-4076
internet:
www.ita.doc.gov/legal

INTRODUCTION

The 1988 Trade Act directed the Attorney General to provide guidance concerning the Department of Justice's enforcement policy with respect to the Foreign Corrupt Practices Act of 1977 ("FCPA"), 15 U.S.C. §§ 78dd-1, *et seq.*, to potential exporters and small businesses that are unable to obtain specialized counsel on issues related to the FCPA. The guidance is limited to responses to requests under the Department of Justice's Foreign Corrupt Practices Act Opinion Procedure (described below at p. 10) and to general explanations of compliance responsibilities and potential liabilities under the FCPA. This brochure constitutes the Department of Justice's general explanation of the FCPA.

U.S. firms seeking to do business in foreign markets must be familiar with the FCPA. In general, the FCPA prohibits corrupt payments to foreign officials for the purpose of obtaining or keeping business. In addition, other statutes such as the mail and wire fraud statutes, 18 U.S.C. § 1341, 1343, and the Travel Act, 18 U.S.C. § 1952, which provides for federal

prosecution of violations of state commercial bribery statutes, may also apply to such conduct.

The Department of Justice is the chief enforcement agency, with a coordinate role played by the Securities and Exchange Commission (SEC). The Office of General Counsel of the Department of Commerce also answers general questions from U.S. exporters concerning the FCPA's basic requirements and constraints.

This brochure is intended to provide a general description of the FCPA and is not intended to substitute for the advice of private counsel on specific issues related to the FCPA. Moreover, material in this brochure is not intended to set forth the present enforcement intentions of the Department of Justice or the SEC with respect to particular fact situations.

BACKGROUND

As a result of SEC investigations in the mid-1970's, over 400 U.S. companies admitted making questionable or illegal payments in excess of $300 million to foreign government officials, politicians, and political parties. The abuses ran the gamut from bribery of high foreign officials to secure some type of favorable action by a foreign government to so-called facilitating payments that allegedly were made to ensure that government functionaries discharged certain ministerial or clerical duties. Congress enacted the FCPA to bring a halt to the bribery of foreign officials and to restore public confidence in the integrity of the American business system.

The FCPA was intended to have and has had an enormous impact on the way American firms do business. Several firms that paid bribes to foreign officials have been the subject of criminal and civil enforcement actions, resulting in large fines and suspension and debarment from federal procurement contracting, and their employees and officers have gone to jail. To avoid such consequences, many firms have implemented detailed compliance programs intended to prevent and to detect any improper payments by employees and agents.

Following the passage of the FCPA, the Congress became concerned that American companies were operating at a disadvantage compared to foreign

companies who routinely paid bribes and, in some countries, were permitted to deduct the cost of such bribes as business expenses on their taxes. Accordingly, in 1988, the Congress directed the Executive Branch to commence negotiations in the Organization of Economic Cooperation and Development (OECD) to obtain the agreement of the United States' major trading partners to enact legislation similar to the FCPA. In 1997, almost ten years later, the United States and thirty-three other countries signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The United States ratified this Convention and enacted implementing legislation in 1998. *See* Convention and Commentaries on the DOJ web site.

The anti-bribery provisions of the FCPA make it unlawful for a U.S. person, and certain foreign issuers of securities, to make a corrupt payment to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to, any person. Since 1998, they also apply to foreign firms and persons who take any act in furtherance of such a corrupt payment while in the United States.

The FCPA also requires companies whose securities are listed in the United States to meet its accounting provisions. *See* 15 U.S.C. § 78m. These accounting provisions, which were designed to operate in tandem with the anti-bribery provisions of the FCPA, require corporations covered by the provisions to make and keep books and records that accurately and fairly reflect the transactions of the corporation and to devise and maintain an adequate system of internal accounting controls. This brochure discusses only the anti-bribery provisions.

ENFORCEMENT

The Department of Justice is responsible for all criminal enforcement and for civil enforcement of the anti-bribery provisions with respect to domestic concerns and foreign companies and nationals. The SEC is responsible for civil enforcement of the anti-bribery provisions with respect to issuers.

ANTI-BRIBERY PROVISIONS

BASIC PROHIBITION

The FCPA makes it unlawful to bribe foreign government officials to obtain or retain business. With respect to the basic prohibition, there are five elements which must be met to constitute a violation of the Act:

A. Who -- The FCPA potentially applies to *any* individual, firm, officer, director, employee, or agent of a firm and any stockholder acting on behalf of a firm. Individuals and firms may also be penalized if they order, authorize, or assist someone else to violate the anti-bribery provisions or if they conspire to violate those provisions.

Under the FCPA, U.S. jurisdiction over corrupt payments to foreign officials depends upon whether the violator is an "issuer," a "domestic concern," or a foreign national or business.

An "issuer" is a corporation that has issued securities that have been registered in the United States or who is required to file periodic reports with the SEC. A "domestic concern" is any individual who is a citizen, national, or resident of the United States, or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of business in the United States, or which is organized under the laws of a State of the United States, or a territory, possession, or commonwealth of the United States.

Issuers and domestic concerns may be held liable under the FCPA under *either* territorial or nationality jurisdiction principles. For acts taken within the territory of the United States, issuers and domestic concerns are liable if they take an act in furtherance of a corrupt payment to a foreign official using the U.S. mails or other means or instrumentalities of interstate commerce. Such means or instrumentalities include telephone calls, facsimile transmissions, wire transfers, and interstate or international travel. In addition,

issuers and domestic concerns may be held liable for any act in furtherance of a corrupt payment taken *outside* the United States. Thus, a U.S. company or national may be held liable for a corrupt payment authorized by employees or agents operating entirely outside the United States, using money from foreign bank accounts, and without any involvement by personnel located within the United States.

Prior to 1998, foreign companies, with the exception of those who qualified as "issuers," and foreign nationals were not covered by the FCPA. The 1998 amendments expanded the FCPA to assert territorial jurisdiction over foreign companies and nationals. A foreign company or person is now subject to the FCPA if it causes, directly or through agents, an act in furtherance of the corrupt payment to take place within the territory of the United States. There is, however, no requirement that such act make use of the U.S. mails or other means or instrumentalities of interstate commerce.

Finally, U.S. parent corporations may be held liable for the acts of foreign subsidiaries where they authorized, directed, or controlled the activity in question, as can U.S. citizens or residents, themselves "domestic concerns," who were employed by or acting on behalf of such foreign-incorporated subsidiaries.

B. Corrupt intent-- The person making or authorizing the payment must have a corrupt intent, and the payment must be intended to induce the recipient to misuse his official position to direct business wrongfully to the payer or to any other person. You should note that the FCPA does not require that a corrupt act succeed in its purpose. The *offer* or *promise* of a corrupt payment can constitute a violation of the statute. The FCPA prohibits any corrupt payment intended to *influence* any act or decision of a foreign official in his or her official capacity, to induce the official to do or omit to do any act in violation of his or her lawful duty, to obtain any improper advantage, or to *induce* a foreign official to use his or her influence improperly to affect or influence any act or decision.

C. Payment -- The FCPA prohibits paying, offering, promising to pay (or authorizing to pay or offer) money or anything of value.

D. Recipient -- The prohibition extends only to corrupt payments to a *foreign official*, a *foreign political party* or *party official*, or any *candidate* for foreign political office. A "foreign official" means any officer or employee of a foreign government, a public international organization, or any department or agency thereof, or any person acting in an official capacity. You should consider utilizing the Department of Justice's Foreign Corrupt Practices Act Opinion Procedure for particular questions as to the definition of a "foreign official," such as whether a member of a royal family, a member of a legislative body, or an official of a state-owned business enterprise would be considered a "foreign official."

The FCPA applies to payments to *any* public official, regardless of rank or position. The FCPA focuses on the *purpose* of the payment instead of the particular duties of the official receiving the payment, offer, or promise of payment, and there are exceptions to the anti-bribery provision for "facilitating payments for routine governmental action" (see below).

E. Business Purpose Test -- The FCPA prohibits payments made in order to assist the firm in *obtaining* or *retaining business* for or with, or *directing business* to, any person. The Department of Justice interprets "obtaining or retaining business" broadly, such that the term encompasses more than the mere award or renewal of a contract. It should be noted that the business to be obtained or retained does *not* need to be with a foreign government or foreign government instrumentality.

THIRD PARTY PAYMENTS

The FCPA prohibits corrupt payments through intermediaries. It is unlawful to make a payment to a third party, while knowing that all or a portion of the payment will go directly or indirectly to a foreign official. *The term "knowing" includes conscious disregard and deliberate ignorance.* The elements of an offense are essentially the same as described above, except that in this

case the "recipient" is the intermediary who is making the payment to the requisite "foreign official."

Intermediaries may include joint venture partners or agents. To avoid being held liable for corrupt third party payments, U.S. companies are encouraged to exercise due diligence and to take all necessary precautions to ensure that they have formed a business relationship with reputable and qualified partners and representatives. Such due diligence may include investigating potential foreign representatives and joint venture partners to determine if they are in fact qualified for the position, whether they have personal or professional ties to the government, the number and reputation of their clientele, and their reputation with the U.S. Embassy or Consulate and with local bankers, clients, and other business associates. In addition, in negotiating a business relationship, the U.S. firm should be aware of so-called "red flags," *i.e.*, unusual payment patterns or financial arrangements, a history of corruption in the country, a refusal by the foreign joint venture partner or representative to provide a certification that it will not take any action in furtherance of an unlawful offer, promise, or payment to a foreign public official and not take any act that would cause the U.S. firm to be in violation of the FCPA, unusually high commissions, lack of transparency in expenses and accounting records, apparent lack of qualifications or resources on the part of the joint venture partner or representative to perform the services offered, and whether the joint venture partner or representative has been recommended by an official of the potential governmental customer.

You should seek the advice of counsel and consider utilizing the Department of Justice's Foreign Corrupt Practices Act Opinion Procedure for particular questions relating to third party payments.

PERMISSIBLE PAYMENTS AND AFFIRMATIVE DEFENSES

The FCPA contains an explicit exception to the bribery prohibition for "facilitating payments" for "routine governmental action" and provides affirmative defenses which can be used to defend against alleged violations of the FCPA.

FACILITATING PAYMENTS FOR ROUTINE GOVERNMENTAL ACTIONS

There is an exception to the anti-bribery prohibition for payments to facilitate or expedite performance of a "routine governmental action." The statute lists the following examples: obtaining permits, licenses, or other official documents; processing governmental papers, such as visas and work orders; providing police protection, mail pick-up and delivery; providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products; and scheduling inspections associated with contract performance or transit of goods across country.

Actions "similar" to these are also covered by this exception. If you have a question about whether a payment falls within the exception, you should consult with counsel. You should also consider whether to utilize the Justice Department's Foreign Corrupt Practices Opinion Procedure.

"Routine governmental action" does *not* include any decision by a foreign official to award new business or to continue business with a particular party.

AFFIRMATIVE DEFENSES

A person charged with a violation of the FCPA's anti-bribery provisions may assert as a defense that the payment was lawful under the written laws of the foreign country or that the money was spent as part of demonstrating a product or performing a contractual obligation.

Whether a payment was lawful under the written laws of the foreign country may be difficult to determine. You should consider seeking the advice of counsel or utilizing the Department of Justice's Foreign Corrupt Practices Act Opinion Procedure when faced with an issue of the legality of such a payment.

Moreover, because these defenses are "affirmative defenses," the defendant is required to show in the first instance that the payment met these requirements. The prosecution does not bear the burden of demonstrating

in the first instance that the payments did not constitute this type of payment.

SANCTIONS AGAINST BRIBERY

CRIMINAL

The following criminal penalties may be imposed for violations of the FCPA's anti-bribery provisions: corporations and other business entities are subject to a fine of up to $2,000,000; officers, directors, stockholders, employees, and agents are subject to a fine of up to $100,000 and imprisonment for up to five years. Moreover, under the Alternative Fines Act, these fines may be actually quite higher -- the actual fine may be up to twice the benefit that the defendant sought to obtain by making the corrupt payment. You should also be aware that fines imposed on individuals may *not* be paid by their employer or principal.

CIVIL

The Attorney General or the SEC, as appropriate, may bring a civil action for a fine of up to $10,000 against any firm *as well as* any officer, director, employee, or agent of a firm, or stockholder acting on behalf of the firm, who violates the anti-bribery provisions. In addition, in an SEC enforcement action, the court may impose an additional fine not to exceed the greater of (i) the gross amount of the pecuniary gain to the defendant as a result of the violation, or (ii) a specified dollar limitation. The specified dollar limitations are based on the egregiousness of the violation, ranging from $5,000 to $100,000 for a natural person and $50,000 to $500,000 for any other person.

The Attorney General or the SEC, as appropriate, may also bring a civil action to enjoin any act or practice of a firm whenever it appears that the firm (or an officer, director, employee, agent, or stockholder acting on behalf of the firm) is in violation (or about to be) of the anti-bribery provisions.

OTHER GOVERNMENTAL ACTION

Under guidelines issued by the Office of Management and Budget, a person or firm found in violation of the FCPA may be barred from doing business with the Federal government. *Indictment alone can lead to suspension of the right to do business with the government.* The President has directed that no executive agency shall allow any party to participate in any procurement or non-procurement activity if any agency has debarred, suspended, or otherwise excluded that party from participation in a procurement or non-procurement activity.

In addition, a person or firm found guilty of violating the FCPA may be ruled ineligible to receive export licenses; the SEC may suspend or bar persons from the securities business and impose civil penalties on persons in the securities business for violations of the FCPA; the Commodity Futures Trading Commission and the Overseas Private Investment Corporation both provide for possible suspension or debarment from agency programs for violation of the FCPA; and a payment made to a foreign government official that is unlawful under the FCPA cannot be deducted under the tax laws as a business expense.

PRIVATE CAUSE OF ACTION

Conduct that violates the anti-bribery provisions of the FCPA may also give rise to a private cause of action for treble damages under the Racketeer Influenced and Corrupt Organizations Act (RICO), or to actions under other federal or state laws. For example, an action might be brought under RICO by a competitor who alleges that the bribery caused the defendant to win a foreign contract.

GUIDANCE FROM THE GOVERNMENT

The Department of Justice has established a Foreign Corrupt Practices Act Opinion Procedure by which any U.S. company or national may request a statement of the Justice Department's present enforcement intentions under the anti-bribery provisions of the FCPA regarding any proposed business conduct. The details of the opinion procedure may be found at 28 CFR Part 80. Under this procedure, the Attorney General will issue an

opinion in response to a specific inquiry from a person or firm within thirty days of the request. (The thirty-day period does not run until the Department of Justice has received all the information it requires to issue the opinion.) Conduct for which the Department of Justice has issued an opinion stating that the conduct conforms with current enforcement policy will be entitled to a presumption, in any subsequent enforcement action, of conformity with the FCPA. Copies of releases issued regarding previous opinions are available on the Department of Justice's FCPA web site.

For further information from the Department of Justice about the FCPA and the Foreign Corrupt Practices Act Opinion Procedure, contact Mark F. Mendelsohn, Deputy Chief, Fraud Section, at (202) 514-1721; or Deborah Gramiccioni, Assistant Chief, Fraud Section, at (202) 353-0449.

Although the Department of Commerce has no enforcement role with respect to the FCPA, it supplies general guidance to U.S. exporters who have questions about the FCPA and about international developments concerning the FCPA. For further information from the Department of Commerce about the FCPA contact Eleanor Roberts Lewis, Chief Counsel for International Commerce, or Arthur Aronoff, Senior Counsel, Office of the Chief Counsel for International Commerce, U.S. Department of Commerce, Room 5882, 14th Street and Constitution Avenue, N.W., Washington, D.C. 20230, (202) 482-0937.

Last Updated: January 2006
usdoj/criminal/fraud/mm:dlj

FCPA - Opinion Procedure Regulations

FOREIGN CORRUPT PRACTICES ACT OPINION PROCEDURE

28 C.F.R. part 80 (current as of July 1, 1999)

Sec. 80.1 Purpose.

These procedures enable issuers and domestic concerns to obtain an opinion of the Attorney General as to whether certain specified, prospective--not hypothetical--conduct conforms with the Department's present enforcement policy regarding the anti-bribery provisions of the Foreign Corrupt Practices Act of 1977, as amended, 15 U.S.C. 78dd-1 and 78dd-2. An opinion issued pursuant to these procedures is a Foreign Corrupt Practices Act opinion (hereinafter FCPA Opinion).

Sec. 80.2 Submission requirements.

A request for an FCPA Opinion must be submitted in writing. An original and five copies of the request should be addressed to the Assistant Attorney General in charge of the Criminal Division, Attention: FCPA Opinion Group. The mailing address is 10th & Constitution Avenue, NW, Bond Building, Washington DC 20530.

Sec. 80.3 Transaction.

The entire transaction which is the subject of the request must be an actual--not a hypothetical--transaction but need not involve only prospective conduct. However, a request will not be considered unless that portion of the transaction for which an opinion is sought involves only prospective conduct. An executed contract is not a prerequisite and, in most--if not all--instances, an opinion request should be made prior to the requestor's commitment to proceed with a transaction.

Sec. 80.4 Issuer or domestic concern.

The request must be submitted by an issuer or domestic concern within the meaning of 15 U.S.C. 78dd-1 and 78dd-2, respectively, that is also a party to the transaction which is the subject of the request.

Sec. 80.5 Affected parties.

An FCPA Opinion shall have no application to any party which does not join in the request for the opinion.

Sec. 80.6 General requirements.

Each request shall be specific and must be accompanied by all relevant and material information bearing on the conduct for which an FCPA Opinion is requested and on the circumstances of the prospective conduct, including background information, complete copies of all operative documents, and detailed statements of all collateral or oral understandings, if any. The requesting issuer or domestic concern is under an affirmative obligation to make full and true disclosure with respect to the conduct for which an opinion is requested. Each request on behalf of a requesting issuer or corporate domestic concern must be signed by an appropriate senior officer with operational responsibility for the conduct that is the subject of the request and who has been designated by the requestor's chief executive officer to sign the opinion request. In appropriate cases, the Department of Justice may require the chief executive officer of each requesting issuer or corporate domestic concern to sign the request. All requests of other domestic concerns must also be signed. The person signing the request must certify that it contains a true, correct and complete disclosure with respect to the proposed conduct and the circumstances of the conduct.

Sec. 80.7 Additional information.

If an issuer's or domestic concern's submission does not contain all of the information required by Sec. 80.6, the Department of Justice may request whatever additional information or documents it deems necessary to review the matter. The Department must do so within 30 days of receipt of the opinion request, or, in the case of an incomplete response to a previous

request for additional information, within 30 days of receipt of such response. Each issuer or domestic concern requesting an FCPA Opinion must promptly provide the information requested. A request will not be deemed complete until the Department of Justice receives such additional information. Such additional information, if furnished orally, shall be promptly confirmed in writing, signed by the same person or officer who signed the initial request and certified by this person or officer to be a true, correct and complete disclosure of the requested information. In connection with any request for an FCPA Opinion, the Department of Justice may conduct whatever independent investigation it believes appropriate.

Sec. 80.8 Attorney General opinion.

The Attorney General or his designee shall, within 30 days after receiving a request that complies with the foregoing procedure, respond to the request by issuing an opinion that states whether the prospective conduct, would, for purposes of the Department of Justice's present enforcement policy, violate 15 U.S.C. 78dd-1 and 78dd-2. The Department of Justice may also take such other positions or action as it considers appropriate. Should the Department request additional information, the Department's response shall be made within 30 days after receipt of such additional information.

Sec. 80.9 No oral opinion.

No oral clearance, release or other statement purporting to limit the enforcement discretion of the Department of Justice may be given. The requesting issuer or domestic concern may rely only upon a written FCPA Opinion letter signed by the Attorney General or his designee.

Sec. 80.10 Rebuttable presumption.

In any action brought under the applicable provisions of 15 U.S.C. 78dd-1 and 78dd-2, there shall be a rebuttable presumption that a requestor's conduct, which is specified in a request, and for which the Attorney General has issued an opinion that such conduct is in conformity with the Department's present enforcement policy, is in compliance with those provisions of the FCPA. Such a presumption may be rebutted by a

preponderance of the evidence. In considering the presumption, a court, in accordance with the statute, shall weigh all relevant factors, including but not limited to whether information submitted to the Attorney General was accurate and complete and whether the activity was within the scope of the conduct specified in any request received by the Attorney General.

Sec. 80.11 Effect of FCPA Opinion.

Except as specified in Sec. 80.10, an FCPA Opinion will not bind or obligate any agency other than the Department of Justice. It will not affect the requesting issuer's or domestic concern's obligations to any other agency, or under any statutory or regulatory provision other than those specifically cited in the particular FCPA Opinion.

Sec. 80.12 Accounting requirements.

Neither the submission of a request for an FCPA Opinion, its pendency, nor the issuance of an FCPA Opinion, shall in any way alter the responsibility of an issuer to comply with the accounting requirements of 15 U.S.C. 78m(b)(2) and (3).

Sec. 80.13 Scope of FCPA Opinion.

An FCPA Opinion will state only the Attorney General's opinion as to whether the prospective conduct would violate the Department's present enforcement policy under 15 U.S.C. 78dd-1 and 78dd-2. If the conduct for which an FCPA Opinion is requested is subject to approval by any other agency, such FCPA Opinion shall in no way be taken to indicate the Department of Justice's views on the legal or factual issues that may be raised before that agency, or in an appeal from the agency's decision.

Sec. 80.14 Disclosure.

(a) Any document or other material which is provided to, received by, or prepared in the Department of Justice or any other department or agency of the United States in connection with a request by an issuer or domestic concern under the foregoing procedure shall be exempt from disclosure under 5 U.S.C. 552 and shall not, except with the consent of the issuer or

domestic concern, be made publicly available, regardless of whether the Attorney General responds to such a request or the issuer or domestic concern withdraws such request before receiving a response.

(b) Nothing contained in paragraph (a) of this section shall limit the Department of Justice's right to issue, at its discretion, a release describing the identity of the requesting issuer or domestic concern, the identity of the foreign country in which the proposed conduct is to take place, the general nature and circumstances of the proposed conduct, and the action taken by the Department of Justice in response to the FCPA Opinion request. Such release shall not disclose either the identity of any foreign sales agents or other types of identifying information. The Department of Justice shall index such releases and place them in a file available to the public upon request.

(c) A requestor may request that the release not disclose proprietary information.

Sec. 80.15 Withdrawal.

A request submitted under the foregoing procedure may be withdrawn prior to the time the Attorney General issues an opinion in response to such request. Any request so withdrawn shall have no force or effect. The Department of Justice reserves the right to retain any FCPA Opinion request, documents and information submitted to it under this procedure or otherwise and to use them for any governmental purposes, subject to the restrictions on disclosures in Sec. 80.14.

Sec. 80.16 Additional requests.

Additional requests for FCPA Opinions may be filed with the Attorney General under the foregoing procedure regarding other prospective conduct that is beyond the scope of conduct specified in previous requests.

Department of Justice

EVENT: GUILTY PLEA
Defendant: The Titan Corporation

FOR IMMEDIATE RELEASE

March 1, 2005

OFFICE OF THE UNITED STATES ATTORNEY
SOUTHERN DISTRICT OF CALIFORNIA
San Diego, California

United States Attorney
Carol C. Lam

CONTACT: Assistant U. S. Attorney
Eric J. Beste (619) 557-5104
For Immediate Release

NEWS RELEASE SUMMARY - March 1, 2005

United States Attorney Carol C. Lam and United States Department of Justice, Criminal Division, Fraud Section Chief Joshua R. Hochberg jointly announced that The Titan Corporation ("Titan"), a San Diego, California-based military intelligence and communications company, pled guilty today to a three-count Information charging it with one felony count of Bribery under the Foreign Corrupt Practices Act ("FCPA"), in violation of Title 15, United States Code, Section 78dd-1, one felony count of Falsification of Books and Records under the FCPA, in violation of Title 15, United States Code, Sections 78m(b)(2)(A) and 78m(b)(5), and one felony count of Aiding or Assisting in the Filing of a False Tax Return, in violation of Title 26, United States Code, Section 7206(2). Titan entered its guilty plea, pursuant to a plea agreement with the United States, in Federal District Court in San Diego before the Honorable Roger T. Benitez, United States District Court Judge. In the same proceeding, Judge Benitez sentenced Titan to pay a criminal fine of $13,000,000, and ordered the company to serve 3 years of supervised probation. As a condition of probation, Judge

Benitez ordered Titan to institute a strict compliance program and internal controls designed to prevent future FCPA violations.

The FCPA requires issuers of publicly-traded securities to refrain from making corrupt payments to foreign government officials and candidates for foreign political office, and to implement policies and practices that reduce the risk that employees and agents will engage in bribery. The instant charges stem from Titan's corrupt payment of more than $2 million, through an agent in the Republic of Benin, towards the election campaign of Benin's then-incumbent President. The Information does not allege that the then-incumbent President of Benin knew of the corrupt payments, and no criminal charges have been brought against him.

According to the Information, beginning in or about 1998, Titan and its subsidiaries embarked on a project with the African nation of Benin to build and operate a wireless telephone network in that country. Part of Titan's compensation for this project included a management fee worth millions of dollars. In order to secure and keep this business, Titan engaged the services of an agent who claimed to have close ties to the then-President of Benin. Beginning in 1999, without performing adequate due diligence to determine if its agent was complying with the FCPA, Titan began paying this agent hundreds of thousands of dollars for "consulting" services that were never properly documented or shown to have been performed.

As recounted in the Information, in or about January 2001, Titan began making improper payments to the Benin agent for the purpose of influencing the upcoming presidential election in Benin. Specifically, employees and agents of Titan agreed to pay millions of dollars to the Benin agent with the intent of supporting the then-incumbent President of Benin's reelection campaign, under the guise of making "social payments" towards the betterment of the people of Benin. At the request of Titan, the Benin agent submitted false invoices to Titan totaling over $2 million for these funds, and Titan paid the bribes to the Benin agent in several installments between January 2001 and May 2001.

The Information alleges that Titan's illegal payments further violated the FCPA's prohibition on the falsification of books, records, and accounts of

publicly-traded companies. Titan had a duty under federal securities law to make and keep books, records and accounts which accurately and fairly reflected the transactions and disposition of its assets. By using false invoices to conceal its improper payments in Benin, Titan knowingly falsified its books, records, and accounts. In addition, as outlined in the Information, Titan violated federal tax laws by claiming the bribes as deductible business expenses on its federal income tax return.

Pursuant to the plea agreement, Titan and the government had agreed to recommend that Titan pay a $13 million criminal fine in this case. Titan has also agreed to pay $15.4 million in disgorgement and prejudgment interest in a parallel civil case to be filed today by the United States Securities and Exchange Commission in Federal District Court in Washington, D.C. The combined civil/criminal penalty of $28 million imposed on Titan is the largest FCPA civil/criminal penalty to date for a public company.

In announcing today's guilty plea and sentencing, United States Attorney Lam said, "Titan's payment of the largest combined FCPA criminal and civil penalty in history demonstrates both the severity and scope of the misconduct in this case. All United States companies should take note that attempting to bribe foreign officials is criminal conduct and will be appropriately prosecuted." United States Attorney Lam noted that the criminal investigation into the bribery allegations outlined in the Information continues.

San Diego Federal Bureau of Investigation Special Agent in Charge Daniel R. Dzwilewski noted, "Titan admitted corruptly making payments intended to influence the outcome of the election in Benin. Titan's egregious acts warranted the use of this particular measure and should send a clear message that corporations will be held accountable both criminally and civilly for their actions, not only within the confines of the United States, but also their dealings in foreign countries."

Rick W. Gwin, Special Agent in Charge, Defense Criminal Investigative Service, stated, "Titan is a major Department of Defense contractor, and is commonly referred to as a 'Top 100 Defense Contractor,' with annual sales to the Department of Defense of over $1 billion. This plea demonstrates

the Department of Defense's commitment to ensuring that its contracting parties play by the rules."

Denise L. Rubin, IRS Criminal Investigation Special Agent in Charge for San Diego, stated, "The IRS expects the same level of honesty from corporations as from individuals. Tax laws apply to all entities and this investigation underscores the commitment of the IRS Criminal Investigation Division to combat corporate fraud."

The case is the result of a joint investigation by the Federal Bureau of Investigation, San Diego Division; the Internal Revenue Service, Criminal Investigation; and the Defense Criminal Investigative Service, which is the investigative service arm of the Department of Defense Inspector General's Office. These agencies and the Department of Justice worked cooperatively with a parallel civil investigation being conducted by the United States Securities and Exchange Commission, Division of Enforcement.

The Department of Justice's investigation is continuing.

DEFENDANT
Titan Corporation San Diego, California

SUMMARY OF CHARGES

Count 1: Foreign Corrupt Practices Act (15 U.S.C. § 78dd-1)

Maximum fine of the greater of $2,000,000, or twice the gross pecuniary gain derived from the offense; a maximum term of probation of up to five years; a mandatory special assessment of $400 per count.

Count 2: Falsifying Books & Records (15 U.S.C. § 78m(b)(2)(A))

Maximum fine of the greater of $25,000,000, or twice the gross pecuniary gain derived from the offense; a maximum term of probation of up to five years; a mandatory special assessment of $400 per count.

Count 3: Aid or Assist in Filing of False Return (26 U.S.C. § 7206(2))

Maximum fine of the greater of $500,000 and the costs of prosecution; a maximum term of probation of up to five years; a mandatory special assessment of $400 per count.

AGENCIES

Federal Bureau of Investigation, San Diego Division

Internal Revenue Service, Criminal Investigation

Department of Defense Inspector General's Office, Defense Criminal Investigative Service U.S. Securities and Exchange Commission, Division of Enforcement

Department of Justice

FOR IMMEDIATE RELEASE
MONDAY, DECEMBER 6, 2004
WWW.USDOJ.GOV

CRM
(202) 514-2008
TDD (202) 514-1888

INVISION TECHNOLOGIES, INC. ENTERS INTO AGREEMENT WITH THE UNITED STATES

WASHINGTON, D.C. - Assistant Attorney General Christopher A. Wray of the Criminal Division announced today that InVision Technologies, Inc. - a public company based in Newark, California that sells, in domestic and foreign markets, an airport security screening product designed to detect explosives in passenger baggage - has agreed to resolve the criminal liability associated with potential violations of the Foreign Corrupt Practices Act (FCPA) by paying $800,000 in penalties to the United States and cooperating fully in the parallel investigations by the Department of Justice and the Securities and Exchange Commission.

In a separate, related agreement, General Electric Company, which announced today that it had completed its acquisition of InVision, agreed, among other things, to ensure compliance by InVision of InVision's obligations under its agreement and to effect FCPA compliance programs within its new InVision business.

The investigations by the Department and the SEC revealed that InVision, through the conduct of certain employees, was aware of a high probability that its agents or distributors in the Kingdom of Thailand, the People's Republic of China and the Republic of the Philippines had paid or offered to pay money to foreign officials or political parties in connection with transactions or proposed transactions for the sale by InVision of its airport security screening machines. The investigations followed the voluntary disclosure to the Department and the SEC by InVision and GE of facts obtained in their internal investigation into the potential FCPA violations.

The key terms of the Department's agreements with InVision and General Electric are as follows:

The InVision Agreement

The term of the InVision Agreement is two years. In exchange for the Department's agreement not to prosecute InVision for the conduct disclosed by InVision and GE (which assisted InVision in conducting an internal investigation) to the Department and the SEC, InVision agrees, among other things, to:

- Accept responsibility for its misconduct, agree that a statement of facts summarizing the subject transactions is materially accurate and agree not to contradict those facts;
- Negotiate in good faith a settlement with the SEC;
- Pay a monetary penalty to the United States of $800,000; and
- Fully and affirmatively disclose to the Department and the SEC activities that InVision believes may violate the FCPA, and continue to cooperate with the Department and the SEC in their investigations.

The GE Agreement

The GE Agreement, which has a term of one year, governs the obligations of GE with respect to its InVision business. In exchange for the Department's agreement not to prosecute GE for conduct disclosed by InVision and GE to the Department and the SEC, GE agrees, among other things, to:

- Integrate the InVision business into GE's FCPA compliance program and retain an independent consultant acceptable to the Department to evaluate the efficacy of GE's effort in that regard;
- Cause the full performance by InVision of the InVision Agreement;
- Accept, based on its present factual understandings, that the factual statement in the InVision Agreement describing the subject

transactions is materially accurate and refrain from contradicting that statement; and

- Fully and affirmatively disclose to the Department and the SEC activities that GE reasonably believes are material to the investigations of the Department and the SEC, and to continue to cooperate in those investigations.

The case was prosecuted by Deputy Chief Peter B. Clark, Acting Deputy Chief Mark F. Mendelsohn and Trial Attorney Thomas E. Stevens of the Fraud Section.

ANTI-BRIBERY BOOKS & RECORDS PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT
Current through Pub. L. 105-366 (November 10, 1998)

UNITED STATES CODE
TITLE 15. COMMERCE AND TRADE
CHAPTER 2B--SECURITIES EXCHANGES

§ 78m. Periodical and other reports

(a) Reports by issuer of security; contents

Every issuer of a security registered pursuant to section 78l of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security--

(1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 78l of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange.

(b) Form of report; books, records, and internal accounting; directives

* * *

(2) Every issuer which has a class of securities registered pursuant to section 78l of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall--

> (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
>
> (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that--
>
> > (i) transactions are executed in accordance with management's general or specific authorization;
> >
> > (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
> >
> > (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
> >
> > (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

(3) (A) With respect to matters concerning the national security of the United States, no duty or liability under paragraph (2) of this subsection shall be imposed upon any person acting in cooperation with the head of any Federal department or agency responsible for such matters if such act in cooperation with such head of a

> department or agency was done upon the specific, written directive of the head of such department or agency pursuant to Presidential authority to issue such directives. Each directive issued under this paragraph shall set forth the specific facts and circumstances with respect to which the provisions of this paragraph are to be invoked. Each such directive shall, unless renewed in writing, expire one year after the date of issuance.
>
> (B) Each head of a Federal department or agency of the United States who issues such a directive pursuant to this paragraph shall maintain a complete file of all such directives and shall, on October 1 of each year, transmit a summary of matters covered by such directives in force at any time during the previous year to the Permanent Select Committee on Intelligence of the House of Representatives and the Select Committee on Intelligence of the Senate.

(4) No criminal liability shall be imposed for failing to comply with the requirements of paragraph (2) of this subsection except as provided in paragraph (5) of this subsection.

(5) No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2).

(6) Where an issuer which has a class of securities registered pursuant to section 78l of this title or an issuer which is required to file reports pursuant to section 78o(d) of this title holds 50 per centum or less of the voting power with respect to a domestic or foreign firm, the provisions of paragraph (2) require only that the issuer proceed in good faith to use its influence, to the extent reasonable under the issuer's circumstances, to cause such domestic or foreign firm to devise and maintain a system of internal accounting controls consistent with paragraph (2). Such circumstances include the relative degree of the issuer's ownership of the domestic or foreign firm and the laws and practices governing the business operations of the country in which such firm is located. An issuer which

demonstrates good faith efforts to use such influence shall be conclusively presumed to have complied with the requirements of paragraph (2).

(7) For the purpose of paragraph (2) of this subsection, the terms "reasonable assurances" and "reasonable detail" mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.

* * *

<§ 78dd-1 [Section 30A of the Securities & Exchange Act of 1934].

Prohibited foreign trade practices by issuers

(a) Prohibition

It shall be unlawful for any issuer which has a class of securities registered pursuant to section 78l of this title or which is required to file reports under section 78o(d) of this title, or for any officer, director, employee, or agent of such issuer or any stockholder thereof acting on behalf of such issuer, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to--

(1) any foreign official for purposes of--

> (A) (i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage; or
>
> (B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person;

(2) any foreign political party or official thereof or any candidate for foreign political office for purposes of--

> (A) (i) influencing any act or decision of such party, official, or candidate in its or his official capacity, (ii) inducing such party, official, or candidate to do or omit to do an act in violation of the lawful duty of such party, official, or candidate, or (iii) securing any improper advantage; or
>
> (B) inducing such party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality.

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person; or

(3) any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office, for purposes of--

> (A) (i) influencing any act or decision of such foreign official, political party, party official, or candidate in his or its official capacity, (ii) inducing such foreign official, political party, party official, or candidate to do or omit to do any act in violation of the lawful duty of such foreign official, political party, party official, or candidate, or (iii) securing any improper advantage; or
>
> (B) inducing such foreign official, political party, party official, or candidate to use his or its influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person.

(b) Exception for routine governmental action

Subsections (a) and (g) of this section shall not apply to any facilitating or expediting payment to a foreign official, political party, or party official the purpose of which is to expedite or to secure the performance of a routine governmental action by a foreign official, political party, or party official.

(c) Affirmative defenses

It shall be an affirmative defense to actions under subsection (a) or (g) of this section that--

(1) the payment, gift, offer, or promise of anything of value that was made, was lawful under the written laws and regulations of the foreign official's, political party's, party official's, or candidate's country; or

(2) the payment, gift, offer, or promise of anything of value that was made, was a reasonable and bona fide expenditure, such as travel and lodging expenses, incurred by or on behalf of a foreign official, party, party official, or candidate and was directly related to--

> (A) the promotion, demonstration, or explanation of products or services; or
>
> (B) the execution or performance of a contract with a foreign government or agency thereof.

(d) Guidelines by Attorney General

Not later than one year after August 23, 1988, the Attorney General, after consultation with the Commission, the Secretary of Commerce, the United States Trade Representative, the Secretary of State, and the Secretary of the Treasury, and after obtaining the views of all interested persons through public notice and comment procedures, shall determine to what extent compliance with this section would be enhanced and the business community would be assisted by further clarification of the preceding provisions of this section and may, based on such determination and to the extent necessary and appropriate, issue--

(1) guidelines describing specific types of conduct, associated with common types of export sales arrangements and business contracts, which for purposes of the Department of Justice's present enforcement policy, the Attorney General determines would be in conformance with the preceding provisions of this section; and

(2) general precautionary procedures which issuers may use on a voluntary basis to conform their conduct to the Department of Justice's present enforcement policy regarding the preceding provisions of this section.

The Attorney General shall issue the guidelines and procedures referred to in the preceding sentence in accordance with the provisions of subchapter II of chapter 5 of Title 5 and those guidelines and procedures shall be subject to the provisions of chapter 7 of that title.

(e) Opinions of Attorney General

(1) The Attorney General, after consultation with appropriate departments and agencies of the United States and after obtaining the views of all interested persons through public notice and comment procedures, shall establish a procedure to provide responses to specific inquiries by issuers concerning conformance of their conduct with the Department of Justice's present enforcement policy regarding the preceding provisions of this section. The Attorney General shall, within 30 days after receiving such a request, issue an opinion in response to that request. The opinion shall state whether or not certain specified prospective conduct would, for purposes of the Department of Justice's present enforcement policy, violate the preceding provisions of this section. Additional requests for opinions may be filed with the Attorney General regarding other specified prospective conduct that is beyond the scope of conduct specified in previous requests. In any action brought under the applicable provisions of this section, there shall be a rebuttable presumption that conduct, which is specified in a request by an issuer and for which the Attorney General has issued an opinion that such conduct is in conformity with the Department of Justice's present enforcement policy, is in compliance with the preceding provisions of this section. Such a presumption may be rebutted by a preponderance of the evidence. In considering the presumption for purposes of this paragraph, a court shall weight all relevant factors, including but not limited to whether the information submitted to the Attorney General was accurate

and complete and whether it was within the scope of the conduct specified in any request received by the Attorney General. The Attorney General shall establish the procedure required by this paragraph in accordance with the provisions of subchapter II of chapter 5 of Title 5 and that procedure shall be subject to the provisions of chapter 7 of that title.

(2) Any document or other material which is provided to, received by, or prepared in the Department of Justice or any other department or agency of the United States in connection with a request by an issuer under the procedure established under paragraph (1), shall be exempt from disclosure under section 552 of Title 5 and shall not, except with the consent of the issuer, be made publicly available, regardless of whether the Attorney General responds to such a request or the issuer withdraws such request before receiving a response.

(3) Any issuer who has made a request to the Attorney General under paragraph (1) may withdraw such request prior to the time the Attorney General issues an opinion in response to such request. Any request so withdrawn shall have no force or effect.

(4) The Attorney General shall, to the maximum extent practicable, provide timely guidance concerning the Department of Justice's present enforcement policy with respect to the preceding provisions of this section to potential exporters and small businesses that are unable to obtain specialized counsel on issues pertaining to such provisions. Such guidance shall be limited to responses to requests under paragraph (1) concerning conformity of specified prospective conduct with the Department of Justice's present enforcement policy regarding the preceding provisions of this section and general explanations of compliance responsibilities and of potential liabilities under the preceding provisions of this section.

(f) Definitions

For purposes of this section:

(1) A) The term "foreign official" means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or

department, agency, or instrumentality, or for or on behalf of any such public international organization.

(B) For purposes of subparagraph (A), the term "public international organization" means--

(i) an organization that is designated by Executive Order pursuant to section 1 of the International Organizations Immunities Act (22 U.S.C. § 288); or

(ii) any other international organization that is designated by the President by Executive order for the purposes of this section, effective as of the date of publication of such order in the Federal Register.

(2) (A) A person's state of mind is "knowing" with respect to conduct, a circumstance, or a result if--

(i) such person is aware that such person is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or

(ii) such person has a firm belief that such circumstance exists or that such result is substantially certain to occur.

(B) When knowledge of the existence of a particular circumstance is required for an offense, such knowledge is established if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes that such circumstance does not exist.

(3) (A) The term "routine governmental action" means only an action which is ordinarily and commonly performed by a foreign official in--

(i) obtaining permits, licenses, or other official documents to qualify a person to do business in a foreign country;

(ii) processing governmental papers, such as visas and work orders;

(iii) providing police protection, mail pick-up and delivery, or scheduling inspections associated with contract performance or inspections related to transit of goods across country;

(iv) providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products or commodities from deterioration; or

(v) actions of a similar nature.

(B) The term "routine governmental action" does not include any decision by a foreign official whether, or on what terms, to award new business to or to continue business with a particular party, or any action taken by a foreign official involved in the decision-making process to encourage a decision to award new business to or continue business with a particular party.

(g) Alternative Jurisdiction

(1) It shall also be unlawful for any issuer organized under the laws of the United States, or a State, territory, possession, or commonwealth of the United States or a political subdivision thereof and which has a class of securities registered pursuant to section 12 of this title or which is required to file reports under section 15(d) of this title, or for any United States person that is an officer, director, employee, or agent of such issuer or a stockholder thereof acting on behalf of such issuer, to corruptly do any act outside the United States in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to any of the persons or entities set forth in paragraphs (1), (2), and (3) of this subsection (a) of this section for

the purposes set forth therein, irrespective of whether such issuer or such officer, director, employee, agent, or stockholder makes use of the mails or any means or instrumentality of interstate commerce in furtherance of such offer, gift, payment, promise, or authorization.

(2) As used in this subsection, the term "United States person" means a national of the United States (as defined in section 101 of the Immigration and Nationality Act (8 U.S.C. § 1101)) or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship organized under the laws of the United States or any State, territory, possession, or commonwealth of the United States, or any political subdivision thereof.

§ 78dd-2. Prohibited foreign trade practices by domestic concerns

(a) Prohibition

It shall be unlawful for any domestic concern, other than an issuer which is subject to section 78dd-1 of this title, or for any officer, director, employee, or agent of such domestic concern or any stockholder thereof acting on behalf of such domestic concern, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to--

(1) any foreign official for purposes of--

(A) (i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage; or

(B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect

> or influence any act or decision of such government or instrumentality,

in order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person;

(2) any foreign political party or official thereof or any candidate for foreign political office for purposes of--

> (A) (i) influencing any act or decision of such party, official, or candidate in its or his official capacity, (ii) inducing such party, official, or candidate to do or omit to do an act in violation of the lawful duty of such party, official, or candidate, or (iii) securing any improper advantage; or
>
> (B) inducing such party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person;

(3) any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office, for purposes of--

> (A) (i) influencing any act or decision of such foreign official, political party, party official, or candidate in his or its official capacity, (ii) inducing such foreign official, political party, party official, or candidate to do or omit to do any act in violation of the lawful duty of such foreign official, political party, party official, or candidate, or (iii) securing any improper advantage; or
>
> (B) inducing such foreign official, political party, party official, or candidate to use his or its influence with a

> foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person.

(b) Exception for routine governmental action

Subsections (a) and (i) of this section shall not apply to any facilitating or expediting payment to a foreign official, political party, or party official the purpose of which is to expedite or to secure the performance of a routine governmental action by a foreign official, political party, or party official.

(c) Affirmative defenses

It shall be an affirmative defense to actions under subsection (a) or (i) of this section that--

(1) the payment, gift, offer, or promise of anything of value that was made, was lawful under the written laws and regulations of the foreign official's, political party's, party official's, or candidate's country; or

(2) the payment, gift, offer, or promise of anything of value that was made, was a reasonable and bona fide expenditure, such as travel and lodging expenses, incurred by or on behalf of a foreign official, party, party official, or candidate and was directly related to--

> (A) the promotion, demonstration, or explanation of products or services; or
>
> (B) the execution or performance of a contract with a foreign government or agency thereof.

(d) Injunctive relief

(1) When it appears to the Attorney General that any domestic concern to which this section applies, or officer, director, employee, agent, or stockholder thereof, is engaged, or about to engage, in any act or practice constituting a violation of subsection (a) or (i) of this section, the Attorney

General may, in his discretion, bring a civil action in an appropriate district court of the United States to enjoin such act or practice, and upon a proper showing, a permanent injunction or a temporary restraining order shall be granted without bond.

(2) For the purpose of any civil investigation which, in the opinion of the Attorney General, is necessary and proper to enforce this section, the Attorney General or his designee are empowered to administer oaths and affirmations, subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which the Attorney General deems relevant or material to such investigation. The attendance of witnesses and the production of documentary evidence may be required from any place in the United States, or any territory, possession, or commonwealth of the United States, at any designated place of hearing.

(3) In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Attorney General may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, or other documents. Any such court may issue an order requiring such person to appear before the Attorney General or his designee, there to produce records, if so ordered, or to give testimony touching the matter under investigation. Any failure to obey such order of the court may be punished by such court as a contempt thereof.

All process in any such case may be served in the judicial district in which such person resides or may be found. The Attorney General may make such rules relating to civil investigations as may be necessary or appropriate to implement the provisions of this subsection.

(e) Guidelines by Attorney General

Not later than 6 months after August 23, 1988, the Attorney General, after consultation with the Securities and Exchange Commission, the Secretary of Commerce, the United States Trade Representative, the Secretary of State, and the Secretary of the Treasury, and after obtaining the views of all interested persons through public notice and comment procedures, shall determine to what extent compliance with this section would be enhanced

and the business community would be assisted by further clarification of the preceding provisions of this section and may, based on such determination and to the extent necessary and appropriate, issue--

(1) guidelines describing specific types of conduct, associated with common types of export sales arrangements and business contracts, which for purposes of the Department of Justice's present enforcement policy, the Attorney General determines would be in conformance with the preceding provisions of this section; and

(2) general precautionary procedures which domestic concerns may use on a voluntary basis to conform their conduct to the Department of Justice's present enforcement policy regarding the preceding provisions of this section.

The Attorney General shall issue the guidelines and procedures referred to in the preceding sentence in accordance with the provisions of subchapter II of chapter 5 of Title 5 and those guidelines and procedures shall be subject to the provisions of chapter 7 of that title.

(f) Opinions of Attorney General

(1) The Attorney General, after consultation with appropriate departments and agencies of the United States and after obtaining the views of all interested persons through public notice and comment procedures, shall establish a procedure to provide responses to specific inquiries by domestic concerns concerning conformance of their conduct with the Department of Justice's present enforcement policy regarding the preceding provisions of this section. The Attorney General shall, within 30 days after receiving such a request, issue an opinion in response to that request. The opinion shall state whether or not certain specified prospective conduct would, for purposes of the Department of Justice's present enforcement policy, violate the preceding provisions of this section. Additional requests for opinions may be filed with the Attorney General regarding other specified prospective conduct that is beyond the scope of conduct specified in previous requests. In any action brought under the applicable provisions of this section, there shall be a rebuttable presumption that conduct, which is specified in a request by a domestic concern and for which the Attorney General has issued an opinion that such conduct is in conformity with the

Department of Justice's present enforcement policy, is in compliance with the preceding provisions of this section. Such a presumption may be rebutted by a preponderance of the evidence. In considering the presumption for purposes of this paragraph, a court shall weigh all relevant factors, including but not limited to whether the information submitted to the Attorney General was accurate and complete and whether it was within the scope of the conduct specified in any request received by the Attorney General. The Attorney General shall establish the procedure required by this paragraph in accordance with the provisions of subchapter II of chapter 5 of Title 5 and that procedure shall be subject to the provisions of chapter 7 of that title.

(2) Any document or other material which is provided to, received by, or prepared in the Department of Justice or any other department or agency of the United States in connection with a request by a domestic concern under the procedure established under paragraph (1), shall be exempt from disclosure under section 552 of Title 5 and shall not, except with the consent of the domestic concern, by made publicly available, regardless of whether the Attorney General response to such a request or the domestic concern withdraws such request before receiving a response.

(3) Any domestic concern who has made a request to the Attorney General under paragraph (1) may withdraw such request prior to the time the Attorney General issues an opinion in response to such request. Any request so withdrawn shall have no force or effect.

(4) The Attorney General shall, to the maximum extent practicable, provide timely guidance concerning the Department of Justice's present enforcement policy with respect to the preceding provisions of this section to potential exporters and small businesses that are unable to obtain specialized counsel on issues pertaining to such provisions. Such guidance shall be limited to responses to requests under paragraph (1) concerning conformity of specified prospective conduct with the Department of Justice's present enforcement policy regarding the preceding provisions of this section and general explanations of compliance responsibilities and of potential liabilities under the preceding provisions of this section.

(g) Penalties

(1) (A) Any domestic concern that is not a natural person and that violates subsection (a) or (i) of this section shall be fined not more than $2,000,000.

(B) Any domestic concern that is not a natural person and that violates subsection (a) or (i) of this section shall be subject to a civil penalty of not more than $10,000 imposed in an action brought by the Attorney General.

(2) (A) Any natural person that is an officer, director, employee, or agent of a domestic concern, or stockholder acting on behalf of such domestic concern, who willfully violates subsection (a) or (i) of this section shall be fined not more than $100,000 or imprisoned not more than 5 years, or both.

(B) Any natural person that is an officer, director, employee, or agent of a domestic concern, or stockholder acting on behalf of such domestic concern, who violates subsection (a) or (i) of this section shall be subject to a civil penalty of not more than $10,000 imposed in an action brought by the Attorney General.

(3) Whenever a fine is imposed under paragraph (2) upon any officer, director, employee, agent, or stockholder of a domestic concern, such fine may not be paid, directly or indirectly, by such domestic concern.

(h) Definitions

For purposes of this section:

(1) The term "domestic concern" means--

(A) any individual who is a citizen, national, or resident of the United States; and

(B) any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of

business in the United States, or which is organized under the laws of a State of the United States or a territory, possession, or commonwealth of the United States.

(2) (A) The term "foreign official" means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization.

(B) For purposes of subparagraph (A), the term "public international organization" means --

(i) an organization that has been designated by Executive order pursuant to Section 1 of the International Organizations Immunities Act (22 U.S.C. § 288); or

(ii)any other international organization that is designated by the President by Executive order for the purposes of this section, effective as of the date of publication of such order in the Federal Register.

(3) (A) A person's state of mind is "knowing" with respect to conduct, a circumstance, or a result if--

(i) such person is aware that such person is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or

(ii) such person has a firm belief that such circumstance exists or that such result is substantially certain to occur.

(B) When knowledge of the existence of a particular circumstance is required for an offense, such knowledge is established if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes that such circumstance does not exist.

(4) (A) The term "routine governmental action"means only an action which is ordinarily and commonly performed by a foreign official in--

(i) obtaining permits, licenses, or other official documents to qualify a person to do business in a foreign country;

(ii) processing governmental papers, such as visas and work orders;

(iii) providing police protection, mail pick-up and delivery, or scheduling inspections associated with contract performance or inspections related to transit of goods across country;

(iv) providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products or commodities from deterioration; or

(v) actions of a similar nature.

(B) The term "routine governmental action" does not include any decision by a foreign official whether, or on what terms, to award new business to or to continue business with a particular party, or any action taken by a foreign official involved in the decision-making process to encourage a decision to award new business to or continue business with a particular party.

(5) The term "interstate commerce"means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State or between any State and any place or ship outside thereof, and such term includes the intrastate use of--

(A) a telephone or other interstate means of communication, or

(B) any other interstate instrumentality.

(i) Alternative Jurisdiction

(1) It shall also be unlawful for any United States person to corruptly do any act outside the United States in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to any of the persons or entities set forth in paragraphs (1), (2), and (3) of subsection (a), for the purposes set forth therein, irrespective of whether such United States person makes use of the mails or any means or instrumentality of interstate commerce in furtherance of such offer, gift, payment, promise, or authorization.

(2) As used in this subsection, a "United States person"means a national of the United States (as defined in section 101 of the Immigration and Nationality Act (8 U.S.C. § 1101)) or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship organized under the laws of the United States or any State, territory, possession, or commonwealth of the United States, or any political subdivision thereof.

§ 78dd-3. Prohibited foreign trade practices by persons other than issuers or domestic concerns

(a) Prohibition

It shall be unlawful for any person other than an issuer that is subject to section 30A of the Securities Exchange Act of 1934 or a domestic concern, as defined in section 104 of this Act), or for any officer, director, employee, or agent of such person or any stockholder thereof acting on behalf of such person, while in the territory of the United States, corruptly to make use of the mails or any means or instrumentality of interstate commerce or to do any other act in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to--

(1) any foreign official for purposes of--

> (A) (i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign

> official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage; or
>
> (B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such person in obtaining or retaining business for or with, or directing business to, any person;

(2) any foreign political party or official thereof or any candidate for foreign political office for purposes of--

> (A) (i) influencing any act or decision of such party, official, or candidate in its or his official capacity, (ii) inducing such party, official, or candidate to do or omit to do an act in violation of the lawful duty of such party, official, or candidate, or (iii) securing any improper advantage; or
>
> (B) inducing such party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality.

in order to assist such person in obtaining or retaining business for or with, or directing business to, any person; or

(3) any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office, for purposes of--

> (A) (i) influencing any act or decision of such foreign official, political party, party official, or candidate in his or its official capacity, (ii) inducing such foreign official, political party, party official, or candidate to do or omit to

do any act in violation of the lawful duty of such foreign official, political party, party official, or candidate, or (iii) securing any improper advantage; or

(B) inducing such foreign official, political party, party official, or candidate to use his or its influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such person in obtaining or retaining business for or with, or directing business to, any person.

(b) Exception for routine governmental action

Subsection (a) of this section shall not apply to any facilitating or expediting payment to a foreign official, political party, or party official the purpose of which is to expedite or to secure the performance of a routine governmental action by a foreign official, political party, or party official.

(c) Affirmative defenses

It shall be an affirmative defense to actions under subsection (a) of this section that--

(1) the payment, gift, offer, or promise of anything of value that was made, was lawful under the written laws and regulations of the foreign official's, political party's, party official's, or candidate's country; or

(2) the payment, gift, offer, or promise of anything of value that was made, was a reasonable and bona fide expenditure, such as travel and lodging expenses, incurred by or on behalf of a foreign official, party, party official, or candidate and was directly related to--

(A) the promotion, demonstration, or explanation of products or services; or

(B) the execution or performance of a contract with a foreign government or agency thereof.

(d) Injunctive relief

(1) When it appears to the Attorney General that any person to which this section applies, or officer, director, employee, agent, or stockholder thereof, is engaged, or about to engage, in any act or practice constituting a violation of subsection (a) of this section, the Attorney General may, in his discretion, bring a civil action in an appropriate district court of the United States to enjoin such act or practice, and upon a proper showing, a permanent injunction or a temporary restraining order shall be granted without bond.

(2) For the purpose of any civil investigation which, in the opinion of the Attorney General, is necessary and proper to enforce this section, the Attorney General or his designee are empowered to administer oaths and affirmations, subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which the Attorney General deems relevant or material to such investigation. The attendance of witnesses and the production of documentary evidence may be required from any place in the United States, or any territory, possession, or commonwealth of the United States, at any designated place of hearing.

(3) In case of contumacy by, or refusal to obey a subpoena issued to, any person, the Attorney General may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, or other documents. Any such court may issue an order requiring such person to appear before the Attorney General or his designee, there to produce records, if so ordered, or to give testimony touching the matter under investigation. Any failure to obey such order of the court may be punished by such court as a contempt thereof.

(4) All process in any such case may be served in the judicial district in which such person resides or may be found. The Attorney General may make such rules relating to civil investigations as may be necessary or appropriate to implement the provisions of this subsection.

(e) Penalties

(1) (A) Any juridical person that violates subsection (a) of this section shall be fined not more than $2,000,000.

(B) Any juridical person that violates subsection (a) of this section shall be subject to a civil penalty of not more than $10,000 imposed in an action brought by the Attorney General.

(2) (A) Any natural person who willfully violates subsection (a) of this section shall be fined not more than $100,000 or imprisoned not more than 5 years, or both.

(B) Any natural person who violates subsection (a) of this section shall be subject to a civil penalty of not more than $10,000 imposed in an action brought by the Attorney General.

(3) Whenever a fine is imposed under paragraph (2) upon any officer, director, employee, agent, or stockholder of a person, such fine may not be paid, directly or indirectly, by such person.

(f) Definitions

For purposes of this section:

(1) The term "person," when referring to an offender, means any natural person other than a. national of the United States (as defined in 8 U.S.C. § 1101) or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship organized under the law of a foreign nation or a political subdivision thereof

(2) (A) The term "foreign official" means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization.

For purposes of subparagraph (A), the term "public international organization" means --

(i) an organization that has been designated by Executive Order pursuant to Section 1 of the International Organizations Immunities Act (22 U.S.C. § 288); or

(ii) any other international organization that is designated by the President by Executive order for the purposes of this section, effective as of the date of publication of such order in the Federal Register.

(3) (A) A person's state of mind is "knowing"with respect to conduct, a circumstance, or a result if --

(i) such person is aware that such person is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur; or

(ii) such person has a firm belief that such circumstance exists or that such result is substantially certain to occur.

(B) When knowledge of the existence of a particular circumstance is required for an offense, such knowledge is established if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes that such circumstance does not exist.

(4) (A) The term "routine governmental action"means only an action which is ordinarily and commonly performed by a foreign official in--

(i) obtaining permits, licenses, or other official documents to qualify a person to do business in a foreign country;

(ii) processing governmental papers, such as visas and work orders;

(iii) providing police protection, mail pick-up and delivery, or scheduling inspections associated with contract performance or inspections related to transit of goods across country;

(iv) providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products or commodities from deterioration; or

(v) actions of a similar nature.

(B) The term "routine governmental action" does not include any decision by a foreign official whether, or on what terms, to award new business to or to continue business with a particular party, or any action taken by a foreign official involved in the decision-making process to encourage a decision to award new business to or continue business with a particular party.

(5) The term "interstate commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State or between any State and any place or ship outside thereof, and such term includes the intrastate use of —

(A) a telephone or other interstate means of communication, or

(B) any other interstate instrumentality.

§ 78ff. Penalties

(a) Willful violations; false and misleading statements

Any person who willfully violates any provision of this chapter (other than section 78dd-1 of this title), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as

provided in subsection (d) of section 78*o* of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

(b) Failure to file information, documents, or reports

Any issuer which fails to file information, documents, or reports required to be filed under subsection (d) of section 78*o* of this title or any rule or regulation thereunder shall forfeit to the United States the sum of $100 for each and every day such failure to file shall continue. Such forfeiture, which shall be in lieu of any criminal penalty for such failure to file which might be deemed to arise under subsection (a) of this section, shall be payable into the Treasury of the United States and shall be recoverable in a civil suit in the name of the United States.

(c) Violations by issuers, officers, directors, stockholders, employees, or agents of issuers

(1) (A) Any issuer that violates subsection (a) or (g) of section 30A of this title [15 U.S.C. § 78dd-1] shall be fined not more than $2,000,000.

(B) Any issuer that violates subsection (a) or (g) of section 30A of this title [15 U.S.C. § 78dd-1] shall be subject to a civil penalty of not more than $10,000 imposed in an action brought by the Commission.

(2) (A) Any officer, director, employee, or agent of an issuer, or stockholder acting on behalf of such issuer, who willfully violates subsection (a) or (g) of section 30A of this title [15 U.S.C. § 78dd-1] shall be fined not more than $100,000, or imprisoned not more than 5 years, or both.

(B) Any officer, director, employee, or agent of an issuer, or stockholder acting on behalf of such issuer, who violates subsection (a) or (g) of section 30A of this title [15 U.S.C. § 78dd-1] shall be subject to a civil penalty of not more than $10,000 imposed in an action brought by the Commission.

(3) Whenever a fine is imposed under paragraph (2) upon any officer, director, employee, agent, or stockholder of an issuer, such fine may not be paid, directly or indirectly, by such issuer.

Due Diligence Checklist

For a U.S. acquiring company, an FCPA Due Diligence Checklist should include:

- Determining whether the Target Company engages in business in a country with corruption propensity. Transparency International website at www.transparency.org.
- Determining whether wire transfers exist in foreign subsidiaries which do not disclose or identify the payee
- Determining whether agents or consultants do not have sufficient resources to deliver their mandates
- Determining whether agents or consultants have close family political ties
- Determining whether agents or consultants have undisclosed sub-agents
- Determining whether agents or consultants require payment in cash
- Determining whether agents or consultants have requested transfers of monies to offshore financial havens
- Determining whether agents or consultants are under contracts requiring FCPA Certification
- Determining whether senior management personnel in foreign subsidiaries are rotated
- Determining whether check issuance and wire transfer procedures requiring at least two levels of authorization occurs
- Reviewing financial accounts to identify large and frequent payments in cash, payments of unusually large commissions, reimbursements of poorly documented expenses, or foreign political contributions
- Interviewing relevant employees regarding unethical conduct by a consultant or intermediary

For a Target Company subject to the record keeping requirements of the FCPA, repeat this Due Diligence Checklist with its foreign subsidiaries, because bribery or corrupt activity by a foreign subsidiary can lead to SEC enforcement action against the parent.

ABOUT THE AUTHOR

JT Grenough has handled six major assignments for Fortune 1000 companies, and served as a regional audit director for a Fortune 300 company, writing Investigative Reports for Executive Management. In the last ten years he was instrumental in fraud auditing and investigations of over two billion in assets for Fortune 1000 companies.