UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 49675 / May 11, 2004

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2005 / May 11, 2004

ADMINISTRATIVE PROCEEDING
File No. 3-11480

In the Matter of **THE WARNACO GROUP, INC.,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

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

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept.[1] Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. § 201.1 et seq., and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

[1] Simultaneously with this proceeding, the Commission has instituted or filed the following settled actions: *SEC v. William S. Finkelstein,* 04 CV 3573 (May 11, 2004 S.D.N.Y.) (SS); *In the Matter of Linda J. Wachner*, Rel. No. 34-49677 (May 11, 2004); *In the Matter of Stanley P. Silverstein*, Rel. No. 34-49676 (May 11, 2004); and *In the Matter of PricewaterhouseCoopers LLP*, Rel. No. 34-49678 (May 11, 2004).

III.

On the basis of this Order and Respondent's Offer, the Commission finds[2] that:

FACTUAL FINDINGS

A. Respondent and Other Related Parties

Warnaco is a Delaware corporation with its headquarters in New York, New York. During the relevant period, Warnaco was one of the largest apparel manufacturers in the United States, reporting net revenues of $2 billion. Warnaco's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act. During the relevant period, Warnaco was a Fortune 500 company that traded on the New York Stock Exchange, Inc. under the symbol "WAC." Warnaco filed for bankruptcy on June 11, 2001. On February 4, 2003, Warnaco emerged from bankruptcy under new management and began trading on the NASDAQ National Market under the symbol "WRNC."

William S. Finkelstein, age 55, was the senior vice president and chief financial officer ("CFO") of Warnaco from May 1995 until February 2002. Warnaco terminated Finkelstein's employment on September 5, 2002.

Linda J. Wachner, age 57, was the chief executive officer ("CEO") of Warnaco from 1986 until November 2001. She also held the position of chairman of the board of directors during her tenure at the company. Warnaco terminated Wachner's employment on November 16, 2001. She is a resident of New York, New York.

Stanley P. Silverstein, age 51, was Vice President, General Counsel, and Secretary of Warnaco during all relevant periods. He is currently Chief Administrative Officer and Senior Vice President, Corporate Development for Warnaco. Silverstein is a resident of Englewood, New Jersey. Silverstein is licensed to practice law in the State of New York.

PricewaterhouseCoopers LLP ("PwC") is a national public accounting firm with its headquarters in New York, New York. PwC audited Warnaco's financial statements and provided various consulting services for the company during the period 1995 through 1998. PwC also performed quarterly reviews of Warnaco's financial results for the period 1996 through the third quarter of 1999.

B. Summary

On March 2, 1999, Warnaco issued a false and materially misleading press release reporting its earnings for the fourth quarter and fiscal year 1998. The press release, which reported "record" earnings results, failed to disclose that Warnaco would be restating its financial results for the prior three years to correct a $145 million inventory overstatement. Instead, Warnaco hid the true reason for the write-down of inventory. In the press release, Warnaco characterized the inventory write-down as part of the company's write-off of deferred start-up costs under a new

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[2] The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

accounting pronouncement, AICPA Statement of Position ("SOP") 98-5.[3] At the time that it issued the press release, Warnaco knew that it could not account for the inventory overstatement as part of its adoption of SOP 98-5, because the error did not involve deferred start-up costs. In fact, the overstatement had been caused by material defects in Warnaco's inventory accounting and internal control systems that had allowed inventory to become overstated by more than twenty percent over a period of years.

On April 2, 1999, Warnaco filed a misleading fiscal 1998 annual report with the Commission. The report disclosed that Warnaco had restated its financial results. The restatement decreased 1998 net income by $49 million; turned a $23 million net profit in 1997 into a $12 million net loss; and increased Warnaco's net loss for 1996 from $8.2 million to $31 million. However, the annual report did not disclose the true cause of the $145 million restatement. As it had done in the press release, Warnaco claimed in the annual report that the restatement resulted from the write-off of previously-deferred "start-up related" costs identified in connection with Warnaco's adoption of SOP 98-5.

In the Fall of 2000, Warnaco issued a misleading and inaccurate quarterly report for the third quarter of 2000. That report improperly offset Warnaco's reported debt and cash balances in order to create the appearance that the company was in compliance with certain financial covenants in its largest licensing agreement. This offsetting of cash against debt was improper under generally accepted accounting principles ("GAAP") and necessitated a restatement in April 2001.

In addition, since April 2001, Warnaco has issued restatements of its financial results on two subsequent occasions to correct significant accounting errors unrelated to the restatements discussed above. Indeed, during the past four years, Warnaco has restated its financial results for every year from 1996 through 2001 at least once, and has restated its fiscal 1998 through 2000 financial results twice.

As set forth below, Warnaco's materially misleading press release in March 1999, its misleading disclosures in its 1998 annual report and quarterly report for the third quarter of 2000, and its failure to report accurate financial results and maintain adequate internal controls during the relevant time period violated the federal securities laws.

C. Facts

1. Inventory Restatement

a. Background

Warnaco is one of the largest manufacturers and distributors of apparel in the United States. It designs and manufactures a broad line of intimate apparel, sportswear, swimwear and

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[3] American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") 98-5, which was issued on April 3, 1998, required companies to expense start-up costs in the period in which they were incurred, rather than capitalizing them as had been previously permitted. Companies were required to write-off any previously deferred start-up costs on their books at the time of adoption. SOP 98-5 became effective in fiscal 1999, although companies were permitted to adopt the SOP early. Warnaco adopted SOP 98-5 at the end of its fiscal 1998 year.

other clothing under a variety of well-known brand names. Warnaco's Intimate Apparel Division ("IAD") is a leading supplier of intimate apparel to department and specialty stores in the United States.

During the period from at least 1997 through early 1999, the cost accounting and internal control systems at IAD were severely outdated and inadequate, given the size of the division's operations. IAD did not have a reliable perpetual inventory system or other means for accurately determining the value of its inventory on a regular basis. The division's physical inventory count was taken once a year at mid-year, and reconciled to the general ledger.

Like many manufacturing companies, Warnaco used a "standard cost system" to value its inventory internally. The standard costs were based on the estimated cost to produce Warnaco's inventory. GAAP permits a company to use a standard cost system for internal accounting. However, the company must adjust the value of the inventory to actual cost before filing its financial statements. The company makes this adjustment by apportioning the difference (or "variance") between inventory (i.e., goods produced by the company, but not yet sold), and the cost of goods sold. Inventory is carried as an asset on the balance sheet; cost of goods sold is recorded as an expense item on the income statement. Capitalizing costs into inventory instead of recording them as an expense to cost of goods sold increases the inventory balance (thus increasing the company's assets) and decreases the company's expenses (thus increasing its net income).

However, IAD's standard cost system was old and prone to error. Many of the standard costs had not been updated in years. In some instances, the standard costs were missing entirely, meaning that Warnaco treated some items as if it had cost nothing to produce them. Because much of the data in IAD's standard cost system was outdated or missing during the period 1996-1998, the division experienced large variances between standard and actual costs each year. A larger variance increased the risk that Warnaco was not accurately reporting its inventory. Indeed, as a result of the shortcomings in the standard cost system, capitalized variances accounted for $42 million of IAD's inventory by 1997, more than forty percent of the total value of the division's inventory.

Members of Warnaco's senior management, including its then-CFO, William Finkelstein, and then-CEO, Linda Wachner, knew that IAD's accounting and internal control systems were antiquated and prone to error. However, Warnaco did not take sufficient measures to correct the errors in a timely manner. Warnaco's independent auditors, PwC, had warned Warnaco as part of its 1996 and 1997 audits that the standard cost system needed to be updated to eliminate the large variances.

b. Discovery of the Inventory Overstatement

In mid-1997, on PwC's recommendation, Warnaco hired consultants from PwC to update and correct IAD's standard cost system ("the Standard Cost Project"). As part of the Standard Cost Project, PwC consultants examined IAD's inventory accounts and preliminarily concluded by the Spring of 1998 that the inventory accounts were overstated by at least $60 million. The consultants conveyed their findings to Warnaco's senior management during a meeting on March 31, 1998. By June 1998, IAD personnel working with the PwC consultants confirmed these findings and identified another $23 million in improperly recorded inventory. At that time, senior management at Warnaco was informed that the potential overstatement could be as high as $83 million. However, no adjustment was made to the inventory accounts at that time.

In June 1998, after Warnaco informed PwC that the company internally estimated that its inventory was overvalued by at least $80 million, PwC recommended that Warnaco begin amortizing the adjustment over a period of years. Warnaco declined to record the adjustment until the Standard Cost Project was completed and the total amount of the overstatement was determined. PwC acceded to this request.

In July 1998, the PwC engagement partner for the Warnaco account retired and was replaced by another PwC partner. The new engagement partner believed that Warnaco's audit committee should be informed about the potential inventory overstatement. After the engagement partner informed the audit committee and certain members of the board of directors of the potential overstatement at the August 1998 meeting, Wachner expressed dissatisfaction with the partner's failure to raise the issue with management prior to the meeting and requested that PwC address the issue. As a result, PwC replaced the engagement partner and assigned a new audit team.

c. PwC's Audit Work Confirms the Overstatement

In the Fall of 1998, IAD completed its annual physical inventory count and attempted to reconcile the physical inventory to the value of the inventory recorded on IAD's books. The reconciliation process confirmed the findings of the Standard Cost Project: the value of the actual physical inventory was $60 million to $80 million ***less*** than the inventory value recorded on IAD's internal records and publicly reported in Warnaco's periodic reports.

After being informed of the results of the physical inventory reconciliation, Finkelstein directed IAD's controller to examine the division's cost accounting system for defects that could have caused the inventory overstatement. In early October 1998, IAD's controller delivered to Finkelstein a memorandum detailing significant and pervasive defects in IAD's cost accounting system, including the improper capitalization of variances and missing or incomplete cost data in the system. The controller advised that these defects caused the overstatement. Finkelstein dismissed the controller's findings as "preliminary," and took no action to correct or further investigate the flaws identified by the controller. Finkelstein did not inform PwC of the controller's conclusions.

In late October or early November 1998, Finkelstein informed PwC of a significant unresolved discrepancy identified in the IAD reconciliation process. Finkelstein then asked PwC whether Warnaco could write off the inventory overstatement as part of the restructuring costs Warnaco planned to recognize in the fourth quarter of 1998. After consulting with the concurring partner, the audit team advised Finkelstein that GAAP did not permit such accounting treatment.

Finkelstein and Wachner then asserted to PwC that the overstatement must be due to "start-up costs" that had been erroneously capitalized and recorded into inventory.[4] Finkelstein proposed

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4 "Start-up costs" are those costs associated with one-time activities related to opening a new facility or introducing a new product or service. Historically, GAAP allowed companies to capitalize their start-up costs, and then amortize those costs over a period of years. However, SOP 98-5 required companies to record start-up costs as

writing off the inventory discrepancy as part of Warnaco's early adoption of a new accounting principle, AICPA Statement of Position ("SOP") 98-5, which required companies to record start-up costs as they were incurred, rather than amortizing them over time. However, Finkelstein did not provide any evidence to support this assertion at that time.[5]

Given the magnitude of the inventory discrepancy, PwC informed Finkelstein and Wachner that PwC could not rely upon Warnaco's books and records or internal control systems in determining the correct value of IAD's inventory. Warnaco had neither the personnel nor the expertise to complete the reconciliation or correctly value inventory; therefore, the audit team engaged some of the same consultants who had worked on the Standard Cost Project to create a new system for valuing IAD's inventory. PwC also required Warnaco to complete another physical inventory count, observed by the PwC auditors, to ensure that the inventory discrepancy was a valuation problem and not a physical inventory problem. The physical inventory confirmed that the problem was not one of missing inventory, but rather was due to an overvaluation of existing inventory.

In the course of its work, although PwC could not conclusively determine how the unresolved differences had accumulated, PwC identified certain flaws in IAD's cost accounting system. These flaws -- including missing or incomplete standard costs and the division's failure to update or maintain the standard cost files over the prior five years-- had prevented the system from properly reducing the value of inventory recorded on Warnaco's books as inventory was sold. During a meeting in December 1998 and in subsequent discussions, PwC notified Warnaco's senior management, including Finkelstein and Wachner, of its findings. These findings were consistent with the problems the PwC consultants had identified and brought to Warnaco's attention in March 1998.

In February 1999, PwC completed its work and determined that Warnaco's inventory was overvalued by $159 million. PwC determined that this overstatement could not be written off under SOP 98-5 and informed Warnaco that it would have to restate its financial results for the preceding three years. Finkelstein and Wachner rejected PwC's conclusion, insisting that the overstatement was attributable to start-up costs. Over the course of a two-day meeting held in late February 1999, senior Warnaco management tried to persuade PwC that the overstatement should be written off in the current year as start-up costs under SOP 98-5. At the start of the two-day meeting, Finkelstein for the first time gave PwC a two-page schedule attributing nearly the entire overstatement to start-up costs. After reviewing the schedule, PwC concluded that it could not rely upon it to support the company's proposed accounting treatment, because costs on the schedule could not be traced back to Warnaco's books and records or came from factories that had been open for many years and thus did not qualify as start-up costs under Warnaco's start-up policy.

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expenses at the time they are incurred. All public companies were required to adopt SOP 98-5 and write off their start-up costs by no later than fiscal 1999.

[5] Warnaco had a very expansive start-up policy that deemed all new or expanded plants to be in start-up phase for up to three years from the time they began operating. During this phase, Warnaco classified all of the plant's operating expenses above the standard cost as start-up, and recorded them each quarter into a separate "start-up account" on its books. Finkelstein oversaw this process, and the start-up accounts were audited by PwC each year. As of year-end 1998, Warnaco had over $71 million recorded in its start-up accounts that would be written off under SOP 98-5.

PwC determined that, at most, only $14 million of the overstatement could be reclassified and accounted for as a current year write-off of start-up costs. The remaining inventory overstatement – $145 million – could not be written off pursuant to SOP 98-5.

Accordingly, at the conclusion of the two-day meeting, PwC told Finkelstein and the rest of Warnaco's senior management that: (i) the overstatement must be accounted for as the correction of an error, thus necessitating a restatement of previously-reported financial statements; and (ii) PwC would not certify financial statements that accounted for the overstatement as part of the change in accounting to adopt SOP 98-5.

The following day, PwC informed Warnaco's board of directors that the inventory error could not be written off under SOP 98-5 and would require Warnaco to restate its financial results for a three-year period. As CFO, Finkelstein attended the board meeting and participated in the discussion of the problem. At the end of the meeting, the board agreed that Warnaco would restate its financial results.

As shown below, the restatement had a material impact upon Warnaco's previously reported results for 1996, 1997, and the first three quarters of 1998:

	Inventory ($ in thousands)			***Net Income ($ in thousands)***			***EPS (diluted)***		
	Prev. Reported	***Restated***	***%***	***Prev. Reported***	***Restated***	***%***	***Prev. Reported***	***Restated***	***%***
1998†	625,545	492,827	-21%	94,352	69,948*	- 26%	1.48	0.72	- 51%
1997	526,185	431,185	-18%	23,032	(12,319)	-154%	0.42	(0.23)	-155%
1996	387,318	349,335	- 10%	(8,239)	(31,409)	-281%	(0.16)	(0.61)	-281%

† Cumulative results from the first three quarters of 1998

* Adjusted to exclude $23,976 related to adoption of SOP 98-5 effective beginning of fiscal 1998

d. <u>Warnaco Issues a False and Misleading Press Release</u>

On March 1, 1999, shortly after the board meeting concluded, Finkelstein gave PwC a draft press release announcing Warnaco's fiscal 1998 results. In the draft release, Warnaco touted "record" earnings and falsely characterized the inventory error as a part of Warnaco's write-off of start-up costs pursuant to SOP 98-5, stating that:

> Included in this fiscal year is the <u>early adoption of the change in accounting for start-up costs that writes-off non-cash accumulated costs previously deferred, relating to the start-up of new and expanded manufacturing operations</u>. The amount of this charge in fiscal year 1998 is $104.8 million, net of tax. In connection with the inventory costs related to start-up activities and write-offs, $35.5 million, net of tax, and $23.2 million, net of tax, have been reflected in the statement of operations for fiscal years 1997 and 1996, respectively. (Emphasis added.)

The pro forma statement of operations attached to the press release also misleadingly combined both the 1998 portion of the inventory overstatement and Warnaco's actual write-off under SOP 98-5 into a single entry called "Write-off of Deferred Start-Up." Thus, Warnaco reported that it would be writing off, on a net of tax basis, start-up costs of $104.8 million. In fact, Warnaco wrote off only $72.6 million in start-up costs. The remaining amount written off by Warnaco, $90.7

million, ($32.1 million for 1998, plus the $35.5 million and $23.1 million identified in the press release as "inventory costs related to start-up activities and write-offs" for 1996 and 1997) was actually the correction of the inventory overstatement.

The draft press release gave no indication that Warnaco would be writing down its inventory by $145 million pre-tax (or $90.7 million after tax) to correct an inventory overstatement. Nor was there any indication that Warnaco had calculated its "record" earnings by ignoring the effect of the restatement. The press release failed to tell investors that the earnings reported in the press release were not presented in conformity with GAAP, and that Warnaco's annual report, which would be filed the following month, would report significantly lower net income and earnings, as indicated below:

	3/1/99 Press Release (in thousands)	***4/1/99 10-K (in thousands)***
Operating Income	$ 282,758	$ 85,575
Pre-tax Income from Continuing Operations	$ 218,968	$ 21,785
Income before Charges and Accounting Change	$ 141,672	$ 14,097

The PwC engagement partner advised Finkelstein that the press release was inappropriate and inconsistent with the way the financial statements would be presented in Warnaco's upcoming 1998 annual report. Despite these warnings, Finkelstein replied that Warnaco would nevertheless issue the press release. Warnaco issued the misleading press release, substantially unchanged, the following day. Warnaco's stock traded slightly higher on the news of Warnaco's reported "record" results.

e. Warnaco's 1998 Annual Report

On April 1, 1999, Warnaco filed its annual report on Form 10-K for fiscal 1998. In this report, Warnaco restated its financial results for fiscal 1996-1998 to reduce inventory and increase cost of goods sold by $145 million, as required by GAAP. Warnaco misleadingly continued to claim, however, that the restatement related to the adoption of SOP 98-5. In the notes to the audited financial statements, Warnaco explained the restatement to its investors as an inventory "revision" resulting from deferred "start-up related and production inefficiency costs" identified as part of Warnaco's adoption of new accounting standard SOP 98-5. Specifically, the notes to the audited financial statements stated:

> *Adjustments, Reclassifications and Revisions:* As noted above, the Company early adopted SOP 98-5 in fiscal 1998. <u>In connection with the adoption of the new accounting standard, an extensive effort was undertaken to identify all start-up related production and inefficiency costs that had previously been deferred.</u> Over the last six years, the Company has opened or expanded 10 manufacturing facilities. In addition, to support anticipated future growth, the Company opened 2 new manufacturing facilities during 1998 for a total of 12 new facilities. <u>This resulted in the Company's incurring plant inefficiencies and other start-up related costs resulting from high turnover and related training and other costs. Such start-up related production and inefficiency costs have been classified in other assets and inventories. Because certain such costs identified in this process related to fiscal 1997 and 1996 activities, such prior year consolidated financial statements have been revised to reflect additional cost of goods sold[.]</u> (Emphasis added.)

The Form 10-K was misleading. The restatement was not the result of "previously deferred" start-up costs and was not related to Warnaco's adoption of SOP 98-5. Rather, the restatement was precipitated by a material failure of Warnaco's inventory accounting and internal control systems. The annual report did not clearly explain to investors that Warnaco had restated its financial results for a three-year period to correct a $145 million inventory overvaluation, and did not disclose that this restatement was caused by the failure of Warnaco's accounting system to properly deduct costs from inventory as goods were sold.

At the time the Form 10-K was filed, there was no reasonable basis for Warnaco to describe the inventory restatement as the write-off of deferred "start-up related" costs identified in connection with Warnaco's adoption of SOP 98-5. Warnaco's senior management knew as a result of the Standard Cost Project and IAD's own internal projections that IAD's inventory was overvalued on Warnaco's books by at least $60-$80 million. Senior management knew that the PwC consultants had identified defects in IAD's inventory systems that potentially could have caused IAD's inventory to be overvalued by the amounts in question. Furthermore, Finkelstein, Warnaco's then-CFO, knew that the IAD controller had confirmed certain of these errors in October and that the controller had concluded that the inventory overstatement was due to the failure of the system to properly deduct costs from inventory as that inventory was sold. Warnaco's disclosure concealed a material weakness in its cost accounting and internal control systems.

Warnaco did not correct the misleading disclosure until May 16, 2000, over a year later, when it filed an amended 1998 Form 10-K. The notes to the financial statements in the amended report removed all references to start-up related production and inefficiency costs and, for the first time, informed investors that:

> *Reclassifications and Restatement:* . . . In connection with the fiscal 1998 year-end closing, the Company determined that in fiscal 1996, 1997 and the first three quarters of 1998, as merchandise was sold, inventories were relieved at less than actual cost per unit, leaving an accumulation of inventory costs. As a result, costs related to [those periods] have been restated to reflect additional costs of goods sold[.] . . . This restatement resulted from flaws in the Company's Intimate Apparel Division inventory costing control system that have since been addressed.

2. Improper Offset of Debt Against Cash in the Third Quarter of 2000

In the Summer of 2000, due to its deteriorating financial situation, Warnaco faced the possibility of being unable to meet the financial covenants of its long-term debt, which totaled nearly $2 billion. Warnaco sought and subsequently obtained waivers of the financial covenants from its banks. It then entered into a series of negotiations with its bank consortium to restructure its long-term debt. The negotiations culminated in an agreement between the banks and Warnaco that was signed on October 6, 2000.

On November 2, 2000, Warnaco publicly announced its earnings for the third quarter of 2000. In the consolidated balance sheet attached to the press release issued that day, Warnaco reported that it had shareholders' equity of $348 million, cash of $227 million, and debt of $1.79 billion as of the end of the third quarter on September 30, 2000. In the conference call with investors held that day, Finkelstein reported that "[d]ebt net of cash was $1.644 billion."

Shortly after the press release was issued, Warnaco's lenders contacted Warnaco to inquire whether, based upon the numbers reflected in the press release, the company was in compliance with the financial covenants in Warnaco's license agreement with Calvin Klein, Inc. The financial covenants in that license required Warnaco to maintain a debt-to-equity ratio of less than 5-to-1. The debt and equity amounts reported in the earnings release, however, revealed that Warnaco's debt-to-equity ratio had risen above 5-to-1. Under the terms of the licensing agreement, a violation of the covenant could result in termination of the license, which accounted for more than twenty-five percent of Warnaco's gross revenues.

After Finkelstein confirmed that the lenders' calculations were correct, he decided to retroactively offset Warnaco's cash on hand as of September 30 against its debt, which would reduce Warnaco's debt on paper and create the appearance that Warnaco had remained in compliance with the debt-to-equity covenant as of the end of the quarter. In order to convince Warnaco's auditors that the cash against debt set-off was proper under Generally Accepted Accounting Principles, Finkelstein asked Warnaco's general counsel to send a letter to the auditors stating that Warnaco and its lenders had entered into a legally enforceable agreement as of September 29, 2000 that Warnaco's cash on hand would be offset against its debt. The general counsel sent the letter without ascertaining whether a legally enforceable agreement had been reached by that date.

On November 12, 2000, Warnaco filed its quarterly report on Form 10-Q for the third quarter of fiscal 2000. At Finkelstein's direction, Warnaco offset its cash on hand as of September 30 against its long-term debt to prepare the consolidated balance sheet for the report. The balance sheet reported cash of $36.5 million and long-term debt of $1.6 billion. By using these revised amounts, Warnaco's debt-to-equity ratio appeared to be slightly less than 5-to-1, indicating that Warnaco remained in compliance with the Calvin Klein licensing agreement. The quarterly report did not disclose that the reported cash and long-term debt amounts differed from the amounts Warnaco had previously announced in its earnings release on November 2, 2000. Nor did the report disclose that Warnaco had offset $190.5 million in cash against long-term debt in order to reach the reported cash and debt amounts.

The revised cash and debt amounts that Warnaco reported in its Form 10-Q were not calculated in conformity with GAAP. Under Financial Accounting Standards Board ("FASB") Interpretation No. 39 ("FIN 39"), accounts can be offset only in certain limited instances:

> [T]he offset of assets and liabilities in the balance sheet is improper except where a right of setoff exists. . . . A right of setoff exists when all of the following conditions are met: (a) Each of *two* parties owes the other determinable amounts; (b) The reporting party has the right to set off the amount owed with the amount owed by the other party; (c) The reporting party intends to set off; and (d) The right of setoff is enforceable at law.

FIN 39 also states that cash cannot be treated as an amount owed to the depositor by the financial institution and cannot be subject to set-off.

None of the FIN 39 requirements were met. FIN 39 specifically prohibits the set off of cash held on deposit at a financial institution, and therefore Warnaco could not treat its cash deposits as a "debt" owed to it by the banks. Moreover, there was no legally enforceable agreement between Warnaco and its banks to repay the $190.5 million that was setoff. Finally, Warnaco never repaid the full $190.5 million, indicating that there was no agreement to offset that amount. Therefore, under GAAP, Warnaco was not permitted to offset the $190.5 million against debt. As a result, the quarterly report was misleading.

3. <u>Warnaco's $26 Million Restatement of Shareholders' Equity in April 2001</u>

On April 18, 2001, Warnaco filed its annual report on Form 10-K for fiscal 2000. In this filing, Warnaco again restated its financial statements dating back to January 3, 1998 to correct a new set of accounting errors, including a $52 million understatement of Warnaco's accounts receivable reserves, a $6 million understatement of accrued liabilities, inventory and other assets that were overstated by $17 million, and a deferred tax asset that was understated by $49 million. The net effect of the adjustments was to reduce shareholders' equity by $26 million as of January 3, 1998.

The majority of the adjustment – the $52 million understatement of accounts receivable reserves at Warnaco's IAD – was due to Warnaco's failure over a period of years to accrue a sufficient reserve for customer returns and discounts, as required by GAAP. At the request of Warnaco's new auditors, Deloitte & Touche, Warnaco prepared an analysis of the customer return reserve and concluded that it should have established a total of $41 million or more in reserves beginning in 1997.

As a result of these errors, Warnaco filed inaccurate financial statements from 1998 through 2000. Warnaco also failed to maintain books and records that accurately reflected the transactions of the company and failed to establish an adequate system of internal controls.

4. <u>Warnaco's $51 Million Restatement In July 2002</u>

On August 23, 2001, Warnaco announced that it expected to take an estimated $43 million charge to earnings and restate its financial results for the prior three fiscal years (1999, 2000, and 2001). Ultimately, the errors turned out to be larger than Warnaco had anticipated. On July 31, 2002, Warnaco filed its overdue annual report on Form 10-K for fiscal year 2001, restating its financial results for the years 1999 through 2001 to reduce net income or increase net loss by a total of $51 million over the period. The restatement reduced net income for 1999 by $4.1 million; increased net loss for 2000 by $45.8 million; and increased net loss for the first quarter of 2001 by $1.1 million.

This restatement resulted from significant accounting problems at Warnaco's Designer Holdings Limited ("DHL") subsidiary, which manufactures designer jeans and sportswear under the Calvin Klein logo. From at least 1999, DHL had improperly accounted for "inter-company transactions," that is, transactions between DHL and other divisions or subsidiaries of Warnaco. DHL recorded the transactions at a lower cost than the other divisions. Moreover, because DHL failed to reconcile its accounts payable for a period of years, DHL failed to timely discover the error. Further, when Warnaco and its auditors scrutinized the DHL accounts after the inter-company error was discovered, they found additional accounting errors relating to the recording of accounts payable and inventory at European subsidiaries, including the booking of some entries to the general ledger without proper support. Ultimately, these errors led to the $51 million restatement.

As with the inventory error at IAD described above, the errors at DHL resulted from material weaknesses in DHL's internal controls. DHL failed to maintain basic internal controls. Moreover, Warnaco had no corporate policy during this period to ensure that each division performed basic accounting control measures, such as reconciling all major accounts at the end of each month or each quarter. If DHL had reconciled its accounts on a regular basis, it would have identified the errors that resulted in the $51 million restatement and corrected them in a timely manner.

As a result of this conduct, Warnaco's Forms 10-K for 1999-2001 misstated cost of goods sold, net income, accounts payable, and earnings per share. Warnaco also failed to maintain books and records that accurately reflected the transactions of Warnaco and failed to establish an adequate system of internal controls.

D. <u>Violations</u>

1. <u>Warnaco Issued a False and Misleading Press Release</u>

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit materially false or misleading statements or omissions made in connection with the purchase or sale of securities. *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998). "Moreover, half-truths are as violative . . . as outright falsehoods." *SEC v. Schiffer*, S.D.N.Y. 1998 Fed. Sec. L. Rep. ¶ 90,247, 1998 WL 307375, at *2 (S.D.N.Y.).

A fact is material if there is a substantial likelihood that a reasonable investor would consider the information to be important. *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988). Information concerning a company's financial condition and profitability is material information. *See, e.g.*, *SEC v. Murphy*, 626 F.2d 633, 653 (9th Cir. 1980). Misstatements of income are material because "earnings reports are among the pieces of data that investors find most relevant to their investment decisions." *Ganino v. Citizens Util. Co.,*, 228 F.3d 154, 164 (2d Cir. 2000) (citation omitted).

Section 10(b) and Rule 10b-5 require that a defendant act with scienter, which has been defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter can be satisfied by showing that a defendant acted recklessly. *See, e.g.*, *ITT v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980); *Schiffer*, 1998 WL 307375, at *3. For the purposes of establishing scienter on the part of a company, the mental state of the company's officers is imputed to the company. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1089 n.3 (2d Cir. 1972).

Warnaco issued a false and misleading press release on March 2, 1999 that materially misrepresented Warnaco's financial results. The press release reported "record" earnings results without informing investors that these results were substantially greater than the audited results Warnaco would report the following month in its annual report. It obscured the material information that Warnaco's inventory was overstated by $145 million (more than twenty percent), and failed to disclose this overstatement had been caused by materially deficient accounting and internal control systems at Warnaco's largest division. Instead, Warnaco falsely claimed that the inventory write-down was part of the write-off of start-up costs under new accounting pronouncement SOP 98-5, making it appear that these were costs incurred in growing the business when in fact Warnaco would be restating its financial results to correct the $145 million overstatement of its inventory.

As a result of these acts and omissions, Warnaco violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

2. Warnaco Violated the Reporting Provisions of the Exchange Act

Section 13(a) of the Exchange Act and Rule 13a-1 thereunder require issuers whose securities are registered with the Commission pursuant to Section 12 of the Exchange Act to file annual reports with the Commission. These reports must be complete and accurate in all material respects. *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir. 1991); *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979). Rule 12b-20 of the Exchange Act requires that an issuer's periodic reports include any additional information "necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." The issuer's legal obligation "extends not only to accurate quantitative reporting of the required items in its financial statements, but also to other information, qualitative as well as quantitative, needed to enable investors to make informed decisions." *In re Sony Corp. and Sumio Sano*, 67 SEC Docket 1609, 1998 WL 439898 at *4 (Aug. 5, 1998).

Warnaco filed a misleading fiscal 1998 Form 10-K annual report on April 2, 1999 that falsely attributed Warnaco's $145 million restatement to "previously deferred" start-up related costs identified in connection with Warnaco's adoption of SOP 98-5. Warnaco failed to disclose that the restatement was precipitated by a material failure of Warnaco's inventory accounting and internal control systems and did not clearly explain to investors that Warnaco had restated its financial results for a three-year period to correct a $145 million inventory overvaluation.

Warnaco also filed a misleading and inaccurate third quarter 2000 Form 10-Q quarterly report on November 12, 2000 that improperly offset $190.5 million in cash against debt in order to avoid a claim of non-compliance with the Calvin Klein licensing agreement. This offset was not in conformity with GAAP.

In addition, Warnaco filed annual reports for the years 1998 through 2001 that contained inaccurate financial statements that were not presented in conformity with GAAP, due to a series of errors that required Warnaco to restate its financial results for this period on three separate occasions.

By its conduct, Warnaco violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

3. Warnaco Violated the Books and Records and Internal Control Provisions of the Exchange Act

Section 13(b)(2)(A) of the Exchange Act requires that issuers make and keep books, records, and accounts which, in reasonable detail, accurately and fairly represent the transactions and dispositions of the company. Section 13(b)(2)(B) of the Exchange Act requires reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain accountability of assets.

During the period 1996 through 2001, Warnaco's books and records failed to accurately reflect the company's transactions as set forth below:

- During the period from at least 1996 through the end of 1998, as a result of the weaknesses in the IAD inventory accounting and internal control systems, Warnaco's books and records overstated the actual value of the company's inventory by $145 million.

- In November 1999, as a result of Warnaco's decision to improperly offset cash against long term debt, the company's books and records understated long-term debt and cash on hand by $190.5 million.

- During the period from at least 1997 through 2000, due to the company's failure to account properly for customer returns and other errors, Warnaco's books and records understated shareholders' equity by $26 million and understated by material amounts the company's accounts receivable reserves, accrued liabilities, and inventory and other assets.

- During the period from at least 1998 through 2001, as a result of DHL's failure to properly account for inter-company transactions and other errors, Warnaco's books and records did not accurately reflect the company's financial position and results of operations, resulting in an overstatement of net income of $51 million.

Warnaco also failed to maintain adequate internal controls sufficient to ensure that Warnaco's financial statements would be prepared in conformity with GAAP, as required by Section 13(b)(2)(B) of the Exchange Act. The inventory and internal control systems at Warnaco's largest division, IAD, were inadequate and error-prone. Senior management at Warnaco was aware of these defects, but did not take steps to rectify the situation promptly. Further, Warnaco's senior management failed to ensure that all of Warnaco's divisions had sufficient internal controls to identify and correct the accounting errors that led to Warnaco's 2001 and 2002 restatements.

By its conduct, Warnaco violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

E. <u>Undertakings</u>

Respondent undertakes to:

1. Require its board of directors to appoint a special committee comprised entirely of outside directors ("Special Committee") that shall retain, within thirty days after entry of this Order, a qualified independent consultant not unacceptable to the staff of the Division of Enforcement to perform a complete review of Warnaco's internal controls and policies relating to:

a. All inventory systems at the Intimate Apparel Division, including but not limited to cost accounting systems and internal control systems relating to inventory valuation;

b. Procedures relating to inter-company accounts, accounts payable transactions, and appropriate reconciliation of all accounts at the company (including both corporate and division or subsidiary);

c. Internal audit functions at the company; and

d. Financial reporting functions.

Warnaco shall cooperate fully with the Independent Consultant in this review. Within 120 days after appointment, the Independent Consultant shall complete its review and submit to the Special Committee and Division Staff a written report fully documenting its findings and proposed recommendations. Within sixty days after receipt of such report, Warnaco's board of directors shall adopt and implement such recommendations; provided, however, that as to any recommendation that Warnaco believes is unduly burdensome or impractical, Warnaco may suggest an alternative policy or procedure designed to achieve the same objective, submitted in writing to the Independent Consultant and the Division Staff. The Independent Consultant shall reasonably evaluate any alternative policy or procedure proposed by Warnaco. Warnaco agrees that it will abide by the decision of the Independent Consultant regarding such alternative proposals.

Warnaco further agrees to require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Respondent, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order shall not, without prior written consent of the Division Staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Respondent, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.

2. Require for a period of two years that:

a. Warnaco's general counsel continue to report directly to the audit committee of the board of directors on any matter relating to Warnaco's financial reporting obligations; and

b. Former general counsel Stanley P. Silverstein not sign any documents to be filed with the Commission by or on behalf of Warnaco and not participate in or be responsible for the preparation or review of such filings, *except that* Silverstein may provide information to others upon request for inclusion into such filings if he also provides a copy of any such information to Warnaco's audit committee.

In determining whether to accept the Offer, the Commission has considered the undertakings set forth in the preceding paragraphs.

F. Findings

Based on the foregoing, the Commission finds that Warnaco violated Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1 and 13a-13 thereunder.

IV.

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

ACCORDINGLY, IT IS HEREBY ORDERED:

Pursuant to Section 21C of the Exchange Act, that Warnaco cease and desist from committing or causing any violations and any future violations of Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 10b-5, 12b-20, 13a-1, and 13a-13 promulgated thereunder.

By the Commission.

Jonathan G. Katz
Secretary