



## SUMMARY

This is a financial reporting case in which inadequate internal controls caused Oregon-based Lattice Semiconductor Corp. to file inaccurate Forms 10-Q for the second and third quarters of 2003. By failing to segregate duties concerning the creation and entry of journal entries into the general ledger and failing to modernize and integrate its accounting system, Lattice contributed to the former controller's ability to enter unsupported journal entries totaling \$5.5 million and to conceal such entries for seven months from senior management and Lattice's auditor. These unsupported entries led Lattice to restate its financial statements for the first three quarters of 2003 in April 2004<sup>1</sup>, reducing previously reported revenue by \$10.6 million (an approximate 6% decrease) and increasing previously reported loss by \$8.9 million (an approximate 13% increase). As a result, Lattice violated the reporting, books and records, and internal controls provisions of the Exchange Act.

### **A. RESPONDENT**

**Lattice Semiconductor Corp.**, a Delaware corporation headquartered in Hillsboro, Oregon, designs, manufactures, and sells semiconductor products. Lattice's stock is registered under Section 12(g) of the Exchange Act and trades on the Nasdaq National Market.

### **B. FACTS**

#### **1. Lattice's Business and Deferred Revenue Accounting**

Lattice manufactures semiconductor products and sells them to end users directly and through distributors. Sales to distributors account for nearly half of Lattice's revenue. Lattice delays revenue recognition on sales to distributors until the distributors report product resale to Lattice. Lattice uses deferred income accounting to reflect the anticipated revenue and corresponding costs for its products shipped to distributors but not yet sold to end users. For example, when Lattice ships a product to a distributor, it records in its general ledger the list price as a credit to deferred revenue and the cost of the product as a debit to deferred cost. Deferred income is the balance sheet liability account reflecting deferred revenue less deferred cost.

#### **2. The Cross-Check of the Deferred Revenue Account in the General Ledger**

At the close of each quarter, the former controller<sup>2</sup> performed an account reconciliation to cross-check the accuracy of Lattice's estimate of deferred revenue as reflected in its general ledger. This account reconciliation was based on the carrying value of the Lattice inventory sitting on distributors' shelves and provided an estimate of the minimum deferred revenue balance required to reflect sales of this inventory. Lattice's accounting policies provided that if there was no material discrepancy between the account reconciliation estimate of deferred revenue and the estimate of deferred revenue reflected in Lattice's general ledger, the general ledger was accurate and the books could be closed for the quarter.

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<sup>1</sup> Although Lattice restated its financial statements for the first quarter of 2003, that first quarter restatement is not addressed in this Order.

<sup>2</sup> The Commission instituted settled Administrative and Cease-and-Desist Proceedings against the former controller, Ronald Lee Hoyt, CPA, on September 30, 2005, in which Hoyt agreed not to practice before the Commission for three years.

### **3. The Discrepancies and Unsupported Journal Entries**

#### **(a) The Second Quarter 2003 Discrepancy of \$1.3 Million and the Unsupported Journal Entries to Reconcile the Discrepancy**

In July 2003, the former controller performed his usual reconciliation of the deferred revenue account in connection with his preparation of quarterly financial statements. The reconciliation showed that the estimate of deferred revenue was \$1.3 million higher than the deferred revenue balance on the general ledger, indicating an understatement of Lattice's deferred revenue and that Lattice had prematurely recognized revenue. Exploiting weaknesses in Lattice's internal controls, the former controller then wrote and caused the entry of two unsupported journal entries totaling \$1.3 million to offset the imbalance between the estimate of deferred revenue derived from the account reconciliation and the estimate of deferred revenue in the general ledger. These journal entries consisted primarily of credits (increases) to deferred revenue and debits (reductions) to accrued accounts payable instead of debits (reductions) to revenue. After making the unsupported journal entries, the former controller closed the books for the quarter. As a result, Lattice recognized revenue prematurely.

#### **(b) The Third Quarter Discrepancy of \$5.5 Million and the Unsupported Journal Entries to Reconcile the Discrepancy**

At the end of the third quarter, the former controller again performed his customary reconciliation to cross-check the amount of deferred revenue recorded in the general ledger. This time, the discrepancy was \$5.5 million. The former controller, again exploiting weaknesses in the company's internal controls, then wrote and caused the entry of several unsupported journal entries, totaling \$5.5 million (inclusive of the \$1.3 million of unsupported journal entries from the second quarter), to offset the imbalance and close the books for the quarter.

The use of unsupported journal entries in the second and third quarters of 2003 contributed to Lattice's recognition of revenue contrary to Generally Accepted Accounting Principles (GAAP). Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises" (CON 5), provides that "revenues are considered to be earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenue." CON 5 Para. 83. Accounting Research Bulletin No. 43 (ARB 43) provides that "Profit is deemed to be realized when a sale in the ordinary course of business is effected . . ." ARB 43 Chapter 1.A.1.

### **4. Lattice's Internal Investigation and Restatement**

On January 12, 2004, the former controller disclosed to Lattice's former VP of finance<sup>3</sup> the second and third quarter general ledger imbalances of \$1.3 and \$5.5 million, respectively. When Lattice learned about the unsupported journal entries, it relieved the former controller of responsibility for journal entries and the general ledger and began an internal investigation. The audit committee subsequently hired independent outside counsel to investigate. As described more fully below, the investigations identified material internal controls weaknesses and resulted in changes to the method of estimating deferred revenue and restatements of all 2003 Forms 10-Q on April 19, 2004. The restatements reduced previously reported revenue by \$10.6 million (an approximate 6% decrease) and increased previously reported net loss by \$8.9 million (an approximate 13% increase).

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<sup>3</sup> The former VP of Finance terminated employment with Lattice in August 2005.

## **5. Lattice's Internal Controls Weaknesses**

In the relevant period, Lattice had two material weaknesses in the design and operation of its internal controls: failure to segregate duties concerning journal entries and failure to recognize that its method of calculating deferred revenue had become inaccurate over time.

With respect to Lattice's failure to segregate duties, Lattice's accounting practices enabled the former controller to have sole review and approval of all journal entries and gave him access to the general ledger. The lack of segregation allowed the former controller to make the unsupported journal entries without review. Lattice's dependence on the former controller was such that, although it terminated him in March 2004, it hired him three days later as a consultant to assist with the quarterly filing.

At least a year before the former controller's misconduct, Lattice's auditor orally notified Lattice's former VP of finance that the lack of segregation of duties for journal entries and general ledger reconciliation was an internal controls weakness. However, no changes to Lattice's controls were made.

The second material control weakness related to Lattice's failure to integrate its accounting system. In particular, Lattice's accounting system failed to recognize that a percentage used in its account reconciliation methodology to estimate deferred revenue had become inaccurate over time because the accounting system had not been properly integrated to precisely determine the effects of sales discounts. During the relevant period, Lattice had not been collecting as large a percentage of cash from its distributors as it had historically, and Lattice's finance staff did not have adequate systems or personnel to account for the effects of this change. The failure to recognize the drop in percentage of cash collected also caused Lattice to overstate the amount of previously deferred revenue taken into income.

## **C. VIOLATIONS**

### **1. Reporting Violations: Section 13(a) of the Exchange Act and Rule 13a-13 Thereunder**

Section 13(a) of the Exchange Act and Rule 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act, such as Lattice, to file quarterly reports with the Commission and to keep this information current. The obligation to file such reports embodies the requirement that they be true and correct. See, e.g., *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978). Lattice violated these provisions by filing materially inaccurate Forms 10-Q for the second and third quarters of 2003.

### **2. Record-Keeping Violation: Section 13(b)(2)(A) of the Exchange Act**

Section 13(b)(2)(A) of the Exchange Act requires Section 12 registrants to make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of their assets. Lattice's books and records inaccurately reflected the transactions and disposition of assets for the second and third quarters of 2003, in violation of Section 13(b)(2)(A).

**3. Internal Control Violation: Section 13(b)(2)(B) of the Exchange Act**

Section 13(b)(2)(B) requires issuers with securities registered under Section 12 of the Exchange Act to devise and maintain a system of internal accounting controls sufficient to reasonably assure, among other things, that transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP.

Lattice had two primary areas of material weakness in the design and operation of internal controls: segregation of duties and failure to update its estimate methodology. These material weaknesses contributed to the former controller's ability to make and conceal the unsupported journal entries. Lattice therefore violated Section 13(b)(2)(B) of the Exchange Act.

**D. REMEDIAL EFFORTS**

In determining to accept the Offer, the Commission considered Lattice's cooperation and remedial actions.

**IV.**

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

Accordingly, it is hereby ORDERED that Respondent Lattice cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rule 13a-13 thereunder.

By the Commission.

Nancy M. Morris  
Secretary