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

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 53236 / February 7, 2006**

**ACCOUNTING & AUDITING ENFORCEMENT**
**Release No. 2370 / February 7, 2006**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-12173**

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| **In the Matter of**<br><br>**CUMMINS INC.,**<br><br>**Respondent.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934** |

## I.

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

## II.

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

## III.

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

## A. RESPONDENT

**Cummins Inc.**, an Indiana corporation headquartered in Columbus, Indiana, manufactures, distributes, and services engines and engine-related products world-wide. Cummins' common stock is registered with the Commission under Section 12(b) of the Exchange Act. Cummins' stock trades on the New York Stock Exchange and Pacific Stock Exchange under the symbol "CMI." The company's fiscal year ends on December 31.

## B. FACTS

From 1997 through 2002, Cummins failed to reconcile key accounts at two manufacturing locations, in Fridley, Minnesota and Darlington, United Kingdom. These manufacturing locations together accounted for approximately fifteen to twenty percent of Cummins' total revenues. Because Cummins failed to reconcile these accounts, errors in the accounts went uncorrected. The errors had a material impact on Cummins' previously-reported results. On August 4, 2003, Cummins restated its financial results for the years 2000 through 2002 to correct these and other errors.

### Fridley's Reconciliation Deficiencies

The reconciliation deficiencies at the Fridley facility, which were the primary cause of the accounting errors, began as early as 1997. Cummins' accounting policies at the time required that each manufacturing plant reconcile its major accounts, including accounts payable, on a monthly basis. At the Fridley location, however, the staff failed to reconcile its accounts payable subsidiary ledgers to the general ledger between 1997 and 2002. Instead, they simply rolled forward the accounts payable balance reflected in the general ledger account each month without investigating or reconciling the differences between subsidiary ledgers and the general ledger. Cummins' internal auditors cited the Fridley location in 1997 and 1998 for failing to reconcile its subsidiary ledgers for the accounts payable accounts to the general ledgers on a regular basis. In fact, each year during the period from 1997 to 2001, Cummins' internal audit reports recommended that Cummins institute a monitoring process to ensure the proper reconciliation of key accounts. However, Cummins did not institute a monitoring system until 2001.

In 1998 and 1999, Cummins took two actions to address unrelated matters that had the unintended effect of exacerbating the accounts payable problem at the Fridley facility. First, partly in response to Y2K concerns, as well as to consolidate and standardize financial systems and processes, Cummins began implementing a new management information software system. Fridley was one of the first locations to implement the new system, beginning in 1998 and continuing into 1999. However, Cummins did not adequately train Fridley's employees on the new system. Because the Fridley employees did not understand how the new system worked, they created "work around" procedures to fix what they perceived to be problems with the new system and its implementation. These ad hoc "work arounds" introduced additional errors into the accounts payable system. Because Fridley was not reconciling its accounts payable accounts, however, Fridley did not identify and correct these errors.

Second, during 1998 and 1999, Cummins underwent a major restructuring that, among other things, resulted in the departure of a significant portion of Cummins' financial and accounting staff. The exodus of experienced finance personnel particularly affected the Fridley location and further complicated the intermittent efforts to reconcile Fridley's accounts. During this period, Cummins also consolidated its accounting functions, relocating most of the accounting functions, including the reconciliation of accounts payable, from Fridley to a Cummins' office in Nashville. However, a misunderstanding between the Fridley and Nashville offices led each to believe that the other was responsible for reconciling the accounts payable accounts. Due to this misunderstanding, reconciliations were not performed on Fridley's accounts payable accounts from 1999 through at least part of 2002. In addition, Fridley changed controllers three times between 2000 and 2001, further compounding the internal controls breakdown.[1]

In 1999, Cummins' independent auditor noted in its letter to the Audit Committee several problems with reconciliations and internal controls throughout Cummins. In response to these findings, Cummins began a targeted review of various accounts. The year-long effort, which was assisted by Cummins' independent auditors, resulted in a $44 million charge to earnings in 2000. The effort did not address the problems at Fridley, however. Thereafter, to address concerns with reconciliations company-wide in 2001, Cummins created a corporate quality assurance position to investigate all balance sheet accounts, with particular emphasis on internal controls and unreconciled accounts. Additionally, Cummins required that all business units periodically submit reports on designated accounts to the quality assurance manager, providing information on the status of their balance sheet reconciliations. Fridley reported the deficiencies in its accounts payable reconciliation to the quality assurance manager in August 2001. However, because the Fridley controller at the time had been on the job for only a month, Cummins' corporate controller gave Fridley a grace period of several months in which to correct the reconciliation errors.

Although Cummins corrected many of the reconciliation deficiencies at other locations, Cummins failed to devote sufficient resources to correct the reconciliation problems at Fridley. During most of the period from mid-2001 to the end of 2002, Fridley had only one full-time consultant and one full-time employee working on the reconciliations. By 2001, the accounts payable accounts at Fridley had not been reconciled for at least four years, and the limited staff working on the issue – who lacked experience with accounts payable – was unable to identify, segregate, and correct the improper entries recorded in or missing from the accounts payable subsidiary ledgers or the general ledger accounts. Thus, the reconciliation remediation process stretched into the fourth quarter of 2002 without completion.

In August 2002, following the passage of the Sarbanes-Oxley Act of 2002, Cummins corporate management directed that all unreconciled accounts be reported to corporate headquarters and reconciled by year-end 2002. Faced with this deadline, Fridley reported to the corporate office in late October 2002 that its accounts payable accounts remained unreconciled, but

[1] The controller at each Cummins facility is the person responsible for accounting procedures and internal controls at that location.

indicated that it expected no material impact upon income. At the end of December 2002, however, Fridley personnel completed their analysis of the unreconciled accounts and determined that the problem was much larger than originally expected. On January 3, 2003, Fridley reported to Cummins corporate senior management there was a "$16 million accounts payable problem."

**Darlington's Reconciliation Deficiencies**

In June 2000, Cummins' internal auditors reported that the Darlington, U.K. facility had not been reconciling its accounts payable general ledger accounts to the supporting subsidiary ledgers. As was the case at Fridley, it appeared that the accounting staff at Darlington did not understand how to reconcile accounts properly. Cummins replaced the Darlington controller in early 2002, as part of its targeted review and clean-up, and required the Darlington facility to report periodically regarding the status of its account reconciliations. However, as with Fridley, Cummins failed to devote sufficient resources to training the accounting staff at the facility and correcting the problem in a timely manner. Darlington did not complete the reconciliation of its accounts until year-end 2002, over two years after the problem had been identified at the corporate level.

**Cummins' Restatement**

In late January 2003, Cummins notified the SEC that it had discovered a potentially material accounting error. Following this disclosure, Cummins took the following steps: (i) it sent trained accounting personnel from the corporate office and the company's outside auditor to Fridley to investigate the accounts payable accounts reconciliation issues and resolve them; (ii) it retained special counsel to conduct an internal investigation; (iii) it issued a press release announcing the potential adjustment; and (iv) it fired the accounting personnel responsible for the delinquent account reconciliations in question.

On August 4, 2003, Cummins filed its 2002 Annual Report on Form 10-K, which contained restated financial results for the years 2000, 2001, and 2002.[2] The restatement corrected prior period accounting errors caused primarily by Cummins' failure to timely reconcile a number of key accounts, including the accounts payable accounts at Fridley and Darlington, and to correct a $44 million charge to earnings the company took in 2000 to correct the reconciliation errors that had been identified at that time.[3] The restatement had a material effect on Cummins's earnings results:

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[2] Cummins reported unaudited financial results for 2002 in three Quarterly Reports on Form 10-Q, filed on May 15, 2002, August 14, 2002 (amended on October 17, 2002), and November 1, 2002, and a current report on Form 8-K, filed on May 12, 2003.

[3] The restated financial statements were audited by Cummins' current auditor, PricewaterhouseCoopers LLP ("PwC"), because Arthur Andersen LLP, Cummins' predecessor auditor for the years 2000 and 2001, had ceased operations. The restatement also included additional and unrelated adjustments that PwC identified in the course of performing the 2000 and 2001 re-audits.

| | *2002 (Millions)* | *2001 (Millions)* | *2000 (Millions)* | ***Pre-2000 (Millions)*** |
|---|---|---|---|---|
| Previously reported net earnings | $72 | $(102) | $8 | |
| Restatement adjustments (after tax) | $10 | $(1) | $6 | ($37) |
| Restated net earnings | $82 | $(103) | $14 | |
| As a percentage of restated earnings | 12% | 1% | 43% | |

**<u>Cummins' Remedial Measures</u>**

Cummins instituted a number of improvements to its internal controls designed to prevent any recurrence of similar problems in the future, including: making specific internal control enhancements at Fridley and Darlington; hiring experienced finance, accounting, and internal audit personnel throughout Cummins; improving reporting lines between business unit controllers and the corporate controller; improving internal controls governing account reconciliations; and expanding the oversight by the Audit Committee of the Board of Directors.

## C. LEGAL ANALYSIS

Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act to file annual and quarterly reports with the Commission. The obligation to file such reports embodies the requirement that they be true and correct. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979). Section 13(b)(2)(A) of the Exchange Act requires issuers to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. Section 13(b)(2)(B) requires issuers to devise and maintain systems 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.

A fundamental concept underlying accurate financial reporting is that all accounting entries that are required to be recorded must, in fact, be recorded.[4] During the relevant period, two Cummins manufacturing facilities failed to properly record transactions and the disposition of assets on their books and ledgers.[5] Cummins' failure to properly record these transactions resulted in material discrepancies between the general ledger accounts on Cummins' books and the

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[4] Financial Accounting Standards Board Concepts Statement No.5 (As Amended) ("Con 5"), *Recognition and Measurement in Financial Statements of Business Enterprises*, para. 63.

[5] Under Con 5, an asset or liability should be recognized on the company's books when it meets four fundamental criteria: definition, measurability, relevance, and reliability. "Recognition" is the process of formally recording or incorporating an asset or liability in an entity's financial statements. Because Cummins failed to perform reconciliations in a timely manner, it failed to detect, quantify, and record many accounting items that met the recognition criteria set forth in Con 5.

supporting subsidiary ledgers for the accounts payable accounts. If Cummins had properly and timely performed reconciliations for these key balance sheet accounts, it would have detected and corrected the errors years earlier.

Cummins also failed to maintain sufficient internal accounting controls to provide reasonable assurances that its transactions were recorded as necessary to permit the preparation of its financial statements in conformity with generally accepted accounting principles. Among other things, Cummins failed to employ and train qualified personnel in its Fridley and Darlington finance departments and failed to have an internal control system adequate to monitor the accounts reconciliation process.

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

## IV.

In determining to accept the Offer, the Commission considered remedial acts that were undertaken by Respondent and the cooperation that Respondent afforded the Commission staff during its investigation of this matter.

## V.

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

Accordingly, it is hereby ORDERED that**:**

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

By the Commission.

Nancy M. Morris
Secretary