

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

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 57754 / May 1, 2008**

**ACCOUNTING AND AUDITING ENFORCEMENT**  
**Release No. 2821 / May 1, 2008**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13031**

**In the Matter of**

**UTStarcom, Inc.,  
Hong Liang Lu and  
Michael J. Sophie,**

**Respondents.**

**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 UTStarcom, Inc. (“UTSI”), Hong Liang Lu (“Lu”) and Michael J. Sophie (“Sophie”) (collectively “Respondents”).

**II.**

In anticipation of the institution of these proceedings, Respondents have 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 them and the subject matter of these proceedings, which are admitted, Respondents consent 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 Respondents’ Offer, the Commission finds that:

## **Summary**

1. This matter involves recurring internal control deficiencies and inaccurate financial filings by UTSI, a publicly-traded telecommunications company that has restated its financial statements three times since 2005 to correct multiple accounting irregularities. Since 2000, UTSI has improperly recognized revenue on transactions subject to undisclosed side agreements, failed to properly disclose and account for related party transactions, and failed to properly record compensation expenses related to employee stock options. Despite being put on notice of potential accounting issues by, among other things, material weakness letters sent by the company's outside auditors, CEO Hong Liang Lu and former CFO Michael J. Sophie failed to implement and maintain adequate internal controls and falsely certified that UTSI's financial statements and books and records were accurate.

## **Respondents**

2. UTSI, a Delaware corporation with headquarters in Alameda, California, is a telecommunications company that sells software and hardware products in emerging and established telecommunications markets around the world. The majority of UTSI's operations are in Hangzhou, China and overseas. UTSI went public in 2000, and its common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the NASDAQ Global Select Market under the symbol UTSI.

3. Lu, 53, is a co-founder of UTSI and has served as a board member and Chief Executive Officer since 1995. Lu resides in San Ramon, California and Hangzhou, China.

4. Sophie, 50, was UTSI's Chief Financial Officer from 2000 through August 2005 and UTSI's Chief Operating Officer from June 2005 through May 2006. Sophie resides in Pleasanton, California.

## **Facts**

### **Background**

5. Historically, China has been UTSI's largest market. Between 1995 and 2002, nearly all of UTSI's revenue derived from sales by UTSI's subsidiary in China ("UT-China"). By late 2002, UTSI's business plan was expanded to include growth on an international scale. UTSI defines "international" sales as all sales outside of China, including sales in the U.S., Japan, India, and other overseas markets. In 2003 and 2004, sales in China accounted for 86% and 79% of UTSI's revenue, respectively. By 2006, sales in China accounted for 32% of UTSI's revenue. The finance department at UT-China handled the accounting for all transactions in China, and UTSI's finance department in the U.S. handled the accounting for all international transactions.

6. In March 2003, UTSI received a Management Recommendation letter from its auditors detailing internal control weaknesses identified during the December 31, 2002 year-end audit. The letter was addressed to the audit committee and copied to Lu and Sophie. Among other things, the letter specifically noted that UTSI should "strengthen procedures to ensure side letters and contract amendments are communicated and accounted for in a timely manner." In its

written response to the auditor's letter, UTSI said it had implemented the necessary controls to track and monitor side letters and non-routine transactions. UTSI sometimes used letter agreements, or side letters, to supplement or amend contractual terms. Such letters were allowed so long as the accounting for them was done properly.

7. UTSI received another Management Recommendation letter from its auditors in April 2004 detailing multiple internal control weaknesses (many classified as material) identified during the December 31, 2003 year-end audit. The letter was copied to Lu and Sophie, and again noted concerns about the use of side letters that were not forwarded to the finance department. The auditors also expressed concerns with many complex related-party transactions entered into by UTSI. The auditors informed UTSI that the company did not adequately disclose significant transactions involving joint venture arrangements between UTSI and its customers. In its written response, UTSI said it had strengthened controls to identify side letters and implemented monitoring procedures to identify significant joint venture transactions.

8. UTSI also received management recommendation letters from its auditors noting multiple material weaknesses in connection with the 2004 and 2005 year-end audits.

#### UTSI Prematurely Recognized Revenue From International Sales Subject To Undisclosed Side Agreements

9. Between 2003 and 2005, UTSI prematurely recognized nearly \$50 million in net revenue from international sales, all of which occurred outside the U.S., which were subject to side agreements that had been concealed from the company's finance personnel. Because these agreements promised future performance by UTSI, revenue should not have been recognized under Generally Accepted Accounting Principles ("GAAP").

10. Among other contingent transactions, UTSI improperly recognized revenue from the sale of a \$22 million network system to a purchaser in India. At the time of the sale, securities analysts had expressed concerns about UTSI's ability to enter markets outside China, and Lu specifically highlighted this deal as indicative of UTSI's success in gaining traction in India.

11. UTSI delivered the system and recognized revenue from the \$22 million sale in phases over several quarters, including the second quarter of 2004 and the second quarter of 2005. Before recognizing the revenue, UTSI's finance department required the purchaser to sign a final acceptance certificate certifying that all elements of the phase had been delivered and successfully installed.

12. During the second quarter of 2004, the purchaser sent UTSI the final acceptance certificate, but included a proposed side agreement requiring UTSI to upgrade the system after the end of the quarter. Lu and Sophie were aware of the proposed side agreement. UTSI's revenue recognition manager, with the knowledge of Lu and Sophie, specifically admonished that approving the side agreement would prevent revenue recognition. Lu personally communicated with the customer to request that they accept the products without a side agreement.

13. Notwithstanding these directions, a UTSI sales executive signed a side agreement with the purchaser, but failed to adequately disclose the agreement to finance personnel, resulting in the improper recognition of revenue by the company. Lu and Sophie failed to take adequate steps to determine how the customer's request for a side agreement had been resolved and whether revenue recognition was appropriate.

14. During the second quarter of 2005, UTSI recognized additional revenue from the India sale. Once again, a UTSI sales executive had signed a side letter making the customer's acceptance contingent on future upgrades (and thus rendering revenue recognition improper under GAAP). Lu and Sophie were aware the customer had made such a request, but received a communication from finance personnel that the final acceptance certificates received from the customer were acceptable. Neither Lu nor Sophie took steps to determine how the issue was resolved and whether revenue was properly recognized.

15. In addition to the India transaction, UTSI entered into five other international sales transactions totaling \$27.5 million in net revenue where side agreements had been entered into promising future products or services. These side agreements should have precluded revenue recognition. On June 26, 2006, UTSI restated its financial statements for the period between Q1 2003 through Q3 2005, reversing \$49.5 million in net revenue that had been improperly recognized by the company.

#### UTSI Prematurely Recognized Revenue On Sales In China With Undisclosed Contract Modifications

16. Between 2000 and 2005, UTSI prematurely recognized over \$350 million in revenue from 78 sales transactions in China. On some occasions, UTSI sales personnel entered into contracts that contained non-standard product upgrade provisions precluding revenue recognition. In some instances, sales personnel documented the sales on two separate contracts, and only the company's standard contract (without the upgrade provisions) was made available to UTSI's finance personnel. As a result, UTSI repeatedly recognized revenue for contingent sales in violation of GAAP.

17. Lu and Sophie had been on notice since at least 2003 of significant internal control weaknesses in China, including the fact that in some instances side letters and contract amendments introducing revenue contingencies were not forwarded by sales offices to the contract and finance departments. Although Lu and Sophie took steps to improve internal controls in response to this information, neither those steps nor the resulting controls were sufficient to detect the improper dual contract practices and failed to prevent certain improprieties.

18. On October 10, 2007, UTSI restated its financial statements from 2000 through the second quarter of 2006 to reverse \$271 million in net revenue improperly recognized by the company.

#### UTSI Failed to Disclose and Properly Account for Related Party Transactions

19. In 2001, a China-based company called MDC was formed in order to provide value-added services to UTSI products. The father of UT-China's Executive Vice President

founded MDC; the UT-China executive served as the “alternate” chairman of MDC’s board of directors. Numerous officers and other employees of UT-China invested in MDC, and certain UT-China employees worked for MDC while their salaries were paid by UT-China.

20. In 2003, UT-China entered into a complex transaction involving MDC and another customer in China, whereby MDC took ownership of UTSI inventory that had decreased in value. Because UTSI failed properly to treat MDC as a consolidated entity, no impairment of the inventory value was recorded by UTSI at the time.

21. Lu and Sophie had been on notice of concerns raised by the company’s auditors about UTSI’s failure to adequately disclose related party transactions entered into by UTSI. Although Lu and Sophie took steps to improve internal controls in response to this information, neither those steps nor the resulting controls were sufficient to detect the improper transaction with MDC and failed to prevent inaccurate reporting of certain related party transactions.

22. On April 13, 2005, UTSI restated its 2003 financial statements in part to consolidate MDC, as MDC was deemed a related party controlled by UTSI. The restatement resulted in the write down of \$7.5 million in UTSI inventory held by MDC.

#### UTSI Failed Properly to Account for Stock Compensation Expenses

23. UTSI failed properly to account for certain stock option grants because the company used incorrect grant dates for determining compensation expenses. Under GAAP, UTSI was required to record an expense on its financial statements for any stock options granted “in-the-money” – i.e. where the exercise price of the option was less than the market price for the security on the date the option was granted.

24. Certain grants to UTSI officers were backdated or accounted for with incorrect grant dates prior to the proper authorization of the grant by the company’s Compensation Committee. This resulted in an exercise price below market price on the date of the grant, yet no expense was recorded by the company.

25. UTSI failed to establish and implement adequate internal controls for the granting of employee stock options. Among other things, UTSI failed to maintain necessary documentation showing when the grants were actually authorized by the Compensation Committee.

26. On October 10, 2007, UTSI restated its financial statements from 1998 through the second quarter of 2006 to recognize an additional \$27 million in compensation expenses related to employee stock options.

#### Respondents Lu And Sophie Signed False Certifications Under Section 302 Of The Sarbanes-Oxley Act

27. Lu and Sophie, as UTSI’s CEO and CFO, were required to sign certifications each fiscal quarter and fiscal year stating that, based on their knowledge, the company’s quarterly and annual reports did not contain any misstatements or omit material information, that the reports disclosed all significant deficiencies in the design or operation of UTSI’s internal controls, and

that the reports fairly presented in all material respects UTSI's financial condition and results of operations. Lu executed such certifications for the quarters and years from the first quarter of 2004 through the second quarter of 2006, and Sophie executed such certifications for the quarters and years from the first quarter of 2004 through the second quarter of 2005. For the reasons set forth above, these certifications were false.

### **Violations**

28. As a result of the conduct described above, UTSI violated Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder by filing inaccurate periodic reports with the Commission, by failing to make and keep accurate books and records, and by failing to devise and maintain an adequate system of internal accounting controls. The company filed inaccurate periodic reports and failed to keep accurate books and records because the company improperly recorded revenue for transactions that involved side agreements with revenue contingencies and failed properly to account for related-party transactions and stock compensation expenses. In addition, UTSI failed to devise and maintain an effective system of internal controls relating to side agreements, related parties and stock option practices.

29. As a result of the conduct described above, Lu and Sophie caused UTSI's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder insofar as they did not take steps adequate to ensure that UTSI filed accurate financial statements, made and kept accurate books and records, and implemented and maintained adequate internal controls. Also as a result of the conduct described above, Lu and Sophie violated Exchange Act Rule 13a-14 by falsely certifying that UTSI's periodic filings did not contain any material misstatements or omissions, disclosed all significant deficiencies in UTSI's internal controls, and fairly presented UTSI's financial condition and results of operations.

### **UTSI's Remedial Efforts**

In determining to accept the Offer, the Commission considered remedial acts undertaken by UTSI.

## **IV.**

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

Accordingly, it is hereby ORDERED that:

A. Respondent UTSI 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 13a-1 and 13a-13 thereunder;

B. Respondent Lu cease and desist from 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 13a-1

and 13a-13 thereunder, and from committing any violations and any future violations of Rule 13a-14 thereunder; and

C. Respondent Sophie cease and desist from 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 13a-1 and 13a-13 thereunder, and from committing any violations and any future violations of Rule 13a-14 thereunder.

By the Commission.

Nancy M. Morris  
Secretary