

Memorandum

SEC Charges Computer Sciences Corporation And Its Former Executives With Accounting Fraud, Invoking Sarbanes-Oxley's Clawback Provision

July 6, 2015

On June 5, 2015, the Securities and Exchange Commission ("SEC") entered into settled administrative cease-and-desist proceedings with Computer Sciences Corporation ("CSC") and some of its former executives due to the company's alleged manipulation of financial results and concealment of problems with the company's largest contract.¹ Among other things, CSC agreed to pay a \$190 million penalty to settle the charges, and two of CSC's former executives agreed to return a portion of their compensation to CSC pursuant to the clawback provision of the Sarbanes-Oxley Act of 2002. The SEC also charged former CSC finance executives for ignoring accounting standards to increase reported profits.

Factual Background and SEC Findings

CSC entered into a contract with the United Kingdom's National Health Service ("NHS") to build and deploy an electronic patient record system. The contract had the potential to earn CSC \$5.4 billion in revenue if the company satisfied the timeframes outlined in the contract. The contract also included penalties of up to \$160,000 per day for missed deadlines. CSC had trouble developing the software. CSC and NHS amended the contract, NHS agreeing to waive the penalties in exchange for certainty of deployment of the electronic record system on an agreed upon date. It later became clear that CSC would not be able to meet its commitments under the amended contract either.

In its order, the SEC noted that, under SEC disclosure rules and Generally Accepted Accounting Principles ("GAAP"), CSC was required to disclose that it would likely experience material adverse financial

¹ See U.S. Securities and Exchange Commission, "[SEC Charges CSC and Former Executives with Accounting Fraud](#)" (June 5, 2015).

consequences as a result of its failure to meet the temporal requirements of the amended contract. During the relevant period, however, the only disclosure that CSC made with regard to the NHS contract was that the contract was profitable and that the company expected to recover its \$1 billion investment in the contract. Despite the fact that CSC did not reach the contract's milestones and that it received many letters from NHS indicating that it was in default of the contract, CSC's chief executive officer ("CEO"), Michael Laphen, reported to investors during an earnings call that CSC "completed the activities scheduled within the quarter."²

The SEC alleged that in addition to CSC's failure to disclose material adverse financial consequences, thereby misleading investors, CSC used improper accounting. The SEC alleged that CSC under-accounted for the reduction in contract value of the renegotiated contract with NHS. GAAP requires companies to reflect the impact of a decrease in the profit margin on a contract by recording an inception-to-date adjustment.³ Laphen signed a management representation letter to CSC's independent auditors, stating that "the Company's [accounting model] on the NHS contract used to prepare the third quarter 2011 financial statements represents the best estimate of the probable contract value." The SEC alleged that CSC's improper accounting also constituted a violation of disclosure rules in that CSC failed to accurately reflect the reduction in contract value of the renegotiated contract with the NHS, both in written filings with the SEC and in statements that Laphen made to investors.

Additionally, the SEC alleged that when Robert Sutcliffe, the Finance Director for the NHS account, determined that the CSC contract with NHS would generate a significant loss and would not earn the forecasted 16% profit margin, Sutcliffe led a fraudulent "gap closing" exercise. Sutcliffe and his team allegedly added items to CSC's accounting models to falsely increase profits in order to avoid reporting a large shortfall to CSC's earnings, which CSC was required to record under GAAP. CSC continued to report that the company would maintain its predicted 16% profit margin on the NHS contract.

In response to its failure to adhere to the contract, CSC proposed new contract amendments, pursuant to which CSC would reduce the total price that NHS would pay by about 10%, in return for reducing the services CSC was required to provide by 30%. According to the SEC, NHS rejected this extremely lopsided offer. Nevertheless, CSC allegedly adopted these proposed contract amendments into its accounting model for the NHS contract. The SEC found that this constituted a violation of GAAP because CSC recognized profit on contract change that had not been accepted. Moreover, the SEC alleged that in further violation of the SEC's disclosure rules, CSC executives failed to inform investors of this change to their accounting methods.

² *In the Matter of Computer Sciences Corp., Michael Laphen, Michael Mancuso, Wayne Banks, Claus Zilmer, & Paul Wakefield Respondents*, Release No. 34-75110 (June 5, 2015).

³ *Id.*

Further, the SEC found that Michael Mancuso, CSC's former Chief Financial Officer ("CFO"), concealed from investors an agreement pursuant to which CSC borrowed money from NHS at a high interest rate in order to allow CSC to meet its cash flow targets. According to the SEC, CSC paid over 6% interest on hundreds of millions of dollars even though CSC could have borrowed the money at a considerably lower interest rate. The cash advance agreement allegedly resulted in significant bonus payouts to senior executives, who would not have received any bonuses without the cash advance. Mancuso described the cash flow results as "a glowing achievement." CSC failed to disclose the unusual cash advance agreement, which the SEC explained was a violation of SEC disclosure rules.⁴

The Settlement

CSC and five of the eight executives charged entered into a settlement with the SEC without admitting or denying the SEC's findings. CSC agreed to pay a \$190 million penalty and to retain an independent consultant to review the company's ethics and compliance programs.

In addition, as part of the settlement, the SEC invoked the clawback provision of the Sabanes-Oxley Act. Section 304 of the Sarbanes-Oxley Act provides that "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the issuer's CEO and CFO must reimburse the issuer for:

1. "any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period" following the false filing; and
2. "any profits realized from the sale of securities of the issuer during that 12-month period."⁵

Under this provision, Laphen agreed to return more than \$3.7 million in compensation to CSC, in addition to paying a \$750,000 penalty. Similarly, Mancuso agreed to return \$369,100 in compensation to the company pursuant to Section 304 and to pay a \$175,000 penalty.

The Remaining Charges Against CSC Executives

The SEC filed complaints in federal court in the Southern District of New York against former CSC finance executives Robert Sutcliffe, Edward Parker, and Chris Edwards, none of whom agreed to settle the charges through an administrative cease-and-desist order.

Significance of the Actions

The SEC's actions highlight the importance of accurately disclosing financial results and material trends and

⁴ The SEC also found that CSC and the company's finance executives in Denmark and Australia overstated the company's earnings, failing to comply with accounting standards and disclosure rules.

⁵ The Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243.

uncertainties that may impact the company's performance. These actions further indicate that the SEC may pursue clawback penalties in addition to corporate fines in pursuing settlements from companies and their executives. As noted by Andrew J. Ceresney, the Director of the SEC's Division of Enforcement, "CSC repeatedly based its financial results and disclosures on the NHS contract it was negotiating rather than the one it actually had, and misled investors about the true status of the contract. The significant sanctions in this case against the company, CEO, and CFO reflect our focus on ensuring that such misconduct is vigorously pursued and punished."⁶

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at (212) 455-3815 or yafit.cohn@stblaw.com, any other member of the Firm's Public Company Advisory Practice or any of the following members of the Firm's Government and Internal Investigations Practice:

NEW YORK CITY

Nicholas S. Goldin

+1-212-455-3685
ngoldin@stblaw.com

Joshua A. Levine

+1-212-455-7694
jlevine@stblaw.com

Mark J. Stein

+1-212-455-2310
mstein@stblaw.com

WASHINGTON, D.C.

Peter H. Bresnan

+1-202-636-5569
pbresnan@stblaw.com

Jeffrey H. Knox

+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro

+1-202-636-5529
cscarboro@stblaw.com

⁶ See "[SEC Charges CSC and Former Executives with Accounting Fraud](#)," *supra* note 1.



UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori
Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000