

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 49677 / May 11, 2004

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2006 / May 11, 2004

ADMINISTRATIVE PROCEEDING
File No. 3-11482

In the Matter of

LINDA J. WACHNER,

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 Linda J. Wachner (“Wachner” 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, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over her 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: *In the Matter of The Warnaco Group, Inc.*, Rel. No. 34-49675 (May 11, 2004); *SEC v. William S. Finkelstein*, 04 CV 3574 (May 11, 2004 S.D.N.Y.) (SS); *In the Matter of Stanley P. Silverstein*, Rel. No. 34-49676 (May 11, 2004); *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 finds² that:

FACTUAL FINDINGS

A. Respondent and Related Parties

Linda J. Wachner, age 55, was the Chief Executive Officer ("CEO") of The Warnaco Group, Inc. from 1986 until November 2001. She also held the position of chairman of the board of directors. Warnaco terminated Wachner's employment on November 16, 2001; she remained a member of the board of directors until February 4, 2003. Wachner is a resident of New York, New York.

The Warnaco Group, Inc. ("Warnaco" or "company") is a Delaware corporation with its headquarters in New York, New York. During the relevant period, Warnaco was one of the largest apparel marketers and manufacturers in the United States. 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. In February 2003, the company emerged from bankruptcy under new management and began trading on the NASDAQ National Market under the symbol "WRNC."

PricewaterhouseCoopers LLP ("PwC") is a national public accounting firm with its U.S. headquarters in New York, New York. PwC audited Warnaco's financial statements and provided various consulting services for the company for fiscal years 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

During the period from at least 1996 through early 1999, Warnaco's inventory accounts were materially overstated in its books and records and in reports filed with the Commission and disseminated to the public. The inventory overstatement was caused by serious and pervasive flaws in the company's cost accounting systems at its largest division, the Intimate Apparel Division. As a result, by early 1999, inventory at the division was overstated by more than 100 percent, and the company's entire inventory balance was overstated by more than twenty percent. Warnaco had to restate its financial results for a three-year period, 1996 through the first three quarters of 1998.

On April 2, 1999, Warnaco filed with the Commission its Annual Report on Form 10-K for the year ended January 2, 1999 (fiscal 1998), which "revised" the company's previously-reported financial results for the years 1996 through the first three quarters of 1998. Warnaco did not disclose in its annual report that it had restated to correct an inventory overstatement caused by flaws in the company's cost accounting systems. Instead, Warnaco improperly attributed the "revision" to the write-off of "start-up related production and inefficiency costs" in connection

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.

with the adoption of a new accounting pronouncement. Accordingly, the annual report contained material misstatements.

Wachner and other members of Warnaco's senior management knew or should have known that it was improper to attribute the inventory restatement to the write-off of start-up related costs in the company's annual report. Nevertheless, Wachner approved and signed the misleading annual report. As a result, Wachner caused Warnaco's reporting violation. Wachner and other members of Warnaco's senior management also knew or should have known that Warnaco's internal control systems were inadequate and that the company's books and records did not accurately reflect the value of inventory during the period. By failing to require the company to take adequate steps to address these problems, Wachner caused the company's books and records and internal control violations.

C. Facts

1. Inventory Restatement

a. Indications of an Inventory Overstatement

Warnaco is one of the largest marketers and manufacturers of apparel in the United States. It designs and manufactures a broad line of intimate apparel, sportswear, swimwear and 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, IAD's inventory control systems did not accurately account for the value of manufactured inventory. The systems had not been updated in decades and were outdated and inadequate.

As CEO of the company, Wachner knew or should have known that IAD's accounting systems were antiquated and prone to error. In mid-1997, in response to a recommendation from Warnaco's independent auditors, PwC, Wachner caused Warnaco to hire consultants from PwC to update and improve IAD's standard cost system ("the Standard Cost Project").³

As part of the Standard Cost Project, the 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 PwC consultants conveyed their preliminary findings to Wachner and other senior managers during a meeting on March 31, 1998. By July 1998, Wachner and other senior management at the company were informed that IAD accounting personnel, who were working with the PwC consultants, estimated that the potential overstatement could be as high as \$83 million. No adjustment was made to inventory at that time.

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 the company's board

³ Wachner also caused Warnaco to hire consultants from PwC and SAP America, Inc. to implement a company-wide global information system that would include improvements in all company financial and inventory controls. However, the SAP project never was successfully implemented.

of directors should be informed about the potential inventory overstatement. After the engagement partner informed the audit committee of the potential overstatement at the August 1998 board 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.

b. The Inventory Overstatement Is Confirmed

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 was consistent with the preliminary 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 books and publicly reported in Warnaco's periodic reports.

In late October or early November 1998, Warnaco's CFO informed PwC of the significant discrepancy identified in the IAD reconciliation process. Wachner joined in the CFO's assertion that the discrepancy must be due to "start-up costs" that had been erroneously recorded into inventory.⁴ The CFO proposed writing off the inventory discrepancy as part of Warnaco's early adoption of a new accounting principle, American Institute of Certified Public Accountants Statement of Position ("SOP") 98-5, which required companies to record start-up costs as they were incurred, rather than amortizing them over time. The CFO did not provide any evidence to support this claim.

Given the magnitude of the inventory discrepancy, the audit team informed Wachner and other members of senior management that PwC could not rely upon Warnaco's books and records or internal control systems in determining the correct value of IAD's inventory. Instead, Warnaco and the PwC audit team engaged some of the same PwC consultants who had worked on the Standard Cost Project to create a new system for valuing IAD's inventory. Warnaco also completed a second physical inventory count to ensure that the inventory discrepancy was a valuation problem and not a physical inventory problem. In December 1998, the second 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 this work, 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 Wachner, of their findings. These findings were consistent with the problems the PwC consultants had identified and brought to Wachner's attention in March 1998.

⁴ "Start-up costs" under SOP 98-5 are "defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer or beneficiary, initiating a new process in an existing facility, or commencing some new operation." Historically, GAAP allowed companies to capitalize their start-up costs, and amortize the expense over a period of years. However, SOP 98-5 required companies to record start-up costs at the time they were incurred. All public companies were required to adopt SOP 98-5 and write off their start-up costs by no later than fiscal 1999.

In February 1999, PwC completed its work and determined that Warnaco's inventory was overvalued by \$159 million. To account for the necessary inventory write-down, PwC decided that Warnaco would have to restate its financial results for the preceding three years. However, Wachner and the CFO continued to insist that the inventory overstatement was attributable to start-up costs that had been misallocated to the inventory accounts and should be written off as part of the company's adoption of SOP 98-5 without causing a restatement. During a two-day meeting held in late February 1999, senior Warnaco management attempted to convince the auditors that the overstatement should be written off under SOP 98-5. After reviewing the information provided by Warnaco, PwC determined that, at most, only \$14 million of the overstatement could be written-off as start-up costs. The remaining inventory overstatement -- \$145 million -- had to be accounted for as the correction of an error, thus necessitating a restatement of previously-reported financial results for fiscal 1996 through the first three quarters of 1998.

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

As shown below, the restatement had a material impact upon the company'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.

c. Warnaco's Annual Report

On April 2, 1999, Warnaco filed its annual report on Form 10-K for fiscal 1998. In this report, the company revised its financial results for fiscal 1996-1998 to reduce inventory and increase cost of goods sold by \$145 million, as required by GAAP. However, the Form 10-K report misleadingly asserted that the restatement related to the company's adoption of SOP 98-5. In the notes to the audited financial statements, Warnaco explained the restatement to its investors by claiming that the inventory "revision" was the result of "start-up related and production inefficiency costs" identified by the company during its adoption of new accounting standard SOP 98-5. Specifically, the annual report stated:

Adjustments, Reclassifications and Revisions: As noted above, the Company early adopted SOP 98-5 in fiscal 1998. 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. 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. 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 costs of goods sold[.] (Emphasis added.)

PwC acceded to Warnaco's description of the restatement and described the restatement in similar terms in its "Report of Independent Accountants" attached to Warnaco's financial statements.

The Form 10-K report was misleading and inaccurate. The restatement was not the result of "previously deferred" start-up costs and was not related to the company's adoption of SOP 98-5. Rather, the restatement resulted from material flaws in IAD's inventory accounting system. 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 IAD's inventory costing system to account properly for the value of inventory.

Wachner reviewed the fiscal 1998 Form 10-K before it was filed and signed the document as CEO of the company. As a result of her meetings with PwC in late February and early March 1999, Wachner understood that Warnaco's auditors had determined that the inventory overstatement could not be attributed to misclassified start-up costs. Wachner also knew or should have known that the overstatement had not been discovered in connection with the adoption of SOP 98-5, as implied in the annual report. In light of the information Wachner received during meetings with PwC and Warnaco management between March 1998 and March 1999, Wachner knew or should have known at the time that she signed the filing that Warnaco's annual report mischaracterized the cause of the restatement.

Warnaco did not correct the misleading disclosure until May 16, 2000, when it filed an amended 1998 Form 10-K. The amended report, signed by Wachner as CEO, 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. Respondent's Bonus

Under the terms of her employment contract with Warnaco, Wachner was eligible to receive a bonus if the company met a predetermined earnings threshold in a given fiscal year. In fiscal 1998, Warnaco did not meet its earnings threshold because of the impact of the restatement upon earnings. However, Warnaco calculated earnings for purposes of the bonus calculation without including the effect of the restatement. By doing so, Warnaco appeared to meet the earnings

threshold, resulting in a significant bonus for Wachner and other executives at the company. Had the effect of the restatement been factored into the bonus calculation, Wachner would not have been eligible to receive a bonus under her contract.

D. Violations

1. Respondent Was a Cause of Warnaco's Violation of 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. *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 "as necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). 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).

By filing a Form 10-K annual report for fiscal 1998 that mischaracterized the reason for the restatement of the company's financial results, Warnaco violated Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder. At the time Wachner approved and signed Warnaco's annual report, she knew or should have known that the restatement of the company's financial results was not related to the adoption of SOP 98-5 or the write-off of start-up related costs. Wachner knew or should have known that the restatement was due to material flaws in the company's cost accounting and internal control systems. By approving and signing the Form 10-K, Wachner was a cause of Warnaco's violation of Section 13(a) and Rules 12b-20 and 13a-1 of the Exchange Act.

2. Respondent Was a Cause of Warnaco's Violations of 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. Warnaco violated Section 13(b)(2)(A) of the Exchange Act because IAD's books, records, and accounts did not accurately and fairly reflect the inventory balance during the period 1996 through 1998. Wachner knew or should have known that the inventory accounts at the IAD were overstated, and her failure to ensure that Warnaco corrected IAD's inventory accounts in a timely manner was a cause of Warnaco's Section 13(b)(2)(A) violation.

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 from at least 1997 through early 1999, Warnaco's internal controls at the Intimate Apparel Division were inadequate to provide reasonable assurances that transactions in the inventory and cost of goods sold accounts were properly recorded. Wachner knew or should have known IAD's inventory costing control system was inadequate to assure the accuracy of Warnaco's books and records, and her failure to ensure that proper internal controls were in place was a cause of Warnaco's Section 13(b)(2)(B) violation.

E. Findings

Based on the foregoing, the Commission finds that Wachner was a cause of Warnaco's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-1 thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the remedies specified in Wachner's Offer.

ACCORDINGLY, IT IS HEREBY ORDERED:

A. Pursuant to Section 21C of the Exchange Act, that Respondent Wachner 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 12b-20 and 13a-1 promulgated thereunder.

B. IT IS FURTHER ORDERED THAT Respondent Wachner shall, within 10 days of the entry of this Order, pay \$1,328,444 in disgorgement and prejudgment interest, to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies Linda J. Wachner as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Antonia Chion, Associate Director, Division of Enforcement, Securities and Exchange Commission, 450 5th Street N.W., Washington, D.C. 20549-0801.

By the Commission.

Jonathan G. Katz
Secretary