

**2006 PORTLAND DIRECTORS INSTITUTE
"GOVERNMENT INVESTIGATIONS" FACT SCENARIO**

FarFlung Electronic Systems, Inc. ("FarFlung") is a Portland company listed on NASDAQ. It makes sophisticated electronic "docking guidance" systems that aid large marine vessels in docking safely, even at night. Its products are large, custom-built, multicomponent systems that sell for anywhere from \$150,000 to over \$1 million each. Its products are used in both civil and military applications, and it has customers both in the U.S. and abroad, including foreign governments. FarFlung uses the calendar year as its fiscal year.

FarFlung is a relatively young company, having been started in 1999 by some people who left Big Local Electronics Company. It went public in 2001. FarFlung is divided into two divisions, U.S. and International sales, and it has a large sales force. The CEO and SVP-Sales often directly negotiate larger deals. The company uses a commission system which rewards salespeople well. The CEO is a hard-driver who creates an aggressive corporate culture which rewards and expects strong financial performance. The CEO handpicked the SVP-Sales for his job, and the SVP-Sales, who is in charge of both divisions, is considered an extension of the CEO.

FarFlung's accounting department is thinly staffed and has had some turnover in recent years. The CFO is a CPA who worked at Tick & Tie, FarFlung's auditors, prior to joining the company. She is considered a rising star but has been unsuccessful in convincing the CEO and Board to allow her to hire additional personnel. She has on a number of occasions spoken with the Audit Committee about the need to beef up the internal audit function and to have the division accounting personnel report directly to her rather than to the division head and Sr. VP of Sales, but they have rebuffed her based on the CEO's view that the company cannot afford such a luxury. In addition, after the 2003 year end audit conducted by Tick & Tie, they noted deficiencies in the accounting function and advised specific improvements, none of which have been implemented by the Audit Committee.

On August 5, 2005, the Audit Committee receives an anonymous report through its whistleblower hotline that FarFlung has been (1) bribing foreign military officials in order to have its docking systems selected for purchase, and (2) creating dubious documentation of sales in violation of revenue recognition rules in order to inflate the company's earnings at the end of fiscal quarters. The report says that this behavior has been going on at least since the beginning of 2004.

The Chair of the Audit Committee, who is a good friend of the CEO and was invited by the CEO to join the Board several years earlier, goes directly to the CEO and the General Counsel and advises them of the whistleblower report. The CEO and General Counsel believe that the whistleblower report has come from a disgruntled former accounting department employee who has been threatening to sue the company for wrongful termination and who they do not believe is particularly credible. The General Counsel has been with the company for only 2 years and before that he was an associate with Hem, Haw & Bill, P.C., the company's regular outside counsel for 4 years. He is generally competent but a bit in over his head, and does not like to question or give bad news to the CEO. Despite their feelings about the former employee, the Audit Committee Chair, CEO and General Counsel decide that the General Counsel should conduct his own investigation, but that he should do so quietly and without advising the other Audit Committee members, Hem & Haw (as it is usually known) or FarFlung's outside auditors, Tick & Tie.

The General Counsel begins to make some initial inquiries, interviewing numerous company employees and collecting relevant documents. He does not prepare a report but collects a large file of documents and interview notes. After this initial work, despite his initial skepticism, he does have some concerns about what he is learning. It appears the report may have some merit, and that perhaps even the CEO, CFO and/or Sr. VP of Sales were involved. He reports his preliminary findings to the Audit Comm. Chair, who decides to schedule an Audit Committee meeting to discuss this development. The other Audit Committee members are a bit miffed that they were kept in the dark at the outset, but ultimately the Audit Committee decides to hire outside counsel to conduct a more thorough investigation. They discuss using a large, high-powered California law firm with whom the company does not have prior involvement, but based on that firm's reputation for charging exorbitant amounts for these types of investigations, they decide to have Hem & Haw do it instead.

The CEO and CFO are advised of this decision; no action is taken with respect to either of them based on their both telling the Audit Comm. Chair that they know nothing about these alleged problems. Meanwhile, the Audit Committee also advises Tick & Tie of the potential problem and the upcoming investigation. Tick & Tie agrees to wait until it sees Hem & Haw's report, although they state that they do have some concerns about FarFlung's upcoming third quarter financial statements.

Hem & Haw, aided by a forensic accounting firm, undertakes a thorough investigation which reveals a large number of revenue and expense recognition errors and a general corporate culture of aggressive revenue target-setting and pressure to meet earnings projections at quarter-ends. The investigation also reveals that FarFlung's sales personnel in the International division have been engaged in bribing foreign military personnel in Latin America and the Middle East in order to have their products chosen for purchase. This investigation results in a written report which is given to the Audit Committee in early October, 2005. The findings reveal the need for FarFlung to restate its financial statements for the fiscal year 2004 and the first two quarters of 2005. The report is highly critical of the Sr. VP of Sales for directing his salespeople to "do whatever it takes to make sales and recognize revenue," including the foreign bribes and creating dubious documentation where necessary of sales at quarter ends. The report is more ambiguous regarding the knowledge of the CEO, but did find that he created intense pressure at all levels to meet earnings expectations of the analysts. The report does not conclude that the CFO was aware of any this activity, but does criticize her for not learning of it.

Meanwhile, at the same time Hem & Haw's investigation is underway, the whistleblower contacts the SEC and provides them with similar information to that which he reported to the company. The SEC immediately opens an informal investigation of FarFlung and serves it with a subpoena seeking a broad range of documents related to the company's revenue recognition on international sales. In addition, the SEC advises the U.S. Attorney's Office in Portland of the initiation of the informal investigation of FarFlung. The U.S. Attorney's Office expresses interest in FarFlung to the SEC but tells it that DOJ will wait to see what the SEC comes up with before it decides whether or not to seek prosecution of anyone at FarFlung. FarFlung does not initially tell the SEC of Hem & Haw's investigation or the existence of their report, and is generally uncooperative with the SEC's desire for production of a broad range of documents.

The Audit Committee provides Hem & Haw's report to Tick & Tie, who immediately withdraws its audit and review opinions on FarFlung's 2004 year-end and Q1 and Q2 2005 financial statements and tells FarFlung it will not issue an opinion on the third quarter financials. Tick & Tie also advises the company that it believes FarFlung will need to restate these prior financial statements.

On October 20, 2005, FarFlung announces that it will be late in filing its 10-Q for the third quarter, and will be restating its financial statements for year-end 2004 and the first two quarters of 2005. Although the total amount of the restatements are not particularly large as the restatement moved revenue from one period to another, it did have the effect of reducing year-end revenue for 2004 by 10%, resulting in a \$.03/share loss rather than a \$.05/share profit. On this news, the price of FarFlung's stock drops 20%. Following this, several class action securities fraud cases are filed, followed shortly by several state court derivative class action lawsuits against FarFlung's officer and directors. In addition, the SEC, concluding that FarFlung is not interested in fully cooperating, obtains a formal order of investigation and the DOJ initiates a similar investigation.