Exhibit M
### Leasing Reserve

**LEASE RESERVES BY MARKET SEGMENT**

<table>
<thead>
<tr>
<th>Reserve %</th>
<th>Lease Reserve Balance as of 8/20/2000</th>
<th>Lease Reserve Balance as of 9/19/2000</th>
<th>Additional Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive Local Exchange Carrier</td>
<td>$20,158</td>
<td>$11,911</td>
<td>$(8,248)</td>
</tr>
<tr>
<td>Internet Service Provider - Tier 1</td>
<td>$21,329</td>
<td>$26,471</td>
<td>$5,142</td>
</tr>
<tr>
<td>Internet Service Provider - Tier 2</td>
<td>$13,009</td>
<td>$12,910</td>
<td>$(100)</td>
</tr>
<tr>
<td>Internet Service Provider - Tier 3</td>
<td>$1,171</td>
<td>$1,280</td>
<td>$109</td>
</tr>
<tr>
<td>Enterprise Line of Business</td>
<td>$2,574</td>
<td>$2,531</td>
<td>$(43)</td>
</tr>
<tr>
<td>Govt/State/School Districts/Universities</td>
<td>$106</td>
<td>$134</td>
<td>$28</td>
</tr>
<tr>
<td>Small and Medium Business</td>
<td>$3,817</td>
<td>$3,507</td>
<td>$(310)</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$62,165</td>
<td>$58,745</td>
<td>$(3,421)</td>
</tr>
</tbody>
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**A/R RESERVE**

<table>
<thead>
<tr>
<th></th>
<th>Lease Reserve Balance as of 9/19/2000</th>
<th>Additional Provision</th>
</tr>
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<tbody>
<tr>
<td>Outstanding Billed A/R</td>
<td>$2,670</td>
<td>$3,873</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$2,670</td>
<td>$3,873</td>
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</tbody>
</table>

**INVENTORY RESERVES**

<table>
<thead>
<tr>
<th></th>
<th>Lease Reserve Balance as of 9/19/2000</th>
<th>Additional Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Funded Inventory</td>
<td>$37,549</td>
<td>$34,899</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$37,549</td>
<td>$34,899</td>
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</table>

**SPECIFIC RESERVES**

<table>
<thead>
<tr>
<th></th>
<th>Lease Reserve Balance as of 9/19/2000</th>
<th>Additional Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nations Bank</td>
<td>$1,370</td>
<td>$1,370</td>
</tr>
<tr>
<td>IBASIS</td>
<td>$6,600</td>
<td>$6,600</td>
</tr>
<tr>
<td>ACNET</td>
<td>$1,897</td>
<td>$1,897</td>
</tr>
<tr>
<td>ICG</td>
<td>$122,944</td>
<td>$122,944</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$7,970</td>
<td>$132,811</td>
</tr>
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</table>

**ADDITIONAL RESERVES**

<table>
<thead>
<tr>
<th></th>
<th>Lease Reserve Balance as of 9/19/2000</th>
<th>Additional Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting Reserve</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Pending Lease Reserve</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td><strong>Leasing Reserve Total</strong></td>
<td>$125,555</td>
<td>$245,327</td>
</tr>
</tbody>
</table>
*All amounts are in $K
<table>
<thead>
<tr>
<th>LEASE RESERVE AS % OF LEASE RECEIVABLE</th>
<th>Prepaid Month Less Payable</th>
<th>Current Month Less Payable</th>
<th>Percent Reserved</th>
<th>Reserve</th>
<th>FTE General &amp; Telephone</th>
<th>Reserve Balance</th>
<th>% reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive Local Exchange Center</td>
<td>$201,150</td>
<td>$119,128</td>
<td>59.0%</td>
<td>$119,128</td>
<td>$11,811</td>
<td>$11,811</td>
<td>100.0%</td>
</tr>
<tr>
<td>Internet Service Provider: Tar 1</td>
<td>$212,024</td>
<td>$264,714</td>
<td>80.0%</td>
<td>$264,714</td>
<td>$26,471</td>
<td>$26,471</td>
<td>100.0%</td>
</tr>
<tr>
<td>Internet Service Provider: Tar 2</td>
<td>$108,000</td>
<td>$128,994</td>
<td>80.0%</td>
<td>$128,994</td>
<td>$12,900</td>
<td>$12,900</td>
<td>100.0%</td>
</tr>
<tr>
<td>Internet Service Provider: Tar 3</td>
<td>$7,000</td>
<td>$6,574</td>
<td>94.0%</td>
<td>$6,574</td>
<td>$1,280</td>
<td>$1,280</td>
<td>100.0%</td>
</tr>
<tr>
<td>Enterprise Line of Business</td>
<td>$201,428</td>
<td>$291,423</td>
<td>70.0%</td>
<td>$291,423</td>
<td>$29,142</td>
<td>$29,142</td>
<td>100.0%</td>
</tr>
<tr>
<td>Government/Local/Telecommunication</td>
<td>$10,000</td>
<td>$15,000</td>
<td>66.6%</td>
<td>$15,000</td>
<td>$1,500</td>
<td>$1,500</td>
<td>100.0%</td>
</tr>
<tr>
<td>Land and Mineral Business</td>
<td>$26,500</td>
<td>$22,300</td>
<td>84.0%</td>
<td>$22,300</td>
<td>$2,230</td>
<td>$2,230</td>
<td>100.0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$542,214</strong></td>
<td><strong>$513,437</strong></td>
<td><strong>78.6%</strong></td>
<td><strong>$513,437</strong></td>
<td><strong>51,343</strong></td>
<td><strong>51,343</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

*All figures as of December 31, 2005. The following adjustments will be made to the data: Losses from operations, adjustments to the lease reserves, and changes in assumptions. The figures do not include any adjustments for changes in the lease rates or lessee's financial condition. The reserve balance as of December 31, 2005, includes $51,343 related to the lease reserves.

CONFIDENTIAL
<table>
<thead>
<tr>
<th>September Estimate</th>
<th>1-30</th>
<th>31-60</th>
<th>61-90</th>
<th>91+</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/R Aging</td>
<td>$41,900</td>
<td>$68,113</td>
<td>$24,326</td>
<td>$11,190</td>
<td>$145,529</td>
</tr>
<tr>
<td>Reserve Rate</td>
<td>1%</td>
<td>2%</td>
<td>4%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>A/R Reserve</td>
<td>$419</td>
<td>$1,362</td>
<td>$973</td>
<td>$1,119</td>
<td>$3,873</td>
</tr>
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</table>

*All amounts are in $K*
<table>
<thead>
<tr>
<th>Age</th>
<th>1-30</th>
<th>31-60</th>
<th>61-90</th>
<th>91-120</th>
<th>121-150</th>
<th>151-180</th>
<th>181-360</th>
<th>361+</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior Month PFI Aging (On Sales Type Leases Only)</td>
<td>47,763</td>
<td>79,921</td>
<td>41,365</td>
<td>26,135</td>
<td>26,707</td>
<td>15,554</td>
<td>21,333</td>
<td>3,956</td>
<td>262,736</td>
</tr>
<tr>
<td>Reserve Rate</td>
<td>7.3%</td>
<td>7.3%</td>
<td>7.3%</td>
<td>10%</td>
<td>15%</td>
<td>25%</td>
<td>50%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Prior Month PFI Reserve</td>
<td>3,509</td>
<td>5,871</td>
<td>3,039</td>
<td>2,814</td>
<td>4,006</td>
<td>3,889</td>
<td>10,667</td>
<td>3,956</td>
<td>37,549</td>
</tr>
</tbody>
</table>

### PFI As of 9/18/00

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>PFI Balance-Sales Type Leases</td>
<td>21,046</td>
</tr>
<tr>
<td>PFI Balance-Operating Leases + Maintenance Contracts</td>
<td>62,436</td>
</tr>
<tr>
<td>Total PFI Balance</td>
<td>83,482</td>
</tr>
<tr>
<td>Reserve Rate</td>
<td>7.2%</td>
</tr>
<tr>
<td>Current PFI Reserve (On Sales Type Leases Only)</td>
<td>1,524</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Age</th>
<th>1-30</th>
<th>31-60</th>
<th>61-90</th>
<th>91-120</th>
<th>121-150</th>
<th>151-180</th>
<th>181-360</th>
<th>361+</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net increase/(decrease) to Reserve</td>
<td>(1,985)</td>
<td>(3,831)</td>
<td>815</td>
<td>(1,221)</td>
<td>404</td>
<td>(1,379)</td>
<td>2,648</td>
<td>1,898</td>
<td>(2,651)</td>
</tr>
</tbody>
</table>

*All amounts are in $K*
<table>
<thead>
<tr>
<th>Lessee</th>
<th>Equipment Cost</th>
<th>Market Segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>PSINET #23</td>
<td>19,049,983.15</td>
<td>ISP-1</td>
</tr>
<tr>
<td>PSINET #22</td>
<td>16,721,743.66</td>
<td>ISP-1</td>
</tr>
<tr>
<td>PSINET #24</td>
<td>11,831,273.25</td>
<td>ISP-1</td>
</tr>
<tr>
<td>RHYTHMS NETCONNECTIONS #19</td>
<td>8,026,826.30</td>
<td>CLEC</td>
</tr>
<tr>
<td>@HOME CORP #41</td>
<td>6,746,581.50</td>
<td>ISP-1</td>
</tr>
<tr>
<td>IBASIS #14</td>
<td>4,048,059.85</td>
<td>CLEC</td>
</tr>
<tr>
<td>ARBROS #1</td>
<td>3,791,330.20</td>
<td>ISP-1</td>
</tr>
<tr>
<td>GLOBAL KNOWLEDGE #1</td>
<td>2,707,700.50</td>
<td>ISP-1</td>
</tr>
<tr>
<td>HGH SPEED ACCESS #17</td>
<td>2,671,039.63</td>
<td>CLEC</td>
</tr>
<tr>
<td>NAVISITE #12</td>
<td>1,973,898.00</td>
<td>ISP-1</td>
</tr>
<tr>
<td>September Top 10 Total</td>
<td>77,568,436</td>
<td></td>
</tr>
</tbody>
</table>

*All amounts are in $K*
Exhibit N
Lease Reserve Memo

3975 - 19

External to System, Created in Notes

3975 -Capital Corporation (CSCC)

Assets

The Lease Reserve is monitored and updated by Michael Gonzalez, and subject to review in the quarterly A/R reserve meetings. Attendees of the meeting include Jonathon Chadwick, Dennis Powell, Rick Timmons, Darrel Brinkman and PwC. PwC obtained the following information through discussions with Michael Gonzalez and the Leasing Reserve Analysis at external w/p 3975-19.

Components of the Lease Reserve

Lease Reserves by Market Segment - PwC notes that the Client differentiates the customers by evaluating the customer’s financial statements, revenue, number of employees and years of being public. From the information gathered and analyzed by the credit department, a reserve percentage is established for each market segment. The market segments are as follows:

1) Competitive Local Exchange Carrier

The Company’s reserve levels are estimated at 10% for the unbilled portion of the outstanding, receivable balance. The reserve percentage was estimated at this level because the Company believes these companies tend to be established companies with strong credit; and hence, are likely to pay for their leases. PwC notes that this percentage is consistent with the prior year.

2) Internet Service Provider - Tier 1

The Company’s reserve levels are estimated at 10% for the unbilled portion of the outstanding, receivable balance. The reserve percentage was estimated at this level because the Company believes these companies tend to be large companies with strong credit; and hence, are likely to pay for their leases. PwC notes that this percentage is consistent with the prior year.

3) Internet Service Provider - Tier 2

The Company’s reserve levels are estimated at 10% for the unbilled portion of the outstanding, receivable balance. The reserve percentage was estimated at this level because the Company believes these companies tend to be established companies with strong credit; and hence, are likely to pay for their leases. PwC notes that this percentage is consistent with the prior year.

4) Internet Service Provider - Tier 3

The Company’s reserve levels are estimated at 15% of the unbilled portion of the outstanding,

PwC 017694
receivable balance because they consist of smaller companies who are less likely make payments on their leases on a regular basis. This reserve level is consistent with prior year.

5) **Small and Medium Business**

The Company's reserve levels are estimated at 15% because they consist of smaller companies who are less likely make payments on their leases on a regular basis. This reserve level is consistent with prior year.

6) **Enterprise Line of Business**

The Company's reserve levels are estimated at 1% due to the fact that the Company will likely collect on their receivables. This reserve level is also consistent with that of prior year.

**Inventory Reserves**

1) **Pre-funded Inventory**

This receivable balance represents inventory which is held and used by the customer, but the lease agreement has not been signed. Therefore, exposure exists as CSCC is less likely to be paid until the contract is signed. CSCC calculates the percentage by taking a weighted average rate of all the lessees' outstanding receivable balances (CLEC, ISP Tier 1-3, Enterprise Line of Business and Small and Medium Business). This methodology is consistent with prior year. The reserve percentage calculated is 6.7%.

2) **Estimated Current Month Activity**

The Lease Reserve has a one-month lag; therefore, a reserve relating to booked receivables for the month of April (P 9) has not been established. Michael Gonzalaz of CSCC estimates what the increased reserve, relating to April, should be by the following calculation:

\[
\text{Net Activity for April} = \frac{\text{Purchases from CSI and VARs}}{\text{(Cash Receipts on April purchases)}} \\
\text{(Weighted Ave %)}
\]

(Weighted Ave %)

Estimated Reserve

**Specific Reserves**

1) **Keycorp**

PwC notes that the Keycorp reserve balance was eliminated in P9 (April). The elimination occurred as the lessee was on a balloon payment schedule (small, monthly payments with a lump sum payment at the end of the lease for amount not covered in monthly payments) and if the lessee leased a certain dollar value of equipment then the lump sum payment would be forgiven. The criteria was met by the lessee; therefore, CSCC eliminated the revenue related to the lump sum payment and the corresponding reserve. PwC notes that the elimination of the reserve appears reasonable and waives further review.

2) **Nations Bank**

PWC 017695
The Nations Bank lease agreement specifies that if the lessee leases equipment valued over $100 M, the lessee will receive a credit of $7.6M. Nations met the criteria to receive the $7.6M credit and applies the credit to outstanding invoices. Therefore, the reserve has been reduced by the applied credits.

As the original, reserve balance is immaterial, PwC waives further review.

Additional Reserves

1) Accounting Reserve - $10M

2) Pending Lease Reserve - $5M

The above reserves represent a general reserve for unforeseen exposures as the leasing business is relatively new, and CSCC is unable to predict all potential exposures. Based on discussions with management, reserve level appears to be reasonable. To date, CSCC has not had any write-offs of its receivables; therefore the relatively small general reserve appears appropriate.

Document Status:

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<th>Reviewed</th>
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<tbody>
<tr>
<td>Jaime Wayland</td>
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Maintenance

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<tr>
<td>Jaime Wayland</td>
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<th>Editors:</th>
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</thead>
<tbody>
<tr>
<td>Jaime Wayland</td>
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</tbody>
</table>

PWC 017696
Exhibit O
EXECUTIVE SUMMARY

Cisco Systems Capital Corporation (Cisco Capital), a wholly-owned subsidiary of Cisco Systems, Inc. (Cisco Inc.), specializes in financing networking equipment and associated costs through leases and loans to Cisco customers. Currently there are over 2,250 lease schedules in place, totaling $650 million in equipment acquisition costs. Cisco Capital has extended leasing to their customers since April 1997. Cisco manages all aspects of the leasing process internally, with the exception of lease invoicing and collections which are outsourced to American Express. Maintenance of the leasing function will soon be converted to E-Lease, a customized capital leasing application.

As of Q2 FY2000, there were 15 closed loans with fundable loan facilities totaling $425 million and loan commitments of up to $1.5 billion. Loan financing has been available to customers since October 1998. Currently, Cisco Capital is responsible for all aspects of the loan process. In the next several months loan operations will manage the validation and approval of each loan disbursement, and outsource the physical disbursement process, invoicing, and collections component to Citibank.

The objectives of this review included evaluating the current domestic capital process, assessing the overall control environment over capital lease and loan processing, and identifying opportunities for process improvement.

Although fundamental controls governing the lease process are adequate, key controls governing the loan process are weak and should be strengthened. Management is aware of these concerns and is currently assessing required process modifications and related systems to increase control and support anticipated growth in both the lease and loan processes.

Significant Risk Areas & Opportunities for Process Improvement

- **Loan Operations** Policies and Procedures - There is an overall need for standardization of the loan process.
  - Implement detailed policies and procedures for the loan funding process by strengthening key controls governing classification of loans, characters of each classification, and basis for the funding.
  - Maintain adequate substantiation of all loan disbursements, implementing checklists as needed for data integrity.
  - Track active loan funding balances to monitor the available loan facility, and to ensure proper reporting to management.
  - Standardize the information required from customers for loan funding, consulting with legal to determine requirements.

- **Standardization of Credit Approval Processes** - Policies and procedures are in place for the credit approval process. However, with the growth of the leasing and financing business, further standardization of the credit process is required.
  - Standardize working files for both leasing and loan financing credit review, implementing checklists to track documents and signature approvals required for the credit approval process.
  - Implement detailed procedures for the credit approval process, updating the policy and procedures to include loans.

- **Lease Operations Policies and Procedures** - Lease operations were in the process of standardizing the process and developing policies and procedures at the time of the audit. Going forward, the following areas are opportunities for continued improvement:
  - Implement standardized policies and procedures which include terminated leases, tech migration and buyouts.
  - Require document checklists and approval signatures to ensure proper maintenance of work files.
# Observations & Action Plans

<table>
<thead>
<tr>
<th>Area Observed</th>
<th>Action Plan</th>
<th>Owner/Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) There is a lack of standardization to the loan process.</td>
<td>- Implement standardized procedures for the entire loan process, ensuring that tranche set-up is consistent on a go-forward basis and that adequate controls are built for the disbursement of funds.</td>
<td>S. Raffo</td>
</tr>
<tr>
<td>There was a lack of standardization for the disbursement and invoicing operations process.</td>
<td>- Consult with the legal department to determine documentation required for loan disbursements.</td>
<td>Q4 FY00</td>
</tr>
<tr>
<td>We noted the following exceptions:</td>
<td>- Implement processes and systems to ensure that the following actions occur:</td>
<td></td>
</tr>
<tr>
<td>• Tranches were set-up inconsistently across loan facilities.</td>
<td>- Disbursements do not occur without adequate support and authorization.</td>
<td></td>
</tr>
<tr>
<td>• The process for releasing credit holds on orders was inconsistent, and holds were released by several parties.</td>
<td>- Loan balances are monitored and tracked adequately.</td>
<td></td>
</tr>
<tr>
<td>• Supporting information for disbursements were inconsistent, and incomplete.</td>
<td>- There is complete and timely invoicing to the customer.</td>
<td></td>
</tr>
<tr>
<td>• Notices of Borrowing are not always required for disbursements, and the amounts on the notice are not always consistent with what was paid on behalf of the customer.</td>
<td>- Collections are adequately tracked, and payments received from customers are properly applied.</td>
<td></td>
</tr>
<tr>
<td>• Active loan balances were not adequately maintained to support management reporting figures and amortization schedules.</td>
<td>Management has considered outsourcing the disbursement of loan funding. Invoicing to customers and collections process to Citibank. The validation and approval for a disbursement will be retained in-house.</td>
<td></td>
</tr>
<tr>
<td>• Loan payments received from loan customers cannot be adequately distinguished from Cisco Inc. net 30 customers.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Business Impact:**

Increased risk of misappropriated funds, disputes over application of funding and loan repayment losses.

---

**Loan Operations**

**Internal Control Services**
### Observations & Action Plans

<table>
<thead>
<tr>
<th>Area Observed</th>
<th>Action Plan</th>
<th>Owner / Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>2) Loan funding was inadequately substantiated. We noted that documentation for loan disbursements was not consistent.</td>
<td>Implement detailed procedures for the loan funding process including classification of loans, characters of each classification, and basis for the funding.</td>
<td>S. Rafi Q4 FY03</td>
</tr>
<tr>
<td>Not all funding information was included in the work files that we observed, and the Invoices submitted by customers were often non-standard summaries of Cisco Inc. invoices which did not include the itemization of products or services. Signed copies of all related disbursements, and the related amortization schedules were not consistently found in work files.</td>
<td>Develop a standardized method for managing loan disbursements.</td>
<td></td>
</tr>
<tr>
<td>The lack of standardized information may have contributed to the fact that an accurate and current loan balance was not always available when reporting to upper level management.</td>
<td>Consult with the legal department to determine what documentation is required for loan disbursements, and if a standardized copy of the appendices is available for the loan customers to submit when necessary.</td>
<td></td>
</tr>
<tr>
<td>Business Impact: Increased risk for financial loss, misappropriation of funds, and erroneous reporting to upper level management.</td>
<td>Until an automated system can be implemented to house this information, require a list of documents to be consistently retained in organized work files to substantiate all disbursements. This should include:</td>
<td></td>
</tr>
<tr>
<td>- Notice of Borrowing</td>
<td>• Notice of Borrowing</td>
<td></td>
</tr>
<tr>
<td>- Invoice from CSI / Vendor</td>
<td>• Invoice from CSI / Vendor</td>
<td></td>
</tr>
<tr>
<td>- Signed and approved disbursement documents (intercompany adjustment, Check Request or Wire Transfer)</td>
<td>• Signed and approved disbursement documents (intercompany adjustment, Check Request or Wire Transfer)</td>
<td></td>
</tr>
<tr>
<td>- Active or available loan balance.</td>
<td>• Active or available loan balance.</td>
<td></td>
</tr>
<tr>
<td>- Current loan amortization schedule and related invoicing.</td>
<td>• Current loan amortization schedule and related invoicing.</td>
<td></td>
</tr>
<tr>
<td>- System enhancements should be considered to eventually minimize the documents required per account.</td>
<td>• System enhancements should be considered to eventually minimize the documents required per account.</td>
<td></td>
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</table>
### OBSERVATIONS & ACTION PLANS

<table>
<thead>
<tr>
<th>AREA OBSERVED</th>
<th>ACTION PLAN</th>
<th>OWNER / TIMING</th>
</tr>
</thead>
</table>
| 3) Existing lease credit approval policies should be updated and standardized and include the maintenance of supporting document files. | - Update and revise the procedures to include the current lease process.  
- Implement a formal checklist of supporting documentation for credit profiles and evaluations, until an automated system can be implemented to track the credit approval process and lines of credit.  
- House the credit profiles and evaluations in a centralized repository. | B. Fukuhara  
Q4 FY00 |
| There is a need to formalize a standard process for lease credit evaluations, and the maintenance of supporting documentation. | Data tested was inconsistent across files, and did not have a formal checklist in place. | Business impact:  
Increased risk for lost revenues or assets. |

<table>
<thead>
<tr>
<th>AREA OBSERVED</th>
<th>ACTION PLAN</th>
<th>OWNER / TIMING</th>
</tr>
</thead>
</table>
| 4) The overall loan structuring and credit approval process requires more standardization, including the maintenance of supporting document files. | - Formalize standard procedures for the loan structuring and loan credit approval process, updating existing policies and guidelines as required.  
- Implement a formal document checklist, with the appropriate signatures required for credit approval, and term sheet approval respectively. The list should include at least the following signed documents to be maintained:  
  - Letter of Interest.  
  - Commitment letter.  
  - Customer Credit Profile/Credit Risk Analysis/Executive Summary.  
  - Business plan.  
  - Finalized Term Sheet.  
- Formalize the credit signature authority matrix for the approval of negotiated Term Sheets. | B. Fukuhara  
Q4 FY00 |
| While there were general guidelines for loan structuring and "box" guidelines in place, there is still a need to formalize a standard process for loan structuring and credit evaluations.  
Files retained for the up-front process of negotiation and credit approvals were incomplete. We noted that signed copies of all related documents were not consistently maintained in the work files, and evidence of approval via the appropriate levels of management were not available.  
The signature authority matrix for credit approval should be expanded to include the overall approval of loan financing and finalized term sheets. | Business impact:  
Increased risk for lost revenues or lost assets. |
### OBSERVATIONS & ACTION PLANS

<table>
<thead>
<tr>
<th>AREA OBSERVED</th>
<th>ACTION PLAN</th>
<th>OWNER / TIMING</th>
</tr>
</thead>
</table>
| 5) Documentation is inconsistent in lease operations "red-boards." In line with findings from the Capital Leasing Review in July 1996, information included in the red-boards is inconsistent and incomplete. A formal checklist for the documentation required for leases is not currently required. Credit approval emails were not always included in the files to substantiate the line of credit extended. Signed copies of the customer approved schedule documents are not always retained in the work files. Business Impact: Increased risk for disputed terms and conditions. | - Develop a checklist of documentation and approvals required for leases.  
- The checklist should include at least the following documents:  
  - Signed MLA and Proposal  
  - Certificate of Acceptance  
  - Line of Credit Approval (email)  
  - Invoices from VAR or Cisco Inc.  
  - Signed Schedule documents, including equipment schedule.  
- Maintain signed and finalized copies of documents in work files.  
Management has addressed the issue of implementing standard checklists for red-boards. | J. Linford  
Q4 FY00 |
| 6) Lease policies and procedures are not currently in place. Per our testing, there was not a formal process in place to handle terminations and buyouts for lease operations at the time of the audit. In addition, we noted that there were instances where MLA’s were not signed prior to the shipping of Cisco equipment to customers. Business Impact: Late MLA’s pose an uncontrolled financial risk. | - Update the policies and procedures to handle terminations and buyouts.  
- Continue to ensure that MLA’s are consistently signed before orders are released and shipped.  
Management indicates that overall policies and procedures have been drafted for lease operations, and that the current lease process requires all MLA’s to be signed prior to shipping equipment. | J. Linford  
J. Larrick  
Q4 FY00 |

---

**Lease Operations**

**INTERNAL CONTROL SERVICES**
# Observations & Action Plans

<table>
<thead>
<tr>
<th>Area Observed</th>
<th>Action Plan</th>
<th>Owner / Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>7) Pricing policies and procedures are not currently in place.</td>
<td>• Ensure that there is a standard process for the pricing function, and finalize policies and procedures for pricing, exceptions to pricing, and pricing as they relate to terminations and buyouts.</td>
<td>J. Larrick Q4 FY00</td>
</tr>
<tr>
<td>While pricing and tech migration guidelines and models exist for the majority of lease deals, a clear procedure and approval process for pricing and exceptions were not in place at the time of the audit.</td>
<td>• Include a standard signature approval matrix for handling pricing deals which are exceptions to the regular process.</td>
<td></td>
</tr>
<tr>
<td>Standardized procedures for the pricing as it pertains to terminations and buyouts are also required.</td>
<td><strong>Management is currently in the process of standardizing processes and policies pertaining to pricing.</strong></td>
<td></td>
</tr>
<tr>
<td>Business Impact: Increased risk for financial losses.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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| 8) Supporting documentation is not consistently retained for pricing exceptions. | • Maintain files containing documentation and the approvals required for substantiating exceptions to pricing. | J. Larrick Q4 FY00 |
| While pricing guidelines are maintained and distributed to the sales team periodically, there is little documentation to support exceptions to these guidelines, and the approvals that were required. | • Ensure that email support documents are retained in a centralized location (i.e. on the server.) | |
| Most information that we noted came in the form of email correspondences between the sales and pricing teams. | **Management is in the process of establishing standardization as it pertains to the support documentation required for pricing exceptions.** | |
| Business Impact: Increased risk for financial loss due to uncontrolled pricing. | | |
Exhibit P
Cisco Systems Capital
Compliance Project
Phase 1
October 12, 2000

Deloitte & Touche

For Discussion Purposes Only

CONFIDENTIAL
<table>
<thead>
<tr>
<th>Page</th>
<th>Contents</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Objectives</td>
</tr>
<tr>
<td>4</td>
<td>Review of Audit Scope and Approach</td>
</tr>
<tr>
<td>6</td>
<td>Findings: Loans, Venture Leases, Leases</td>
</tr>
<tr>
<td>9</td>
<td>Issues Summary</td>
</tr>
<tr>
<td>10</td>
<td>Issues Requiring Attention</td>
</tr>
<tr>
<td>11</td>
<td>Pre- and Post-Funding Compliance</td>
</tr>
<tr>
<td>12</td>
<td>Process and Procedures</td>
</tr>
<tr>
<td>13</td>
<td>Information Management and Accounting</td>
</tr>
<tr>
<td>14</td>
<td>Documentation and File Management</td>
</tr>
<tr>
<td></td>
<td>Path Forward</td>
</tr>
</tbody>
</table>
Objectives

The objectives for Phase 1 of this engagement between Deloitte & Touche ("D&T") and Cisco Systems Capital Corporation ("CSC") were described in a separate Statement of Work. Phase 1 addressed various components of CSC's Compliance function, including:

- Review of the loan and venture lease documentation, and a limited review of the lease portfolio documentation, for adherence to conditions precedent to funding per credit loan and lease agreements.
- Prepare a summary of the compliance terms and status for each loan and lease reviewed.
- Develop an application to provide periodic status information regarding ongoing compliance.
- Provide senior management with D&T's observations and recommendations regarding the overall credit risk management process.
- Assist CSC senior management with development of a recommendation regarding the staffing, organizational location, and reporting responsibilities of the Compliance function. This recommendation will be addressed in a separate document.
Review of Scope and Approach

For Phase 1 of this engagement, D&T's Capital Markets Group performed the following:

1. Reviewed all loans, all venture leases, and a sample of the lease portfolio to identify compliance with conditions precedent to funding and compliance with loan and lease covenants:
   - 31 loans totaling $1.6 billion in commitments and estimated $300MM in outstandings.
   - 11 venture leases totaling $29MM in commitments and estimated $5.8MM in outstandings.
   - 17 leases totaling $520MM in commitments.

2. Prepared a summary of loans which did not comply with conditions precedent or did not comply with post-closing credit requirements.

3. Created an Excel-based compliance tracking tool to facilitate monitoring of loan and lease agreement and covenant compliance.

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October 12, 2000
4. Provided electronic workfiles for individual loans and venture leases, and a table summarizing leases, to CSC management for review.

5. Identified issues having a potential impact on the operational activities of CSC.

    - Assigned ratings to each comment based on the following scale:
      - **High Risk Critical Items** should be addressed in the immediate future.
      - **Moderate Risk Items** should be addressed within the next six to twelve months.
      - **Low Risk Items** - other issues which may impact future operations.

    - Proposed improvements for addressing these issues described above.

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   October 12, 2000

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   - 5.
Findings: Loans

D&T reviewed documentation for all 31 existing loans, totaling $1.6 billion in commitments and estimated $300MM in outstandings:

- 100 percent of loans did not comply with conditions precedent for funding.
- Critical documents were not found in the loan files, including:
  - UCC-1 filings in support of assignment of assets to CSC.
  - UCC-3 confirmation of lien position.
- 80 percent of loans did not comply with post-funding requirements.
- Critical information was not found in the loan files, including:
  - Compliance certificates.
  - Interim financial information.
- Two loans were past due, with no evidence of collection located in the loan files.
Findings: Venture Leases

D&T reviewed documentation for all 11 existing venture leases, totaling $29MM in commitments and estimated $5.8MM in outstandings:

- 100 percent of venture leases did not comply with pre-funding requirements.
- Venture lease files did not contain critical documents, including:
  - UCC-1 filings in support of assignment of assets to CSC.
  - UCC-3 confirmation of lien position.
  - Insurance showing CSC as loss payee.
- 100 percent of venture leases did not comply with post-funding requirements.
- Significant information was not contained in the files, including:
  - Compliance certificates.
  - Interim financial information.
Findings: Leases

D&T reviewed a small sample of the least portfolio (17 leases) totaling $520MM in commitments:

- 88 percent of leases reviewed (17 leases) did not comply with pre-funding requirements.
- Critical documents were not found in the lease files, including:
  - Incumbency certificates.
  - Lien searches.
  - UCC-1 filings in support of assignment of assets to CSC.
- 100 percent of leases reviewed (17 leases) did not comply with post-funding requirements.
- Critical information was not found in the files, including:
  - Compliance certificates.
  - Interim financial information.
  - Certificates of insurance.
### Issues Requiring Attention

#### PRE- AND POST-FUNDING COMPLIANCE

<table>
<thead>
<tr>
<th>Issue</th>
<th>Impact</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSC does not have a documented, professional process to ensure compliance with either the conditions precedent to the funding of any extension of credit or the monitoring of post-funding covenants contained in the credit agreements.</td>
<td>The level of legal exposure and credit and financial risk to CSC significantly increases without proper borrower and collateral documentation, effective oversight of the conditions prior to funding, and an on-going monitoring process for required credit and financial information.</td>
<td>Establish formal written procedures and assign responsibility for the review of conditions precedent to funding and on-going adherence to credit covenants.</td>
</tr>
<tr>
<td>Critical gaps exist in loan and lease balance and payment status information.</td>
<td>Maintenance of correct outstanding balance and interest payment information is a critical function for any lender. Besides the risk of an inappropriate level of customer service, clear legal and financial risk is apparent.</td>
<td>Establish exception approval requirements and process if conditions are not met or are to be waived prior to funding.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Establish a Quality Control function and designate responsibility to ensure the proper recordation of information necessary to service the extension of credit. In addition, responsibility for servicer oversight should be assigned to ensure performance as described in the servicing contract.</td>
</tr>
</tbody>
</table>

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For Discussion Purposes Only

- 10 -

October 12, 2000
Issues Requiring Attention

PROCESS AND PROCEDURES

Issue

- CSC does not have an integrated and defined credit process to support the stated business objective of financing 20 percent of Cisco System's sales of $50 billion within the next three years.

Impact

- Communication and accountability are not well-defined, and critical decisions and differentiation of responsibilities have not been formalized. The result is several gaps in the credit process which can expose CSC to legal and financial risk.

Recommendation

- Within the current CSC organizational structure, create a separate Compliance "box" to ensure that critical documentation controls are in place and assets are properly serviced.

- Develop, design, and publish standard Risk Acceptance Criteria policies and procedures to support the business for lending transactions.

- Develop policies to standardize underwriting criteria, with deviations representing the exception rather than the rule.

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- 11 -

October 12, 2000
Issues Requiring Attention

INFORMATION MANAGEMENT

Issue
- Front-end and back-end systems are not available to provide financial support and risk management information on the loan and venture lease portfolios.
- Outstanding individual balances, interest accruals, and other information for outstanding credits is unclear, erroneous, or not readily available.

Impact
- CSC management does not have current information of the delinquency status and current balances of the loan and lease portfolios, thus cannot act on problem situations in a timely manner.
- There have been lost revenue opportunities due to inaccurate or untimely billings; inability to manage/reconcile loan and lease portfolio balances; timely recognition of emerging risk issues due to non-payment; or the inability to strategically manage portfolios based on identified risks.

Recommendation
- CSC should implement a standard loan portfolio accounting software to track and manage loans and leases, enabling management to review payment status at any time.
- CSC should conduct a comprehensive and integrated analysis of standardized portfolio tools. While Lease Pak is utilized to support venture lease activities, the size and complexity of the portfolio may warrant a more comprehensive and integrated approach.

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For Discussion Purposes Only
October 12, 2000
Issues Requiring Attention

DOCUMENTATION AND FILE MANAGEMENT

Issue
- Credit documentation is not standardized or centralized.
- Covenants are located in numerous documents—there is no consistent place to review and verify compliance.
- Documentation and other information is fragmented as credit files are disorganized and incomplete.

Impact
- It is extremely difficult for CSC management to verify compliance and draw meaningful credit conclusions on the underwriting and documentation process.

Recommendation
- Establish a standardized approval/documentation process.
- Place all covenants in a single standard location within the loan agreement.
- Credit files should be centralized and a prefunding compliance and post approval quality control process should be performed to ensure that all documentation has been obtained.
Path Forward

Critical issues currently exist in several areas that should be addressed immediately:

- Responsibility for Pre- and Post-Funding Compliance
- Process and Written Procedures
- Information Management
- Documentation and File Management

Statements of Work to address some of these issues have been approved by CSC management.

D&T is in process of identifying staff to assist CSC with these issues and is beginning work on the compliance checklist and ongoing compliance activities.

Confidential
Exhibit Q
To All,

The Internal Audit Report for the Cisco Capital Process Review has been finalized and is now being released for distribution.

The executive summary is as follows:

Cisco Systems Capital Corporation (Cisco Capital), a wholly-owned subsidiary of Cisco Systems, Inc. (Cisco Inc.), specializes in financing networking equipment and associated costs through leases and loans to Cisco customers. Currently there are over 2,250 lease schedules in place, totaling $650 million in equipment acquisition costs. Cisco Capital has extended leasing to their customers since April 1997. Cisco manages all aspects of the leasing process internally, with the exception of lease invoicing and collections which are outsourced to American Express. Maintenance of the leasing function will soon be converted to E-Lease, a customized capital leasing application.

As of 02 FY2000, there were 15 closed loans with fundable loan facilities totaling $425 million and loan commitments of up to $1.5 billion. Loan financing has been available to customers since October 1998. Currently, Cisco Capital is responsible for all aspects of the loan process. In the next
several months loan operations will manage the validation and approval of each loan disbursement, and outsource the physical disbursement process, invoicing, and collections component to Citibank.

The objectives of this review included evaluating the current domestic capital process, assessing the overall control environment over capital lease and loan processing, and identifying opportunities for process improvement.

Although fundamental controls governing the lease process are adequate, key controls governing the loan process are weak and should be strengthened. Management is aware of these concerns and is currently assessing required process modifications and related systems to increase control and support anticipated growth in both the lease and loan processes.

Significant Risk Areas & Opportunities for Process Improvement
- Loan Operations Policies and Procedures - There is an overall need for standardization of the loan process.
  - Implement detailed policies and procedures for the loan funding process by strengthening key controls governing classification of loans, characters of each classification, and basis for the funding.
  - Maintain adequate substantiation of all loan disbursements, implementing checklists as needed for data integrity.
  - Track active loan funding balances to monitor the available loan facility, and to ensure proper reporting to management.
  - Standardize the information required from customers for loan funding, consulting with legal to determine requirements.

- Standardization of Credit Approval Processes - Policies and procedures are in place for the credit approval process. However, with the growth of the leasing and financing business, further standardization of the credit process is required.
  - Standardize working files for both leasing and loan financing credit review, implementing checklists to track documents and signature approvals required for the credit approval process.
  - Implement detailed procedures for the credit approval process, updating the policy and procedures to include loans.

- Lease Operations Policies and Procedures - Lease operations were in the process of standardizing the process and developing policies and procedures at the time of the audit. Going forward, the following areas are opportunities for continued improvement:
  - Implement standardized policies and procedures which include terminated leases, tech migration and buyouts.
  - Require document checklists and approval signatures to ensure proper maintenance of work files.

Please contact me should you have any questions or comments regarding this project or the contents of this report.

Thanks.

- att1.htm
Cisco Capital Review Report.ppt
Exhibit R
Title: FAS 13 Testing - Sales
Reference: 3975 - 24
Type: Created in Notes

Area: 3975 - Capital Corporation (CSCC)
File Section: Assets

Details:

Note: Double-click on the icon to view the results of the FAS 13 Testing on Sales Type Leases:

Sales Type Lea

Document Status: Reviewed

Completed By:
Dan George

Reviewed By:

Review Categorization:

Maintenance

Created By:
Mary K. Glide

Last Modified By:
Dan George

Editors:
Mary K. Glide; Scott Pinkerton; Dan George
<table>
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<th>Termination</th>
<th>Lease End Options</th>
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<td>Begin Purchase</td>
<td>ABCEF</td>
</tr>
</tbody>
</table>

**Explanation:**

A. PwC examined the supporting documentation and noted that the supporting documentation included the signed lease agreement.

B. PwC examined the supporting documentation and noted that the supporting documentation included the document (or transaction series) checklist.

C. PwC examined the supporting documentation and noted that the supporting documentation included the invoice from Class (or the VAR) for the equipment purchased.

D. PwC examined the supporting documentation and noted that the supporting documentation included the FAS 13 calculation to determine the treatment of the lease.

E. PwC examined the supporting documentation and noted that the supporting documentation included the input data from the LeasePak system.

F. PwC examined the supporting documentation and noted that the lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph 5(b) of FAS 13). This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statute or regulation to transfer title.

G. PwC examined the supporting documentation and noted that the lease contains a bargain purchase option (as defined in paragraph 6(a) of FAS 13).

H. PwC examined the supporting documentation and noted that the lease term (as defined in paragraph 5(b)) is equal to or more than the estimated economic life of the leased property (as defined in paragraph 5(c)). However, if the beginning of the lease term falls within the last 25 percent of the period estimated economic life of the leased property, including earlier years of use, the criterion shall not be used for purposes of classifying the lease.

I. PwC examined the supporting documentation and noted that the present value of the beginning of the lease term is the minimum lease payments (as defined in paragraph 5(b)), excluding that portion of the payments representing interest costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit element, specify or ascertain 90 percent of the present value of the fair value of the leased property (as defined in paragraph 9(e)) to the lesser at the inception of the lease over any residual interest in property retained by the lessor and expected to be realized by this. However, if the beginning of the lease term falls within the last 25 percent of the period normal economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease (as defined in paragraph 5(c)), unless (8) it is impracticable for him to lease the lessee is required to use the implicit rate.

J. PwC examined the lease agreement and noted that the lessee did not make any payments until month seven, 0. PwC therefore, calculated the net present value of the lease payments as follows:

a. Calculated the present value of the 30 monthly payments.

**Note:**

The page is not fully transcribed, but it contains a table and notes related to lease agreements and supporting documentation.
3. Calculated the present value on the present value of the 30 monthly payments for the 6 months no payment is made.

J PwC examined the LeasePak schedule, and noted that the Company recorded the minimum lease payments plus the unamortized residual value as the gross investment in the lease in accordance with FAS 13 paragraph 17a.

K PwC examined the LeasePak schedule, and noted:
1) the difference between the gross investment in the lease in (J) above and the sum of the present values of the two components of the gross investment was recorded as unearned income (unless RIR is negative, then no unearned income was recorded) - PwC recalculated within an immaterial amount.
2) the discount rate used in determining the present value was the interest rate implicit in the lease.
3) the net investment in the lease consists of the gross investment less the unearned income.
4) the unearned income is being amortized to income over the lease term.
In accordance with FAS 13 paragraph 17b.

L PwC examined the LeasePak schedule, and noted that the present value of the minimum lease payments, computed at the interest rate implicit in the lease, was recorded as the sales price (unless RIR is negative, then the minimum lease payments is recorded as the sales price). PwC also noted that the cost or carrying amount, if different, less the present value of the unamortized residual value according to the benefit of the lessor, computed at the internal rate implicit in the lease, was charged against income.

M The estimated residual value shall be reviewed at least annually. If the review results in a lower estimate than had been previously established, a determination must be made as to whether the decline is an estimated residual value in other than temporary. If the decline is an estimated residual value is judged to be other than temporary, the accounting for the transaction shall be revised using the charged estimate. The resulting reduction in the net investment shall be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value shall not be made.

N PwC examined the lease agreement, and noted no evidence of a residual guarantee or a penalty for failure to renew the lease at the end of the lease term. PwC makes further examination.

O PwC examined the supporting documentation (related to the lease agreement), and noted no evidence of a change in the provisions of the lease, a renewal or extension of an existing lease or a termination of a lease.

P PwC recalculated the remaining unamortized income at 4/5/00, based on the FAS 13 amortization schedule. PwC then traced and agreed the remaining unamortized income of 4/5/00 (per the FAS 13 amortization schedule) to the "current unamortized income" balance per the LeasePak Balance Sheet Type Direct Finance & Installment Contracts schedule.

Note: PwC traced the total unamortized income per the LeasePak Balance Sheet Type Direct Finance & Installment Contracts schedule to the balance sheet without exception.

1) PwC examined the supporting documentation, and noted that the Company recorded the unearned income related to maintenance. For Sea Perks, Program Manager Lease Accounting, CDIC, the unearned income related to maintenance was improperly recorded. It appears that the following entry was booked to record the transaction:

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<tr>
<th>DR</th>
<th>Accounts Receivable - Maintenance</th>
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</thead>
<tbody>
<tr>
<td>CR</td>
<td>Revenue - Maintenance</td>
</tr>
<tr>
<td></td>
<td>to record receivable related to maintenance</td>
</tr>
<tr>
<td></td>
<td>to record amortization on lease contract</td>
</tr>
</tbody>
</table>

Although it appears that the Company reversed the impact to the P&L and the net investment, PwC recommends that the client identify:

c) similar transactions with maintenance (or other cost) improperly recorded, and;

d) the impact to the P&L and balance sheet, if any, prior to year-end (see related point forward attached to WIP).
<table>
<thead>
<tr>
<th>Other Receivables</th>
<th>Present Value</th>
<th>Unearned Income</th>
<th>Revenue</th>
<th>COS</th>
<th>L</th>
<th>M</th>
<th>N</th>
<th>O</th>
<th>P</th>
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Unearned Income includes 100% of tax receivables

Revenue and COS includes Maintenance
Exhibit S
Client Name: Cisco Systems, Inc.
Period End: 07/29/2000

Title: FAS 13 Testing - Direct Financing
Reference: 3975 - 25
Type: Created in Notes

Area: 3975 - Capital Corporation (CSCC)
File Section: Assets

Details:

Note: Double-click on the icon to view the results of the FAS 13 Testing on Direct Finance Type Leases:

Direct Financing

Document Status: Reviewed
Completed By:
Dan George

Reviewed By:

Review Categorization:

Maintenance

Created By:
Mary K. Glide

Last Modified By:
Dan George

Editors:
Mary K. Glide; Scott Pinkerton; Dan George
### SFAS 13 ANALYSIS

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<th>Minimum Payments</th>
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</table>

**TM Lease**

A. The lessee examined the supporting documentation and noted that the supporting documentation included the signed lease agreement.

B. The lessee examined the supporting documentation and noted that the supporting documentation included the document (or transaction routing) checklist.

C. The lessee examined the supporting documentation and noted that the supporting documentation included the invoice from Class (or the VAR) for the equipment purchased.

D. The lessee examined the supporting documentation and noted that the supporting documentation included the FAS 13 calculation to determine the treatment of the lease.

E. The lessee examined the supporting documentation and noted that the supporting documentation included the print-out from the Lease/Pay system.

F. The lessee examined the supporting documentation, and noted that the lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph 5(d) of FAS 13). This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nonrefundable, for example, the minimum required by statutory regulation to transfer title.

G. The lessee examined the supporting documentation, and noted that the lease contains a bargain purchase option (as defined in paragraph 5(d) of FAS 13).

H. The lessee examined the supporting documentation, and noted that the lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, the conclusion shall not be used for purposes of classifying the lease.

I. The lessee examined the supporting documentation, and noted that the present value of the minimum lease payments (as defined in paragraph 5(j), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessee, including any profit retained, equals or exceeds 90 percent of the excess of the fair value of the leased property as defined in paragraph 5(k) to the lessee at the inception of the lease over any related investment tax credit retained by the lessor and expanded to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, the lessee shall not use for purposes of classifying the lease.

J. The lessee examined the supporting documentation, and noted that the present value of the minimum lease payments (as defined in paragraph 5(k), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessee, including any profit retained, equals or exceeds 90 percent of the excess of the fair value of the leased property as defined in paragraph 5(k) to the lessee at the inception of the lease over any related investment tax credit retained by the lessor and expanded to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, the lessee shall not use for purposes of classifying the lease.
J PwC examined the LeaseFair schedule, and noted that the sum of (i) the minimum lease payments and (ii) the unguaranteed residual value accruing to the benefit of the lessor was recorded as the gross investment in the lease in accordance with FAS 13 paragraph 16a.

K PwC examined the LeaseFair schedules, and noted:

1) the difference between the gross investment in the lease in (J) above and the cost or carrying amount, if different, of the leased property was recorded as unearned income.
2) the net investment in the lease consists of the gross investment plus any unamortized initial direct costs less the unearned income.
3) the unearned income and initial direct costs are being amortized to income over the lease term (or based on the fixed interest method as the results obtained are not materially different from those which would have resulted from the present value method).

In accordance with FAS 13 paragraph 16b.

L PwC examined the lease agreement, and noted no evidence of a residual guarantee or a penalty for failure to renew the lease at the end of the lease term. PwC notes latter examination.

M The estimated residual value shall be reviewed at least annually and, if necessary, adjusted in the manner prescribed in paragraph 17(d).

N PwC recalculated the remaining unamortized income at 412/000, based on the FAS 13 amortization schedule. PwC then traced and agreed the remaining unamortized income at 422/000 (per the FAS 13 amortization schedule) to the "current unamortized income" balance per the LeaseFair Balance: Sales Type, Direct Finance & Installment Contracts schedule.

Note: PwC determined the total unamortized income per the LeaseFair Balance: Sales Type, Direct Finance & Installment Contracts schedule to the balance sheet without exception.
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<th>Revenue</th>
<th>Unearned Income/Residual</th>
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<th>L</th>
<th>M</th>
<th>N</th>
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<td>1,248,088</td>
<td></td>
<td>117,666</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td></td>
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<tr>
<td></td>
<td>44,697</td>
<td>396,618</td>
<td></td>
<td>94,201</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>47,612</td>
<td>1,246,472</td>
<td>(76,865)</td>
<td>62,612</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>3,464,404</td>
<td></td>
<td>806,361</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
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<td>♦</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
<td>31</td>
<td></td>
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<td></td>
<td>224,419</td>
<td>4,680,400</td>
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<td>271,705</td>
<td>♦</td>
<td>♦</td>
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<td></td>
<td>277,561</td>
<td>5,614,501</td>
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<td>231,502</td>
<td>♦</td>
<td>♦</td>
<td>♦</td>
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</tbody>
</table>
Exhibit T
Client Name: Cisco Systems, Inc.  
Period End: 07/29/2000  

Title: FAS 13 Testing - Operating  
Reference: 3975 - 26  
Type: Created in Notes  

Area: 3975 - Capital Corporation (CSCC)  
File Section: Assets  

Details:  
Note: Double-click on the icon to view the results of the FAS 13 Testing on Operating Leases (both Cisco and 3rd Party):  

Operating Lease Te  

<table>
<thead>
<tr>
<th>Document Status:</th>
<th>Reviewed</th>
</tr>
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<tbody>
<tr>
<td>Completed By:</td>
<td>Scott Pinkerton</td>
</tr>
<tr>
<td>Reviewed By:</td>
<td></td>
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<tr>
<td>Review Categorization:</td>
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Maintenance  

<table>
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<tr>
<th>Created By:</th>
<th>Mary K. Glide</th>
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<tbody>
<tr>
<td>Last Modified By:</td>
<td>Scott Pinkerton</td>
</tr>
<tr>
<td>Editors:</td>
<td>Mary K. Glide; Scott Pinkerton</td>
</tr>
</tbody>
</table>
### SFAS 10 ANALYSIS

<table>
<thead>
<tr>
<th>Lease #</th>
<th>Lease</th>
<th>Lease Start Date</th>
<th>Lease End Date</th>
<th>Tech Refresh</th>
<th>Lease Options</th>
<th>Supporting Documentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1005030501</td>
<td>SCHERING SCH #506-001</td>
<td>May-02</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>2</td>
<td>1072010100</td>
<td>NBX, INC. SCH #1</td>
<td>Dec-07</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>3</td>
<td>2432050500</td>
<td>EDUCATION NETWORKS OF AMERICA - SCH #5</td>
<td>Nov-99</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>4</td>
<td>0988021000</td>
<td>TAYLOR BON SCH #21</td>
<td>Jun-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>5</td>
<td>1143001000</td>
<td>KEY SERVICES SCH #1</td>
<td>Mar-08</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>6</td>
<td>1256020700</td>
<td>JF EDWARDS SCHED #7</td>
<td>May-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>7</td>
<td>1265031000</td>
<td>I NETWORKS, INC. SCH #1</td>
<td>Sep-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>8</td>
<td>1197001200</td>
<td>GLOBAL KNOWLEDGE NETWORK - SCH 12</td>
<td>Jul-99</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>9</td>
<td>1188001000</td>
<td>GEOTRANS SCH #61</td>
<td>May-08</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>10</td>
<td>1236031000</td>
<td>AUTOMATION RESEARCH - SCH #1</td>
<td>Oct-08</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>11</td>
<td>1156011000</td>
<td>ASI COMMUNICATIONS SCH #1</td>
<td>Feb-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>12</td>
<td>2052010500</td>
<td>CINCINNATI BELL - SCH#84</td>
<td>Jul-09</td>
<td>Y</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>13</td>
<td>2167050100</td>
<td>QUALCOMM - SCH #1</td>
<td>Mar-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>14</td>
<td>2487050800</td>
<td>EDUCATION NETWORKS OF AMERICA - SCH #8</td>
<td>Dec-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>15</td>
<td>2506051000</td>
<td>KPMG - SCH #1</td>
<td>Jun-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
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<tr>
<td>16</td>
<td>2509050500</td>
<td>AMERIX CORP - SCH #1</td>
<td>Oct-09</td>
<td>N</td>
<td>Single Purchase Option</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
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<tr>
<td>17</td>
<td>3544061000</td>
<td>BELL SOUTH NET - SCH #1</td>
<td>Apr-09</td>
<td>N</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
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<tr>
<td>18</td>
<td>1102020500</td>
<td>IBM - SCH #5</td>
<td>Aug-09</td>
<td>Y</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
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<tr>
<td>19</td>
<td>2524020300</td>
<td>US AUTONOMY - SCH #2</td>
<td>Jun-09</td>
<td>Yes</td>
<td>Renewal, FMV Purchase, or Return of Equipment</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
<tr>
<td>20</td>
<td>3050020500</td>
<td>APPLE COMPUTER - SCH #25</td>
<td>Sep-09</td>
<td>Yes-3rd party</td>
<td>3rd party has FMV purchase right</td>
<td>✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓ ✓</td>
</tr>
</tbody>
</table>

**Notes:**

- **A:** PwC examined the supporting documentation and noted that the supporting documentation included the signed lease agreement.
- **B:** PwC examined the supporting documentation and noted that the supporting documentation included the document (or transaction model) checklist.
- **C:** PwC examined the supporting documentation and noted that the supporting documentation included the invoice from Cisco (or the VAP) for the equipment purchased.
- **D:** PwC examined the supporting documentation and noted that the supporting documentation included the FAS 12 calculation to determine the treatment of the lease.
- **E:** PwC examined the supporting documentation and noted that the supporting documentation included the joint-venture from the lessor's lease system.
- **F:** PwC examined the supporting documentation and noted that the lease transfers ownership of the property to the lease by the end of.
the lease term (as defined in paragraph 5(j)) of FAS 13. This criterion is met to situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title.

G. PwC examined the supporting documentation, and noted that the lease contains a bargain purchase option (as defined in paragraph 5(j)) of FAS 13.

1. PwC examined the lease agreement, and noted that in the PVA of the minimum lease payments was met the 90.5% test (per FAS 13) and it includes a bargain purchase option.

For Sue Pichard, the leased equipment is from Covalt. PwC gathers that the lease is operating lease (in accordance with current revenue recognition guidelines) as it is primarily a financing lease. In the explanation appears reasonable, PwC wishes further examination.

H. PwC examined the supporting documentation, and noted that the lease term (as defined in paragraph 5(j)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(j)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

2. PwC examined the lease agreement, and noted that the lease period exceeded 75% of the estimated economic life of the leased property. PwC gathers that the lease agreement can be terminated at any time after the first 12 months and there is no penalty to the lessee after the three years. Therefore, the Company assumed that the lease would be terminated at the end of the first three years as there is no penalty to the lease. As the client's explanation appears conservative and reasonable, PwC wishes further examination.

I. PwC examined the supporting documentation, and noted that the present value of the beginning of the lease term is not less than the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing interest costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereof, equal to or not less than 90 percent of the lesser of the fair value of the leased property (as defined in paragraph 5(j)) to the lessee at the inception of the lease and 75 percent of the total estimated economic life of the leased property. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. In this case, the lessor computes the present value of the minimum lease payments using the implicit rate implicit in the lease (as defined in paragraph 5(j)). A lease shall be considered the present value of the minimum lease payments using the incremental rate implicit in the lease (as defined in paragraph 5(j)), unless (i) it is impracticable for him to borrow at the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of these conditions are met, the lease shall the implicit rate.

3. PwC examined the lease agreement, and noted that the PV of the minimum lease payments met the 90.0% test (per FAS 13). PwC also noted that the lease has a negative internal rate of return. Therefore, PwC recalculated the 90.0% test as follows:

<table>
<thead>
<tr>
<th>Minimum Monthly Payments</th>
<th>215,001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offsite Costs</td>
<td>25</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>217,259</td>
</tr>
</tbody>
</table>

As the PVA of the minimum lease payments (in the original calculation) is based on a negative (NI) and the minimum lease payments are less than 90% of the total costs, it appears that the lease was properly classified as an operating lease.

4. PwC examined the lease agreement, and noted that the PV of the minimum lease payments met the 90.0% test (per FAS 13). For Sue Park, this term was booked in Mar, 2000 although it commenced in June 1999 (or 6 months after the commencement date). Although the lease is only 12 months Sue Park believes that this should have been booked as a capital lease. As the lease period will end prior to year-end and this appears to be an isolated incident, PwC wishes further examination.

J. PwC traced the leased asset (road) and total accumulated depreciation (per the LeasePlan schedule) to the fixed asset detail in accordance with FAS 13 paragraph 10(a).

5. PwC was unable to trace and agree the leased asset cost and total accumulated depreciation (per the FAS 13 schedule) to the fixed asset detail. For Sue Pichard, the difference is primarily due to the impact of the initial value on the fixed asset cost. The Company has changed its methodology for recording fixed assets subsequent to this transaction. Currently, the Company records the full amount of the asset and records depreciation expense down to the residual value.

K. PwC examined the LeasePlan schedule, and noted that the Company is recording revenue on the straight-line basis in accordance with FAS 13 paragraph 10(c).

L. PwC examined the LeasePlan schedule, and noted that the Company had not incurred any "initial direct costs."
Client Name: Cisco Systems, Inc.  
Period End: 07/29/2000  

Title: FAS 13 Testing - Installments/Maintenance  
Reference: 🌟3975 - 27  
Type: Created in Notes  

Area: 3975 - Capital Corporation (CSCC)  
File Section: Assets  

Details:  
Note: Double-click on the icon to view the results of the Installment/Maintenance Lease testing:  

🔍 Installment Lea  

Document Status: Reviewed  

- Completed By:  
  - Dan George  
  
- Reviewed By:  
  
Review Categorization:  

Maintenance  

- Created By:  
  - Mary K. Glide  
- Last Modified By:  
  - Dan George  

Editors:  
- Mary K. Glide; Scott Pinkerton; Dan George  

PWC 017727
## SFAS 13 ANALYSIS

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<tr>
<th>Lease #</th>
<th>Lease</th>
<th>Lease Start Date</th>
<th>Supporting Documentation</th>
<th>Length of Lease</th>
<th>Monthly Payment</th>
<th>Total Recalculated F</th>
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<tr>
<td>1</td>
<td>Allied Riser - SCH #1251 (other charges)</td>
<td>Jan-00</td>
<td>✓ ✓ ✓ ✓</td>
<td>36</td>
<td>56,126</td>
<td>2,030,126 ✓</td>
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<tr>
<td>2</td>
<td>ISP CHANNEL, INC. - SCH #50 (other charges)</td>
<td>Sep-99</td>
<td>✓ ✓ ✓ ✓</td>
<td>12</td>
<td>34,375</td>
<td>1,732,550 ✓ Why does this agree with the other cost lease schedule (no payments)?</td>
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<td>3</td>
<td>GTE DATA SERVICES - SCH #2850 (other charges)</td>
<td>Sep-98</td>
<td>✓ ✓ ✓ ✓</td>
<td>48</td>
<td>3,000,000</td>
<td>72,851</td>
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<td>4</td>
<td>ADP - SCH #110-01M (maintenance)</td>
<td>Mar-00</td>
<td>✓ ✓ ✓ ✓</td>
<td>53</td>
<td>30,030</td>
<td>1,601,191</td>
</tr>
<tr>
<td>5</td>
<td>PISNET, INC. - SCH #16M (maintenance)</td>
<td>Feb-00</td>
<td>✓ ✓ ✓ ✓</td>
<td>26</td>
<td>4,000</td>
<td>1,601,191 ✓</td>
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<tr>
<td>6</td>
<td>NATIONSBANK - SCH #95M (maintenance)</td>
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<td>9,500</td>
<td>34,994</td>
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<td>7</td>
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<td>12</td>
<td>561,957</td>
<td>20,917,293</td>
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<td>DIGITAL ISLAND - SCH #25M (maintenance)</td>
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<td>4,944</td>
<td>1,877,882 ✓</td>
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<td>RHYTHMS NETWORKS - SCH #11M (maintenance)</td>
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<td>87,823</td>
<td>3,212,840 ✓</td>
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<tr>
<td>10</td>
<td>OFFICE DEPOT - SCH #7M (maintenance)</td>
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<td>✓ ✓ ✓ ✓</td>
<td>36</td>
<td>26,000</td>
<td>1,678,228 ✓</td>
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<td>11</td>
<td>BELLEVUE NET - SCH #2M</td>
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<td>12</td>
<td>766,000</td>
<td>34,994</td>
</tr>
<tr>
<td>12</td>
<td>BBS DEALING RESOURCES - SCH #2M</td>
<td>Sep-98</td>
<td>✓ ✓ ✓ ✓</td>
<td>12</td>
<td>3,475,775</td>
<td>No payment as of 4/25/00</td>
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<tr>
<td>13</td>
<td>GTE DATA SERVICES - SCH #42M</td>
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<td>207,563</td>
<td>12,454,997 ✓</td>
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<tr>
<td>14</td>
<td>NATIONSBANK</td>
<td>Oct-98</td>
<td>✓ ✓ ✓ ✓</td>
<td>30</td>
<td>88,994</td>
<td>2,209,575 ✓</td>
</tr>
<tr>
<td>15</td>
<td>PERSHING DVISCH</td>
<td>Feb-00</td>
<td>✓ ✓ ✓ ✓</td>
<td>30</td>
<td>24,300</td>
<td>1,236,211 ✓</td>
</tr>
<tr>
<td>16</td>
<td>BANCA BANK CALIFORNIA (maintenance)</td>
<td>Jan-01</td>
<td>✓ ✓ ✓ ✓</td>
<td>30</td>
<td>28,244</td>
<td>1,694,445 ✓</td>
</tr>
<tr>
<td>17</td>
<td>LLS LOGIC CORP</td>
<td>Mar-01</td>
<td>✓ ✓ ✓ ✓</td>
<td>30</td>
<td>27,244</td>
<td>1,694,445 ✓</td>
</tr>
<tr>
<td>18</td>
<td>KISH SPEED ACCESS (maintenance)</td>
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<td>✓ ✓ ✓ ✓</td>
<td>36</td>
<td>35,149</td>
<td>1,083,582 ✓</td>
</tr>
</tbody>
</table>
Exhibit V
CONFIDENTIAL

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

In Re: 

CISCO SYSTEMS, INC., 

) No. C-01-20418-JW (PVT)

SECURITIES LITIGATION

This document relates to: 

ALL ACTIONS. 

CONFIDENTIAL

DEPOSITION OF JOSEPH KRAEMER

New York, New York

Wednesday, February 8, 2006

REPORTED BY: BARBARA R. ZELTMAN
to enter a period of extreme financial stress."

First of all, can I assume that mid-2000, you mean June 30/July 1, the midpoint of the year?

A Yes.

Q Tell me what, publicly, information was available that showed that the CLECs sector was poised to enter into extreme financial stress.

A Well, I think just to be consistent with what I said this morning, we may need to refer back to the record, but let me try to do it so we don't have to do that.

The issue would be how do you define extreme stress and what might be the criteria associated with that. And I think we identified things this morning about supply/demand relationships, pricing situations, regulatory environment, capital market access. Those were the types of factors that were mentioned.

Q I'm interested more in the sources. What are the sources of public information that you are alluding to when you
say that there was publicly available information?

A Well, you would have to go -- if you take, for example, the supply/demand relationship -- well, let's say capital market access, the first one. There would have been -- well, there's documents on the record on the Cisco side talking about the fact for the need to provide capital to the startups as a prerequisite for success, the spurt in funding provided by Cisco Capital. All that would go to issues associated with public market access.

With respect to issues on pricing, there were discussions in the industry, investment banks, Sprint, AT&T about the inability to maintain prices, that even though volume was going up, you didn't have the ability to maintain price so that the volumes were going up in excess of the ability to increase revenues.

And with respect to the regulatory side, there was a whole record at the FCC and to the courts of various parties that were attacking FCC policies and industry
protection to the startup CLEC.

You also had at that time, of course, the public situation associated with the ISPs and the dot coms.

Q So there's this great deal of publicly available information that you just identified.

And there's also a huge community of analysts following this industry at this point in time, correct?

MR. DROSMAN: Objection. Vague and ambiguous.

Q There is a substantial body of analysts covering this industry at this point in time?

MR. DROSMAN: Same objection.

Q You can answer.

A There's a large number of analysts that are looking at the telecommunications industry.

Q Can you think of a single one that as of mid-2000 was able to find the public information you just referred to and express the conclusion that the CLECs sector was poised to enter a period of extreme financial...
stress?

A  As we sit here, I can't cite a specific source.

Q  Not a single one?

A  As we sit here.

Q  Okay.

Now, if we can look briefly at Page 78 of your report -- excuse me.

Before we leave that last line of questioning, I would like to ask you the same question but now move the date forward in time to October 1.

Do you know a single analyst following this industry that as of October 1 was able to review the information you described to conclude that the CLEC sector was poised to enter into a period of extreme financial stress?

A  As we sit here, I couldn't name a specific analyst.

Q  On Page 78, subparagraph (e), you are describing a list of analysts' recommendations that was contained in actually two lists contained in the Williams report; is that correct?
Case 5:01-cv-20418-JW     Document 485     Filed 03/13/2006     Page 7 of 9

CONFIDENTIAL

A  Correct.  16:55:07

Q  And I just want to make sure I  16:55:09
understand here.

You are not disputing in this  16:55:10
paragraph that Mr. Williams accurately sets
forth the consensus recommendation on each of  16:55:14
these 16 companies during the time periods in  16:55:19
his report; is that correct?

A  That's correct. I'm looking at it as  16:55:36
to what is the predicted value of such.

Q  So you are not disputing that these  16:55:37
were the consensus estimates by the analyst
community at the three points in time,  16:55:42
March 31, 2000, June 30, 2000, and
September 30, 2000, correct?

A  Correct.  16:55:48

Q  You are simply disagreeing with those  16:55:52
analysts and saying, with the benefit of
hindsight, that they got it wrong?

MR. DROSMAN: Objection. Misstates  16:56:00
witness's testimony.

A  What I was -- I mean, what I was  16:56:02
saying was that the use of analysts' reports
as a predictive tool was flawed.

Q  But you don't dispute that  16:56:04
consistently through these three quarters of 2000, the bulk of these 16 companies -- the bulk of the companies set forth in the Williams reports received positive recommendations from the analyst community?

MR. DROSMAN: Objection. Vague and ambiguous.

A And we probably have to look at the list, but overall my impression was that the analysts' reports were favorable to the companies.

Q But you believe now that those analysts got it wrong; is that correct?

A Well, in order to say they got it wrong, you would probably have to read each report separately and understand what the criteria was on which they base the decision. The issue in this context was the use of analysts' reports to essentially look at the economic health or predictive value of such reports. In other words, it was a methodological issue.

Q I think I might have misunderstood something you testified to this morning.

In the WorldCom EDS case, were you

253
CERTIFICATE

STATE OF NEW YORK

: ss.

COUNTY OF NEW YORK

I, BARBARA R. ZELTMAN, Shorthand Reporter and Notary Public, within and for the State of New York, do hereby certify:

That the witness whose deposition is hereinbefore set forth, was duly sworn by me and that such deposition is a true record of the testimony given by the witness.

I further certify that I am not related to any of the parties to this action by blood or marriage, and that I am in no way interested in the outcome of this matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 9th day of February, 2006.

BARBARA R. ZELTMAN
Court Reporter and Notary Public
Exhibit W
TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Scope Of Engagement</td>
<td>1</td>
</tr>
<tr>
<td>II. Qualifications</td>
<td>1</td>
</tr>
<tr>
<td>III. Evidence Considered In Developing Opinions</td>
<td>2</td>
</tr>
<tr>
<td>IV. Summary Of Opinions</td>
<td>2</td>
</tr>
<tr>
<td>V. Financial Statements And Generally Accepted Accounting Principles.</td>
<td>3</td>
</tr>
<tr>
<td>VI. The Role Of Management And The Auditor</td>
<td>3</td>
</tr>
<tr>
<td>VII. Objective Of The Audit And Generally Accepted Auditing Standards.</td>
<td>5</td>
</tr>
<tr>
<td>A. Objective of the Audit</td>
<td>5</td>
</tr>
<tr>
<td>B. GAAS and Auditing Guidance</td>
<td>6</td>
</tr>
<tr>
<td>C. Audit Risk and Materiality</td>
<td>8</td>
</tr>
<tr>
<td>VIII. PricewaterhouseCoopers' Audit Of Cisco’s FY 2000 Consolidated</td>
<td>9</td>
</tr>
<tr>
<td>Financial Statements Complied With GAAS</td>
<td></td>
</tr>
<tr>
<td>A. General Responses to Mr. Regan’s Report</td>
<td>9</td>
</tr>
<tr>
<td>1. Mr. Regan mischaracterizes the nature of accounting estimates and the auditor’s responsibilities in testing them.</td>
<td>9</td>
</tr>
<tr>
<td>2. Mr. Regan ignores the fact that Cisco had excellent internal controls, a history of producing accurate accounting estimates, and a generally conservative approach to accounting.</td>
<td>12</td>
</tr>
<tr>
<td>3. Mr. Regan’s hindsight assertions that accounting changes made by Cisco in FY 2001 should have been made in FY 2000 ignore the fact that the industry in which Cisco operated underwent a decline in FY 2001, which makes comparisons between the two periods inappropriate.</td>
<td>13</td>
</tr>
<tr>
<td>B. General Standard One: The Audit Was Performed by Persons Having Adequate Technical Training and Proficiency as An Auditor</td>
<td>14</td>
</tr>
<tr>
<td>C. General Standard Two: PwC Maintained An Independent Mental Attitude</td>
<td>15</td>
</tr>
<tr>
<td>D. General Standard Three: PwC Exercised Due Professional Care in the Planning and Performance of Its Audit and Preparation of Its Report</td>
<td>17</td>
</tr>
<tr>
<td>E. Fieldwork Standard One: The Audit Was Adequately Planned and Assistants Were Properly Supervised</td>
<td>18</td>
</tr>
<tr>
<td>F. Fieldwork Standard Two: PwC Had a Sufficient Understanding of the Internal Control Environment</td>
<td>21</td>
</tr>
<tr>
<td>G. Fieldwork Standard Three: PwC Obtained Sufficient Competent Evidential Matter to Afford a Reasonable Basis for Its Opinion</td>
<td>22</td>
</tr>
<tr>
<td>1. Capital Corporation</td>
<td>23</td>
</tr>
<tr>
<td>a. Lease reserves</td>
<td>26</td>
</tr>
<tr>
<td>b. Pre-funded inventory (PFI)</td>
<td>32</td>
</tr>
<tr>
<td>i. PwC’s auditing procedures</td>
<td>26</td>
</tr>
<tr>
<td>ii. Financial accounting issues</td>
<td>27</td>
</tr>
<tr>
<td>i. PwC’s auditing procedures</td>
<td>32</td>
</tr>
</tbody>
</table>
ii. Financial accounting issues. ............................................. 32

c. Guaranteed leases. ....................................................... 35
   i. PwC’s audit procedures. ........................................... 35
   ii. Financial accounting issues. ................................. 36

d. Working capital/non-equipment loans .................. 42
   i. PwC’s auditing procedures. ................................ 42
   ii. Financial accounting issues. ................................. 44

2. Returns reserve ......................................................... 46
   a. PwC’s auditing procedures. ................................ 46
   b. Financial accounting issues. ................................. 50

3. Inventory and Related Allowance for Excess Inventory ... 61
   a. PwC’s auditing procedures. ................................ 61
   b. Financial accounting issues. ................................. 65

4. Revenue Transactions With Conditional Terms ........ 75
   a. PwC’s auditing procedures. ................................ 75
   b. Financial accounting issues. ................................. 80

5. Related Parties .......................................................... 88
   a. PwC’s auditing procedures. ................................ 88
   b. Financial accounting issues. ................................. 89

IX. PwC’s Reviews of Cisco’s Interim Financial Information In The First Three Quarters Of FY 2000 And The First Quarter of FY 2001 Conformed With GAAS ............................................. 94
   A. Applicable Professional Standards Relating To Interim Reviews ................................. 94
   B. PwC’s Review Procedures ......................................... 96
   C. Capital Corporation .................................................. 97
   D. Returns Reserve ........................................................ 99
   E. Inventory and Related Allowance for Excess and Obsolete Inventory ... 100
   F. Revenue Transactions ............................................... 101
I. Scope Of Engagement.

I have been engaged by counsel for PricewaterhouseCoopers LLP ("PwC") to evaluate PwC's audit of the consolidated financial statements for Cisco Systems, Inc. ("Cisco") for the fiscal year ended July 29, 2000 ("FY 2000") and its reviews of Cisco's interim unaudited financial information for the three quarters of fiscal year 2000 and the first quarter of fiscal year 2001 ("Q1 FY 2001"). In addition, I have been asked to evaluate the opinions expressed by other accounting and auditing experts in this matter, including plaintiffs' expert, D. Paul Regan ("Mr. Regan").

II. Qualifications.

I am a certified public accountant. I retired from the practice of public accountancy in 2002.

Prior to that time, for thirty-five years I was employed by and later became a partner with Ernst & Young LLP ("E&Y"), one of the four largest global accounting, auditing and professional services firms, and one of its predecessor firms, Arthur Young & Company.

Beginning in 1974, I started to specialize in consulting on and resolving complex accounting, auditing, and financial reporting issues arising in my firm's public accountancy practice. As a quality control element of the firm's audit process, I performed pre-issuance reviews, which included reviewing the audited financial statements of clients for compliance with applicable accounting and financial disclosure standards and reviewing the conduct of the audit for compliance with generally accepted auditing standards. Upon satisfactory completion of such reviews I approved issuance of the firm's audit report on the financial statements. Additionally, where applicable, I reviewed related client annual reports to shareholders and filings with the U.S. Securities and Exchange Commission ("SEC") for compliance with the rules and regulations governing such reports and filings and approved inclusion of the firm's reports therein. In this role, through specialized training, reading and applying professional literature, experience in practice, discussions and meetings with others in the firm dealing with similar matters, and frequent accessing and contributing to firm knowledge databases, I became very knowledgeable concerning the application of generally accepted accounting principles, generally accepted auditing standards, and SEC rules, regulations, and practices, and I have had experience in dealing with such matters both as a consultant/reviewer and as an auditor.

I also was a member of Ernst & Young's Southern California Technology Communications Entertainment industry practice group and developed similar levels of knowledge concerning the business issues and related accounting and auditing practices unique to technology companies. I also have had experience in dealing with such industry-specific matters as a consultant, reviewer and an auditor.
During the last ten years I also personally conducted a number of financial statement fraud investigations, many of which involved improper revenue recognition issues, and have studied and received training in financial statement fraud investigations, the causes and identification of fraud, and fraud prevention.

A more complete summary of my background and experience is presented as Appendix A to this report.

During the last four years I served as an expert witness in a lawsuit entitled Micro Enhancements International, Inc. v. Coopers & Lybrand LLP., et al. filed in Washington State Superior Court, in which I both gave a deposition and testified at trial as to my findings and opinions.

I also served as an expert witness in a lawsuit entitled In re Homestore.com, Inc. Securities Litigation filed in the United States District Court for the Central District of California. I provided deposition testimony in that litigation.

I have not published any writings during the last ten years.

For my services in this lawsuit I am being compensated at the hourly rate of $500.

III. Evidence Considered In Developing Opinions.

In forming my opinions, I have reviewed and considered the evidence and information contained in Appendix B to this report. In addition, I have performed extensive accounting and auditing research. I also have relied upon my own professional judgment and expertise obtained during the many years I have been practicing public accounting.

IV. Summary Of Opinions.

The following are my opinions:

- PwC's audit of Cisco's consolidated financial statements for FY 2000 conformed in all material respects to the applicable professional standards and customary practices for conducting audits of the financial statements of publicly traded entities.

- PwC's reviews of Cisco's interim unaudited financial information for each of the first three quarters of FY 2000 and the first quarter of FY 2001 conformed in all material respects to the applicable professional standards and customary practices for conducting reviews of the interim financial information of publicly traded entities.

- The alleged accounting errors and the audit and review performance deficiencies discussed in Mr. Regan's October 17, 2005 expert report
("Regan Report") are either incorrect or not material in the circumstances.

The opinions expressed in this report are based on my work to date. My work is continuing and I therefore reserve the right to modify or add to the opinions expressed in this report.

V. Financial Statements And Generally Accepted Accounting Principles.

An issuer's management is responsible for preparing its financial statements in accordance with Generally Accepted Accounting Principles ("GAAP"). Independent auditors perform financial statement audits to determine whether such financial statements taken as a whole are fairly presented in all material respects in accordance with GAAP. GAAP encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules and procedures provide a standard by which to measure financial presentations.

Accounting principles are designed to convey in summary form the substantive economic effects of various transactions and events and to enhance the comparability of financial reporting among various business enterprises.

While financial statements are referred to as historic because they focus on past transactions and events, they nonetheless involve a significant degree of estimation and professional judgment. Moreover, assumptions regarding the outcome of uncertain future events play an important role in management's preparation of financial statements.

VI. The Role Of Management And The Auditor.

The management of a company is responsible for establishing its accounting policies and preparing its financial statements, while an independent auditor is responsible for performing audit procedures and expressing an opinion on the financial statements prepared by management. According to Generally Accepted Auditing Standards ("GAAS"): Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's knowledge of these matters and internal control is limited to that acquired through
the audit. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management’s responsibility.”

GAAS considers an entity’s transactions and related assets, liabilities, and equity to be within the direct knowledge and control of management. An auditor’s knowledge of these financial statement components, therefore, is indirect and is filtered through: a) the inherent limitations of an audit, which preclude testing on a one hundred percent basis, and b) management’s representations to the auditors regarding assumptions that may be built into the financial statements, along with management’s intent with respect to the future development of existing conditions.

During an audit, management makes many representations to the independent auditors, both written and oral, in response to specific inquiries, through the presentation of information, or through the financial statements. These representations are integral to the auditors’ ability to obtain sufficient competent evidential matter to express an opinion on their client’s financial statements. At the end of an audit, the independent auditors obtain written representations from management to complement and corroborate the other audit procedures.

“[T]he auditor’s responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on them.” The standard report including an unqualified opinion that independent auditors issue at the conclusion of an audit reads as follows:

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of ____, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

This is the extent of the representations made by the auditor regarding the company’s financial statements. The auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform

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1 AU Section 110, paragraph 3.
2 AU Section 333, paragraph 2.
3 AU Section 110.
4 AU Section 508, paragraph 8.
5 As discussed below in Section IX.A, auditors do not opine on interim financial information.
the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.\textsuperscript{6}

VII. Objective Of The Audit And Generally Accepted Auditing Standards.

A. Objective of the Audit.

The objective of an audit is to perform adequate procedures to express an opinion that provides reasonable assurance about the conformity of the financial statements with Generally Accepted Accounting Principles ("GAAP"). An unqualified audit opinion does not provide assurance about the financial health or future earnings of an entity. It provides only reasonable assurance on the fair presentation of the financial statements and does not insure or guarantee sound financial condition.

An audit does not guarantee that all misstatements related to errors or irregularities will be detected because of such factors as: (a) the use of professional judgment throughout the audit process; (b) the need for independent auditors to work within economic limits; (c) the use of selective testing in designing and performing audit procedures; (d) the inherent limitations of internal control; and (e) much of the evidence available to the independent auditors is persuasive rather than convincing in nature. For those reasons, auditors do not "certify" their client's financial statements. They can "obtain only reasonable assurance that material misstatements in the financial statements, including misstatements resulting from fraud, are detected."\textsuperscript{7} Thus,

the auditor is not an insurer and his or her report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with generally accepted auditing standards.\textsuperscript{8}

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Audit procedures performed to obtain the competent evidential matter required to provide a reasonable basis for the independent auditors' opinion on financial statements include: inspection, observation, inquiries, confirmations, and analytical procedures. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

\textsuperscript{6} AU Section 110.02.
\textsuperscript{7} AU Section 316.A.10 (emphasis added).
\textsuperscript{8} AU Section 230.13.
B. GAAS and Auditing Guidance.

Independent certified public accountants conduct audits of financial statements in accordance with generally accepted auditing standards. These standards are issued by the American Institute of Certified Public Accountants ("AICPA") and are set forth at AU Section 150, Generally Accepted Auditing Standards, in a volume entitled U.S. Auditing Standards. There are ten standards which fall within the following categories:

General Standards:

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

Standards of Field Work:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor’s name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor’s work, if any, and the degree of responsibility the auditor is taking.

Nine of the ten standards consist of a single sentence, and the remaining GAAS standard is expressed in three sentences. The standards thus are statements of concepts which are subject to interpretation and application in myriad ways.

To achieve greater uniformity in the performance of audits, the AICPA issues more detailed guidance from time to time in the form of Statements on Auditing Standards (“SAS”). The SASs generally address a single topic and provide guidance on issues to be considered and procedures employed in the conduct of an audit in accordance with GAAS. The vast majority of information in issued SASs is descriptive rather than prescriptive because auditing involves the application of professional judgment to the challenges presented by each entity in auditing its financial statements and the selection and performance of auditing procedures to be applied in the circumstances. Further, certain tests performed may achieve more than one audit objective. Therefore, the fact that an auditor does not use one or more descriptive procedures set forth in a SAS does not mean that an audit was not performed in accordance with generally accepted auditing standards.

The generally accepted auditing standards together with the currently effective SASs are codified by the AICPA and issued in U.S. Auditing Standards. This volume is what is commonly referred to as generally accepted auditing standards or GAAS although strictly speaking generally accepted auditing standards are only the ten standards discussed above.

The auditing pronouncements providing the most relevant guidance for planning an audit are found in AU Section 311, Planning and Supervision; AU Section 312, Audit Risk and Materiality; AU Section 316A, Consideration of Fraud in a Financial Statement Audit; and AU Section 319, Consideration of Internal Control in a Financial Statement Audit.

Under this guidance, during the planning phase the auditor determines the nature, extent, and timing of the auditing procedures to be undertaken based on factors such as the size and complexity of the entity to be audited, its internal control, its business, industry and competitive conditions, the potential for fraud, and the systems used to process information.

In this process the auditor gives consideration to and obtains knowledge to plan the audit from sources such as the entity’s management and the audit committee of the board of directors, interim financial statements and the audited
financial statements for the preceding year, prior experience with the entity, knowledge regarding the industry in which the entity operates as it relates to the audit (such as economic conditions, government regulations, and changes in technology), as well as relevant auditing standards.

The auditor also considers financial statement specific factors such as: what level of financial statement misstatement would be material to users of the financial statements; the entity's accounting policies and the accounting practices common in its industry; what areas required adjustment in prior audits; what financial statement areas have a higher potential for error based on factors such as extensive use of estimation processes; and whether there are related party transactions or other unique conditions present that may require the extension or modification of audit tests.

C. Audit Risk and Materiality.

The concept of materiality is inherent in the work of independent auditors performing an audit. “Materiality” recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important. GAAP defines materiality as:

the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.\(^9\)

The independent auditors' consideration of materiality is a matter of professional judgment and is influenced by the auditors' perception of the needs of a reasonable person who will rely on the financial statements.

The representation in the auditor's standard report regarding fair presentation, in all material respects, in conformity with generally accepted accounting principles indicates the auditor's belief that the financial statements taken as a whole are not materially misstated.\(^10\)

Materiality is a qualitative assessment and is not purely quantitative. As set forth in SAB 99, the auditor does not rely exclusively on a numerical threshold or percentage of revenues or income, but rather makes a materiality determination based on all of the relevant circumstances.

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\(^9\) Statement of Fin. Accounting Concept No. 2, Qualitative Characteristics of Accounting Information ¶ 132 (Fin. Accounting Standards Bd. 1980).

\(^10\) AU Section 312.03.
Although Mr. Regan acknowledges the qualitative nature of a "materiality" determination, he nonetheless routinely applies a benchmark of $84.7 million of after-tax income in assessing whether Cisco made material misstatements in its FY 2000 consolidated financial statements. He further suggests that PwC automatically would have found any accounting errors that resulted in after-tax effects exceeding that benchmark to be material. In reality, PwC would have discussed any such findings with management and considered all the surrounding circumstances as well as the factors set forth in SAB 99 before concluding that such misstatements were in fact material to Cisco's financial statements.

VIII. PricewaterhouseCoopers' Audit Of Cisco's FY 2000 Consolidated Financial Statements Complied With GAAS.

It is my opinion that PwC's audit of Cisco's FY 2000 consolidated financial statements conformed in all material respects with each of the GAAS standards.

A. General Responses to Mr. Regan's Report.

Before responding specifically to each of Mr. Regan's criticisms of Cisco's accounting and PwC's audit work, I have several general responses to Mr. Regan's report, which apply to many of his specific criticisms.

1. Mr. Regan mischaracterizes the nature of accounting estimates and the auditor's responsibilities in testing them.

Financial statements prepared in accordance with GAAP — especially those of a large and complex entity such as Cisco — contain a great many estimates. An accounting estimate is an approximation of a financial statement element, item, or account. Accounting estimates are often included in historical financial statements because:

- The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events; and
- Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.\(^\text{12}\)

Many of the Cisco accounts which Mr. Regan contends were misstated involved precisely this type of accounting estimate. In suggesting that those estimates were materially misstated, I believe that Mr. Regan mischaracterizes the nature of accounting estimates and the degree of accuracy required (or possible) in making such estimates.

\(^{11}\) See, e.g., Regan Report at 43.
\(^{12}\) AU Section 342.01.
Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.\textsuperscript{13} There is no such thing as "the correct estimate." In formulating accounting estimates, management's goal is to arrive at estimates that have a reasonable basis, when viewed in the context of the financial statements taken as a whole.\textsuperscript{14} By concluding that any number of Cisco's accounting estimates were misstated by a specified dollar amount, Mr. Regan implies a degree of mathematical precision which simply cannot be achieved in such estimates, and which is contemplated neither by GAAP nor by GAAS. Moreover, the fact that management's estimate may later prove to be inaccurate does not necessarily imply that management lacked a reasonable basis for its estimate at the time it was made.

Mr. Regan also overstates the degree of formality that management is required to employ in making its accounting estimates. GAAS expressly recognizes that management's estimation process may be entirely reasonable even if it is neither documented nor formally applied.\textsuperscript{15}

Likewise, Mr. Regan implicitly mischaracterizes the role of the auditor in evaluating management's accounting estimates. The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. SAS No. 57, \textit{Auditing Accounting Estimates}, codified as AU Section 342, provides guidance in this area. This means that the auditor will evaluate significant estimates, not every estimate made by management. This also means that the auditor does not substitute his or her own judgment regarding the "best" estimate for management's estimate. Instead, the auditor determines whether management's accounting estimates, viewed in the context of the financial statements as a whole, have a reasonable basis and fall within the range of reasonable estimates.\textsuperscript{16}

When evaluating accounting estimates, the auditor's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that:\textsuperscript{17}

\begin{itemize}
  \item [a.] All accounting estimates that could be material to the financial statements have been developed.
  \item [b.] Those accounting estimates are reasonable in the circumstances.
\end{itemize}

\textsuperscript{12} AU Section 342.03.
\textsuperscript{13} AU Section 312.36.
\textsuperscript{14} AU Section 342.05.
\textsuperscript{15} AU Section 342.07.
\textsuperscript{16} See also AU Section 9312.05-09.
\textsuperscript{17} AU Section 342.07.
c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

Subparagraph 10 of AU Section 342 provides some suggested approaches for evaluating the reasonableness of estimates by management:

In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management’s estimate

c. Review subsequent events or transactions occurring prior to completion of fieldwork.

Audit evidence is used to determine the range of amounts that appear acceptable. As no single estimate can be considered accurate with certainty, the client’s estimate is acceptable if it falls within this range. A difference between the auditor’s estimate and the client’s estimate would not necessarily be considered an error. However, if the auditor believes that the client’s estimate is not acceptable, it should treat the difference between that estimate and the closest acceptable estimate as a likely misstatement and assess the overall nature and impact of these differences to determine whether there is a particular bias (i.e., over or understatement of earnings) that may be material in relation to the overall fairness of the financial statements and that may warrant further discussion with management and/or the audit committee.

As discussed in more detail below, I believe that PwC complied with all applicable professional standards in testing Cisco’s accounting estimates during the relevant audit work.
2. Mr. Regan ignores the fact that Cisco had excellent internal controls, a history of producing accurate accounting estimates, and a generally conservative approach to accounting.

GAAS explicitly recognizes that a company's internal controls may reduce the likelihood of material misstatements in making accounting estimates. Relevant aspects of internal controls include the following:\(^{18}\)

a. Management communication of the need for proper accounting estimates.

b. Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate.

c. Preparation of the accounting estimate by qualified personnel.

d. Adequate review and approval of the accounting estimates by appropriate levels of authority, including—

   1. Review of sources of relevant factors.
   2. Review of development of assumptions.
   3. Review of reasonableness of assumptions and resulting estimates.
   4. Consideration of the need to use the work of specialists.
   5. Consideration of changes in previously established methods to arrive at accounting estimates.

e. Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates.

f. Consideration by management of whether the resulting accounting estimate is consistent with the operational plans of the entity.

Throughout the relevant time, Cisco had an excellent system of internal controls. That fact was noted repeatedly by the PwC auditors in their audit workpapers.\(^{19}\) Cisco's excellent internal controls significantly increased the

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\(^{18}\) AU Section 342.06.

\(^{19}\) See, e.g., PWC 016444-62 (Assessment of Control Environment) (noting that Cisco's financial management was highly qualified, conservative, and established high ethical standards); PWC 016515-16 (Work Paper "Assess and document specific risks of material misstatement" – 500 – (Footnote continued)
likelihood that management’s accounting estimates were reasonable. Likewise, Cisco management had a long history of producing consistently accurate accounting estimates.\footnote{GAAS explicitly recognizes that a history of accounting estimates which are borne out by subsequent financial results is a strong indicator that management has a reasonable basis for making its estimates.\footnote{See, \textit{e.g.}, PWC 016444-62 (noting that Cisco’s budgeted results were consistently achieved and its estimates accurate).}} GAAS explicitly recognizes that a history of accounting estimates which are borne out by subsequent financial results is a strong indicator that management has a reasonable basis for making its estimates.\footnote{AU Section 342.06c.}

In evaluating the reasonableness of management’s accounting estimates, PwC was entitled to place significant reliance upon Cisco’s strong system of internal controls and upon its history of producing accurate accounting estimates. Yet Mr. Regan does not even mention these factors in his report.

3. Mr. Regan’s hindsight assertions that accounting changes made by Cisco in FY 2001 should have been made in FY 2000 ignore the fact that the industry in which Cisco operated underwent a decline in FY 2001, which makes comparisons between the two periods inappropriate.

In several instances, Mr. Regan points to changes in accounting judgments or estimates made by Cisco management in FY 2001 and concludes that similar adjustments should have been made to the company’s financial statements for FY 2000. Under any circumstances, I believe it would be inappropriate to reach such a conclusion in the absence of evidence demonstrating that the circumstances prompting the change in FY 2001 were in existence in FY 2000. In most instances, Mr. Regan points to no such evidence.

Even worse, as Mr. Regan is surely aware, the industries in which Cisco and its customers operated underwent significant and unforeseen changes between the start of Cisco’s FY 2000 and the end of its FY 2001. The collapse of some high-tech companies, and the decline in entire segments of the high-tech industry, has been well documented. Without pinpointing precisely when such events occurred relative to the changes in accounting judgments and estimates at issue, it would be particularly inappropriate to draw any conclusions about Cisco’s FY 2000 accounting on the basis of adjustments made in FY 2001. Yet Mr. Regan offers little if any evidence to support his implicit assumption that the industry changes that prompted Cisco to change certain of its accounting estimates in FY 2001 had already occurred before the end of FY 2000.

Finally, I have reviewed the report of Jeffrey Williams submitted on behalf of PwC (the “Williams Report”). Because that report was prepared simultaneously with my report, I have not had an opportunity to review it in detail, but Mr.
Williams' conclusions are consistent with my own understanding of the nature and timing of the downturn in the relevant industries and companies. As described in more detail in the Williams Report, the first indicia of serious financial problems in the industries in which Cisco and its customers operated, which might have had a material effect on Cisco's financial condition or performance, did not arise until long after PwC had completed its audit of Cisco's FY 2000 financial statements. It is particularly inappropriate for Mr. Regan to use accounting decisions made by Cisco after the industry decline in early 2001 to draw conclusions about the company's accounting during the period prior to those changes.


To ascertain the educational background and professional status of the individuals assigned to areas of key responsibilities in PwC's audits and reviews of Cisco's annual and interim financial statements during the Class Period, I read the depositions of the PwC personnel and reviewed firm documents. Most of the members of the Cisco audit team had college degrees in either accounting or finance. All senior members of the team were CPAs.

From the deposition testimony, it was clear that these individuals also had a great deal of experience in serving companies in the electronics and other high technology fields, as might be expected from working in PwC's San Jose office in the heart of the Silicon Valley. This prepared them to effectively deal with the business and financial accounting issues of unique importance to this industry sector. I also noted from the deposition testimony that the PwC team members had participated in numerous firm education and training programs. Additionally, I know from my professional experience that:

- PwC by virtue of its reputation, career opportunities, and status as one of the largest public accounting firms in the United States is able to attract and retain high quality, well qualified, and motivated individuals to its professional staff; and

- PwC maintains high standards for the personnel it hires and retains.

Moreover, I found nothing in my review of the PwC working papers that caused me to believe there was a deficiency in audit performance that would raise questions about the audit team's technical training and proficiency. I also note that Mr. Regan does not challenge the technical training and proficiency of the audit team in his report.

Accordingly, it is my opinion that PwC's audit team had adequate technical training and proficiency to perform the audit of Cisco's FY 2000 consolidated financial statements in accordance with relevant professional standards.
C. General Standard Two: PwC Maintained An Independent Mental Attitude.

GAAS requires that an accounting firm, all of its partners, and its employees participating in the engagement meet professional standards for independence. Such standards have been established to provide users of a company’s financial statements and the accounting firm’s audit report assurance that the audit and the audit report have not been influenced by circumstances that a reasonable person would believe create a conflict of interests or impairs the objectivity of the auditors in performing the audit. In general terms the areas covered by the independence standards include situations where:

The auditor has:
- ownership of a client’s securities or other financial interests in the client;
- a loan to or from the client;
- voting power over some of the client’s securities;
- a joint closely held investment; or

the auditor acts as:
- a director, officer, or employee, or in any capacity equivalent to that of a member of management;
- a promoter, underwriter, or voting trustee; or
- a trustee for any pension or profit-sharing trust of the client.

These rules also extend in certain ways to dependents and close relatives of audit personnel. Under the rules, a lack of independence by the firm’s partners and or by employees of the firm participating in the engagement is ascribed to the firm and the firm thereby loses its independence with respect to that client.

During the Class Period independence rules were established primarily by the American Institute of Certified Public Accountants and were promulgated within its Code of Professional Conduct. The basic rule is simple; it states:

Rule 101-Independence. A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.22

The complexity in the independence rules, however, is demonstrated by the more than 100 interpretations and rulings that apply the rules to various circumstances.

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22 American Institute of Certified Public Accountants (AICPA) Professional Standards, Code of Professional Conduct § 101.01.
The SEC also establishes its own independence standards that take into account those of the AICPA but extend the requirements as the SEC believes necessary for protection of the public securities markets.

In my review of the PwC working papers, I noted PwC's audit team:

- Requested and received confirmations as to independence in accordance with U.S. GAAS and SEC rules from each non-U.S. PwC firm performing audit work on the audit engagement; 23

- Obtained written independence confirmations from each professional, including partners and managers and excepting individuals associated with the engagement solely as a result of having provided consultation or SEC review functions, in PwC's U.S. firm assigned to the Cisco audit engagement before the individual commenced work on the engagement; 24

- Discussed independence matters and changes in PwC's independence documentation policies with audit team members at the team mobilization meeting held April 4, 2000; 25

- Accumulated information concerning: (1) non-audit services provided to Cisco; and (2) whether any business arrangements or alliances exist between PwC and Cisco or any of its affiliates, and considered whether they could potentially impair independence; 26

- Accumulated information concerning all former PwC partner level personnel and other former PwC personnel occupying positions that could influence Cisco's affairs or financial statements, and considered whether they could potentially impair independence as a result of having benefits being paid or payable in the future by PwC; 27

- Sent information about Cisco and its affiliates to PwC's Independence Compliance Office for inclusion in the firm's independence database

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23 See, e.g., PWC 016411-12 (Work Paper "Obtain confirmations regarding independence from non-U.S. PwC firms - Public entity" 150 – Mobilization).

24 See, e.g., PWC 000206 (D. George's independence confirmation).


26 See, e.g., PWC 019552-53 (Work Paper "Consider non-audit services and business arrangements and alliances" 8900 – Audit Completion); PWC 030057-59 (Work Paper “Acknowledgement of Receipt” 9030 – Canada (Skystone) (re FY 2000)).

maintained to assure compliance with independence requirements concerning non-purchase of Cisco's securities;\textsuperscript{28} and

- Confirmed in writing its independence to Cisco's audit committee and had discussions concerning independence issues with the committee.\textsuperscript{29}

Notwithstanding all these efforts, some situations arose where certain PwC partners and employees were found to hold Cisco stock. For the most part, these situations were identified based on PwC's independence monitoring systems and were corrected immediately. Although neither the Cisco engagement partner nor anyone in PwC's independence group considered such instances to actually compromise PwC's ability to maintain an independent attitude, PwC advised Cisco's audit committee about all such circumstances so that it could also evaluate whether it had concerns about PwC's ability to conduct an independent audit.\textsuperscript{30} The audit committee elected to continue with PwC as Cisco's audit firm.\textsuperscript{31}

Based on my review, I conclude that PwC was in compliance with professional and SEC independence requirements in all respects material to the performance of its audits and interim reviews during the class period.


The third general standard requires the auditor to plan and perform the audit with due professional care. AU Section 230.03 defines due care based on the definition found in \textit{Cooley on Torts}:

Everyman who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill

\textsuperscript{29} PWC 069462-63 (Aug. 8, 2000 Minutes of the Audit Committee); PWC 032304 (Aug. 8, 2000 Letter to Audit Committee Members regarding independence).
\textsuperscript{30} See CIS-PPNPF-0004350-51 (Exhibit 781) (informing audit committee that a small number of PwC employees were found to own Cisco stock; only one, from PwC's New Jersey office, had performed any work in connection with Cisco, and that work totaled only four hours). PwC also notified the SEC about these instances and agreed to improve its independence monitoring and compliance functions. As part of these efforts, PwC created a comprehensive independence compliance system, including a database to track the investments of all PwC partners and managers.
\textsuperscript{31} Mr. Regan also apparently does not contend these instances compromised PwC's independence since he does not claim that PwC failed to comply with this standard in his report.
commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error, he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.

D. Haggard, *Cooley on Torts* 472 (4th ed. 1932). Thus, due professional care imposes a responsibility on the auditor to exercise reasonable care and diligence in the conduct of an audit.

The third general standard also imposes a responsibility on the auditor to observe the standards of field work and reporting. Thus, the standards are interrelated and interdependent. If an auditor performs the audit in accordance with the standards of field work and reporting with reasonable care and diligence, then the auditor has complied with General Standard Three. Based on my findings, as described in this report, PwC complied with the Standards of Field Work and Standards of Reporting, PwC therefore also complied with General Standard Three.

E. Fieldwork Standard One: The Audit Was Adequately Planned and Assistants Were Properly Supervised.

This standard requires that the audit be adequately planned and assistants, if any, be properly supervised. Audit planning involves establishing the strategy and scope for the conduct of the audit. In planning, an auditor should obtain an understanding of the business, evaluate the overall audit risk, obtain a sufficient understanding of the company’s internal control structure and assess control risk, consider materiality and prepare an appropriate audit plan. The auditor considers many factors in planning an audit including, among others, matters that have affected the business during the year, management’s characteristics, internal controls, financial statement items that are more susceptible to material misstatement, prior year’s working papers and permanent files, and the complexity of accounting issues.

PwC’s audit planning for fiscal year 2000 complied with GAAS. As noted in the planning memorandum, the engagement team considered, among other items,

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32 I have discussed my findings in detail with regard to auditing procedures performed in connection with the specific areas of the audit challenged by Mr. Regan in Section VIII.G below, dealing with Fieldwork Standard Three and PwC’s review of sufficient competent evidential matter.

33 AU Sections 311, 312 and 319.
Cisco’s internal audit work, the prior year financial statements, the 2000 quarterly reports on Form 10-Q, and the acquisitions that had occurred during the year.\textsuperscript{34} The engagement team also gave appropriate consideration to the company’s internal controls as noted in, among other items, the documentation of policies and procedures on the major transaction cycles and in individual audit programs. Preliminary judgment about materiality was also addressed, including the risk of material misstatement of the financial statements arising from fraud.\textsuperscript{35} As a result of these considerations, an audit plan was prepared, including audit programs for specific financial statement areas such as cash, accounts receivable, accounts payable, revenue and inventory.

Mr. Regan states that in planning its audit, PWC did not comply with applicable standards because it failed:

- "to consider, among other things, matters related to the entity’s business and the industry in which it operates and the entity’s accounting policies and procedures. (AU 311.03.)"; and

- "to obtain a level of knowledge of the entity’s business that would enable PWC to obtain an understanding of the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. (AU 311.06.)"\textsuperscript{36}

I did not find this to be the case. Rather, a review of the planning for the FY 2000 audit and deposition testimony shows the following:

- The PwC audit partner and audit senior manager routinely received and reviewed Cisco’s internal financial statement package (the “Black Book”) monthly to obtain and maintain a current knowledge of Cisco’s business and changes and trends therein.\textsuperscript{37}

\textsuperscript{34} See PWC 016299-406 (Exhibit 13) (see especially 016384-87 and 016406); PWC 016416-17 (Work Paper “Consider impact of work of internal auditors” – 150 – Mobilization).


\textsuperscript{36} Regan Report at 43, 55.

• The PwC audit partner and/or senior manager regularly sat in on Cisco’s monthly closing meetings devoted to key issues such as inventory and reserves that occurred in connection with quarterly closings.\(^{38}\)

• Audit team members had knowledge gained from PwC’s reviews of Cisco’s FY 2000 interim financial information contained in its quarterly Form 10-Q filings with the SEC, which included the results of the analytical review procedures PwC performed and the results of inquiries of Cisco operating and financial personnel as well as meetings with Cisco executive management and Cisco’s Audit Committee of its Board of Directors.

• Audit team members participated in business and industry update sessions, which from time to time included Cisco personnel who shared their perspectives on industry developments.\(^{39}\)

• The audit team was aware of Cisco’s accounting policies and procedures from prior year audits as well as the reviews of FY 2000 interim periods.\(^{40}\)

Finally, PwC had a well developed audit methodology and proprietary computerized tools that aided its auditors in planning and conducting financial audits in accordance with GAAS.

This standard also requires proper supervision. Supervision includes providing appropriate instructions to those involved in the audit and reviewing their work. The working papers reflect that the appropriate instructions were provided to those individuals that assisted in the conduct of this engagement. As noted above, audit programs were utilized to provide guidance on the procedures to be performed in the various financial statement areas and other specific procedures performed were noted. From my review of the working papers it was also evident that the work of assistants was appropriately reviewed by those responsible for supervision.

All of this information allowed PwC to plan an effective and efficient audit using a risk-based audit approach whereby greater audit effort is addressed to areas presenting greater potential risk to Cisco’s financial statements.

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\(^{39}\) See, e.g., PWC 016498-99 (Work Paper “Gain or update understanding of the client and its industry” 300 – Client’s business and its industry (re FY 2000)).

F. Fieldwork Standard Two: PwC Had a Sufficient Understanding of the Internal Control Environment.

The second standard of field work requires an auditor to obtain a sufficient understanding of the internal controls of the company to plan the audit and determine the nature, timing and extent of the tests to be performed. An auditor is not responsible for designing the internal controls of the company or for ensuring that those controls are properly implemented and maintained. That is the responsibility of management.

PwC’s understanding of Cisco’s internal control environment for the fiscal year 2000 audit was based on the following:

- PwC (and Coopers & Lybrand) had audited Cisco’s financial statements since at least 1991; both the engagement partner and concurring partners had knowledge of Cisco’s control environment from prior engagements.

- PwC assessed Cisco’s computer systems annually. This assessment focused on the interface between Cisco’s computer systems and the accounting function. PwC’s Operating System Risk Management team performed its own audit, and annually assessed and tested the application and system controls for Cisco’s financially significant systems including Oracle, Networked Commerce and EDI.

- PwC documented its knowledge of Cisco’s internal controls, which the audit team updated through inquiry and observation each fiscal year.

- PwC considered that Cisco’s management had a bias toward conservatism and provided strong encouragement and positive reinforcement in establishing sound financial policies and procedures and reporting its results.

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41 AU Section 319.
42 AU Section 110.03.
43 Coopers & Lybrand merged with Price Waterhouse in 1988 to form the firm now called PricewaterhouseCoopers, LLP.
46 See Deposition of S. Meisel, Sept. 29, 2005, at 18:3-11
47 See, e.g., PWC 016392-406 (Exhibit 13) at 16392-95.
49 See PWC 016299-406 at 16319-20 (Exhibit 13) (in its audit planning questionnaire, PwC indicated that Cisco had a “history of accurate estimates,” even lower risk than a “conservative” company).
• PwC reviewed Cisco's internal audit reports to assess the status of systems and controls and amended its scope, if necessary, in light of any weaknesses noted by internal audit.  

• PwC did not identify any material weaknesses in internal controls when considered in the context of the financial statements as reflected in its report to Cisco's Audit Committee.

In its interactions with Cisco personnel and its testing of Cisco's internal controls that occurred throughout the year as well as in the performance of its reviews of Cisco's quarterly financial information, PwC had numerous opportunities to observe the reasonableness of the results produced by Cisco's systems and procedures by comparing activity in subsequent accounting periods with amounts provided for such activity in earlier accounting periods. PwC therefore adopted an audit approach that generally placed high reliance on Cisco's systems and procedures in areas where experience gained in previous audits had shown that such systems and procedures were highly likely to produce reliable results in accordance with applicable accounting principles.

Based on my review, PwC obtained a sufficient understanding of the internal controls at Cisco to plan its audit and determine the nature, timing and extent of tests to be performed.

G. Fieldwork Standard Three: PwC Obtained Sufficient Competent Evidential Matter to Afford a Reasonable Basis for Its Opinion.

This standard requires the auditor to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements that are being audited. AU Section 326, Evidential Matter, sets forth relevant guidance relating to the third standard:

The independent auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his or her professional judgment after a careful study of the circumstances in the particular case. However, in

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51 CIS-PPNPF-1085062-75 (Exhibit 2055) (Aug. 8, 2000 Letter from PwC to Cisco re engagement to audit financial statements).

52 See PWC 016334-39 (Exhibit 13).

53 Mr. Regan's specific comments about PwC's understanding of the internal control environment at Capital Corporation are discussed below in Section VIII.G.1.
the great majority of cases, the auditor has to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole are fairly presented are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being audited.\(^{54}\)

The guidance contained in GAAS does not specifically define the amount or level of evidentiary matter that is sufficient to afford a reasonable basis for an opinion on the financial statements. Rather, this standard recognizes that the nature of the evidence obtained, the timing of obtaining that evidence and the extent of the procedures performed, in order to express the opinion on the financial statements, are matters of professional judgment and should be adequate to reduce the risk of not detecting a misstatement to a level that is acceptable to the auditor.\(^{55}\)

In considering the overall auditing procedures that were performed by the engagement team and reviewing PwC's working papers, I found that sufficient competent evidential matter was obtained to afford a reasonable basis for the opinion that was expressed on Cisco's fiscal year 2000 consolidated financial statements.

In the sections that follow, I address specific aspects of the audit that were challenged by Mr. Regan.


As discussed above, although PwC adopted an audit approach for Cisco's FY 2000 consolidated financial statements that generally placed a high reliance on the controls and processes Cisco had built into its accounting systems, it did not apply that approach in performing audit procedures for Capital Corporation. Capital Corporation was established in 1996 to extend credit to facilitate sales of Cisco products and services. Because Capital Corporation was a relatively new entity within the Cisco organization that had been experiencing rapid growth, PwC believed its systems, controls and procedures were still being developed and did not yet show sufficient historical results to place high reliance on them for auditing purposes. Therefore, PwC adopted what is called a substantive testing approach to the accounts of Capital Corporation whereby balances were more extensively tested.

PwC's audit procedures relating to Capital Corporation's revenue recognition and lease and loan accounting policies and practices included:

\(^{54}\) AU Section 326.22.
\(^{55}\) AU Section 326.13.
obtaining or updating its understanding of Capital Corporation's systems, procedures, controls, and transaction flows;\(^\text{56}\)

- testing on a sample basis sixty current year leasing transactions for proper classification and income recognition as either sales-type, direct financing, or operating leases;\(^\text{57}\)

- attending management meetings where Capital Corporation's reserve balances were analyzed and considered for adequacy (Cisco had these meetings each month in connection with the monthly closing);\(^\text{58}\)

- testing selected lease receivable balances, amounts assigned to residual values of leased property that was to be returned to Cisco at the end of the lease, and amounts of unearned income on leases;\(^\text{59}\)

- performing analytical reviews of Capital Corporation's income statements as of April and July 2000 and obtaining explanations of the causes of large or unusual fluctuations from Capital Corporation employees familiar with its business and financial information.\(^\text{60}\)

As part of its auditing procedures PwC also considered whether the policies used by Capital Corporation in accounting for its leases and loans were in accordance with GAAP.\(^\text{61}\) One working paper documenting the procedures performed shows that they consisted of the following:\(^\text{62}\)

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\(^{58}\) PWC 017694-96 (Work Paper “Lease Reserve Memo” 3975 – Capital Corporation (CSCC)).


\(^{60}\) PWC 017743-44 (Work Paper “Obtain an analysis of the income statement” 3975 – Capital Corporation (CSCC)); PWC 017787 (Work Paper “Update summary and reconcile to general ledger account when early tests are performed” 3975 – Capital Corporation (CSCC)); PWC 017788-93 (Work Paper “Cap Corp B/S Flux” 3975 – Capital Corporation (CSCC)); PWC 017794-97 (Work Paper “Income Statement Flux” 3975 – Capital Corporation (CSCC)).

\(^{61}\) PWC 017751 (Work Paper “B – The LeasePak receivable listing or individual balances may be inaccurate – Sales Type” 3975 – Capital Corporation (CSCC)); PWC 017732 (Work Paper “C – The LeasePak receivable listing or individual balances may be inaccurate – Direct Financing” 3975 –

(Footnote continued)
Perform the following with regard to the accounting policy for lease transactions:

a) update understanding of the company's accounting policies for lease transactions, including estimated useful life of assets, FAS 13 calculation, calculation of residual value, equipment refresh, etc.;

b) verify that the policy is in compliance with GAAP; and

c) through performance of audit work for this area, ensure the company is in compliance with the accounting policy.

The working paper documenting the performance of this procedure shows that this audit step was specifically reviewed by James W. Sullivan, one of the PwC Senior Managers assigned to the Cisco engagement.

In addition, PwC performed a number of other auditing procedures on Capital Corporation account balances at April 2000, reconciled account balance schedules to Capital Corporation's general ledger, reviewed the process of including the accounts of Capital Corporation in Cisco's consolidated financial statements, and reviewed the changes in account balances between April 2000 and the year-end balances as of July 2000 for reasonableness and conformance to expected balances at year end.63

a. Lease reserves.
   
i. PwC’s auditing procedures.

In performing audit procedures with respect to Capital Corporation’s lease reserves, Mr. Regan contends that PwC failed to comply with AU Section 342 which "provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards." 64

As discussed above (Section VIII.A.1), this auditing guidance recommends that the auditor use one or a combination of potential approaches set forth in subparagraph 10 to develop an understanding of how management developed significant estimates. Unlike Mr. Regan, I do not believe that AU Section 342 required PWC to test each subsidiary estimate — such as the CLEC and ISP reserve percentages — used to establish the lease reserve. AU Section 342 applies to significant estimates and while the lease reserve as a whole may have been such an estimate, the constituent elements of it were not.

I conclude that PwC performed reasonable and customary auditing procedures with respect to the lease receivables reserve, and that such procedures complied with AU Section 342.10. My opinion is based on the following:

- As part of its audit PwC tested the calculation of the lease reserve and determined that it was being calculated in accordance with Cisco’s accounting policies and procedures for this reserve — thereby complying with paragraph 10. a. 65

- In evaluating the adequacy of the recorded reserve, PwC considered the history of write-offs against the reserve and concluded that Cisco’s reserving methodology and the industry grouping percentages used created a reserve balance that was reasonable in all respects — material to Cisco’s consolidated financial statements taken as a whole — thus complying with paragraph 10. b. above. 66 PwC determined that there were no write-offs against the lease reserves in fiscal years 1999 and 2000. 67

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64 Mr. Regan also suggests that PwC’s audit procedures with respect to lease reserves were inadequate when measured against SAB 102. See Regan Report at 44-47. As set forth below, SAB 102 is inapplicable because it was not issued until July 2001.

65 See PWC 017694-96 (Work Paper “Lease Reserve Memo” 3975 – Capital Corporation (CSCC)).

66 See PWC 017694-96.

67 Mr. Regan incorrectly suggests that PwC did not examine the default history on lease receivables based solely on the testimony of Ms. Nolan that she could not recall whether PwC did so. Regan Report at 46.
Some of the remaining criticisms leveled by Mr. Regan against PwC’s auditing procedures for sales-type lease receivables are also cited in his discussion of Cisco’s accounting in this area and are addressed in the following section.

ii. Financial accounting issues.

Mr. Regan claims that Cisco’s reserves for credit losses on sales-type lease receivables reported in its financial statements for periods prior to Q1 01 failed to comply with FAS 5 because Cisco did not have “a systematic methodology and rationale for supporting its loan and lease reserves.” I disagree with that conclusion.

The PwC working papers document that Cisco’s approach was to classify the leases into industry groups and provide reserves based upon pre-established percentages for each industry group. These percentages were consistently applied from July 1999 and throughout fiscal 2000 (five separate reporting periods), and the resulting reserves were conservatively stated in that they exceeded the amounts necessary based on the amount of actual losses incurred during these periods. In fact, there were no write-offs against the lease reserves in fiscal years 1999 and 2000. Moreover, in those same years, Capital Corporation also maintained a general contingency reserve for leases to cover any other unanticipated losses.

Rather than acknowledge the adequacy and conservatism of the reserves established during this period, Mr. Regan’s report assumes that the lease receivable reserve at July 2000 of $110.2 million was inadequate because the reserve had increased to $197.5 million by October 2000 — an increase of nearly 80% on a nearly identical lease receivable balance at the two period-ends. Mr. Regan’s analysis is based entirely on hind-sight and fails to acknowledge the dramatic changes that took place between those two dates in the industry segments in which Cisco and its customers operated. Those changes, which are discussed in depth in the Williams Report, make it inappropriate to use any accounting estimates made by Cisco in FY 2001 as the basis for concluding that similar adjustments should have been made in FY 2000. Most of this increase in the reserve balance for FY

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68 Mr. Regan inappropriately cites SAB 102, Selected Loan Loss Allowance Methodology and Documentation Issues, as applicable guidance from the SEC in arguing that the sales-type lease receivables reserves prior to Cisco’s Q1 01 were not established pursuant to “a systematic methodology and rationale for supporting its loan and lease loss reserves.” Regan Report at 32. Yet, by his own admission, that SAB was not issued until July 2001, a full year after the periods he places in question. Further, although he cites the guidance in that SAB, he never discusses what documentation the Company maintained and how it failed to comply with his ideas of what is required by the SAB. Regan Report at 31-32.

69 See CIS-PPNPF-0769530-31 (Deposition Exhibit (“Exhibit”) 397) (Cisco FY 01 P2 Lease Reserve); CIS-PPNPF-0769471-73 (Exhibit 398) (Cisco FY 00 P1 Lease Reserve); Regan Report at 30-31.

70 See PWC 017694-96.

71 See PWC 025896-98; PWC 017694-96.
2001 was due to significant increases in the credit risks posed by some categories of Cisco’s sales-type lease customers after September 2000.72

The evidence shows that Cisco promptly provided reserves against lease receivables as soon as it received information that those customers’ creditworthiness had substantially declined commencing in October 2000 (Q1 of FY 2001) and continuing from December 200073 to March 2001.74 The Williams Report demonstrates that the industry-wide and company-specific changes that led Cisco to revise its accounting for these leases did not become apparent to a reasonable observer until well after the end of the company’s FY 2000 and the date of PwC’s audit report thereon. Indeed, Mr. Regan’s own report acknowledges that it was not until late calendar year 2000 that two large CLECs — NorthPoint and Covad — were required to restate previously reported quarterly results for their periods ended September 2000 because some of the CLECs important ISP customers were seeking bankruptcy protection while others were reporting an inability to pay their outstanding receivables to the CLECs.

Of course Cisco was required to take changed conditions into account in estimating the sales-type lease receivables reserve at October 2000, and it did. In fact, Cisco was sufficiently concerned about establishing a proper reserve balance at Q1 01 that it modified its procedures and began in Q1 01 to analyze the receivables on a customer by customer basis. This was appropriate in these higher risk circumstances, but in no way did this change in estimating the reserve invalidate the appropriateness of the industry grouping method used in prior periods when the risk of credit loss was substantially lower.

In my opinion, it would have been inappropriate to increase the lease reserve before Q1 01 because, as stated in the Williams Report, that is when the changes occurred which led to the increased credit risk and GAAP does not allow loss reserves to be established before losses have been incurred. An accounting pronouncement issued in April 1999 by FASB in the form of a series of Q&As discussing the provisions of FAS 5 and SFAS 114, confirms this approach:75

14. [Q:] May a creditor simply increase (or not decrease) the allowance for loan losses [referred to as the sales-type lease receivables reserve in this report] in “good” economic times to provide for losses expected to occur in the future?

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72 PwC considered the financial condition of certain of the lease customers in Mr. Regan’s Exhibit C-1B in performing its revenue testing, including PSNet, ICG and RhythmConnections. See, e.g., PWC 005103-05 (Capital Corp Balance Sheet Flux); 005108-09 (Work Paper “Income Statement Flux Analysis (Interim -Dec.) 3975 – Capital Corporation (CSCC)).
73 PWC 005108.
74 PWC 005216-21 (“Leasetec FY01 P9”).
75 FASB Viewpoints, Application of FASB Statements 5 and 114 to a Loan Portfolio, EITF D-80 (Apr. 4, 1999) (Q&A No. 14). Mr. Regan cites FAS 5 and FAS 114 as definitive GAAP authority in establishing reserves. (See, e.g., Regan Report at 35-36, 119, 124).
[A:] No. Under generally accepted accounting principles losses should not be recognized before they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future. It is inappropriate to recognize a loss today for possible or expected future trends that may lead to a loss in the future.

In criticizing Cisco’s method of calculating lease reserves, Mr. Regan further argues that Capital Corporation’s “control activities and information and communication systems relating to sales leases were so inadequate that it precluded Cisco from estimating the lease reserves or recognizing revenue in accordance with GAAP.” As evidence, Mr. Regan cites a March 2000 report prepared by Cisco Systems Internal Control Services entitled “Cisco Capital Process Review,” and a report by Deloitte & Touche (“D&T”) entitled “Cisco Systems Capital (“CSC”) Compliance Project Phase 1” that bears the date of October 12, 2000. Mr. Regan’s criticisms ignores the plain language of these reports and the purposes for which they were prepared.

The “Cisco Capital Process Review” report, prepared by Cisco’s internal audit group, never forms the conclusions that Mr. Regan draws, and if the noted conditions were as serious as to justify the conclusions drawn by him, then they would constitute what auditors call “material weaknesses in internal control.” In that case, the Cisco internal auditors—whose mission, experience, training, on-site presence, and knowledge of the Company made them better prepared to draw appropriate conclusions than Mr. Regan — would have identified those conditions as material weaknesses in their report to Cisco management. However, the Executive Summary section states only that:

Although fundamental controls governing the lease process are adequate, key controls governing the loan process are weak and should be strengthened. Management is aware of these concerns and is currently assessing required process modifications and related systems to increase control and support anticipated growth in both the lease and loan processes.

In other words, the point of the internal audit report is that there are certain deficiencies in CSC’s operating policies and loan procedures that should be addressed and corrected in the normal course of improving CSC’s procedures to accommodate the growth this entity experienced in FY 2000 and the additional growth expected in the future. The criticisms contained in the internal audit report are hardly surprising or alarming, since one of the primary roles of an internal

76 Regan Report at 37.
78 CIS-PNPF-0506642-55 (Exhibit 161) (D&T Oct. 12, 2000 presentation re Cisco Compliance Project Phase 1); Regan Report at 37-41.
auditor is to examine a company's internal controls and to make suggestions for improvement. The fact that the internal auditors did such a thorough job in this regard is itself an indication that Cisco had exceptionally effective internal controls. I understand that Cisco management and PwC reached conclusions similar to those reached by the internal auditors.\textsuperscript{80}

D&T was not engaged by Cisco to audit its lease transactions, but to follow-up on the operational policy and procedures issues raised by the March 2000 Cisco internal audit report and to make recommendations for improvements.\textsuperscript{81} Not surprisingly, that firm had findings consistent with those in the internal audit report. D&T, did not, however, make any findings about the quality of Capital Corporation's lease and loan portfolio or the creditworthiness of its customers. To assess the significance of its findings, one should consider the recommendations that arose from them, but that were omitted from the table in the Regan Report at 41-42. The following recommendations contained in the D&T report relate to the findings cited in Mr. Regan's report:

**Pre- and Post-Funding Compliance.**

- Establish formal written procedures and assign responsibility for the review of condition precedent to funding and on-going adherence to credit covenants.

- Establish exception approval requirements and process if conditions are not met or are to be waived prior to funding.

- Establish a Quality Control function and designate responsibility to ensure the proper recordation of information necessary to service the extension of credit. In addition, responsibility for service oversight should be assigned to ensure performance as described in the servicing contract.

**Information Management.**

- CSC should implement a standard loan portfolio accounting software to track and manage loans and leases, enabling management to review payment status at any time.

- CSC should conduct a comprehensive and integrated analysis of standardized portfolio tools. While Lease Pak is utilized to support venture lease activities, the size and complexity of the portfolio may warrant a more comprehensive and integrated approach.


\textsuperscript{81} See Deposition of D. Worthington, Feb. 11, 2005, at 15:5-17:21; see also DT 00128-31 (Exhibit 97) (Statement of Work).
Documentation and File Management.

- Establish a standardized approval/documentation process.

- Credit files should be centralized and a prefunding compliance and post approval quality control process should be performed to ensure that all documentation has been obtained.

- Place all covenants in a single standard location within the loan agreement.

These recommendations do not indicate such an inadequate and uncontrolled situation that reserves for lease receivables and loans cannot be determined within a reasonable range material to Cisco's consolidated financial statements. Nor do they reflect such an absence of conditions necessary for revenue recognition that revenue must be deferred until cash is received. Rather, consistent with the March 2000 Cisco internal audit report discussed above, these recommendations again are indicative of the growth pains experienced by Capital Corporation and a need to implement improved operational policies and procedures in light of further anticipated growth.82

Further, the fact that Cisco had an internal audit function that identified these operational issues and it then hired D&T to provide its expertise in analyzing the conditions at CSC and make recommendations for improvements demonstrates that Cisco had a high controls consciousness and was interested in identifying and correcting issues before they became significant enough to potentially lead to misstatements in its financial statements.

Most importantly, when PwC tested the documentation of lease transactions as part of its FAS 13 testing, it was able to obtain all of the required documents for revenue recognition purposes. Thus, although the internal audit and D&T reports reflected a need for improvement in Cisco's file maintenance procedures, those reports do not establish that proper documentation did not exist.

Accordingly, there is no basis for reversing the recognition of revenue from sales-type leases in Cisco's FY 2000 financial statements. Rather, my conclusion, based on reading the PwC working papers and selected depositions and after giving consideration to the discussion of this area in Mr. Regan's report, is that Cisco's recognition of revenue from sales-type leases and the reserves provided against such receivables throughout FY 2000 are in accordance with GAAP in all respects material to the Cisco financial statements.

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82 Cisco's "stated business objective of financing 20 percent of Cisco System's sales of $50 billion within the next three years." CIS-PPNPF-0508652 (Oct. 12, 2000 D&T presentation re Cisco Compliance Project Phase 1).
b. Pre-funded inventory (PFI).

i. PwC’s auditing procedures.

Mr. Regan offers no opinions in his report regarding PwC’s audit and review services with respect to Cisco’s accounting for Prefunded Inventory (“PFI”). Therefore, my report does not address PwC’s auditing and review procedures concerning revenue recognition for PFI, but I reserve the right to respond to any supplemental opinions that Mr. Regan may offer in the future.

ii. Financial accounting issues.

From my review of the testimony and documents relating to this issue, I understand the essential facts regarding PFI to be the following:

- A Cisco customer seeking to acquire Cisco products pursuant to a lease arrangement would provide Cisco with a description of the products to be covered under the lease,\(^{83}\) although the customer might desire to acquire these products over time rather than all at once.\(^{84}\) The customer also would provide Cisco with its financial information to allow Cisco to make a credit decision based on the customer’s circumstances.\(^{85}\)

- Cisco would prepare a Master Lease Agreement (“MLA”) setting forth the general terms of the arrangement and specifying the maximum amount of products to be leased.\(^{86}\) In essence this was a credit limit based on Cisco’s evaluation of the customer’s creditworthiness, which was reevaluated before products are shipped. If acceptable to the customer, the MLA was signed by both parties. However, no products were shipped to the customer based solely on a signed MLA because the MLA was not a customer order but was essentially an agreement by Cisco to extend credit in the form of a lease under the terms and conditions in the MLA.

- The customer would order products from Cisco using Cisco’s standard purchase order which contained a term requiring payment within thirty days of the invoice date.\(^{87}\) The customer indicated to Cisco that it wished to utilize lease financing under the MLA to pay for the ordered product.

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\(^{83}\) Deposition of R. Snyder, Apr. 13, 2005, at 52:2-60:17.


• Cisco shipped the ordered products to the customer. Based on inventory availability and other factors such as multiple delivery locations, more than one shipment may have been required to fulfill the customer’s order.88

• The customer received the products.

• After products were shipped, Cisco’s leasing subsidiary, Capital Corporation prepared a Lease Schedule which specifies the exact equipment covered by the lease and certain additional terms of the lease not specified in the MLA, including the monthly payment due and the duration or term of the lease.89 There could be a period of time—sometimes months during Cisco’s FY 2000 and the first fiscal quarter of Cisco’s FY 2001—between when the product subject to a MLA was shipped and the signing of the Lease Schedule by both parties.90 This may have resulted from, for example, a delay by Capital Corporation in preparing and administering the Lease Schedules and completing all tasks necessary for the customer to sign the Lease Schedule91 or because the customer sought to further negotiate the financing terms in the Lease Schedule.92

• As an accommodation to the customer, Cisco did not commence billing for the shipped products until the Lease Schedule was signed.93 However, in the event the parties could not agree on mutually acceptable financing terms, Cisco would invoice the customer and pursuant to the thirty-day payment terms contained in the standard Cisco purchase order that the customer agreed to when it placed its order for the products, the customer was required to pay for the ordered products.94

Cisco recognized revenue from the sale of products expected to be financed under transactions that qualify as sales type or direct financing leases upon

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91 PWC 054181-83 (Exhibit 2050); see also Deposition of J. Kouchakji, Sept. 28, 2005, at 136:9-137:24; Deposition of R. Snyder, Apr. 13, 2005, at 151:4-152:17.
92 Deposition of S. Perkins, Dec. 13, 2004, at 74:4-23 (stating that PFI reserve was meant to provide for this possibility); Deposition of D. Powell, Aug. 30, 2005, at 73:2-74:23, 162:12-163:24.
shipment of the products to the customer and accounted for the sales value of such inventory, which normally would be an accounts receivable, as PFI pending the signing of a Lease Schedule by both the customer and Cisco and entry of its terms into LeasePak.\textsuperscript{95}

In his report, Mr. Regan opines that all criteria necessary for revenue recognition are not met until the Lease Schedule is signed and, therefore, contends that Cisco's recognition of revenue when the products are shipped does not meet the criteria for revenue recognition contained in the SEC's Staff Accounting Bulletin 101 ("SAB 101"), \textit{Revenue Recognition}.__\textsuperscript{96}

In my opinion, Cisco's recognition of revenue in connection with PFI meets the SAB 101 criteria and is appropriate. When all of the elements of the transaction are considered, the appropriate conclusion is that, first, a product sale occurs and second, the product sale is coupled with Cisco granting the customer an option to use lease financing for the purchase, provided that lease terms acceptable to both parties can be negotiated and a lease is executed. Consider the following:

At the time products are shipped, there is no lease financing in place nor is lease financing guaranteed by Cisco or a necessary condition of the customer's order. That is to say the purchase order does not grant the customer any right to lease financing, nor does the MLA. The lease is not a necessary condition to the sale and it is not negotiated and entered into until after the goods were ordered and delivered.

If a customer wanted to be assured of lease financing, it could negotiate and execute a lease with Cisco prior to ordering the products. Customers chose not to do so because they did not want to incur the delay that such a process would entail, and they were willing to bear the risk that if Cisco would not offer lease financing on acceptable terms to them, they would merely pay for the order pursuant to the purchase order terms out of their available funds or go to a third party financing source to obtain lease or debt financing.

For revenue recognition to be appropriate under SAB 101, four criteria must be met. Considering all terms of the transaction, it is apparent that the revenue recognition criteria were met when the product was delivered:

- \textit{Persuasive evidence of an arrangement exists.} The purchase order provides such evidence. It states among other matters: the buyer and


\textsuperscript{96} Although I conclude that Cisco met the criteria for revenue recognition under SAB 101, that standard did not apply to the FY 2000 financial statements because it was not effective until July 2001.
seller, the offer to purchase, the products ordered, the selling price of such products, and the payment terms (i.e., 30 days after invoicing).

- **Delivery has occurred or services have been rendered.** At the time the revenue is recognized under Cisco’s accounting, the products had been delivered in accordance with Cisco’s normal terms for product sales.

- **The seller’s price is fixed and determinable.** As noted above, the purchase order states the price to be paid for the products ordered.

- **Collectibility is reasonably assured.** Cisco had policies and processes in place to evaluate the current creditworthiness of customers, and it would not ship products whether pursuant to product sales or potential leases if a potential customer was determined not to be creditworthy.

Therefore I believe that Cisco’s PFI revenue recognition accounting policies are in accordance with GAAP.

I reserve the right to supplement this analysis of Cisco’s accounting for PFI if Mr. Regan delivers additional conclusions and opinions concerning this matter.

c. Guaranteed leases.

i. PwC’s audit procedures.

As set forth above, I believe PwC exercised due care in developing and performing audit procedures with respect to Capital Corporation and its recognition of revenue from lease transactions. I also believe the auditing procedures performed in this area were sufficient for PwC to have a reasonable basis for concluding that the FY 2000 financial statements of Cisco were fairly stated in accordance with GAAP.

PwC did not take exception during its audit of Cisco’s FY 2000 financial statements to the company’s accounting for Capital Corporation’s guarantee obligations with respect to payments by lessees to third-party lessors under leases of Cisco equipment as not being in compliance with GAAP. As discussed further below, the appropriate accounting treatment for revenue recognition for a portion of the products sold and covered by such guarantees was unclear and was evolving during 1999 and 2000. Cisco’s accounting in this regard was consistent with acceptable industry practice at the time, and PwC therefore had a reasonable basis for not taking exception to Cisco’s accounting.

Moreover, even assuming that Mr. Regan’s criticism of Cisco’s accounting for revenue recognition for leases in connection with lease guarantees was correct, I demonstrate in the following section that Mr. Regan committed several errors in his
estimate of the resulting misstatement which, when properly calculated, was clearly immaterial to Cisco's FY 2000 consolidated financial statements taken as a whole.

ii. Financial accounting issues.

My understanding of the facts relating to Cisco guaranteed leases and their accounting treatment is as follows. Cisco established arrangements with third-party financing entities to lease Cisco's product to customers who desired lease financing where Cisco did not want to be the lessor. These situations included leases to customers located outside of the United States and to smaller U.S. customers. Capital Corporation would refer these customers to one of the entities with which it had financing arrangements. In some instances, Capital Corporation would guarantee some or all of the payment obligations of the ultimate lessee.

In its accounting for these transactions in FY 2000, Cisco recognized revenue from the sale of the products upon shipment if those transactions otherwise met Cisco's normal criteria for revenue recognition. In the same accounting period Cisco also established a reserve of 25% of the guaranteed amount through a reduction of revenues. Thus Cisco's reported revenue for each quarterly period and for the entire FY 2000 period included the sales price of Cisco products ultimately leased to these customers, less any applicable discounts and less the reserve equal to 25% of the Cisco guaranteed payments. Cost of sales was recognized on these products at Cisco's standard cost.

In Q1 01 Cisco concluded that it should change its accounting policy to defer immediate revenue recognition on these sales when the products sold were the subject of operating leases and Cisco guaranteed the lease payments. Because revenue was no longer being recognized immediately, Cisco also ended its practice of providing, through a reduction of revenue, a reserve of 25% of the amount of the guarantee to the third-party lessor.

Mr. Regan contends that Cisco's financial statements were misstated for each quarter within and the annual FY 2000 period as well as Q1 of FY 2001 because "FAS 13, paragraph 22, required Cisco to account for these transactions as a 'borrowing,' in which the proceeds from the 'sale' shall be recorded as an obligation by Cisco. Instead, Cisco booked a 'contingency reserve' of 25% of the revenue it recognized from the 'sales,' in direct violation of GAAP." In other words, Mr. Regan contends that the accounting treatment adopted by Cisco in Q1 01 was always required by GAAP. Mr. Regan further calculates that after-tax earnings for FY 2000 were overstated by $51.9 million ($74.2 million pre-tax).

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98 See Deposition of R. Snyder, Apr. 13, 2005, at 125:4-126:8; CIS-PPNPF-0769223-32 (Exhibit 64).
99 Regan Report at 53.
The accounting literature relevant to this issue is FAS 13, Accounting for Leases and FASB Interpretation 34, Disclosure of Indirect Guarantees of Indebtedness of Others.\(^{100}\) FAS 13, Accounting for Leases was issued in November 1976, and from its issuance was subject to numerous revisions and interpretations because of difficulties understanding its provision or applying them to specific situations. FAS 13 has been the most revised and interpreted financial accounting standard ever issued by the FASB.\(^{101}\) The two paragraphs of FAS 13 cited by Mr. Regan, however, paragraphs 21 and 22, have never been amended or interpreted in any of these authoritative pronouncements. Under the captions: Accounting and Reporting by Lessors – Operating Leases – Participation by Third Parties, these paragraphs provide:

21. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property. A seller may by various arrangements assure recovery of the investment by the third-party purchaser in some operating lease transactions and thus retain substantial risks in connection with the property. For example, in the case of default by the lessee or termination of the lease, the arrangements may involve a formal or informal commitment by the seller to (a) acquire the lease or the property, (b) substitute an existing lease, or (c) secure a replacement lessee or a buyer for the property under a remarketing agreement. However, a remarketing agreement by itself shall not disqualify accounting for the transaction as a sale if the seller (a) will receive a reasonable fee commensurate with the effort involved at the time of securing a replacement lessee or buyer for the property and (b) is not

\(^{100}\) Mr. Regan also cites EITF 95-04, Revenue Recognition of Equipment Sold and Subsequently Repurchased Subject to an Operating Lease, as a source of additional guidance. This citation is inappropriate because EITF 95-04’s focus is on an entirely different subject, namely how a manufacturer accounts for circumstances where:
- it sells a product to a dealer;
- the dealer’s customer subsequently finances the purchase of the product by entering into an operating lease with the manufacturer or an affiliate of the manufacturer; and
- the manufacturer reacquires the product from the dealer in connection with establishing the operating lease.

EITF 95-04 addresses what to do after the manufacturer has reacquired ownership of the product that was originally sold whereas in Cisco’s lease guarantee situation the accounting question is what to do when the product has been sold, the expectation is that Cisco will never reacquire it, but Cisco guarantees the lessees’ payment of its lease obligations to a third party lessee.

\(^{101}\) Through the end of Cisco’s FY 2000, authoritative standard setters had issued 80 pronouncements interpreting or revising FAS 13 (Financial Accounting Standards – 17; FAS Interpretations – 8; FAS Technical Bulletins – 12; EITF Issues – 38; AICPA Statement of Positions – 2; and SEC Staff Accounting Bulletins – 3).
required to give priority to the re-leasing or disposition of the property owned by the third-party purchaser over similar property owned or produced by the seller. (For example, a first-in, first-out remarketing arrangement is considered to be a priority.)

22. If a sale to a third party of property subject to an operating lease or of property that is leased by or intended to be leased by the third-party purchaser to another party is not to be recorded as a sale because of the provisions of paragraph 21 above, the transaction shall be accounted for as a borrowing. (Transactions of these types are in effect collateralized borrowings.) The proceeds from the “sale” shall be recorded as an obligation on the books of the “seller.” Until that obligation has been amortized under the procedure described herein, rental payments made by the lessee(s) under the operating lease or leases shall be recorded as revenue by the “seller,” even if such rentals are paid directly to the third-party purchaser. A portion of each rental shall be recorded by the “seller” as interest expense, with the remainder to be recorded as a reduction of the obligation. The interest expense shall be calculated by application of a rate determined in accordance with the provisions of APB Opinion No. 21, “Interest on Receivables and Payables,” paragraphs 13 and 14. The leased property shall be accounted for as prescribed in paragraph 19(a) for an operating lease, except that the term over which the asset is depreciated shall be limited to the estimated amortization period of the obligation. The sale or assignment by the lessor of lease payments due under an operating lease shall be accounted for as a borrowing as described above.

Neither of these two paragraphs explicitly addresses the issue of lease payment guarantees by sellers to third-party lessors even though numerous examples are provided by the FAS 13 authors of situations where paragraph 21 applies.

In my experience, many issuers and auditors reasonably believed during this time frame that the provisions of FAS 5, Accounting for Contingencies — which, unlike FAS 13, specifically addresses guarantees — applied to situations such as Capital Corporation’s lease guarantees. FAS 34, which interprets FAS 5, requires the disclosure in financial statements of indirect guarantees of the indebtedness of others where such guarantees are material to the financial statements taken as a whole.102

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102 Mr. Regan contends that Cisco failed to comply with the provisions of FAS 34, Disclosure of Indirect Guarantees of Indebtedness to Others, requiring the disclosure of the amount of such guarantees. Regan Report at 53-54. Because this contingent liability was immaterial to Cisco’s (Footnote continued)
The first authoritative indication that FAS 13 should be applied to lease guarantees came during the December 7-8, 1999 AICPA Conference on Current SEC Developments. At that conference, an SEC Professional Accounting Fellow noted that, in the SEC Staff’s view, a direct or indirect guarantee of lease payments represents the retention of a risk of ownership in the leased property within the scope of FAS 13.21 and that, if the risk retained is substantial, the transaction should be accounted for as a financing and not a sale. The SEC Fellow’s remarks were not published in any SEC or professional publication, and his interpretation of FAS 13 was disseminated to accounting professionals only through informal channels of communication. Before the Staff announced its interpretation of FAS 13, many issuers and accountants believed that FAS 5 provided the principles applicable to lease guarantees.

Importantly, the SEC representative did not state that registrants using a differing interpretation of FAS 13.21 had been improperly accounting for such arrangements. Rather, the SEC representative stated that “in the SEC’s view, credit risk represents ownership risk for purposes of applying FAS 13.21.” This causes me to conclude, based on my experience in working with and applying SEC accounting rules and regulations, that the SEC was not saying that registrants who had not previously been following this practice must go back and correct an accounting error; instead I believe the SEC’s message was simply that although there had been more than one way that registrants had been accounting for such arrangements, on a prospective basis it now wanted all registrants to use the method it had selected for these arrangements.\(^{100}\)

Given that Cisco’s accounting for lease guarantees was consistent with acceptable practice at the time and given the fact that the SEC’s different view was not published or otherwise generally disseminated to the accounting community, I believe that Cisco acted reasonably in beginning to apply FAS 13 to the lease guarantees of Capital Corporation involving operating leases during the next full consolidated financial statements taken as a whole, such amounts need not have been disclosed for the financial statements to comply with GAAP. My conclusion is based on the following:

- Per the Contingent Liabilities schedule prepared by Capital Corporation as of the end of FY 2000, the amount of guarantees of lease payments to third party lessors was approximately $110 million;
- Per Cisco’s FY 2000 consolidated balance sheet, Cisco had total assets of $32,497 million and total stockholders equity of $26,497 million, respectively, and the $110 million of guarantees of lease payments to third party lessors was approximately 0.3 of 1% and 0.4 of 1% of such amounts, respectively;
- Approximately $35.6 million of the $110 million exposure had been provided for by the lease reserves established upon recognizing the product sale to the third party lessor and thereafter; this $35.6 million portion of the $110 million of guarantees does not constitute an unrecorded contingent liability.

\(^{100}\) This method of changing the accounting on a prospective basis has been used by the SEC when it wished to reduce the range of alternative accounting treatments, but private sector accounting standard setters had not previously focused on the issue.
fiscal year after the Staff announced its interpretation. For the same reasons, I believe that PwC acted reasonably in not taking exception to Cisco’s accounting for lease guarantees during fiscal 2000.

Moreover, even if Cisco should have deferred revenue associated with guaranteed leases in FY 2000, I conclude that Mr. Regan improperly calculated the effect of this policy change on Cisco’s FY 2000 consolidated financial statements. Mr. Regan made several errors which undermine his calculation of $74.2 million as reflected in Exhibit C-2 of his report. First, Mr. Regan’s calculation fails to consider the portion of FY 2000 sales with third party guarantees that are for leases that qualified for accounting under FAS 13 as either sales-type leases or direct financing leases. This is important because pursuant to FAS 13.21 the deferral accounting required of SEC registrants for sales with third-party lease guarantees is only applicable in circumstances where the seller (Cisco) guarantees lease payments under operating leases.\textsuperscript{104} I understand that Cisco’s management estimates that only 20% of the leases are operating leases.\textsuperscript{105} The effect of this omission is to reduce Mr. Regan’s calculated overstatement by 80% or to approximately $10.4 million ($14.8 million pre-tax).

Second, Mr. Regan’s overstatement calculation includes all sales made in FY 2000 where there are related lease guarantees, instead of limiting sales to those remaining at year end. That is because under FAS 13.22, “rental payments made by the lessee(s) under the operating lease or leases shall be recorded as revenue by the “seller,” even if such rentals are paid directly to the third-party purchaser.” Therefore the only overstatement of revenue and income for FY 2000 is the net amount remaining at year-end and not the total amount of revenue recognized where there were related guaranteed operating leases made during the year.

Next, Mr. Regan improperly calculates the relationship between the total sales and the related reserve used in his calculations. Mr. Regan shows FY 2000 sales of $138 million and reserves against such sales of $24 million yielding a reserve percentage of 17.4%. This is unreasonable because, as Mr. Regan acknowledges, Capital Corporation reserved 25% of the guaranteed amount, which translates into a reserve of around 27.5%\textsuperscript{106} against recorded sales. I also compare the $24 million reserve amount for FY 2000 to the “Contingent Liabilities” schedule.

\textsuperscript{104} The accounting rules work this way because to qualify as either a sales-type or direct financing lease, the risk of ownership of the product must be substantially assumed by the lessee and the lessee must be determined to be creditworthy. Therefore, Cisco’s guarantee of such lease payments constitutes only a remote contingent liability which does not preclude immediate revenue recognition on the sale of products to the third-party lessor.

\textsuperscript{105} CISI-PPNPF-HC_0055074 (Cisco Analysis of Contingent Liability Reserve (re FY 01 Q1)).

\textsuperscript{106} 27.5% is derived using 25% of the sales price plus 25% of the interest element of the lease added by the third-party lessor to the total lease payments. This interest factor is estimated at 10% of the total lease payments resulting in an additional 2.5% of the sales price being guaranteed.
mentioned at footnote 126 of the Regan Report. That report, which displays the reserve balance that was actually on Cisco's books and in its FY 2000 consolidated financial statements, indicates that the reserve balance at year-end for these guaranteed leases was $35.6 million, which includes $8.1 million of additional "Specific Reserves" over and above the 25% reserve amount. As a result of these issues, I find Mr. Regan's calculation to be suspect.

Consequently, I have re-calculated the purported effect of the change in accounting policy for lease guarantees as follows:

- I started with the known reserve balance of $35.6 million at FY 2000 year end from the Capital Corporation "Contingent Liabilities" schedule. I note from that schedule that Capital Corporation adjusts the reserve to be at 25% of the outstanding "Current Guaranty" balance, except where Capital Corporation has transferred leases into "Specific Reserves" categories and increased the reserve to 100% of the current guarantee.

- I determined the amount of related sales by subtracting from the total reserve balance of $35.6 million the $8.1 million of additional "specific reserves" Cisco provided for these accounts over and above the normal 25% reserve. I then divided this amount ($27.5 million) by 27.5% (the 25% reserve on the sale plus a 25% reserve on an estimated 10% of interest in the leases that is also guaranteed) and determined the amount of sales related to the reserve at FY 2000 year end to be $100 million. I believe this sales amount is reasonable for two reasons. First Mr. Regan's analysis ignores the fact that Capital Corporation had guaranteed only 60.2% of amounts actually funded by the third party lessor as shown by the Capital Corporation "Contingent Liabilities" report (that is to say Cisco did not guarantee every lease only those that comprise 60.2% of the balance), which I think accounts for most of the reason that sales in Mr. Regan's Exhibit C-2 are so high in comparison to the related reserve amounts. Second, Mr. Regan's calculations do not account for any reductions in guaranteed amount that occurred during FY 2000 as a result of the lessees under the guaranteed leases making payments to the third party lessors, which, in turn, would reduce the amount of sales that are subject to this calculation.

- I next multiply the $100 million estimated balance of sales related to the reserve by 20% to account for the fact that only 20% of the guaranteed leases are estimated to be operating leases and subject to revenue deferral for the related Cisco product sale. This results in $20 million of sales being potentially subject to deferral.

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107 PWC 007818-30.
I then calculate the net revenue exposure for FY 2000 by subtracting from the $20 million sales amount: (1) 20% of the reserves provided by Cisco of $35.6 million as an estimate of the reserves provided that relate to sales of products that are leased under operating leases by the third-party lessors or $7.1 million; and (2) estimated cost of sales on the $20 million of sales at $5.8 million using 28.8%, the cost of sales percentage used in Exhibit C-2.

After making the above adjustments to Mr. Regan's schedule, I conclude that the amount of the overstatement of Cisco's FY 2000 pre-tax income as a result of not applying the SEC's views on accounting for third party lease guarantees is $7.1 million (after tax this would result in a $5.0 million reduction of net income). This amount is clearly not material to Cisco's FY 2000 consolidated financial statements taken as a whole.108

d. Working capital/non-equipment loans.

i. PwC's auditing procedures.

Capital Corporation provided equipment and working capital loans to customers during the class period. As discussed below in the Financial accounting issues section, Cisco typically reserved 25% percent of the loan amount on working capital (i.e., non-equipment) loans. Mr. Regan contends that PwC failed to comply with AU Section 342, Auditing Accounting Estimates, in evaluating the reasonableness of Cisco's reserve relating to non-equipment loans as part of its audit of Cisco's FY 2000 financial statements.109 I disagree with Mr. Regan's contention.

I believe that Mr. Regan's reference to AU Section 342 is not appropriate, since that section applies only to significant estimates in an issuer's financial statements and Cisco's reserve for non-equipment loans could not be considered a significant estimate in the context of its financial statements taken as a whole.110 The total of loans in this category at the end of FY 2000 was only $71 million per Mr. Regan's Exhibit C-6, and of this amount 25% was reserved for all customers except for AMC, which was 79% reserved. The total amount reserved for non-

108 I have not analyzed Mr. Regan's calculation of his proposed adjustment to Q1 of FY 2001 because at a ($1.3) million pre-tax effect and a ($0.9) million after-tax effect, the Regan's adjustments no matter what errors they contain are immaterial to the results of that fiscal quarter. 109 Regan Report at 122-25. 110 See AU Section 342.01 ("This section provides guidance to auditors in obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards."). Cisco reserved for non-equipment loans as one component of its loan reserve. See PWC 017897-99 (Work Paper "Loan Reserve Memo" 3975 – Capital Corporation (CSCC)). Mr. Regan does not challenge the other aspects of Cisco's loan reserve or PwC's auditing of the loan reserve.
equipment loans was $31.18 million, leaving a net exposure of under $40 million. This net exposure was further reduced as the loans were made to many borrowers rather than just one. Thus, repayment failure by one or two borrowers would not affect the adequacy of the overall reserve provided against these loans.

Moreover, PwC performed appropriate and adequate audit procedures related to Cisco’s loan reserve generally and its non-equipment loans specifically:

- PwC documented the purpose of the non-equipment loans and the company’s practice of reserving 25% of the amount of such loans.
- PwC obtained and reviewed a summary of notes receivable balances and agreed the total to the General Ledger.
- PwC discussed the collectibility of the loan portfolio with Cisco personnel and tested the reserve calculation for twelve notes receivable. The test included five non-equipment borrowers, including AMC.
- PwC obtained an understanding of the loan reserve and evaluated the reasonableness of the reserve calculations.
- PwC performed a flux analysis of balance sheet & income statement changes between its April 2000 testing date and the July 2000 year end.
- PwC attended Cisco’s quarterly reserve meetings during which its loan reserve was reviewed by high-level Cisco accounting management.

Mr. Regan contends that PwC’s audit was deficient because PwC failed to realize it was improper for Cisco to reserve 25% for non-equipment loans at the same time it reserved 100% for equipment loans and because PwC disregarded “the fact that Cisco appeared to have selected the 25% solely for the purpose of

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111 CIS-PPNPF-0769661-65 at 0769665 (Cisco Systems Capital Loan Reserve FY ’00 P12).
112 PWC 017697-99 (Work Paper “Loan Reserve Memo” 3975 – Capital Corporation (CSCC)).
113 PWC 017773-74 (Work Paper “Agree period-end detailed analysis of notes receivables” 3975 – Capital Corporation (CSCC)).
114 PWC 017775-76 (Work Paper “Evaluate the collectibility of notes receivable” 3975 – Capital Corporation (CSCC)).
115 Ibid.; PWC 007892-86 (“CSCC loan reserve analysis 4/29/00”).
116 PWC 017777-78 (Work Paper “Assess adequacy of loan reserves” 3975 – Capital Corporation (CSCC); see also PWC 017697-99 (Work Paper “Loan Reserve Memo” 3975 – Capital Corporation (CSCC)); PWC 007892-7886 (“CSCC Loan Reserve Analysis 4/29/00”).
117 PWC 017787 (Work Paper “Update summary and reconcile to general ledger account when early tests are performed” 3975 – Capital Corporation (CSCC)); PWC 017788-97 (Work Paper “Cap Corp B/S Flux” and “Income Statement Flux” 3975 – Capital Corporation (CSCC)).
118 PWC 017697-99 (Work Paper “Loan Reserve Memo” 3975 – Capital Corporation (CSCC)).
remaining consistent with Cisco's policy of maintaining an aggregate [A/R reserve] of 22%, which is in violation of FAS 114.” Mr. Regan's contention fails given that Cisco properly accounted for the non-equipment loans, as discussed below in the Financial accounting issues section, and because PwC understood and appropriately analyzed the reserve.

Based on my review of the working papers, I conclude that PwC's auditing procedures in this area complied with all GAAS requirements.

ii. Financial accounting issues.

Mr. Regan claims that Cisco violated GAAP by using an “arbitrary procedure” that did not comply with FAS 114 to set its non-equipment loan reserves. He contends that Cisco failed to set sufficient reserves and that its financial results were overstated as a result. I disagree with Mr. Regan's conclusions.

I believe that Cisco used a systematic and reasonable approach for setting reserves. Cisco personnel estimated reserves they believed prudent based on information available to them at each period end, and their judgments were subject to oversight in the quarterly reserve meeting. Cisco typically reserved 25% of the loan amount for non-equipment loans, recording it as a marketing expense as no revenue was recognized. In essence, the 25% reserve applied to the loan at inception was a way to give financial statement recognition to the cost of the inherent risk that Cisco assumed at the date the loans were made. Where Cisco had reason to expect a higher risk of default for a particular customer, it increased

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119 Regan Report at 123, 124.
120 See PwC working papers discussed herein, including PWC 17697-99 (Loan Reserve Memo) ("With non-equipment loans, no revenue is recognized; therefore a reserve against revenue is not appropriate, explaining why this portion of the loan is not reserved at 100%."); see also Deposition of M. Jerome, Sept. 9, 2005, at 128:16-25 ("The 100 percent [for equipment loans] is more akin to a revenue deferral, so that they're saying we don't believe collectability is reasonably assured; therefore, we should reserve 100 percent of the revenue [for the equipment sold]. Whereas, this loan here [a non-equipment loan] is not for -- it's not revenue recognition. It's a loan for something else, and therefore, they're reserving on a methodology associated with collectability."); ibid. at 169:19-171:9 (stating that Cisco compared its 25% non-equipment loan reserve to its 22% aggregate reserve for receivables in its regular business as one data point in assessing the reserve).
121 PWC 017697-99 (Loan Reserve Memo); see also Deposition of B. Fukuhara, Apr. 28, 2005, at 178:11-19 ("So relative to the nonequipment financing, again, taking into consideration in the event of default and the fact that we were senior secured lenders, we believed there was more than adequate collateral to recover on the soft portion of the nonequipment loans. So from a methodology perspective, the company agreed to 25 percent and that's what we applied as a percentage relative to nonequipment reserves."); Deposition of N. Tran, Jan. 10, 2005, at 69:9-17 (stating that the 25 percent was based on experience and feedback from corporate, as well as experience from the Cisco Capital controller).
the reserve amount for that customer, as reflected in the 79% reserve applied to AMC’s non-equipment loan at the end of FY 2000.\textsuperscript{122}

I also disagree with Mr. Regan’s contention that Cisco was required to apply FAS 114 to each loan because, as discussed above, the non-equipment loans were individually immaterial and the aggregate balance was immaterial in FY 2000. FAS 114, along with all other FAS statements, contains the caution that: “The provisions of this statement need not be applied to immaterial items.”\textsuperscript{123}

Mr. Regan presents no persuasive evidence that the non-equipment loans were impaired as of FY 2000. Rather, he relies on hindsight to assert that, because the loans were subsequently given negative credit scores and reserved at higher rates, that must mean that the same negative conditions applied at an earlier time. As discussed above, and in more detail in the Williams Report, many of Cisco’s customers underwent a dramatic downturn in their financial condition and business prospects between the date of PwC’s audit report on Cisco’s FY 2000 financial statements and the time that Cisco subsequently increased the reserves in question. There is no logical reason to believe that adjustments made in FY 2001 reflected conditions which also existed in FY 2000; in fact, the evidence overwhelmingly leads to the opposite conclusion. At the time they were preparing the FY 2000 financial statements, Cisco personnel assigned reserves they believed prudent based on the information available to them and monitored the accounts for the need to increase the reserves. Cisco responded to changing conditions in FY 2001 by assigning customer-by-customer credit scores and increasing reserves for certain customers. This was proper, as GAAP does not allow for an increase in allowances for loan losses before the losses have been incurred.\textsuperscript{124}

Finally, Mr. Regan only identifies a single customer, AMC, for which he claims Cisco failed to set sufficient reserves in FY 2000. Not only is Mr. Regan’s claim improperly based on hindsight,\textsuperscript{125} but even assuming arguendo that Mr.

\textsuperscript{122} Regan Report Exhibit C-6; CIS-PPNPF-0769661-65 at 0769665 (CSCC Non-Equipment Loans Loss Reserve); see also Deposition of N. Tran, Jan. 10, 2005, at 69:18-70:7 (“Normally, in a regular banking industry, you would not reserve anything for loans that you just underwrite. So if you just underwrite a loan, you would have zero reserve against it until, you know, in the near future or far future, if any credit problems arise, you would book a reserve. From Cisco’s perspective, we wanted to be more conservative. So, as soon as a loan was entered into, we immediately applied a 25-percent reserve against it. Then, as the loan matured, we would do periodic credit reviews, or the credit department would do periodic credit reviews, and if the credit rates or scores increased, then we would build upon that general reserve with additional specific reserves.”).

\textsuperscript{123} See also FAS 114.06 (statement is not applicable to “[l]arge groups of smaller-balance homogenous loans that are collectively evaluated for impairment”).

\textsuperscript{124} See Section VIII.G.1.a.ii above; FASB Viewpoints, Application of FASB Statements 5 and 114 to a Loan Portfolio, EITF D-80 (Apr. 4, 1999) (Q&A No. 14).

\textsuperscript{125} Mr. Regan presents no persuasive evidence that the conditions that led Cisco to raise AMC’s reserve to 100% in FY 2001 were present in FY 2000. To the contrary, Cisco increased AMC’s

(Footnote continued)
Regan were correct, the amount of his alleged overstatement — $5.3 million before tax ($3.7 million after tax) — is clearly not material to Cisco’s FY 2000 consolidated financial statements taken as a whole. Accordingly, Cisco’s estimated reserve for AMC in FY 2000 was within a reasonable range.

2. Returns reserve.

a. PwC’s auditing procedures.

Cisco reserved for expected product returns as part of its accounts receivable reserves. Mr. Regan contends that PwC did not comply with applicable standards because it failed to evaluate the reasonableness of management’s estimate of its reserve for future returns pursuant to AU Section 342.10.

I did not find this to be the case. Rather, a review of the FY 2000 working papers and deposition testimony shows that PwC performed the following audit procedures on Cisco’s accounts receivable reserves:

- PwC tested the functioning of the controls over the reserves by attending Cisco’s monthly reserve meetings\(^{126}\) at least once at or near the end of each quarter and observing whether the process continued to function in a thorough and objective manner;\(^{127}\)

- PwC performed substantive analytical review procedures to identify departures from expected relationships that might require further investigation;\(^{128}\)

- PwC assessed the subsequent history of charges against provided reserves to evaluate whether reserves were adequate;\(^{129}\)

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\(^{126}\) These meetings scrutinized the adequacy of the reserves in light of current conditions and were attended by top levels of accounting management. See, e.g., Deposition of T. Cupples, Jan. 24, 2005, at 15:16-19:5 (discussing meeting attendees and process).


• PwC reviewed the provision of reserves for two-tier sales to distributors;\(^{130}\)

• PwC tested whether formulae Cisco used to establish reserves were made in accordance with the relevant company accounting policy and in a manner consistent with prior years and considered whether such formulae continued to be appropriate to the circumstances of the business;\(^{131}\)

• PwC discussed collectibility of specific accounts receivable with management and reviewed documentation supporting management’s collectibility assessments;\(^{132}\) and

• PwC considered whether revenue related to accounts receivable should be deferred because criteria for revenue recognition had not been met.\(^{133}\)

From the above description of the procedures performed by PwC, one can see that PwC used a combination of all three approaches set forth in paragraph 10 of AU Section 342, quoted above in Section VII.C, to audit Cisco’s accounts receivable reserves.

PwC considered the guidance of Financial Accounting Standard ("FAS") 48, Revenue Recognition When Right of Return Exists, in performing its audit of Cisco’s FY 2000 consolidated financial statements. It determined that Cisco maintained a reserve for product returns on non-two-tier product sales pursuant to FAS 48.\(^{134}\)

For example, the following excerpt from a working paper in PwC’s FY 2000 working papers discusses this issue as follows:

Title: Review management information
Area: 3200 Accounts receivable...
...
R&A Reserve

\(^{130}\) PWC 007768-7842 (July 29, 2000 Reserves Meeting materials); PWC 010005 (July 29, 2000 “Combined Bad Debt Reserve Rollforward”); CIS_PPNPF_HC_0018609-874 (July FY 2000 close binder).

\(^{131}\) See, e.g., PWC 017328-31 (Work Paper “Distributor Reserves” 3200 - Accounts receivable).


\(^{133}\) See, e.g., PWC 018018-19 (Work Paper “Evaluate the accounting policy for revenue recognition” 4300 - Deferred revenue).

\(^{134}\) Non-two-tier product sales are sales made directly to customers rather than through two-tier distributors. Mr. Regan does not challenge the adequacy of the reserves related to two-tier distributors or the auditing related to those reserves. Thus, I focus my discussion on the returns for non-two-tier product sales.
PwC notes that the Client has broken out the R&A [Returns & Allowances] reserve into two separate [sic] reserves. Account #11530 represents the reserve based on the aging of A/R. Account #11532 represents the reserve for open RMA’s. PwC notes that the methodology of establishing the reserves has not changed; it is merely a break out of account.\textsuperscript{135}

This demonstrates that PwC was aware that the estimated returns and allowances reserve for non-two-tier product sales was contained both in account 11530 and 11532 in FY 2000 and that the methodology for establishing the reserves was unchanged from that used by Cisco in FY 1999.

PwC’s FY 1999 working papers discuss the reserve for product returns for non-two-tier product sales and reflect that future product returns were reserved for in both the A/R aging part of the reserve and the RMA part of the reserve.\textsuperscript{136} For example, the following excerpt from a working paper in PwC’s FY 1999 working papers discusses the issue as follows:

Title: Non-Disty Reserve Methodology
Reference: 7320-154

...2. Returns & Allowance for Doubtful Accounts/RMA Reserve

This account is made of two parts.

1) Returns and Allowance for doubtful accounts is a general reserve based on a percentage of A/R. The longer the balance is outstanding, the greater the percentage. Current percentages are 1%, 2%, 4%, and 10% related to current, 1-30 days past due, 31-60 days past due, and 61+ days overdue. These percentages are consistent with prior year and are based on historical returns rates. PwC recalculated percentages to the A/R aging to within an immaterial difference. ($819k)

2) The RMA reserve is for all amounts the Company has authorized the customer to return but the customer has yet to do so. The Company reserves 100% of outstanding RMAs that are less than 18 months outstanding. PwC notes that the Company feels that if the product is not returned within 18 months, it will not be and thus need not be reserved. See suggestion related to RMAs.\textsuperscript{137}

\textsuperscript{135} PWC 049065-46 (Work Paper “Review management information” 3200 – Accounts receivable).

\textsuperscript{136} An RMA is a written authorization issued by Cisco to a specific customer to return specifically identified products for credit or refund. A customer must request and obtain an RMA before Cisco will accept a product return.

\textsuperscript{137} PWC 026612-13 (Work Paper “Non-Disty Reserve Methodology” 7320 – Interim review – second quarter). See also PWC 025466-59 (Work Paper “Revenue Reserves Memo” 3200 – Accounts receivable [re FY 1999]) at 025467 (“Returns & Allowance/RMA Reserve (11530) - Reserve is to (Footnote continued)
Thus, PwC’s working papers reflect that PwC understood that Cisco’s Accounts Receivable reserves for FY 1999 and FY 2000 contained reserves for expected returns – both where an RMA had been issued (the RMA reserve) and where an RMA had not yet been issued (the A/R aging reserve).

Mr. Regan contends that the omission of the word “returns” in the discussion of the A/R aging reserve in the FY 2000 working papers indicated a change in the nature of the reserves that should have alerted PwC to the inadequacy of the reserves. However, his assertion is contrary to the representations of Cisco management and to PwC’s working papers discussed above showing that Cisco reserved for expected returns as part of the A/R reserve in both FY 1999 and FY 2000. PwC inquired about the A/R aging reserve in FY 2000 and learned that the methodology used and the reserve percentages were the same as in the prior year.

Mr. Regan also appears to contend that the fact that Phúc Tran, whom Mr. Regan erroneously states was PwC’s “Audit Manager” in FY 2001, had an email exchange with Mr. MacCallum about Cisco’s return reserves during FY 2001 in which Mr. MacCallum told him that “no reserve is made for future returns,” indicates that PwC did not understand the nature of Cisco’s reserves in FY 2000. I disagree with Mr. Regan’s suggestion for numerous reasons. Mr. Tran did not work on the FY 2000 audit; he was a senior associate who joined the audit team in FY 2001, working under the supervision of the audit managers and other senior members of the audit team. Moreover, Mr. Regan ignores: Mr. MacCallum’s testimony that he was new to Cisco at the time he wrote his email and subsequently learned that Cisco did reserve for future returns as part of its A/R reserves; Mr. Tran’s testimony that he “most likely” talked directly with Mr. MacCallum after

record exposure from issued RMAs and expected bad debt from receivables. RMAs are reserved for [as discussed]. The company also calculates returns exposure based on percentages of A/R dependent on age of AR. 1%, 2%, 4%, and 10%... ,”); PWC 017323-27 (Work Paper “A/R Reserves Memo” 3200 – Accounts receivable (re FY 2000)) at 017325 (“PWC notes that the methodology and percentages are consistent with prior year and are used to cover any unknown exposure from any bad debt.”).

138 See, e.g., Deposition of M. Ingram, Aug. 22, 2005, at 15:22-17:25 (stating that Cisco had several different reserves to ensure it appropriately reserved for future returns, of which “the primary one was the 1-2-4-10 reserve; what’s called, also, a general return and bad debt reserves...”); Deposition of D. Powell, Sept. 1, 2005, at 276:12-277:5 (testifying that Cisco reserved for future product estimated returns pursuant to “[t]he returns and allowances that are under AR non-distributor reserves, account 11530; the open RMAs, 11530; the corporate reserve, 11565”); Deposition of J. MacCallum, Aug. 10, 2005, at 23:22-25:21 (explaining that Cisco’s general reserve was a reserve for accounts receivable and future returns and “looked at percentages of historical returns, and used that percentage as a basis to calculate the reserve”); Deposition of E. Alberts, Sept. 30, 2005, at 22:15-23:14 (stating that the A/R aging reserve and other reserves covered future returns).

139 See Regan Report at 71-72.
140 See, e.g., Deposition of P. Tran, Sept. 23, 2005, at 13:7-16:5.
receiving his email;\textsuperscript{142} and Mr. MacCallum’s subsequent email to Mr. Tran correcting his earlier email and stating that Cisco reserved for future returns as part of its A/R aging reserve.\textsuperscript{143}

Cisco’s obligation was to estimate and record the reserve required by FAS 48 for returns from non-two tier product sales, and as demonstrated below it did. PwC’s obligation was to perform auditing procedures under GAAS to be able to express an opinion as to whether Cisco’s consolidated financial statements for FY 2000 were fairly stated in accordance with GAAP. PwC found no reason to depart from its high reliance on Cisco’s systems and procedures in its audit of accounts receivable reserves as amounts provided in each period proved sufficient in light of subsequent history, which PwC monitored on an on-going basis through its reading of the Company’s detailed financial reporting packages known as the Black Books. PwC chose to audit the allowances against accounts receivable on an overall basis, recognizing as it did that Cisco’s accounting policies and procedures, if followed, would result in adequate levels of reserves being established. PwC tested the controls over Cisco’s policies and procedures and performed the audit steps outlined in AU Section 342.10.0.

Accordingly, I conclude that PwC performed appropriate auditing procedures with respect to Cisco’s accounts receivable allowances.


Mr. Regan contends that Cisco did not maintain a sufficient reserve for product returns during the FY 2000 and Q1 of FY 2001 periods for customers other than distributors.\textsuperscript{144} I disagree with that conclusion.

FAS 48 requires a reserve to be established for product sales to account for rights of return. Paragraph 6 of FAS 48 states:

If an enterprise sells its product but gives the buyer the right to return the product, revenue from the sales transaction shall be recognized at time of sale only if all of the following conditions are met:

\textsuperscript{142} Deposition of P. Tran, Sept. 23, 2005, at 42:24-43:8.

\textsuperscript{143} Exhibit 1094 (J. MacCallum Mar. 19, 2001 Email re: Warranty and Sales Accruals) ("Phuc, Another addendum to my previous emails. We have the 1, 2, 4, 10 Returns and Allowance reserve which is partly set up to cover return reserves.").

\textsuperscript{144} Returns from two-tier distributors are accounted for under separate revenue recognition policies that Mr. Regan does not challenge. Mr. Regan also does not challenge Cisco’s accounting for returns pursuant to lease arrangements and warranty-related issues, which are specifically excluded from the requirements of FAS 48, the applicable accounting literature. See FAS 48, paragraph 4 ("This Statement does not apply to: (a) accounting for revenue in service industries if part of all of the service revenue may be returned under cancellation privileges granted to the buyer, (b) transactions involving real estate or leases, or (c) sales transactions in which a customer may return defective goods, such as under warranty provisions.").
a. The seller’s price to the buyer is substantially fixed or determinable at the date of sale.

b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.

c. The buyer’s obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.

d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.²

e. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.

f. The amount of future returns³ can be reasonably estimated (paragraph 8).

Sales revenue and cost of sales that are not recognized at time of sale because the foregoing conditions are not met shall be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first.

Although Cisco’s stated policy was that products were returnable only if they were defective, Cisco accepted product returns on a case-by-case basis for other reasons to maintain customer goodwill.¹⁴⁵ Therefore, FAS 48 requires reserves to be provided for all anticipated returns as set forth in paragraph 3:

This Statement specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate customer or by a party who resells the product to others. The product may be returned for a refund of the purchase price, for a credit applied to amounts owed or to be owed for other purchases, or in exchange for other products. The purchase price or credit may include amounts related to incidental services, such as installation.

Cisco’s accounting policies and procedures covering returns were consistent throughout the class period. During this time period, Cisco maintained an A/R

¹⁴⁵ See, e.g., PWC 014732-70 at 14735 (Cisco’s Returns & Resolutions Team Process Overview).
aging reserve and an RMA reserve that encompassed reserves for expected future returns.

In April 2001, the third quarter of FY 2001, Cisco established an additional reserve to specifically account for the estimated dollar amount of expected returns not covered by issued RMAs. Cisco established this additional account in connection with the reexamination of its business as a result of the slowdown that occurred that quarter. This new reserve account, entitled “Future Returns Reserve” (part of account ("a/c") 11532), was established at $200.4 million in April 2001 and is in addition to other available reserves at such date, including the “RMA Reserve” (a/c 11532) with a balance of $242.3 million, and the “Returns and Allowances” reserve (a/c 11530) with a balance of $111.9 million.146 Before April 2001, Cisco provided for expected returns as a part of the two other reserves discussed above, but because of the sharp increase in the level of RMAs that were requested in its third fiscal quarter of FY 2001, Cisco decided to establish this account and record the additional $200.4 million reserve.147 To the extent that Mr. Regan suggests that the changes implemented by Cisco in FY 2001 demonstrate that similar changes should have been implemented in FY 2000, he again conveniently ignores the dramatic downturn in the relevant industries which occurred in early FY 2001, which are discussed above and in more detail in the Williams Report.

Mr. Regan contends that Cisco did not comply with FAS 48 prior to establishing this additional reserve account in April 2001 because he asserts that Cisco did not previously reserve for expected future returns for which an RMA had not yet been issued. In reaching this conclusion, Mr. Regan ignores contemporaneous evidence and the testimony of Cisco personnel in refusing to believe that one of the purposes of the A/R aging reserve (a/c 11530) during Cisco’s FY 2000 and the first quarter of FY 2001 was to provide for expected returns.148

146 CIS-PPNPF-0077816 (Cisco Systems Corporate Revenue World Wide Revenue Reserve FLUX Summary April FY 01).

147 See Exhibit 1108 at CIS-PPNPF-0172556 (E. Alberts Apr. 26, 2001 Email re Future Returns Reserve Presentation) (“Returns have been steadily increasing over the past several Quarters. General reserves previously were sufficient to cover RMAs. Q2 [FY 01] Opened RMAs were approximately $400M, as a result a Returns Reserve is required.”); Exhibit 1060 (CIS-PPNPF-01067115) (“RMA Reduction/Utilization Program” slide reflecting increase in RMAs between Q1’01 and Q2’01); Deposition of M. Ingram, Aug. 22, 2005, at 16:18-17:6 (“What happened in the third quarter of fiscal year ’01, the economy significantly changed, and as part of our normal course of business of evaluating the sufficiency of our reserves, we noticed this increase [in returns], and we created a futures returns reserve to account for this. We could have done it in a couple of ways. We could have increased the percentage of the 1-2-4-10 in the general reserve, but after we went through the calculation to determine what that increase would be, we decided to actually maintain that calculation and create a reserve called the futures returns reserve.”); PWC 004575-77 (Work Paper “Agree comparative summary totals to the general ledger” 3200- Accounts receivable – Apr. 28, 2001 A/R Lead Schedule reflecting entry of $200 million future returns reserve); PWC 004605-10 (Work Paper “AR Reserves” – 3200 Accounts Receivable re FY 01 Revenue Reserves Summary, including methodology used to set Future Returns Reserve).

despite being aware of deposition testimony from Cisco employees involved in Cisco's revenue accounting that these reserves were maintained to provide for this liability.\textsuperscript{149}

Unlike Mr. Regan, I find the testimony credible and persuasive and consistent with the documentary evidence. As discussed above, PwC's working papers reflect that Cisco's A/R reserves for FY 1999 and FY 2000 were intended to encompass expected future returns. The Cisco witnesses involved with the setting of the reserves consistently testified that the reserves were maintained for this purpose.\textsuperscript{150} Mr. Regan's assertion that Cisco's A/R aging reserve did not provide for future returns, which he bases in large part on emails and memos written by a new Cisco employee named Jim MacCallum in the spring of 2001, is inconsistent with Mr. MacCallum's testimony and writings acknowledging that he subsequently learned that Cisco's A/R aging reserve did provide for future product returns.\textsuperscript{151}

I therefore disagree with Mr. Regan's assertion that there was no reserve for expected future returns in FY 2000 and Q1 2001. The question, then, is the adequacy of those reserves.

Mr. Regan does not claim that the portion of the returns reserve for issued RMAs is inadequate; this is the RMA reserve account (a/c 11532) noted above. In fact, although not discussed or pointed out by Mr. Regan, I believe that the balance in this portion of the reserve is in excess of the actual amounts expected to be required based on Cisco's methodology of providing a reserve equal to 100% of the RMA amount. I will discuss this issue and its effects further below.

\textsuperscript{149} See, e.g., Deposition of M. Ingram, Aug. 22, 2005, at 16:22-17:25 (stating that Cisco had several different reserves to ensure it appropriately reserved for future returns, of which "[t]he primary one was the 1-4-10 reserve; what's called, also, a general return and bad debt reserves...."); Deposition of D. Powell, Sept. 1, 2005, at 276:12-277:5 (testifying that Cisco reserved for future product estimated returns pursuant to "[t]he returns and allowances that are under AR non-distributor reserves, account 11530; the RMAs, 11530; the corporate reserve, 11566"); Deposition of J. MacCallum, Aug. 10, 2005, at 23:22-28:21 (explaining that Cisco's general reserve was a reserve for accounts receivable and future returns and "looked at percentages of historical returns, and used that percentage as a basis to calculate the reserve"); Deposition of E. Alberts, Sept. 30, 2005, at 22:15-23:14 (stating that the A/R aging reserve covered future returns).

\textsuperscript{150} See \textit{ibid.}, discussing testimony of Erik Alberts, Minalani Ingram, Dennis Powell, and Jim MacCallum.

\textsuperscript{151} See, e.g., Deposition of J. MacCallum, Aug. 10, 2005, at 191:9-194:14 (explaining that Exhibit 1086 was based on inaccurate data and incorrect assumptions about Cisco's reserve practices); 225:20-226:6 (stating that the comment he wrote in Exhibit 1091 that "no reserve is made for future returns" was inaccurate and that "subsequent to writing it, I was educated that the general reserve was also there for the returns reserve"); 242:16-243:24 (describing Exhibit 1094, a subsequent email where he concedes he was mistaken in his belief that Cisco did not reserve for future returns by way of the 1, 2, 4, 10 A/R aging reserve); Exhibit 1094 ("Phuc, Another addendum to my previous emails. We have the 1, 2, 4, 10 Returns and Allowance reserve which is partly set up to cover return reserves.").
I reviewed the analyses in Mr. Regan’s report by which he calculates his estimate of the amounts by which he believes Cisco’s financial statements during the Class Period are misstated as a result of Cisco’s failure to provide adequate reserves pursuant to FAS 48 for estimated returns. These analyses comprise Exhibits C-3, C-3A, C-3B, C-3C, C-3D, and C-3E, and the results of this process are summarized in a table at page 67 of the Regan report. I find the following deficiencies with Mr. Regan’s analysis at Exhibit C-3C, which is the schedule used to determine amounts of purported reserve increases needed during the Class Period:

- It is based on reserving the entire sales price of estimated returns but ignores the related cost of sale for such sales in its calculation. FAS 48 requires “Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns.”

- Related to the above deficiency, the calculation ignores the fact that Cisco’s policy of providing a 100% reserve for RMAs in its account 11532 results in the RMA reserve account being carried at amounts above what is required by FAS 48 for the cost of sales amount related to issued RMAs. The over-reserve in this account creates amounts available to provide for expected returns for which an RMA has been issued.

- The method by which Mr. Regan developed his “Gross Future Product Returns at 5%” is unclear to me so I cannot relate it to actual gross product sales for the periods presented.

- Because I cannot determine how Mr. Regan developed his “Gross Future Product Returns at 5%,” which is the principal variable in this schedule, I cannot determine what effect, if any, is given to the fact that a significant portion of the total returns made in any quarter’s sales are returned within the same quarter and, therefore, are already provided for in the RMA return reserve and should not be considered in the calculation at Exhibit C-3C.

- Mr. Regan’s analysis makes no attempt to account for other expense adjustments, e.g., sales commissions, that may be appropriate to consider.

- The calculated “Periodic Change in Reserve” is not reduced by any portion of the changes occurring in the Returns & Allowances reserve account.

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182 FAS 48.7 states: “If sales revenue is recognized because the conditions of paragraph 6 are met, any costs or losses that may be expected in connection with any returns shall be accrued in accordance with FASB Statement No. 5, Accounting for Contingencies. Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns.”
(account 11530), which Cisco employees and PwC working papers indicate was established to provide for, among other matters, estimated future returns before RMAs are opened (account 11532).

A major problem with Mr. Regan's calculation is that all of the above identified deficiencies go in the same direction—that is, if properly considered, each of them would reduce the calculated necessary reserve change, and the aggregate effect of them could substantially eliminate the calculated misstatements. Finally, while Mr. Regan's approach is designed to give some estimate of sufficient reserves, it does not generate an amount that could be characterized as a misstatement because it does not reconcile back to amounts in the Company's financial statements. Further, in evaluating the reasonableness of the reserve, it is important to recognize that a reserve, when made, is not subject to a precise calculation. Rather, a reserve is an estimate and the issue is whether the reserve is within a reasonable range.

In order to test the effects of the above omissions from Mr. Regan's analysis, I took his format for Exhibit C-3C and adjusted it to account for the above noted deficiencies. In doing so I did the following:

The proper base to begin the type of analysis done by Mr. Regan at Exhibit C-3C is Cisco's gross product sales for each fiscal quarter in the analysis period (as well as the fiscal quarter immediately preceding the analysis period because amounts from that period are needed in the analysis of the first period of the analysis). However, that data is not readily available. Mr. Regan attempts to derive this amount at Exhibit C-3E by taking "Total Product Revenue" from Cisco's Black Books, although according to the citation at Exhibit C-3E he uses Cisco's financial statements in its Black Books for the periods May–July 1999 to derive information through March 2000. However, "Product Revenue" per the Black Books is net of reserves, including additions to the Returns & Allowances reserve account (a/c 11530) and the RMA reserve account (a/c 11532).

Therefore to begin the analysis I start with Cisco's net sales as reported in its public filings. This amount includes leasing, training, support, royalty, and service revenues that do not relate to product sales and therefore would not require any return reserves pursuant to FAS 48, and which approximate 10% of Cisco's net sales for fiscal 2000. I believe this 10% extra revenue in the calculation is sufficient to cause net sales to serve as a conservative proxy for product sales before

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153 See, e.g., PWC 25456-59 (Work Paper “Revenue Reserves Memo” 3200 – Accounts receivable) at 57 (“The Company also calculates returns exposure based on percentages of AR dependent on age of AR. 1%, 2%, 4% and 10% related to current, 1-30 days past due, 31-60 days past due, and 61+ days past due.”); PWC 26612-13 (Work Paper “Non-Delay Reserve Methodology” 7320 – Interim review – second quarter) at 12 (“These percentages are consistent with prior year and are based on historical returns rates.”).

provision for expected or actual returns, which I will refer to as gross product sales, because the amounts provided for expected returns would not exceed 5% of product sales using the return percentage selected by Mr. Regan for his analysis. I accept the 5% estimate of a return factor as used by Mr. Regan because data is not available prior to April 2000 for monthly returns by month of original sale, so it is not possible to obtain the exact gross product return rates for 12-month periods prior to March 2001. Moreover, the return rates by month in the 12-month calculations beginning in March 2001 are affected by the increased rates of product returns that began in calendar year 2001 as a result of the slowdown in Cisco's sector of the economy. Therefore, I believe a downward adjustment in the 5.77% rate shown in the "Regression Trendline (JulFY01)" in Mr. Regan's Exhibit C-3B to offset the effect of the 2001 period is warranted and appropriate in the circumstances. I accept Mr. Regan's estimated rate of 5% for purposes of this analysis.

I then deduct the effect of RMAs issued in the quarter to arrive at what I call "Net Future Product Returns," by which I mean sales returns that will occur after the end of the quarter for which a reserve must be established pursuant to FAS 48. Mr. Regan's quarterly calculations give no recognition to the fact that many of the total dollars that need to be provided for expected future returns are already provided for in the RMA reserve (a/c 11532) due to the fact that many RMAs are in fact issued within the same quarter as that of the original sale. If a customer has Cisco product that it does not require or is unsuitable for whatever reason (e.g., a mis-order, a mis-shipment, a damaged product that must be replaced under Cisco's warranty), that customer contact Cisco to return the product for a refund or a credit as soon as it becomes aware of the issue, at which time Cisco will process the return request and issue an RMA. To estimate the amount of returns expected that will result in RMAs being issued in the same quarter, I reduce Mr. Regan's "Gross Future Product Returns at 5%" by 29.5% to eliminate the portion of the gross future product returns for which an RMA has been issued in the same quarter as the sale and which, therefore, is already provided for in the RMA reserve (a/c 11532). I obtain the 29.5% factor by utilizing the data in the "Regression Trendline (JulFY01)" column of Mr. Regan's Exhibit C-3B "Rate of Future RMA Issuance" as follows:

- I sum the monthly return percentages for each month in a quarter (e.g., sales occurring in month 1 of a quarter may be returned in month 1, month 2, or month 3 of any given quarter; sales in month 2 of such quarter have two months of returns during that quarter; and sales in month 3 have only one month of returns during the quarter. [Month 1 = 0.90%+0.83%+0.75%; Month 2 = 0.90%+0.83%; Month 3 = 0.90%. Total = 5.11%.]
• I then divide 5.11%, the total of these return percentages, by 3 to weight for the fact that this is a quarterly calculation and obtain 1.703%.

• Finally, I divide 1.703% by the column total of 5.77% and the result is 0.295, or 29.5%

From the calculated “Net Future Product Returns” balance I deduct 10% of such balance for estimated warranty returns that are not governed by FAS 48\textsuperscript{155} consistent with the approach and percentage used by Mr. Regan. I also deduct 10% of the calculated “Net Future Product Returns” balance to provide for RMAs that will never be used again consistent with the approach and percentage used by Mr. Regan.\textsuperscript{156} The 10% factor for warranties agrees with Cisco’s estimate of the percentage of RMAs issued for warranty reasons in April 2001.\textsuperscript{157} The 10% factor for products not expected to be returned even though an RMA had been issued appears to be in line with a Cisco analysis conducted in the second quarter of FY 2000.\textsuperscript{158}

The next element in my calculation is to reduce the Net Future Products Returns amount for the related estimated cost of sales. Mr. Regan’s quarterly calculations of the reserve required for expected returns where an RMA had not yet been issued are based on 100% of the sales price of the expected future returns, but this amount should be reduced for the cost of the inventory to be returned to Cisco as a part of this return. Paragraph 7 of FAS 48 makes this clear:

If sales revenue is recognized because the conditions of paragraph 6 are met, any costs or losses that may be expected in connection with any returns shall be accrued in accordance with FASB Statement No.

\textsuperscript{155} FAS 48.4 (“This Statement does not apply to: (a) accounting for revenue in service industries if part or all of the service revenue may be returned under cancellation privileges granted to the buyer, (b) transactions involving real estate or leases, or (c) sales transactions in which a customer may return defective goods, such as under warranty provisions.”).

\textsuperscript{156} Regan Report Exhibit C-3C.

\textsuperscript{157} Exhibit 1108 (Apr. 28, 2001 email with attached returns reserve presentation). I note, however, that this figure may underestimate the expected percentage of RMAs issued for warranty reasons in FY 2000 and, thus, it may be more appropriate to use a higher percentage reduction. One would expect the rate of warranty returns as a percentage of sales to remain roughly constant over time. In an era of increasing returns due to an economic downturn, the number of non-warranty returns would likely increase, thus reducing the percentage of returns occurring for warranty reasons.

\textsuperscript{158} See PWC 019077-78 (Work Paper “Accounts Receivable Lead Schedule” 7500 – Initial Quarter Interim review). I note, however, that other documents reflect a higher percentage of RMAs that never result in a product return. See PWC 004605-11 at 4608 (Work Paper “AR Reserves” 3200-4 Assets) (25% estimate based on historical analysis); CIS-PPNF-007828 (World-Wide Returns Trending from April FY ’01 monthly close binder) (“25% of RMA’s not returned”). Because my analysis shows that Cisco’s reserve for future returns is adequate even at Mr. Regan’s lower rate, the difference does not affect my analysis.
5. Accounting for Contingencies sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns.

(Emphasis added).

To determine an appropriate factor for this issue, I calculate the cost-of-sales percentage from Cisco’s FY 2000 consolidated financial statements and find it to be 35.6% (FY 2000 Cost of sales $6,746 / FY 2000 Net sales $ 18,928 = 35.6% [dollars in millions]). I round this amount to 35% to be consistent with the cost of sales percentage used elsewhere in my report and then multiply the 35% by 80% (to give recognition to the 20% of Net Future Product Returns that are previously deducted in order to account for the 10% of issued RMAs that will never result in product returns and the 10% of issued RMAs that relate to warranty issues). I multiply this adjusted percentage of 28% (35% x 80%) by the Net Future Product Returns amount for each quarter.

The next element in my calculation is to reduce the Net Future Products Returns amount to account for the excess reserve amounts already provided in the RMA reserve (a/c 11532) by the RMAs issued in the same fiscal quarter that the original sale was recorded. I calculate the 20.1% factor as follows:

- Because the RMAs reserve (a/c 11532) is established at 100% of each RMA issued, it is overstated by the following amounts. Twenty percent of the RMAs need not be reserved because they relate to warranty items for which a reserve under FAS 48 is not required (10%) or to RMAs that will never result in product returns (10%). As to the remaining 80% of RMAs issued during the quarter, the reserve is overstated by the 35% cost-of-sales factor for the same reason discussed above.

- The excess reserve can be calculated as equal to 0.1 + 0.1 + (0.8 x 0.35) or 48% of the amounts removed from the gross future product returns to obtain net future product returns. We also know that the amount of gross future product returns provided for in the RMA reserve (a/c 11532) is 29.5%, leaving 70.5% of the gross amount as the net future product returns. Dividing 29.5% by 70.5% gives us 41.8%. Therefore, to express the excess reserve in the RMA account (a/c 11532) for RMAs issued in the same quarter as the original sale (48%) as a percentage of each quarter’s net future non-two tier product returns, I multiply 48% by 41.8% and obtain the result of 20.1%.

Following the format used by Mr. Regan, I deduct from my calculated Net Future Product Returns the calculated amounts for:

- RMAs that will never result in product returns (10%);
• Warranty returns (10%);
• Cost of sales related to the estimated sales returns (28%); and
• Amounts of RMAs issued in the same fiscal quarter as the original sale that are in excess of FAS 48 requirements (20.1%)

From this I determine the reserve required outside of the RMA reserve account (a/c 11532) at the end of each quarter, and comparing each current quarter with its immediate predecessor I derive the “Necessary Quarterly Change in Reserve.”

I then use the accounts receivable returns and allowance balance (a/c 11530) at each quarter to calculate the change between successive quarters, and use 50% of this calculated change amount as an appropriate estimate of what Cisco provided for estimated future returns that are not covered by an RMA. I obtain all of the accounts receivable returns and allowance balances from Exhibit C-3A of the Regan report except for the July 1999 fiscal quarter where I needed to perform my own calculation using the same data source because such period was not presented in Exhibit C-3A. I use only a portion of the returns and allowances reserve to provide for the “Necessary Quarterly Change in Reserve” in recognition of the testimony of Cisco employees that the returns and allowances reserve was designed to provide for all types of accounts receivable issues not otherwise provided for in other reserve accounts and not solely to provide for expected product returns for non-two tier sales. I use 50% of the change in the returns and allowances reserve (a/c 11530) in my analysis, leaving the other 50% available for unspecified purposes.

The results of the foregoing analysis are presented at Schedule 1 to my report and are summarized below (in thousands of dollars):

<table>
<thead>
<tr>
<th>Quarter Ended</th>
<th>Necessary Quarterly Change in Reserve</th>
<th>50% of Calculated Necessary Change in Reserve AR R&amp;A Reserve</th>
<th>Reserve Over (Under)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct FY 00</td>
<td>$ 4,050</td>
<td>$ 4,310</td>
<td>$ 260</td>
</tr>
<tr>
<td>Jan FY 00</td>
<td>4,950</td>
<td>3,345</td>
<td>(1,605)</td>
</tr>
<tr>
<td>Apr FY 00</td>
<td>6,525</td>
<td>638</td>
<td>(5,887)</td>
</tr>
<tr>
<td>Jul FY 00</td>
<td>8,775</td>
<td>9,636</td>
<td>861</td>
</tr>
<tr>
<td>FY 00 Total</td>
<td>$ 24,300</td>
<td>$ 17,929</td>
<td>$ (6,371)</td>
</tr>
<tr>
<td>Oct FY 01</td>
<td>$ 9,000</td>
<td>$ 11,820</td>
<td>$ 2,820</td>
</tr>
</tbody>
</table>

The analysis discussed above shows that a sufficient reserve to provide for expected returns of non-two tier product sales where an RMA had not yet been issued is provided for in the Returns & Allowances reserve account (a/c 11530) and by excess amounts above the actual RMA requirements in the RMA reserve account.
(a/c 11532). It should be noted that FAS 48 does not require that the reserve established for returns be accounted for in any special account or that such account or accounts bear any unique titles. It merely requires that an appropriate reserve for expected returns be established if an entity makes sales and allows customers a right of return.

In his narrative but not in his calculations at Exhibit C-3C, Mr. Regan makes the additional claim that the reserve for expected product returns for non-two-tier sales not covered by issued RMAs was understated by $139.6 million at the end of FY 1999, and that this carried over and added to the cumulative overstatement in accounts receivable throughout FY 2000 and the first quarter of FY 2001.\(^\textbf{159}\)

However, Mr. Regan makes no analysis or calculation in support of this contention. Additionally, adding this amount to the results of his FY 2000 and Q1 of FY 2001 calculation results in an alleged overstatement of accounts receivable as of the end of Q1 FY 2001 of $301.3 million. This is a plainly unreasonable amount given that Cisco established an additional reserve of only $200.4 million in April 2001 (Q3 FY 2001) following completion of an extensive accounting analysis performed after it began to experience an unprecedented increase in the return rate for non-two-tier product sales commencing in calendar 2001. Further, because the above analysis demonstrates that Cisco's accounting policies and procedures generated an appropriate reserve for expected future product returns in FY 2000, and because these accounting policies and procedures are consistent with those utilized by Cisco in FY 1999, I have no reason to believe they did not also result in the establishment of an appropriate reserve for expected future product returns in FY 1999.

Accordingly, I conclude, based on my review and analysis, that Cisco complied with FAS 48 in establishing an appropriate reserve for expected returns of non-two-tier product sales throughout FY 2000 and during the first fiscal quarter of FY 2001, and that the resulting reserve balances for such expected product returns, which reduced the accounts receivable and net sales reported in the financial statements for such periods, were not materially misstated.

My conclusion in this regard is buttressed by Cisco's overall reserve environment and by its additional accounts receivable reserves. My review of the deposition testimony, PwC working papers, and other documents leads me to believe that Cisco's management and board of directors were committed to conservatism in establishing reserves, including accounts receivable reserves, and that PwC concluded, based on its audit procedures, that Cisco's reserves were indeed conservative.\(^\textbf{160}\) Moreover, in addition to the returns-specific reserves

\(^{159}\) See Regan Report at 67.

\(^{160}\) See, e.g., Deposition of R. Puette, June 29, 2005, at 42:22-43:5 ("I verified that Cisco employed a very prudent and conservative process to determine the [receivables] reserves, and that I also asked the specific question at every audit committee [meeting], I believe, that I attended, of the auditors and of management, on how they viewed the receivables reserves on a scale of 1 to 10, with (Footnote continued)
discussed above, I note that additional amounts have been provided for in the normal course of Cisco's reserve accounting, including: (1) Cisco's Corporate A/R Reserve (a/c 11565), which contains additional, unallocated reserves for exposure not specifically identified elsewhere; \(^{161}\) and (2) Cisco's Specific Bad Debt Reserve (a/c 11520), which contains additional reserves for estimated specific bad debt A/R exposure for particular customers.\(^{162}\)

3. Inventory and Related Allowance for Excess Inventory.

a. PwC's auditing procedures.

PwC performed extensive audit procedures with respect to inventory and the related allowance for excess inventory. In fact, a significant portion of the total time devoted to the Cisco audit was spent on inventory-related issues. PwC's auditing procedures included:\(^{163}\)

- performing analytical and fluctuation analyses;\(^{164}\)
- reviewing management reports;\(^{165}\)
- discussing with client personnel whether systems and procedures were functioning as intended;\(^{166}\)
- reviewing processes for special classifications of inventory such as demonstration units, field service inventories, and rework inventories;\(^{167}\)
- reviewing the excess or obsolete inventory and other valuation processes;\(^{168}\)
- testing inventory pricing at standard costs and for lower of cost or market determinations;\(^{169}\)

\(^{10}\) being the move [sic] conservative and 1 being the least conservative, and the answers were invariably in the 7 to 8 range.


\(^{162}\) See PWC 017323-27 at 17324 (describing Specific Bad Debt Reserves and noting that disputed accounts are reserved based on a percentage of aged A/R dependent on whether the amounts have been reconciled with the customer, bankruptcies are reserved 100%, collections are reserved 100%, and additional specific amounts are identified by the company and fully reserved).

\(^{163}\) Most of these procedures were performed on the inventory balances during Q2 of FY 2000.

\(^{164}\) PWC 017374-76 (Work Paper "Flux analysis – by inventory type" 3400 – Inventory).

\(^{165}\) PWC 017499 (Work Paper "Review management information" 3400 – Inventory).

\(^{166}\) See, e.g., PWC 017423-25 (Work Paper "Manufacturing overhead/OCOGS accruals" 3400 – Inventory).

\(^{167}\) PWC 017487-91 (Work Paper "Test special attributes" 3400 – Inventory).

\(^{168}\) PWC 017398-99 (Work Paper "Excess and Obsolete reserve" 3400 – Inventory).
• reviewing inter-company profit in inventory;\textsuperscript{170}

• determining the effect of the non-capitalization of overhead into inventory;\textsuperscript{171}

• observing physical inventory taking and taking of cycle counts at various dates throughout the year and at various locations;\textsuperscript{172}

• confirming inventories at third parties;\textsuperscript{173}

• testing inventory cutoff procedures;\textsuperscript{174}

• updating PwC's understanding of inventory controls through the end of the fiscal year;\textsuperscript{175} and

• reviewing the process for aggregating inventory accounts for inclusion in the consolidation and for financial statement disclosure purposes.\textsuperscript{176}

Mr. Regan contends that PwC's audit procedures relating to inventory and inventory reserves were inadequate because PwC allegedly failed to:

• perform updating procedures for the period between detail testing in Q2 of FY 2000 and the end of Cisco's fiscal year;\textsuperscript{177}

• test the development of the allowance for excess inventory consistent with AU Section 342, \textit{Auditing Accounting Estimates};\textsuperscript{178} and

• determine that the inventory reserves were understated and to consider the effect of that purported understatement on Cisco's FY 2000 consolidated financial statements.\textsuperscript{179}

Based on my review of the FY 2000 working papers, Mr. Regan is in error in asserting that PwC performed no audit procedures with respect to inventory and

\textsuperscript{170} PWC 017389-91 (Work Paper "Price testing – summary" 3400 – Inventory).
\textsuperscript{171} PWC 017415-16 (Work Paper "Manufacturing transfers to FSO" 3400 – Inventory).
\textsuperscript{172} PWC 017422 (Work Paper "Overhead absorption calculation” 3400 – Inventory).
\textsuperscript{173} PWC 017503-04 (Work Paper "Cycle count attendance for FY 00” 3460 – Inventory Cycle Counts and Physicals).
\textsuperscript{174} PWC 016703-04 (Work Paper “Inventory confirmations” 975 – Confirmation copies for use in following years).
\textsuperscript{175} PWC 017433 (Work Paper "Cut-off testing – summary” 3400 – Inventory).
\textsuperscript{176} PWC 017496 (Work Paper "Update for early testing” 3400 – Inventory).
\textsuperscript{177} PWC 017453-54 (Work Paper "Agree comparative summary totals to the general ledger” 3400 – Inventory).
\textsuperscript{178} Regan Report at 115.
\textsuperscript{179} Regan Report at 114.
inventory reserves to cover the period between the detail testing in Q2 of FY 2000 and the end of Cisco's fiscal year. The workpapers include an inventory working paper documenting PwC's consideration of "whether there have been any significant changes in internal control and inherent risks since the early test date..." 180 The workpapers also include a fluctuation analysis entitled "Inventory Analytics Final" that expressly considers the reasonableness of changes in inventory balances and the related reserves through Q4 of FY 2000. 181 Moreover, as Mr. Regan acknowledges, 182 PwC attended the close meeting in Q4 of FY 2000, where Cisco discussed the final inventory reserve. This portion of the meeting was attended by the senior members of the audit team, including Mike Jerome. 183

I also disagree with respect to Mr. Regan's second criticism and find that PwC complied with AU Section 342 in testing Cisco's process for developing its inventory reserves. Among other things, AU Section 342.06 recognizes that an entity's internal controls may reduce the likelihood of material misstatements of accounting estimates and identifies specific relevant aspects of internal control in subsections a through f. As I conclude in the Financial accounting issues discussion below, Cisco's process for establishing its reserve for excess or obsolete inventory was appropriate and Cisco's internal controls fulfilled each of the criteria set forth in AU Section 342.06 a. through f. From my review of the working papers, I found that PwC considered each of these factors in its review of Cisco's excess and obsolete reserve process and had a reasonable basis for relying on Cisco's internal controls governing the establishment of this reserve.

Moreover, a number of the audit procedures identified above satisfied PwC's professional responsibilities under AU Section 342 in evaluating the reasonableness of the inventory allowance. For instance:

- Through the inquiry and review processes for special classifications of inventory such as demonstration units, field service inventories, and rework inventories, and the review of excess or obsolete inventory and other valuation processes, the PwC auditors satisfied themselves that all accounting estimates that could be material to the financial statements concerning inventories had been developed.

180 PWC 017498 (Work Paper "Consider changes in internal control and inherent risks since the early testing date" 3400 – Inventory).
181 PWC 009983.
182 Regan Report at 73.
• Through analytical and fluctuation analyses, reviews of management reports, discussions with client personnel and participation in reserve meetings, the PwC auditors satisfied themselves that those accounting estimates were reasonable in the circumstances.

• Through reviewing the process for aggregating inventory accounts for inclusion in the consolidation and for financial statement disclosure purposes, the PwC auditors satisfied themselves that the accounting estimates were presented in conformity with applicable accounting principles and properly disclosed.

Mr. Regan further contends that PwC failed to consider the impact of stretch forecasting in evaluating the inventory reserve calculation. However, his criticism is based on a false premise: that the use of the “stretch” forecast to calculate the excess and obsolete reserve represented a change in practice and did not represent Cisco’s actual estimate of demand. As discussed below, the evidence shows that the stretch forecast did represent management’s reasonable estimate of actual demand.

Mr. Regan also suggests that PwC’s audit procedures were inadequate because it failed to recognize that with the adoption of stretch forecasting, Cisco’s reserves were declining as a percentage of inventory. However, Mr. Regan’s own report contains a chart reflecting that the reserve as a percentage of inventory was 36% at both the end of FY 1999 and 2000, and that there was a constant decline in that percentage over the course of the year.

I therefore conclude that PwC complied with the requirements of AU Section 342, Auditing Accounting Estimates.

Finally, as discussed below in the Financial accounting issues section, I disagree with Mr. Regan’s contention that the excess and obsolete inventory reserve was materially misstated at the end of Q3 and Q4 of FY 2000 as well as Q1 of FY 2001.

Accordingly, I conclude that PwC’s auditing procedures with respect to inventory and inventory reserves, including specifically the reserve for excess and obsolete manufacturing inventory, complied with GAAS.

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184 Regan Report at 112-14.
185 See subsection b below.
186 Although reserves did decrease as a percentage of inventory during the first quarter of 2001, PwC appropriately considered this fact as noted in Section IX.E below, Review of Interim Financial Information.
187 Regan Report at 102.

It is my opinion that Cisco's accounting for inventory and the related allowance for excess and obsolete inventory during the Class Period was reasonable and complied with GAAP.

Cisco described its accounting policy for inventory in Note 1 to the FY 2000 consolidated financial statements as follows: "Inventories are stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis." This policy is typical of manufacturing entities and is in accordance with GAAP, which requires the carrying cost of inventories to be reduced in the period when it becomes evident that it will not be recovered in full. Events that can necessitate reductions in the carrying value of inventory include: obsolescence, excess quantities, damage, deterioration, and declines in the selling price of a company's products.

Cisco's inventory reserve policy was consistently applied during the Class Period.\(^{188}\) Cisco calculated its excess and obsolete manufacturing reserve by comparing on-hand and on-order against the twelve month forecasted demand as reflected in MDS ("Master Demand Schedule").

MDS is created for the principal purpose of running the manufacturing side of Cisco's business; its use in determining inventory reserves is incidental.

- Each month Cisco's Business Units prepare month-by-month expected sales forecasts for each product, by both units and dollars, for the next twelve-month period. Cisco's sales organization develops its own separate month-by-month bookings forecast, expressed only in dollars, for the next twelve-month period. These forecasts, after thorough review by the management of each organization, are then submitted to Cisco's manufacturing organization, which, using information from the forecasts as well as its own knowledge of current backlog status, technical and supply issues, and lead time targets, creates a preliminary MDS for discussion with the management of each business unit submitting input into the forecast.\(^{189}\)

\(^{188}\) The only exception was a minor change made in FY 2000 in how Cisco provided for excess or obsolete inventories for inventory items that had more than $50,000 of potentially excess or obsolete quantities but less than $100,000 of such amounts. This change in Cisco's practices used in identifying and providing for excess or obsolete manufacturing inventory had no material impact on the aggregate calculated manufacturing inventories reserve balances. Compare PWC 017398-99 (Work Paper "Excess and Obsolete reserve" 3400 - Inventory) (for FY 00) with PWC 02556-67 (Work Paper "Excess and Obsolete reserve" 3400-Inventory) (for FY 99).

• The MDS is further reviewed at the Monthly Business Review Meeting, a high level meeting attended by Cisco's Chief Executive Officer, Chief Financial Officer, and the Vice Presidents of Sales, Business Units, and Manufacturing, and any changes resulting from this meeting are factored into the MDS. After this extensive process of preparation and review, the MDS encapsulates Cisco’s best estimate of the expected demand for its products for the next twelve months.\textsuperscript{190}

• The MDS is then transmitted to the supply chain and contract manufacturers ("CMs"). The MDS transmission is not a purchase commitment obligating Cisco to buy the quantities of products in the forecast but rather is a signal to Cisco's supply chain of anticipated demand. The signal allows the CMs (and the CMs' component suppliers) to make their own decisions, at their own financial risk.\textsuperscript{191}

Along with MDS, Cisco manufacturing also creates a Build Plan: the plan to build products to meet forecasted demand. The Build Plan takes into account backlog issues (i.e., products ordered in a prior period but not yet built), and planned changes in the limited quantities of finished goods on hand (i.e., overbuilding in one period to accommodate forecasted demand in a following period that cannot be met by available production capacity in the subsequent period). The Build Plan is focused mostly on activity in the next three months, and planned activity in that near term could change weekly.\textsuperscript{192}

Monthly an Excess or Obsolete ("E&O") inventory report is generated by Cisco’s ERP ("Enterprise Resource Planning") system. Using the information input into the system by MDS, this report identifies all inventory items with total quantities (on hand or on order) in excess of one year’s forecasted usage.\textsuperscript{193}

• Buyers with responsibility for inventory management and purchases review each item in this E&O Report with identified exposures in excess of $100,000 and provide Cisco's Cost Accounting and its Vice President of Materials with any apparent inaccuracies in the MDS forecast, their

\textsuperscript{190} See Deposition of R. Pond, Mar. 30, 2005, at 25:3-26:18, 36:25-37:3; see also, e.g., PWC 033211-56 at 33228 (Q3 FY 01 Inventory and Restructuring Charges Presentation – Material/Production Planning Process Overview); CIS-PPNPF-0534158-202 (Exhibit 339) (Feb. 16, 2000 Manufacturing Status Executive Business Review).


\textsuperscript{193} Deposition of D. Hartman, Jan. 17, 2005, at 212:24-217:9; CIS-PPNPF-HC_0041826-39 (Exhibit 94) (Manufacturing Finance Inventory Reserve Policies & Procedures Summary of changes Q1 '01 to Q3 '01).
judgments as to whether or not they can sell the inventory, and any other information which impacts on the E&O assessment.\textsuperscript{194}

- Directors and Managers within Cisco's Materials organization, Scheduling Department and Manufacturing Finance are asked to identify any other situation that may require an inventory reserve and make the final decision as to which items are "sellable" (i.e., not excess or obsolete, may be returned for credit to vendors, or saleable to others on an "as is" basis in the component parts market at a price that recovers Cisco's inventory cost). Items identified as "sellable" are not included in the E&O reserve calculation.\textsuperscript{195}

- After removing the sellable inventory items and correcting the E&O Report for the effects of errors or omissions found in this review process, the E&O reserve is calculated. In this calculation, inventory items with excess inventory (on hand or on order) exposures over $100,000 are included in the reserve calculation at 100% of the over one year of forecasted usage exposure. Similar items that have less than $100,000 of exposure are not specifically reviewed but rather are included in the reserve calculation at 50% of the amount in excess of one year's forecasted usage.\textsuperscript{196}

- Additionally, specific E&O reserves are added for inventory that will be replaced with new products that renders such inventory obsolete and for items that are useless after engineering personnel have evaluated them.\textsuperscript{197}

- The manufacturing E&O reserve is adjusted to the balance determined by this process on a monthly basis, and such reserve calculations and reserve balances are reviewed with the VP of Operations, Corporate Controller, and the VP of Commodities twice a quarter.\textsuperscript{198}

Significantly, E&O reserves against manufacturing inventories are just one portion of the total reserves against inventories provided by Cisco. During FY 2000 and Q1 of FY 2001 the manufacturing reserves constituted between 36% and 42% of

\textsuperscript{194} Prior to FY 2000 these procedures were applied to each individual inventory item with an identified exposure of in excess of $50,000, but Cisco management determined this was excessively time consuming and the same level of reserve could be established, within material limits, if all E&O report exposures of excess quantities in excess of $50,000 but less than $100,000 were all reserved at 50% of the identified potential exposure rather than individually reviewed. PWC 017398-98; Deposition of D. Hartman, Jan. 17, 2005, at 214:24-215:9; CIS-PPNPF-HC_0041826-39 (Exhibit 94); PWC 004888-89 (Work Paper "Excess and Obsolete reserve" 3400 - Inventory).

\textsuperscript{195} PWC 004888-89.

\textsuperscript{196} \textit{Ibid.}

\textsuperscript{197} \textit{Ibid.}

\textsuperscript{198} CIS-PPNPF-HC_0041826-39 (Exhibit 94); PWC 004888-89.
the total inventory reserves for such periods. Other contributors to the inventory reserves during this five quarter period are reserves for field service and field service repair inventories (which constitute between 30% and 41% of the total inventory reserves), demonstration inventory reserves (between 13% and 16% of the total inventory reserves), and reserves against inventories at subsidiaries, including Capital Corporation (between 8% and 17% of the total inventory reserves).

By Q4 of FY 2000 it had become apparent that Cisco’s manufacturing output was not keeping up with demand. In part this was because Cisco’s demand forecasts, prepared by its Business Units and its sales force, failed to anticipate the true level of demand. In addition, production was constrained by industry wide shortages of certain critical parts and by the ability of Cisco’s third-party contract manufacturers to ramp up capacity for specific products.

In the latter part of FY 2000 and in Q1 of FY 2001, Cisco experienced an unprecedented increase in demand for its products. This was manifested in part by quarter-to-quarter increases in recorded sales of 13%, 16%, and 14% in Q3 and Q4 of FY 2000 and Q1 of FY 2001, respectively, which equates to over 70% annualized sales growth and resulted in quarterly net sales for Q1 of FY 2001 being over $2 billion greater than the corresponding net sales just three quarters earlier.

The increase in product demand also was manifested by increasing wait times customers had to endure between when they placed an order and when they

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199 See CIS-PPNPF-HC_0040236 (Consolidated Inventory Trend – Mar FY 01 Final).

200 Field service inventories are amortized to expense over a 24 month period beginning with their transfer into this inventory classification because if they are not otherwise used, Cisco’s analyses show that they become obsolete and unusable. Field service repair inventories have an aggregate reserve based on internal studies showing that such items are typically repaired in 90 days so the cost of operating the repair facilities during this period is established as a reserve to bring such inventory to the point where it passes all tests and meets all specifications. The field service and field service repair inventory group is 75%+ reserved in each of the five quarterly periods under discussion. See PWC 017413-14 (Work Paper “Inventory reserves – FSO” 3400 – Inventory). Similarly, demonstration inventories are approximately 70% reserved in each of the five quarterly periods under discussion. These inventories are amortized to expense because they are in the hands of potential customers for use in evaluations of the suitability of Cisco’s products for the customer’s intended use and are not available for sale in the normal course of business. The subsidiary inventories category is not reserved as much (approximately 35% to 58%) over the five quarterly periods, but it is fairly immaterial constituting only 5% to 10% of net inventories. See CIS-PPNPF-0561347-90 at 561360 (Exhibit 88) (Manufacturing Finance Feb. FY 01 Close Package) (Consolidated Inventory Trend Feb FY 01 Preliminary).


202 See PWC 015979-85 (May 9, 2000 earnings release for Q3 00); PWC 009635-40 (Aug. 8, 2000 draft earnings release for Q4 00); Exhibit 501 at 11 (10Q for Q1 01).

In Q4 of FY 2000, Manufacturing concluded that the demand forecasts supplied by Cisco’s Business Units and its sales force in recent quarters had consistently underestimated actual demand. The underestimation occurred because in an environment of constantly increasing demand, Cisco had continued to load its MDS using the so-called “base” forecasts, with manufacturing adding some “padding.”\footnote{Complicating matters further was Cisco’s development of products that addressed markets not previously served by Cisco, primarily the telecommunications industry, which heretofore had been dominated by two suppliers: Lucent and Nortel. Customers for Cisco’s new products, however, were not limited to the traditional telecommunications providers because a number of new companies were in the process of building new networks to transmit data or voice communications as a result of opportunities created by the growth in internet communications and favorable changes in the U.S. regulatory environment. The significance to Cisco’s manufacturing process was that the sales of these new products to the new market entrants were made on a system-wide basis where if a new customer selected Cisco’s product offerings, it would immediately demand dozens to hundreds of those products. Cisco’s demand forecast process was unable to anticipate whether it would win one of these so-called “franchise” sales or when it might occur because the extended sales negotiation process involved potential customers analyzing and testing the product against various competitors to select the products and the vendor that best met their requirements. This introduced more “lumpiness” into the forecasting process. See Deposition of R. Pond, Mar. 30, 2005, at 54:5-56:13, 74:19-76:19; see also Deposition of L. Carter, Sept. 30, 2005, at 237:12-238:15; Deposition of C. Kelly, Mar. 28, 2005, at 129:4-130:5.} Cisco’s Business Units and sales groups also prepared on a monthly basis a “stretch” forecast that showed what demand might be if things went well. In Q4 of FY 2000 Cisco began using amounts from the “stretch” forecast as the basis for MDS because it more fairly approximated demand.\footnote{See Deposition of D. Hartman, Jan. 17, 2005, at 14:22-17:15; Deposition of C. Kelly, Mar. 28, 2005, at 92:9-93:17; Deposition of R. Pond, Mar. 30, 2005, at 13:11-14:10, 46:1-49:4, 68:21-70:5; CIS-PPNPF-05343111-43 (Exhibit 341) (July 10, 2000 Manufacturing Status Executive Business Review).}

Manufacturing also found that supplies of certain key components were in such short supply that they must be ordered well in advance of when they were actually needed in production (e.g., thirteen weeks or a whole quarter in advance of when they would be used in building a subassembly — such as a circuit board — of a needed product.) Other key components were in such short supply that they were “on-allocation,” which meant that actual market demand exceeded available supply so that a purchaser could obtain only a fraction of the components that were ordered and actually needed. To address this situation, in the latter part of Q4 of FY 2000 Cisco manufacturing began to issue purchase orders to its CMs that authorized them to purchase, on Cisco’s behalf, specified quantities of these long lead time or on-allocation components in advance of Cisco issuing a purchase order to acquire a specified quantity of completed products that contained these components. The goal of this effort was to eliminate production delays resulting from the unavailability of
these crucial components.\textsuperscript{206} The effect on Cisco's net inventory of Cisco's decision to purchase or commit to purchasing components for specific products can be shown in a variety of ways:

- Comparing the growth in Cisco's gross manufacturing inventories with the growth in net sales for comparable periods shows that during the six FY quarters ending with Q3 of FY 2000, net sales had increased by 90% while gross manufacturing inventories had increased by only 68%, using Q1 of FY 1999 as a base period.\textsuperscript{207}

- However, in Q4 of FY 2000 and Q1 of FY 2001, net sales increased over the Q1 of FY 1999 base period by 120% and 151%, respectively, while gross manufacturing inventories increased by 196% and 379%, respectively. This translates to Cisco's gross manufacturing inventories growing by approximately $200 million in Q4 of FY 2000 and $700 million in Q1 of FY 2001 as a result of Cisco's inventory stocking measures.

- The products being ordered before use and represented by the approximately $200 and $700 million amounts are only those critical lead time or on-allocation components needed to build high demand Cisco products, so it is unlikely that they would be considered excess or obsolete based on the MDS used to determine reserves at such dates.

- If the approximately $200 and $700 million amounts of additional inventory at Q4 of FY 2000 and Q1 of FY 2001 are deducted from Cisco's gross inventory at such dates to calculate an inventory reserve percentage on truly comparable inventories subject to reserving in the prior quarters, then the reserve percentages at Q4 of FY 2000 and Q1 of FY 2001 change to 41% and 39%, respectively, which are consistent with the reserve percentages experienced during the first three quarters of FY 2000.

- Finally, it should be noted that the approximately $200 million of additional inventory at Q4 of FY 2000 is less than 10% of the cost of sales recognized in the following quarter (in fact, the entire net inventory balance at Q4 of FY 2000 (July 2000) of $1,232 million is less than the cost of sales for Q1 of FY 2001, which is $2,378 million). Similarly, the approximately $700 million of additional inventory at Q1 of FY 2001 is


\textsuperscript{207} See CIS-PPNPF-0561347-90 at 561360 (Exhibit 88) (Manufacturing Finance Feb. FY 01 Close Package) (Consolidated Inventory Trend Feb FY 01 Preliminary); PWC 009983 (Inventory Analytics); CIS-PPNPF-HC_0040208-45 at 40236 (Exhibit 90) (Consolidated Inventory Trend – Mar FY 01 Final); CIS PPNPF-HC_0083132 (Consolidated Inventory Trend).
only around 25% of the cost of sales recognized in the following quarter (in fact, the entire net inventory balance at Q1 of FY 2001 (October 2000) of $1,956 million is less than the cost of sales for Q2 of FY 2001 that was $2,581 million). This demonstrates the likelihood of large portions of Cisco's manufacturing inventories at Q4 of FY 2000 or Q1 of FY 2001 being excess or obsolete.

In Q3 of FY 2001 Cisco experienced an unexpected and unprecedented drop in the demand for its products along with other industry participants and was required by GAAP to consider the effect of this demand drop on the carrying value of its inventory. Cisco originally estimated the inventory write-down at $2.5 billion.\(^{208}\) This amount was reported in a press release on April 16, 2001 as soon as Cisco management determined it needed to reduce inventory carrying values and restructure its operations in light of changed market conditions, and was able to quantify the potential effects of these actions.\(^{209}\)

I disagree with Mr. Regan’s criticisms of Cisco’s inventory policy and his conclusion that the excess and obsolete reserve was understated.\(^{210}\) Mr. Regan makes a number of erroneous statements and assumptions in reaching that conclusion.

First, Mr. Regan states that “Cisco’s policy was to have on hand and on order material it needed to manufacture product to meet demand for the next twelve months” in describing his understanding of Cisco’s inventory management policy. However, Randy Pond, Cisco’s Senior Vice President of Operations with responsibility for manufacturing, testified that Cisco operated a “just-in-time” manufacturing process that minimized Cisco’s investment in inventory.\(^{211}\) During the Class Period Cisco’s “Net Inventory Turns,” which is a widely used metric used to measure the efficiency of a manufacturing process and reflects how often in a twelve month period the dollars comprising Cisco’s net inventory are consumed into


\(^{209}\) Cisco was later able to reduce this amount by $250 million through negotiations with its vendors and ultimately recorded an inventory write-down of $2.25 billion in its financial statements for Q3 of FY 2001. See PWC 006851-55.

\(^{210}\) In reviewing Mr. Regan’s discussion of Cisco’s inventory reserves, I have not identified all of the errors and distortions concerning Cisco’s manufacturing and inventory process I noted in reading Mr. Regan’s report; however, I reserve the right to comment thereon if necessary to provide background or context for the matters involving Cisco’s accounting for inventory reserves and/or Mr. Regan’s findings and conclusions thereon that I may be asked to address at trial.

cost of sales, never fell below 6.0. This means that Cisco had on average no more than two months worth of inventory at current production levels (12 months / 6.0 net turn ratio) rather than having inventory on hand or on order to meet demand for the next twelve months as Mr. Regan claims.

Second, Mr. Regan maintains: “In general, the allowance for excess inventory would be expected to rise or decline in direct proportion to gross inventory because, all else being equal, one would expect all inventory to bear an equal risk of becoming excess.” This statement is wrong because it ignores the fact that Cisco built products in over one hundred product families, each with its own supply and demand characteristics. For example, if inventory was increasing because Cisco needed additional parts to build products in high demand — as was the case in Q4 of FY 2000 and in Q1 of FY 2001 — and Cisco’s inventory additions did nothing to increase the amount of inventory in excess of one year’s estimated demand, then Cisco’s allowance for excess or obsolete inventory would not be expected to increase even though the total gross inventory balance was increasing. Alternatively, if Cisco’s gross inventory was being depleted because it manufactured and sold products in high demand and was unable to obtain an equal amount of the raw materials to use in building and selling more of these products, then the inventory reserve percentage might well increase because the remaining gross inventory would be comprised of a greater proportion of excess or obsolete parts. In other words, one cannot make generalizations concerning the level of inventory reserves versus the level of gross inventory without understanding the composition of that inventory and current demand forecasts.

Third, Mr. Regan erroneously states that: “Cisco’s management reduced the inventory allowance, as a percentage of inventory cost, while gross inventory was significantly increasing....” This statement ignores the process by which Cisco establishes its allowance for excess or obsolete inventory and implies that Cisco management arbitrarily uses an overall reserve percentage. In fact, Cisco’s reserving process and methodology remained the same throughout the Class Period. The reserve is calculated by comparing on hand plus on order quantities of each part to the forecasted demand for that part for the next twelve-month period. As described above, Cisco uses its best estimate of the expected demand for each of its products for the next twelve months in its E&O reserving process, and these forecasts are derived from a process that involved numerous people, control points, and reviews throughout the Cisco organization. The excess and obsolete allowance is calculated on a part number-by-part number basis by Cisco’s ERP system identifying the excess quantities using the detailed forecast and then costing out such excess or obsolete parts using Cisco’s standard cost for each identified part.

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212 See CIS-PPNPF-0561347-90 at 561360 (Exhibit 88) (Manufacturing Finance Feb. FY 01 Close Package) (Consolidated Inventory Trend Feb FY 01 Preliminary).
Fourth, Mr. Regan cites a schedule allegedly entitled: "Calculation of Excess Inventory Value," which shows (in millions) that at some point around the end of Q1 of FY 2001 Cisco's MDS showed a total value of $13,000, while its Build Plan showed a total value of $9,065, purportedly resulting in a revenue gap of $3,935. Mr. Regan translates the revenue gap into inventory dollars, using a 25% factor for inventory as a percentage of revenue, of $984 million. Mr. Regan then states: "The cost of $984 million was likely excess inventory. Upon identification of the existence of the $984 gap as of Q1 2001, Cisco's management did not increase the company's reserve to reflect the $984 million gap, or at the very least a significant portion thereof." This statement is incorrect because both the MDS and the Build Plan forecast that in no way commit Cisco to purchase product at these levels. Therefore they say nothing about Cisco's inventory on hand or on order against which inventory reserves need to be established. Mr. Regan further demonstrates his confusion by stating on the next page: "Cisco was not likely able to use the nearly $4 billion in excess inventory in Q3 just as it was unable to use it in Q2." However, he is referring to the above discussed gap between the MDS and the Build Plan forecasts — expressed in revenue dollars — rather than in equivalent amounts of inventory, which is the $984 million amount.

Finally, Mr. Regan criticizes Cisco's decision to load MDS using Cisco's stretch forecast rather than the base forecast beginning in Q4 of FY 2000, but as described above, there is nothing improper about that decision. MDS was supposed to represent Cisco's best estimate of the expected demand for its products for the next twelve months. When Cisco concluded that using the base forecast in MDS understated demand, change was needed and the stretch forecast was found to be a better predictor of future demand at that time so it was used. Thus Cisco made this change in its MDS process not to distort the MDS but to improve its accuracy and usefulness, both as an internal tool and as a signal of anticipated demand to Cisco's suppliers.215

Mr. Regan's calculation of the alleged shortfall in the inventory reserves provided by Cisco in Q3 and Q4 of FY 2000 and Q1 of FY 2001 is discussed at Pages 109-110 of his report and calculated at Schedule C-5A. He starts by calculating for each quarterly period beginning with Q2 of FY 2000 and continuing through Q1 of

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215 After the end of Q1 of FY 2001, Cisco manufacturing became concerned about the magnitude of the difference between the base and stretch forecasts and took action to attempt to improve forecasting precision. Through communications with the Business Units and the sales groups who prepared the forecasts, Cisco manufacturing suggested that effort be directed to narrowing differences between base and stretch forecast for at least some individual products, and a goal for the portion of the twelve-month forecasts that fall within the next three-month period in each successive monthly forecast be that they differ by not more than 50%. See CIS-PPNPF-HC_061331-32 (Exhibit 591) (Nov. 3, 2000 R. Acra Email re base versus stretch forecasts); Deposition of R. Jacoby, June 24, 2005, at 203:20-205:17; see also Deposition of R. Pond, Mar. 30, 2005, at 248:5-19. Again, nothing was improper in this effort to improve the accuracy of the MDS so it could better fulfill its purpose.
FY 2001 the difference between the MDS (Material Plan) and the Build Plan for the next two fiscal quarters and then translates this difference to an inventory effect by multiplying the derived dollar amount by twenty-five percent. Next the increase in the calculated inventory effects from one quarter to the next are calculated and expressed as percentages that are used to derive estimated inventory reserve levels for each quarter beginning with Q3 of FY 2000. The estimated inventory reserve for each quarter is calculated as being the estimated inventory reserve for the prior quarter (or the actual inventory reserve for Q2 of FY 2000) increased by the percentage change in the difference between the MDS and Build Plan levels arising in that quarter. The alleged understatement in inventory reserves at each quarterly period is the difference between the calculated inventory reserve and the actual inventory reserve reduced by amounts attributable to prior quarterly calculations. There are several problems with this calculation:

- There is no logical basis for using differences between the MDS and Build Plan to estimate inventory reserve levels. As stated earlier, these demand forecasts do not represent either inventory on hand or on order so a clear and direct link between differences in future demand forecasts and excess levels of inventory, especially excess inventory on a part by part basis, is not present.

- The calculations are based on changes in demand forecast for the following two quarters. Using the next two quarters, as compared to using just one or three or four quarters as a basis for the calculations is arbitrary and I believe cannot be justified.

- The calculated gap percentage is used to calculate the entire inventory reserve although the gap only arises in connection with manufacturing reserves. As noted above, the manufacturing reserves constitute between 36% and 42% of the total inventory reserves for such periods, so logic would dictate that the calculated amounts should be reduced by roughly 60% to be consistent with the composition of the actual inventory reserves.

- The calculations start with an indicated shortfall in the inventory reserves provided at Q2 of FY 2000 of $158 million that is never discussed or considered as an additional alleged understatement.

As a result of the above issues, I find Mr. Regan's calculation of the alleged inventory reserve understatement to be unsupported and arbitrary. Additionally, this entire section of his report is inconsistent with the facts relating to Cisco's manufacturing process and the information generated to control this process.

In contrast, I find Cisco's inventory accounting policy to be in accordance with GAAP and its process for establishing inventory reserves to be sound, including as it does the use of Cisco's ERP system, the input of numerous people, and the use of
numerous control points and reviews throughout the Cisco organization to ensure accuracy and objectivity. The process is not dominated by one person or one group within Cisco, which would increase the risk of error from bias or the subjectivity of one or a small group of people. The process has been consistently applied before, during, and after the Class Period, and historically has produced appropriate inventory reserves. Finally, I note that during the Class Period the relatively small level of inventory maintained by Cisco coupled with the high demand for its products and the expertise of Cisco's manufacturing organization make it highly unlikely that material amounts of inventories requiring reserves were present yet not identified and provided for.

Therefore, I conclude there is no basis for Mr. Regan's claim that adequate and appropriate levels of inventory reserves were not contained in Cisco's consolidated financial statements during the Class Period.

4. Revenue Transactions With Conditional Terms.

a. PwC's auditing procedures.

PwC performed extensive audit procedures with respect to revenue recognition at Cisco. In planning and designing its audit, PwC was aware that revenue recognition was an area of concern for high-tech manufacturing companies. PwC considered the risk of deliberate misstatement at Cisco to be low given Cisco's "control environment" and "tone at the top." PwC determined that Cisco did not tolerate intentional financial statement misstatements, its organizational structure and internal controls provided effective checks and balances as well as effective supervision and review, it did not make aggressive earnings forecasts, it had a strong corporate code of conduct, and its board of directors and audit committee provided effective oversight of the financial function.216

PwC reviewed the monitoring and internal controls over revenue recognition and concluded that revenue was tracked closely using a variety of financial analytics and ratios. Revenue was tracked throughout the month, not merely at month-end. Because of the importance of this area to Cisco's financial statements, Cisco had a comprehensive accounting policy on Revenue Recognition and it had a Revenue Recognition Manager who supervised an accounting group which monitored the process by which revenue was recorded to assure it was in accordance with GAAP, accumulated data and prepared forecasts of monthly revenue, trained Cisco personnel in the accounting policies and practices to be followed with respect to revenue recognition, and reviewed the accounting for each "non-standard revenue

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transaction." Thus there were controls in place to swiftly identify and correct any errors in the way revenue was recognized in the Company's books and records.

PwC also specifically reviewed and tested the controls relating to revenue recognition in connection with non-standard contracts and determined the following:

- Every non-standard contract—which included any transaction with terms different than Cisco’s standard “Net 30” and “FOB Shipping Point”—was personally approved by the World Wide Sales Controller and entered into the RevTrak database so that such contracts and related invoices were subject to scrutiny.

- Prior to accepting a contract with non-standard terms and conditions, Cisco required the contract to be reviewed and approved by its “Deals Desk.”

- Each of Cisco’s geographic operating areas (“theatres”) had a monthly revenue recognition meeting where every non-standard contract in the RevTrak database was discussed.

- A Corporate Revenue Review meeting was held quarterly prior to closing to discuss all non-standard transactions and assure that revenue was properly recognized.

PwC also reviewed and tested the controls and processes relating to Cisco’s revenue/accounts receivable cycle. As part of its audit procedures, it performed shipping cut-off tests and reviewed revenue recognition from individual contracts on a test basis to provide itself with additional assurance that revenue was accounted for in accordance with GAAP.

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217 PWC 016559-64 (Work Paper “Document and assess monitoring controls over the revenue and receivables cycle” 800 – Monitoring controls).
218 This included transactions involving “futures,” rebates or multiple elements (e.g., a sale of products and professional services).
219 Attendees include theatre representatives and corporate accounting personnel, including the Revenue Recognition Manager. See PWC 016885-99 (Work Paper “Nonstandard T&C’s (Revtrac Database” 2400 – Revenue and receivables cycle).
220 Attendees at this meeting include the corporate controller, the corporate operations controller, the corporate director of finance, the world wide sales controller, the revenue recognition manager, and personnel from the revenue recognition manager’s staff. See ibid.
221 Of course, PwC also performed general procedures indirectly bearing on revenues such as considering information arising from its other auditing procedures to assess whether further work in the revenues area needed to be performed in response to such information, considering the fairness of the financial statement presentation and footnote disclosures concerning revenues, and obtaining written representations from financial and executive management concerning the financial statements.
PwC determined that the internal control process was facilitated by open and frequent communications among Cisco's sales controller, sales finance, manufacturing, legal, and corporate accounting, including revenue recognition, groups. Based on these procedures as well as others documented in PwC's working papers, PwC evaluated the risk of material financial statement misstatements involving revenue recognition to be low and adopted a “high reliance on controls” approach to auditing revenue.

To ensure that the benefit of independent revenue recognition testing was available during the year, PwC reviewed the accounting for non-standard contracts on a test basis at each quarter end. The Company followed the provisions of Statement of Position (“SOP”) 97-2, *Software Revenue Recognition*, in accounting for revenue recognition. PwC’s procedures included evaluating whether transactions were accounted for in accordance with SOP 97-2. PwC also considered the guidance in SAB 101 in reviewing Cisco's revenue recognition policies and procedures. For contracts with futures, this testing involved reviewing Cisco’s support for vendor specific objective evidence (or “VSOE”) — the fair market value of a product that is an element in a sale containing multiple elements — of upgrade products not currently available.

Because PwC tested and evaluated Cisco's internal controls in the early phases of its audit, it re-evaluated them at year-end and found no changes. In reexamining Cisco’s revenue recognition policies, procedures, and practices at year-end, PwC and Cisco discovered a minor error in how Cisco allocated discounts among various products in sales with “futures.” The accounting literature required discounts greater than the normal discount at which Cisco sold it products to be allocated entirely to products then available for delivery whereas Cisco had been allocating this discount proportionately among all components of the sale including the future upgrade product. Cisco made an analysis and corrected for this error in

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223 PWC 035646-68 (“Pricewaterhouse Coopers FY00 Summary Audit Plan” presented to Cisco’s Audit Committee with the notation “Focus on SOP 97-2 and SAB 101” at PWC 035647).

224 The FY 00 Summary Audit Plan (PWC 035646-68) presented to Cisco’s Audit Committee included the notation “Focus on SOP 97-2 and SAB 101.” The SEC delayed the effective date for following SAB 101 requirements to Cisco's Fiscal 2001 so it was not applicable to Cisco's Fiscal 2001 financial statements; the purpose of this reference was to commence the process of identifying where Cisco's revenue recognition accounting might need to change once this SEC accounting bulletin became effective.

225 PWC 018309-13 (Work Paper "Revenue Testing Q1" 6000 - Sales and Cost of Sales); PWC 018314-19 (Work Paper "Revenue Testing Q2" 6000 - Sales and Cost of Sales); PWC 018320-28 (Work Paper "Revenue Testing Q3" 6000-Sales and Cost of Sales); PWC 018329-35 (Work Paper "Revenue Testing Q4" 6000 - Sales and Cost of Sales).

226 PWC 018306 (Work Paper “Consider changes in internal control and inherent risks since the early testing date” 6000 – Sales and Cost of Sales).
its year-end accounts by recording an additional $5 million of deferred revenue, and the revenue accounting group developed a program to educate all Cisco accounting personnel regarding this change.

At the completion of the audit PwC made three recommendations to management concerning revenue recognition in the closing meeting:

- Document management’s approach and conclusion used to support VSOE for revenue with “Futures”;
- Enhance systems and controls to i) evaluate if contracts should be accounted for under SOP 81-1, on under contract accounting, to track costs and the project to ensure appropriate accounting and ii) ensure compliance with SOP 97-2, SAB 101; and
- Ensure adequate controls over per-port offers.

In its August 8, 2000, “Report to the Audit Committee of the Board of Directors” PwC made the following recommendations under the topic “Improve Revenue Recognition Procedures”:

The Company continues to account for its revenue appropriately under the software revenue recognition rules. We recommend that the Company improve the documentation to support the conclusions that the Company has vendor specific objective evidence (‘VSOE’) for undelivered elements of a customer order.

The Company is also entering into more contracts where implementation services are provided. The systems in place to evaluate service contracts, track and account for these projects are not robust enough to scale to the level the Company currently plans on attaining.

Management Response

The Company concurs with PwC that it is in compliance with the software revenue recognition rules. The Company has already established a formal documentation for VSOE on all contracts containing future products/upgrades. In addition, for contracts containing bundled product and service solutions, a formal Revenue Transfer is completed detailing the VSOE calculation and is approved by Corporate Revenue. The Company currently defers all of the revenue from a customer where VSOE cannot be supported.

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228 PWC 020086 (FY 2000 Audit Comments).
The Company is in the process of implementing processes and systems which will support the business model. We expect that the first phase of this project will be completed in the third quarter of fiscal 2001.229

As discussed more fully in the Financial accounting issues section below, Mr. Regan contends that Cisco failed to develop adequate VSOE for futures and, therefore, contends that Cisco improperly recognized revenue by recognizing some of the total revenue from this sale when the currently available product was delivered to the customer. With respect to PwC’s auditing procedures, Mr. Regan contends that PwC did not:

a. Determine whether Cisco maintained adequate evidence to support VSOE for Futures [upgrade products]; and

b. Obtain sufficient competent evidential matter to support Cisco’s assertion the requirements for revenue recognition on non-standard arrangements had been met.230

In addition, Mr. Regan claims that PwC did not comply with AU 342, Auditing Accounting Estimates, because it did not test how Cisco made its VSOE determinations for specific products.231

I disagree with Mr. Regan’s criticisms. First, concerning Mr. Regan’s claim that PwC did not “Determine whether Cisco maintained adequate evidence to support VSOE for Futures,” no accounting or audit standard requires a company to prepare or maintain any specific form of documentation showing how VSOE was established. SOP 97-2 merely requires that a reporting entity have VSOE for all undelivered elements of a transaction in order to recognize any revenue prior to delivery of all of the products constituting the order. Mrinalini Ingram, the Company’s Revenue Recognition Manager, testified that the Company had a process for establishing VSOE for futures that involved Cisco’s marketing organization and its engineering team as well as the corporate revenue recognition group.232 The corporate revenue recognition group also monitored the accuracy of the VSOE forecasted prices by comparison to actual selling prices when the futures products became available.233 Further, Cisco’s own revenue recognition policy stated that all revenue would be deferred where VSOE did not exist.234 So when PwC tested the revenue deferral accounting for non-standard revenue transactions involving

229 PWC 051934-59 at 46.
230 Regan Report at 90.
231 Regan Report at 113-14.

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futures, it was able to: (1) verify that Cisco had evidence of the VSOE of the undelivered products, and (2) satisfy itself that the VSOE estimates were developed by a process that had controls to assure reasonable accuracy. Mr. Regan admits that PwC’s workpapers reflect the performance of VSOE verification procedures.

Mr. Regan’s assertion that PwC failed to comply with AU 342 because it did not test how Cisco made its VSOE determinations for specific products is incorrect. PwC reviewed the controls over the process by which the revenue deferral was determined, which is the accounting estimate in question – not the calculation of VSOE, which is only a sub issue – using an approach that focused on “Review and test the process used by management to develop the estimate.” This is one of the available alternatives provided in AU 342.10, Auditing Accounting Estimates.

With respect to Mr. Regan’s claim that PwC did not “Obtain sufficient competent evidential matter to support Cisco’s assertion the requirements for revenue recognition on non-standard arrangements had been met,” this is a matter of audit judgment, subject to the requirements of the third standard of fieldwork which states: “Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.” I find that the audit evidence relied upon was sufficient and persuasive to meet this standard given the “high reliance on controls” audit approach applied by PwC. PwC performed more extensive analysis and observation of the functioning of applicable systems and controls and less direct testing of transactions as a result of its adopting a high reliance on controls audit approach. Transactions were tested as a basis for placing reliance on the results of an accounting process and to establish that the systems and processes were functioning as designed. Mr. Regan’s opinion incorrectly assumes that little or no reliance was placed on the systems, processes, and controls.

In my opinion, PwC's audit planning, procedures, evaluations and judgments were appropriate based on my review of the working papers, documents and deposition testimony.

b. Financial accounting issues

Mr. Regan challenges Cisco’s accounting for certain complex revenue transactions. His main allegation relates to the accounting for transactions in which Cisco agreed to sell a customer a currently available product along with the right to upgrade to a future-generation product with enhanced functionality (sometimes known as “futures”). He claims that Cisco did not have a reasonable

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236 Regan Report at 87 & nn. 281 and 282.
basis for apportioning the total revenue from the agreement between delivered and undelivered products, and, therefore, that no revenue was eligible for recognition on delivery of the available products.\(^{237}\) He also challenges certain other transactions for which he claims that one or more of the four criteria for revenue recognition under SOP 97-2 were not met. I disagree with Mr. Regan's conclusions.

Cisco, consistent with its practice of being conservative in its financial accounting policies and practices, chose to follow the most rigorous provisions for revenue recognition, which were those set forth in the then most recent accounting literature on revenue recognition, SOP 97-2, *Software Revenue Recognition*,\(^{238}\) even though the vast majority of Cisco's revenues were from sales of products and not software.

SOP 97-2 uses a concept called "vendor-specific objective evidence" or VSOE to allocate the total payments to be received under an agreement with multiple elements, such as one where current products and upgrade products are sold in a single arrangement. VSOE essentially is the price a product sells for when it is sold separately, or, for a product that is not currently being sold or not being sold separately, it is the price the product will sell for when it is available for sale separately. More specifically, for a product not currently being marketed, VSOE is "the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace."\(^{239}\) When VSOE is not available for undelivered elements of an arrangement, SOP 97-2 requires, with limited exceptions, that no revenue under the arrangement may be recognized until either such VSOE does exist or all elements of the arrangement have been delivered.\(^{240}\)

SOP 97-2 also requires four criteria to be met for revenue to be recognized from any sales transaction. They are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.\(^{241}\)

\(^{237}\) See Regan Report at 78-80.
\(^{238}\) Cisco disclosed this accounting change in its 1999 annual financial statements as follows: "The Company adopted Statement of Position (SOP) No. 97-2, 'Software Revenue Recognition,' in the first quarter of fiscal year 1999 and its adoption had no material impact on the Company's operating results or financial position." PWC 21632-74 at 54.
\(^{239}\) SOP 97-2.10.
\(^{240}\) SOP 97-2.12.
\(^{241}\) SOP 97-2.08.
Mr. Regan’s criticism of Cisco’s accounting in this area relates largely to one issue, Cisco’s process for developing VSOE for undelivered products. To begin, he objects to using VSOE for undelivered products at all because it is not routinely used by entities governed by SOP 97-2 due to the requirement that the price for an undelivered item, once determined, not change prior to the product’s introduction into the market. I believe Mr. Regan is correct in his understanding of the general practice, but conclude that he has no basis for extending this general practice to Cisco’s specific facts and circumstances.

Many software companies do not choose to establish VSOE for undelivered software elements because they cannot predict what the market for the product will be and what price the market will support until the software element is available. They also may not try to estimate a VSOE for an undelivered element because the delivered element does not provide full functionality without the upgrade or add-on product, in which case revenue recognition for the delivered element would not be allowable even if VSOE were established for the undelivered element.

I believe that Cisco’s pricing, on the other hand, was subject to accurate prediction because its upgrades were plotted on a product development roadmap for any given product family, and pricing decisions were based on a price per unit of functionality approach (e.g., price per unit of speed or unit of throughput), with prices declining on a per-unit basis on a predictable pricing curve as the product line matured and cost savings from enhanced per unit component functionality were factored in.

Additionally, Cisco had no important technological uncertainties associated with these upgrade products as they basically involved switching out an X component that could perform a certain number of units of specified activity for an X+1 product that bettered the specification at the same or a lower cost per unit.\(^{242}\) While engineering was necessary to interface the new component(s) into the product’s design, the basic design work had been done and the general principles and issues were understood.

Cisco had no important uncertainties as to whether the component(s) needed would be available. Cisco had the product roadmaps of its suppliers available to use in determining what enhancements could be included in a product’s next generation and was in constant communication with the development groups of these suppliers to mutually assure the component upgrade contained the features and met the specifications Cisco expected.

\(^{242}\) Or, the upgrade product involved switching out the X component and the Y component for a new X+Y component that embodied the functionality of what was previously done by two components, but now did it faster and cheaper, or allowed the size of the product to shrink, or generated less heat so the products could be placed closer together without damage. Or the upgrade product did a number of these actions in combination.
Finally, being the leader in its industry, Cisco had the power to establish prices and make them stick unlike less dominant companies that were in a price-follower position to a market-pricing leader such as Cisco.

As discussed above, Cisco also had an established process for developing VSOE, which involved Cisco’s marketing and engineering organizations as well as the corporate revenue recognition group. The corporate revenue recognition group also tested whether or not Cisco ultimately sold the upgrade product for its VSOE.243 As part of its business, Cisco was able to enter into contracts to sell its upgrade products for committed prices. The pricing process that Cisco used to establish the prices for these upgrade products was, in turn, sufficient to establish VSOE.

Therefore, I disagree with Mr. Regan’s dismissal of Cisco’s ability to determine VSOE for upgrade products. I believe that Cisco could establish the pricing of upgrade products well before they were available for introduction into the marketplace.

I also believe Mr. Regan mischaracterizes PwC’s comments about Cisco’s VSOE process. As discussed in the PwC auditing procedures section above, PwC’s observations were with Cisco’s process for documenting its VSOE determinations for future upgrade products – not with Cisco’s ability to develop such VSOE. There is no doubt that PwC accepted Cisco’s VSOE determinations in its audit, including the process by which VSOE was determined. This can be established by reading PwC’s “Report to the Audit Committee of the Board of Directors” presented August 8, 2000 on the results of its audit of Cisco’s financial statements for fiscal 2000,244 where PwC states, without equivocation: “The Company continues to account for its revenue appropriately under the software revenue recognition rules.”245

Mr. Regan also makes a few comments about alleged deficiencies in Cisco’s communications among its business unit controllers and the corporate revenue recognition group. However, I did not find this to be the case from my review of deposition testimony and the cited support in Mr. Regan’s report. In addition, Mr. Regan does not identify any specific instances of improper revenue recognition resulting from this alleged weakness.

Accordingly, I believe that Cisco had the ability to determine VSOE for upgrade products and, as discussed above, had appropriate procedures in place for accounting for futures and other revenue transactions. Moreover, as addressed above, Cisco had strong controls over its accounting for revenue recognition.

244 PwC 051934-59 (PwC’s August 8, 2000 “Report to the Audit Committee of the Board of Directors”).
245 Ibid. at 59.
To further assess Mr. Regan’s allegations that Cisco improperly recognized revenue on certain transactions, I focused on the four largest transactions in his Exhibit C-4, which includes all alleged improper revenue recognition transactions he identified. They are (dollars in thousands): Qwest - $37,076; OC48 Card Upgrade - $36,110; Photonics - $29,289; and HarvardNet - $21,673.

Qwest

Mr. Regan notes that $34 million of revenue from a $71.1 million order received from Qwest in December 1999 was deferred at the beginning of FY 01. He concludes the remaining $37.1 million should also have been deferred due to the fact that so much of the total revenue was still deferred eight months after order placement, and that the order was modified after its placement to replace a software element of the transaction, for which revenue was deferred, with a hardware solution with equivalent functionality. However, he has no information as to when this $37.1 million was recognized as revenue, so he assigns it all to Q3 of fiscal year 2000 when the decision to cease development on the software was made. While I find records supporting the contention that development of the software product was stopped in April 2000, Mr. Regan provides no support for his other assumptions. For example:

- Mr. Regan points to the several iterations between Cisco and Qwest in deciding what hardware product would be furnished in replacement for the ordered software as evidence that VSOE for undelivered upgrades could not have been determined at the inception of the agreement. A more correct interpretation of the situation is that an unexpected change in Cisco’s development plans occurred, and Cisco continued to defer the revenue associated with the undelivered upgraded functionality until the products that Qwest requested and Cisco agreed to provide were shipped beginning in October 2000.

- Rather than $34 million of revenue having been deferred for this upgrade as Mr. Regan states, it appears that the revenue deferral for the upgrade was only $10.9 million, because this was the amount recognized upon delivery of the upgrade when all conditions for revenue recognition for the increase functionality provided by the substituted hardware were met. This amount is corroborated by comments made by the PwC auditor performing the testing of non-standard revenues in Q2 of fiscal 2000, which indicate that the originally deferred amount was 15% of the total order, corresponding to approximately $10.9 million ($71.1 million x 15.33% = $10.9 million). The remainder of the $34 million reserve appears

246 CIS-PPNP-0484082 (RevTrak - II - Review Profile “Project Update”).
247 Ibid.
248 Ibid.
to have been provided by Cisco in Q3 of fiscal 00, based on the following notation in PwC's workpaper: "Darrell Brinkman [Cisco corporate revenue accounting] deferred 100% of the revenue represented by the fair value of the option given to the customer, since the product has not been shipped to the customer." It appears that this remaining amount of deferred revenue, approximating $23.1 million, was not recognized when the upgrade products were shipped, because Cisco learned that Qwest was warehousing some of the products it obtained under the $71.1 million order and decided it would be prudent to retain this amount as deferred revenue due to the potential for Qwest asking to return these products.

- Mr. Regan also remarks: "Although Cisco deferred a portion of the arrangement for this Future, there is no evidence that Cisco utilized VSOE to do so." However, based on the documents he cites at Exhibit C-4 as support for his conclusion, there is no information to support a conclusion or even an inference that VSOE was not calculated and used to defer a portion of the revenue from this contract for the futures product. Cisco's accounting policy was to defer 100% of the revenue from a transaction when there are undelivered elements and VSOE cannot be determined, and Mr. Regan presents no evidence that this policy was not followed.

In summary, I do not see any violation of GAAP in Cisco's accounting for the Qwest transaction; rather I see appropriate and conservative accounting applied regarding the recognition of revenue.

**OC48 Card Upgrade**

Although this item constitutes nearly 25% of the total amounts Mr. Regan sets forth at Exhibit C-4 as alleged revenue misstatements in the Class Period, he does not discuss it anywhere in his report and provides no explanation for why he believes Cisco's accounting was improper. Because the information Mr. Regan supplies concerning the proposed misstatement of revenue related in his report and in the documents cited at Exhibit C-4 is insufficient to allow me to understand the basis for his claims, and because I have seen no evidence that Cisco's accounting for OC48 Upgrades was improper, I disagree with his proposed restatement for these items. I reserve my right to respond further if and when Mr. Regan provides an explanation of the basis for his conclusion that revenue was improperly recognized.

**Photonics**

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249 See PWC 018314-19 (Work Paper "Revenue Testing Q3" 6000 – Sales and Cost of Sales).
250 See PWC 008740-41 (Work Paper "Qwest Optical & Qwest LA Unified School District" 6000 – Sales and Cost of Sales), which documents this return exposure estimate as 50% of $36 million of product sales.
The Photonics product sale questioned by Mr. Regan was to Frontier Communications, a subsidiary of Global Crossing Ltd. Photonics was a product of the optical systems business of Pirelli S.p.A that Cisco acquired in February 2000.\textsuperscript{251} Sales revenue was recognized on this transactioncommencing in the fourth quarter of fiscal 2000. Mr. Regan alleges that Cisco had no reasonable basis for recognizing revenue from this transaction because the product was failing to function properly and due to Cisco’s inexperience with the product. However, Mr. Regan does not consider the most salient point regarding sales recognition for this transaction, namely that the sale had a customer acceptance provision, and Cisco only recognized revenue after the customer had accepted the product.

Cisco’s revenue recognition for this contract was reviewed by PwC in its testing of revenue for the fourth quarter of fiscal 2000 and the resulting working paper indicates the following:

- 80% of the invoice price must be due upon receipt of invoice and the remaining 20% due upon customer acceptance. Due to the customer acceptance clause, Cisco recognizes revenue upon cash receipt (customer acceptance term is 14 days). Therefore, prior to the cash receipt, revenue is deferred. The deferral is located on the “U.S. Corporate Deferred Revenue Summary” for $44M (Photonics Acquisition). Cisco closely tracks the purchases and cash receipts on this account, due to the volume of purchases made by Frontier, in order to recognize revenue on a timely manner per Michelle Lueng, Revenue Recognition.

That working paper also indicates that Frontier’s payment history showed that it did not pay within ten days of the invoice date, so it was reasonable to assume that the customer did not pay until it was satisfied with the functionality of the delivered product. Accordingly, recognition of revenue on the cash basis was appropriate because it matches revenue recognition with customer acceptance of the products.

Therefore, I conclude that the criteria for revenue recognition under SOP 97-2 were met at the date revenue was recognized and believe that Mr. Regan’s criticism of the accounting for revenue recognition for this transaction during the class period is without justification.\textsuperscript{252}

\textsuperscript{251} Cisco Systems Inc. Form 8-K filed 2/17/00.

\textsuperscript{252} In the table at page 85 of his report, Mr. Regan uses a 35% average cost of sales percentage and a 30% income tax expense rate to determine the after-tax effect of his proposed adjustments. I can accept both of these percentages as reasonable for the analytical purposes intended. However, I note that the cost of sales in the Photonics transaction was considerably higher, 49%, in Cisco’s U.S. Corporate Deferred Revenue Summary for July 2000. CIS-PPNFP-HC-0018742.
Mr. Regan alleges that all revenue from this arrangement should have been deferred pursuant to his contention that Cisco was unable to determine VSOE for undelivered elements of the arrangement. However, he has no persuasive support for this conclusion.

- He complains that “individuals such as Ms. Ingram and Mr. Brinkman [of Cisco's corporate revenue recognition group] may not have had the necessary facts in order to make appropriate revenue decisions,” but this statement is not supported with any facts concerning the HarvardNet arrangement and is simply speculation.

- At one point he calls the upgrade rights contingencies, thus implying that they preclude revenue recognition under one or more of the basic revenue recognition criteria imposed by SOP 97-2, although on the preceding page of his report he details these items and identifies them as “Futures”, which are merely upgrade rights that do not preclude revenue recognition for the delivered element provided that VSOE for the upgrade rights is determined and used to defer recognition of the appropriate amount of revenue that relates to the upgrades.

- He cites no other evidence in support of his contentions in his discussion of the HarvardNet arrangement.

Based on my review of the documents related to the HarvardNet transaction cited by Mr. Regan in Exhibit C-4, it appears that Cisco deferred $3.4 million of revenue from the HarvardNet arrangement to account for the upgrade rights in accordance with the provisions of SOP 97-2 to defer revenue related to undelivered elements of the arrangement, and such amount continued to be deferred at the end of fiscal year 2000 pending the exercise by HarvardNet of its right to an upgrade, or expiration of the upgrade right. I have seen nothing to suggest that this amount was not based on VSOE appropriately determined or that the revenue that Cisco recognized during fiscal 2000 was not appropriately recognized.

In fact, Cisco was particularly conservative in recognizing revenue on this transaction. Per a project update notation made subsequent to the end of fiscal year 2000 and cited by Plaintiff Expert at Exhibit C-4, HarvardNet apparently elected not to exercise trade-in or upgrade rights associated with purchased 2 Port DMT cards and 6130 products whose upgraded products were available for “first commercial shipment” in May 2000 (4 Port cards) and June 2000 (6160 product),

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253 Regan Report at 90.
254 Ibid.
255 CIS-PPNFP-0483974 (RevTrak · II · Review Profile “Project Update”).
256 CIS-PPNFP-0483977 (RevTrak · II · Review Profile “Project Update”).
respectively. The notation goes on to state: "With both options expiring, new FMV of remaining options is $2,605,359." Because the options expired shortly after the upgrade product became available, Cisco could have made the effort to determine whether the options had legally expired by the end of fiscal 2000 and recognized some or all of the difference between the $3.4 million deferral and the $2.6 million new deferral as revenue in fiscal year 2000. They chose not to do so as this amount was immaterial to Cisco’s fiscal 2000 financial statements, and as they decided to let additional time pass before the deferred revenue was recognized to ensure that HarvardNet had let its upgrade right expire.

Accordingly, as a result of my review of the four largest transactions appearing on Mr. Regan’s Exhibit C-4, my reading of his report, and consideration of other available evidence as discussed herein, I disagree with Mr. Regan’s proposed adjustments for those transactions. I do not address in detail here the remaining transactions on Exhibit C-4, which aggregate $24 million of challenged recognized revenue during the class period and result in a $13 million effect on net income after consideration of the need to make corresponding adjustments to cost of sales and to income taxes, as they are, in my opinion, immaterial to Cisco’s financial statements for the periods indicated at Exhibit C-4, both individually and in the aggregate.

5. Related Parties

a. PwC’s auditing procedures.

Mr. Regan contends that PwC “failed to follow GAAS in concluding that there were ‘no material related party transactions that must be reported for the annual report.’” Mr. Regan’s conclusion fails because there were no material related-party transactions required to be reported in Cisco’s financial statements, as discussed below in the Financial accounting issues section.

Moreover, PwC carried out appropriate and adequate audit procedures in this area:

- PwC obtained from management a list of known related parties and any transactions with those parties, and reviewed the list for completeness;  

- PwC considered whether procedures carried out during the course of the audit had identified transactions with related parties;

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257 Regen Report at 133.
258 See PWC 019491-92 at 19491 (Work Paper “Identify related parties” 8500 – Related party transactions (re FY 2000)) (“a) PwC notes that the related parties consist of the Board of Directors, significant members of management and parties related to these groups.” b) PwC notes that the related parties listing appears complete.”).
• PwC determined that disclosure in Cisco's financial statements was in compliance with GAAP.260

Based on its procedures, PwC did not identify any material related party transactions that needed to be reported in Cisco's FY 2000 financial statements.261


Mr. Regan states in his report that seven individuals who were Cisco executives or directors were partners in limited partnerships managed by either Kleiner Perkins Caulfield & Byers ("Kleiner Perkins") or Sequoia Capital ("Sequoia"), prominent Silicon Valley-based venture capital firms, and that during the Class Period, primarily in FY 2000, Cisco acquired several companies whose investors included one of the limited partnerships. He alleges that (a) all of the Cisco acquisitions described above were related party transactions "because of the ownership interests of Cisco officers, executives, and directors"; and (b) "Cisco violated GAAP because Cisco's financial statements did not disclose the related party transactions described above."

I disagree with Mr. Regan's contention. Mr. Regan misinterprets the definition of a related party in the relevant financial accounting literature, FAS 57, Related Party Disclosures. Because the entities involved in these transactions are not related parties, there is not a GAAP requirement for disclosure of these transactions in Cisco's consolidated financial statements.

FAS 57 defines related parties as follows:

Related parties. Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting

260 See PWC 019493-94 at 19493 (Work Paper "Identify related party transactions" 8500 - Related party transactions (re FY 2000)) ("PwC notes no material related party transactions that must be reported for the annual report.").

261 See PWC 019497-98 at 19497 (Work Paper "Verify the correctness of information for disclosure items" 8500 - Related party transactions (re FY 2000)) ("PwC obtained appropriate information for purposes of disclosure.").

262 See PWC 019493-94 at 85 ("PwC notes no material related party transactions that must be reported for the annual report."); PWC 019496-96 at 85 (Work Paper "Test material related party transactions" 8500 - Related party transactions (re FY 2000)) ("PwC notes no material related party transactions.").
parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

FAS 57.24(f). In considering whether the transactions were among related parties, as defined above by FAS 57, the key test is whether one party has significant influence over another "to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests." FAS 57.24(f). That is not present in the cited situations.

First, management of the five acquired companies negotiated with Cisco to establish the terms of the transactions, and individual investors in the acquired companies, such as the Kleiner Perkins or Sequoia limited partnerships, had only limited influence over the transaction terms to the extent their representatives held director positions in an acquired company or ultimately through a shareholder vote on the transaction. The limited partners in the limited partnerships, such as six of the seven Cisco executives and directors, did not even have the ability to vote on transactions of the limited partnership. Accordingly, these six Cisco officers and directors were passive investors without the ability to significantly influence the sellers in the transactions, and, therefore, the requisite significant influence is not present.

Second, in the case of the seventh individual, Mr. Donald Valentine, a member of the Cisco Board of Directors and for part of the class period one of a half dozen general partners of certain Sequoia limited partnerships, we learn that Mr. Valentine abstained from any discussion and voting on the Monterey acquisition in the June 22, 1999 meeting of Cisco's Acquisition Committee of its Board of Directors "because he was an investor in Sequoia Ventures that invested in Monterey." As a result of his nonparticipation in Cisco's consideration of the Monterey acquisition, he cannot be considered to have significant influence over Cisco with regard to that acquisition. Moreover, as discussed above, although he may have had some influence over Monterey because he was one of the general partners in a Sequoia limited partnership that was an investor in Monterey, he cannot be considered to have had significant influence over Monterey. The same is true of other instances

263 Deposition of J. Chambers, Sept. 22, 2005, at 327:12-16; see also Exhibit 1828 (Minutes of the Special Meeting of the Acquisition Committee of Cisco Systems, Inc., June 22, 1999) (reflecting that Mr. Valentine abstained from voting and discussion on the Monterey acquisition).
in which he was one of the general partners of a Sequoia limited partnership that was an investor in a company that Cisco acquired. 264

FAS 57 states the purpose underlying the required disclosures is that “[t]ransactions involving related parties cannot be presumed to be carried out on an arm’s length basis, as the requisite conditions of competitive, free-market dealings may not exist.” FAS 57.3. Because there is no practical way to recast related party transactions into elements that would result from an arm’s-length basis transaction, GAAP requires that material related party transactions be disclosed so that users of the financial statements can take the related-party transaction into account in an overall evaluation of the reporting entity. In the above identified transactions, neither the sellers nor Cisco were precluded from pursuing their own separate interests in transactions that were carried out on an arm’s-length basis.

In addition, FAS 57 requires that the specified disclosures be made only with respect to material related party transactions. Mr. Regan does not even specify which transactions he contends should have been disclosed, let alone explain why he contends that any such transaction was material. Nor does Mr. Regan provide any information regarding the size of the Cisco executives’ or officers’ equity interests in any of the acquired companies; given those individuals’ significant economic ties with and ownership interests in Cisco, it is difficult to imagine why they would be motivated, in the context of those transactions, to act in a way that “prevented [Cisco] from fully pursuing its own separate interests.” 265 Finally, I note that Cisco made extensive disclosures in its SEC filings regarding each of these transactions, providing readers with all of the information that would be required by FAS 57 if it applied, other than the indirect ownership interests of the Cisco officers and directors.

On Page 130 of his report, Mr. Regan states that “GAAP, as set forth by SEC rules, also required Cisco to disclose certain relationships and related transactions as follows” and then quotes the requirements of Regulation S-K Item 404(a). Regulation S-K Item 404(a), however, is not a GAAP requirement for disclosure in the financial statements. Rather, Regulation S-K Item 404(a) disclosures, if applicable, are made in a public company’s annual proxy statement or certain registration statements. Because matters disclosed pursuant to Regulation S-K

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264 See Deposition of J. Morgridge, July 15, 2005, at 14:19-15:1 (stating that Mr. Valentine recused himself from voting on an acquisition by Cisco every time the Sequoia fund had an interest in it); Exhibit 616 (Minutes of the Special Meeting of the Acquisition Committee of Cisco Systems, Inc. June 17, 1999) (reflecting that Mr. Valentine abstained from voting on the StratumOne acquisition); Deposition of R. Pucett, June 29, 2005, at 136:8-10 (stating that Mr. Valentine refrained from involvement in discussion and voting on the StratumOne acquisition).

265 FAS 57.24(f).
Item 404(a) are not reported in a company's financial statements, they are not the subject of an audit or review by the company's independent auditors.\textsuperscript{266}

\textbf{Standard of Reporting One: The Financial Statements Are Presented in Accordance With Generally Accepted Accounting Principles.}

The first reporting standard requires the auditor to state whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles. This standard is construed not to require a statement of fact by the auditor but an opinion as to whether the financial statements are presented in conformity with such principles.\textsuperscript{267}

The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation; (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed; and (e) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.

In its audit report on Cisco's consolidated financial statements for fiscal year 2000, PwC stated the following:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and of shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Cisco Systems, Inc. and its subsidiaries at July 29, 2000 and July 31, 1999, and the results of their operations and cash flows for each of the three years in the period ended July 29 2000, in conformity with accounting principles generally accepted in the United States.\textsuperscript{268}

Based on my review, at the time the opinion was issued, PwC had a reasonable belief that the financial statements were presented fairly in accordance


\textsuperscript{267} AU Section 410.02.

\textsuperscript{268} See Exhibit 1566 at 61-62 (Form 10-K for fiscal year ended July 29, 2000).
with GAAP and expressed that opinion as required by the first standard of reporting.

**Standard of Reporting Two: PwC Did Not Observe or Report Any Circumstances Where Accounting Principles Were Not Consistently Observed Between Reporting Periods.**

This standard requires the auditor's report to identify those circumstances where the accounting principles have not been consistently observed during the current period in relation to the prior period. PwC's report did not refer to any change in accounting and I did not note any items that indicated any material changes that would have required recognition in PwC's report. Therefore, PwC also was in compliance with this reporting standard.

**Standard of Reporting Three: PwC Determined That the Financial Statement Disclosures Were Reasonably Adequate.**

This standard indicates that disclosures in the financial statements are considered to be reasonably adequate unless the report of the auditor states otherwise. The engagement team utilized an extensive disclosure checklist to assist them in assessing whether the financial statements included disclosures that would be considered reasonably adequate[^269] and concluded that there were no omissions of required disclosures.[^270] Therefore, as noted in the third standard of reporting, the report did not need to include any comments about the disclosures and PwC complied with this reporting standard.

**Standard of Reporting Four: PwC Expressed an Opinion Regarding Cisco's Financial Statements.**

This standard requires that the audit report express an opinion on the financial statements, taken as a whole, or an assertion indicating that an opinion cannot be expressed. The objective of this standard is to prevent misinterpretation of the degree of responsibility the auditor assumes when the auditor is associated with the financial statements. This standard also requires the auditor to qualify the opinion if the auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP and the effect on the financial statements is material.^[271]

[^269]: See PWC 018434-35 (Work Paper "Test support for disclosure" - 7000-Financial Statements) (indicating disclosure checklist was completed); see also PWC 018444-52 (Work Paper "Update the checklist for new pronouncements" - 7000 - Financial Statements).

[^270]: See PWC 018434-35 (stating that PwC completed the disclosure checklist and found that the disclosures included the required information).

[^271]: AU Section 508.20.
As set forth above, PwC expressed an opinion on the financial statements of Cisco, taken as a whole, and did not express any qualification. The report further stated that:

These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinions expressed above. 272

Based on my review and as described throughout this report, I found that PwC complied with the General Standards and the Standards of Fieldwork and had a reasonable basis for issuing its opinion.

Therefore, in my opinion, PwC conducted its audit of Cisco's fiscal year 2000 financial statements in accordance with generally accepted auditing standards.

IX. PwC's Reviews of Cisco's Interim Financial Information In The First Three Quarters Of FY 2000 And The First Quarter of FY 2001 Conformed With GAAS.

A. Applicable Professional Standards Relating To Interim Reviews.

Beginning in March of 2000, 273 the SEC mandated that "prior to filing, interim financial statements included in quarterly reports on Form 10-Q must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards." 274 The professional guidance on the nature, timing and extent

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272 See Exhibit 1566 at 61-82 (Form 10-K for fiscal year ended July 29, 2000).
273 The third quarter of Cisco's FY 2000.
274 Prior to this change in the SEC rules, a client may have asked the accountant to provide limited services, but not a review, in connection with interim financial statements. In my experience, these services were often limited to reading the Form 10-Q, making certain inquiries of management as a result of reading the information and providing the client with suggestions with respect to the information included in the document. These services did not constitute a review of the interim financial statements and any inquiries that might have been made were significantly more limited than those required by AU Section 722.
of such reviews is codified at AU Section 722A of *U.S. Auditing Standards*, which is principally derived from SAS No. 71, *Interim Financial Information*.

The objective of a review of interim financial statements differs significantly from the objective of an audit of financial statements in accordance with GAAS. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements taken as a whole. A review of interim financial statements does not provide a basis for the expression of such an opinion because the review does not contemplate (a) tests of accounting records, (b) obtaining corroborating evidential matter, or (c) the application of certain other procedures ordinarily performed during an audit.\(^{275}\)

If the accountant issues a report in connection with a review of interim financial statements, the report would include a statement about whether the accountant is aware of any material modifications that should be made to the financial statements in order for those statements to be in conformity with GAAP.\(^{276}\) In other words, such a report would provide only the negative assurance that the accountant is not aware of the need for material modifications, and not the affirmative assurance that the financial statements are presented in conformity with GAAP in all material respects.

The extent of procedures to be performed in a review of interim financial information is a matter of professional judgment based on the accountant’s prior experience and knowledge of the entity and may be modified if the accountant becomes aware of changes in accounting practices or business activity during the review. The accountant is expected to have sufficient knowledge of the entity’s internal control to identify the types of potential material misstatements that the interim financial statements could contain and the likelihood of their occurrence, and then to use that knowledge to select analytical procedures and inquire of management to identify any material modifications that should be made to the interim financial statements to conform with GAAP. In substance then a review consists of analytical procedures, inquiries of management, and follow-up on matters identified through these procedures.

Analytical procedures in a review of interim financial statements generally involve comparisons of the interim information with: comparable information from prior periods such as the immediately preceding interim period or the corresponding interim period of the prior year; anticipated results such as operating plans; and industry results (to the extent relevant and available). Such procedures also may include considering the relationship between amounts within the interim financial statements to expectations and to non-financial information such as key performance indicators.

\(^{275}\) AU Section 722.09.

\(^{276}\) AU Section 722.29.
Inquiries of management in a review are generally addressed to those having responsibility for financial and accounting matters generally cover the following topics: matters about which questions have arisen from performing the analytical review procedures or from previous reviews; changes in accounting policies and practices; changes in the entity's internal control system; changes in business activities; whether management believes the interim financial statements have been prepared in accordance with GAAP consistently applied; and whether subsequent events have occurred that would have a material effect on the interim financial statements.

B. PwC's Review Procedures.

I reviewed PwC's working papers for the first three quarters of fiscal year 2000 and the first quarter of fiscal year 2001 and determined that PwC performed the following procedures in connection with its reviews of Cisco's interim financial information:

- Inquired concerning internal controls, and any significant changes in internal control since the most recent financial statement audit or review of interim financial information;\(^\text{277}\)

- Read the minutes of meetings of stockholders, the board of directors, and committees of the board of directors to identify actions that may affect the interim financial information;\(^\text{278}\)

- Performed analytical procedures on interim financial information to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual;\(^\text{279}\)


\(^{278}\) See PWC 018671 (Work Paper "Read the minutes" 7310 – Interim review – first quarter); PWC 018863 (Work Paper "Read the minutes" 7320 – Interim review – second quarter); PWC 019215-16 (Work Paper "Read client documents" 7500 Initial Quarter Interim review); PWC 006124-25 (Work Paper "Read client documents" 7600 1st Quarter Interim Review – recurring reviews).


96
• Read the interim financial information to consider whether, on the basis of information coming to PwC’s attention, the information to be reported conforms with generally accepted accounting principles;\textsuperscript{280}

• Inquired of officers and other executives having responsibility for financial and accounting matters concerning (1) whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied; (2) changes in the entity’s accounting practices; (3) changes in the entity’s business activities; (4) matters about which questions have arisen in the course of applying the foregoing procedures; and (5) events subsequent to the date of the interim financial information that would have a material effect on the presentation of such information;\textsuperscript{281} and

• Obtained written representations from management concerning its responsibility for the financial information, completeness of minutes, subsequent events, and other matters about which PwC believes written representations are appropriate in the circumstances.\textsuperscript{282}

It is my opinion that PwC’s interim review procedures complied with the professional guidance, including SAS No. 71 and AU Section 722. I disagree with Mr. Regan’s assertion that PwC’s interim review procedures were inadequate and have addressed his criticisms of specific areas in which PwC allegedly failed to comply with professional guidance below.

C. Capital Corporation.

Mr. Regan makes the following criticisms with respect to PwC’s interim reviews relating to Capital Corporation’s interim financial information:

\textsuperscript{280} See PWC 018716-17 (Work Paper “Read the interim financial information” 7310 – Interim review – first quarter); PWC 018910-11 (Work Paper “Read the interim financial information” 7320 – Interim review – second quarter); PWC 019232-33 (Work Paper “Read the interim financial information” 7500 – Initial Quarter Interim review); PWC 006167-68 (Work Paper “Read the interim financial information” 7600 – 1st Quarter Interim Review – recurring reviews).

\textsuperscript{281} See, PWC 019219-21 (Work Paper “Perform general inquiries and consider extended procedures” 7500 – Initial Quarter interim review); PWC 019222-25 (Work Paper “Perform specific inquiries about potential significant and complex accounting matters” – 7500 – Initial Quarter Interim review); PWC 019236-37 (Work Paper “Perform subsequent events procedures” – 7500 – Initial Quarter Interim review).

\textsuperscript{282} See PWC 015139 (Dec. 14, 1999 letter from Cisco to PwC re review of interim financial statements); PWC 015587 (Mar. 13, 2000 letter from Cisco to PwC re review of interim financial statements); PWC 016253-54 (June 13, 2000 letter from Cisco to PwC re review of interim financial statements); PWC 000894-95 (Dec. 11, 2000 letter from Cisco to PwC re review of interim financial statements).
• "[PwC] failed to apply sufficient audit procedures in the 1999 audit, and, as a result, did not possess the level of knowledge contemplated by SAS No. 71." For this same reason, Mr. Regan contends that PwC's review of the first quarter of FY 2001 was deficient.

• PwC did not modify its review procedures after receiving the March 2000 internal audit report concerning CSC.

I disagree with Mr. Regan's conclusions for the following reasons. First, Mr. Regan does not contend that the reserve for sales-type lease receivables included in Capital Corporation's FY 1999 consolidated financial statements is understated. A contention that the auditing procedures applied to this area nonetheless were deficient is disingenuous.

Second, the only fiscal year 1999 audit procedure criticized by Mr. Regan is PwC's purported failure to comply with AU Section 342 in assessing the reasonableness of Cisco Capital's lease reserves. Mr. Regan assumes that PwC used the same procedures in the fiscal year 1999 audit that he found inadequate with regard to fiscal year 2000. As described above in Section VIII.G.1, I found that PwC did perform adequate procedures with regard to the lease reserves and loans in fiscal year 2000.

Third, I discussed the significance of the "Cisco Capital Process Review" report, prepared by Cisco's internal audit group in March 2000, to Cisco's accounting for lease reserves and loans in Section VIII.G.1.a above. In summary, the internal audit report does not identify material weaknesses in the internal accounting controls over the lease or loan portfolio or the reserves provided against these portfolios. Rather, it points out certain deficiencies in CSC's operating policies and procedures that needed to be improved in light of the growth this entity experienced in FY 2000 and the additional growth anticipated in the future.

Nonetheless, the PwC Senior Manager, Mike Jerome, forwarded the report to the auditing team and advised that they should "review and ensure we assess as part of our audit" of Capital Corporation. Given that PwC was not using a high controls

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283 Regan Report at 50-51.
284 Regan Report at 52.
285 Regan Report at 49.
286 I do not discuss Mr. Regan's comments concerning PwC's interim reviews with respect to lease guarantees because the SEC pronouncement did not occur until the second quarter of FY 2000. Moreover, with respect to Cisco's Q1 01 interim financial statements, Capital Corporation changed its accounting for lease guarantees in that quarter to be consistent with the SEC pronouncement, and Mr. Regan's calculation of the difference between his approach and Cisco Capital's is only ($1.3) million pre-tax and ($0.9) million after tax, an amount that is clearly immaterial.
reliance audit approach in this area, the report’s findings did not require PwC to
modify its scope.

D. Returns Reserve.

Mr. Regan criticizes PwC’s interim reviews with respect to product return
reserves on the erroneous ground that although PwC was aware that Cisco was
required to establish a reserve for product returns under FAS 48, it failed to
investigate the matter and determine that Cisco did not have an adequate reserve
for returns.288

Mr. Regan’s analysis is based on two faulty premises; namely that PwC was
not aware of how Cisco reserved for future product returns and also that the reserve
provided by Cisco was insufficient to comply with FAS 48. I discuss and dismiss the
first faulty premise in Section VIII.G.2.a above (addressing PwC’s auditing
procedures regarding the returns reserve). I discuss, analyze and dismiss the
second faulty premise in Section VIII.G.2.b (addressing financial accounting
issues regarding the returns reserve).

In my review of the work performed by PwC in its reviews of Cisco’s first
three fiscal quarters in FY 2000 and in the first fiscal quarter of FY 2001, I found
that PwC gave appropriate consideration to this area because:

- the prior audits had shown that the recorded balances were providing
  adequate reserves for expected future product returns from non-two tier
  sales along with other necessary accounts receivable reserves;289

- relevant accounting policies and practices had not changed;290

- sales returns and allowances were consistent with expectations;291 and

- analytical review procedures disclosed no important changes in trends
  and account relationships requiring additional evaluation.292

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288 Regan Report at 74.
289 See PWC 025457-62.
290 See, e.g., PWC 017323-27 at 17325 (Work Paper “A/R Reserves Memo” 3200 – Accounts
  receivable (re FY 2000)) (“PwC notes that the methodology and percentages are consistent with prior
  year ....”).
291 See, e.g., PWC 056326-28 (Work Paper “Inquire about receivables procedures” 7600 – 1st
  Quarter Interim Review – recurring reviews) (finding that sales returns and allowances are
  consistent with expectations).
292 See, e.g., PWC 019076-78 (Work Paper “Accounts Receivable Analysis” 7500 – Initial
  Quarter Interim review (re Q3 FY 2000)) (no significant changes in A/R between Q2 ’00 and Q3 ’00
  and overall A/R aging appears healthy); PWC 006204-06 (Work Paper “AR Reserves Meeting” 7600 –
  1st Quarter Interim Review) (“RMA Reserves increased by $12.1M or 19% from $86M or $77M, which
  is attributable to increased overall sales (13% increase from prior quarter.).”); PWC 017298-99 at

(Footnote continued)
Accordingly I find PwC's review procedures for product return reserves from non-two-tier sales were both adequate and appropriate in the circumstances.

E. Inventory and Related Allowance for Excess and Obsolete Inventory.

Based on my review of PwC's quarterly workpapers, PwC performed appropriate analytical procedures and made appropriate inquiries of management relating to inventory and the related allowance for excess and obsolete inventory in compliance with SAS 71 for the quarters of FY 2000 and Q1 of FY 2001.

- PwC performed an inventory variance analysis which not only considered quarter over quarter changes in the components of the inventory but also the associated reserves and accruals and inquired of management regarding such changes. PwC noted that the largest inventory increase was in raw materials and that Cisco explained such increases based on its efforts to combat supply constraints and lead time problems;\(^\text{295}\)

- PwC attended the quarterly close and reserve meetings and participated in discussions regarding inventory and reserve balances;\(^\text{294}\)

- PwC prepared a reserve analysis, confirming that Cisco used a consistent approach in setting the excess and obsolete reserve and noting that there was no unreasonable or suspicious change in the reserve from Q1 00 to Q2 01;\(^\text{295}\) and

- PwC analysed the increase in inventory balances and the effect of overhead absorption on gross margin.\(^\text{296}\)

Unlike Mr. Regan, I conclude that based on the procedures performed in connection with the FY 2000 audit, PwC had sufficient knowledge of internal controls relating to inventory and the reserve process that it could conduct an adequate interim review.

\(^{017299}\) (Work Paper "A/R Lead Schedule - P8" 3200 Accounts receivable (re FY 2000)) (noting that increase of 21% in Reserve for Customer Returns (a/c 11530 “is primarily due to an increase in RMA’s which “relates to the increase in sales activity.”); PWC 17333 (Work Paper “Consider changes in internal control and inherent risks since the early testing date” 3200 – Accounts receivable) (“PwC notes that there had been no significant changes [in internal controls or inherent risks] since interim work was performed”).

\(^{293}\) PWC 006216-19 (Work Paper “Inventory Variance and Analysis”).

\(^{294}\) PWC 006227-28 (Work Paper “Inventory - Reserve Meeting Summary & Manufacturing Finance Reporting”).

\(^{295}\) PWC 006222-24 (Workpaper “Inventory - Reserve Analysis”).

\(^{296}\) PWC 006226-26 (Workpaper “Inventory Consolidated Gross Margin – Overhead Absorption”).

100
In criticizing PwC’s interim review procedures in connection with inventory reserves, Mr. Regan again makes the false assertion that the allowance for excess inventory would be expected to rise in direct proportion to any increase in inventory and suggests that PwC neither noted that the reserve percentage had decreased from the prior quarter or inquired of management as to the reason for that decrease.\footnote{297 Regan Report at 116-17.} As discussed above, PwC’s workpapers reflect that PwC did inquire of management regarding the reasons for the substantial increase in inventory. Moreover, PwC attended the monthly and quarterly reserve meetings where Cisco management discussed the amount of inventory and reserves. PwC also obtained and reviewed the monthly Black Books which contained company-prepared documents depicting the reserve percentages, and would have shown the change in such percentages from Q4 00 and Q1 01.

Mr. Regan contends that since PwC’s workpapers do not memorialize any inquiries noting the decrease in turns, that PwC did not consider the fact that Cisco’s turns decreased from 7.8 to 6.1 in Q1 01.\footnote{298 Regan Report at 117.} However, as noted above, PwC received copies of Cisco’s Black Book which reported inventory turns. As also explained above, PwC inquired of management regarding the increase in inventory and was told that Cisco deliberately built up raw materials and other inventory which also would explain the decreased turns.

F. Revenue Transactions.

PwC also performed inquiry and analytical procedures regarding revenue recognition in its interim reviews in FY 2000 and Q1 of FY 2001 as required by SAS 71. In addition in each quarter it performed tests of non-standard revenue transactions to ascertain that Cisco’s recognition of revenue from non-standard revenue transactions was consistent with its policies and procedures which PwC had previously determined were in accordance with GAAP.

Mr. Regan’s report acknowledges that in each interim period PwC tested revenue recognition on non-standard transactions and reviewed a Cisco prepared schedule that itemized revenue recognized during the interim period from “transactions involving Futures/Upgrades, Customer Acceptance, Staging, and other contingencies requiring revenue to be deferred.”\footnote{299 Regan Report at 91.}\footnote{300 Ibid.} Such procedures for interim reviews were more extensive than required by the professional standards.

Mr. Regan contends, however, that “PwC failed to conduct appropriate procedures to ensure that sufficient competent evidential matter to support Cisco’s assertion that requirements for revenue recognition in accordance with GAAP had been met.”\footnote{300 Ibid.} This contention inappropriately applies the requirements from an
auditing standard as if they were part of SOP 97-2, the revenue recognition standard followed by Cisco. That auditing standard is not encompassed within SOP 97-2 and Mr. Regan's criticism is incorrect.

Mr. Regan also contends that because PwC's audit of Cisco's Fiscal 2000 financial statements was deficient, it lacked the requisite knowledge of the Company to perform an adequate interim review of Q1 01 financial information in accordance with SAS 71.\textsuperscript{301} Since I disagree with Mr. Regan's assertion and conclude that PwC's audit of Cisco's FY 2000 financial statements complied with GAAS, I further conclude that PwC had an appropriate basis to perform its interim review of Q1 01.

In sum, I conclude that PwC's interim review procedures for the first three quarters of FY 2000 and the first quarter of FY 2001 complied with the applicable professional standards and reject Mr. Regan's criticisms of the alleged shortcomings in PwC's review procedures with respect to the areas set forth above.

\textsuperscript{301} See, e.g., Regan Report at 125.
Dated: San Francisco, California
November 30, 2005

Clifford Pike

Clifford Pike
Appendix A – Resume
Resumé of Clifford Pike

Ernst & Young LLP


Assurance and Advisory Business Services partner 1979 - 2002
  • Partner in-charge of Orange County audit and assurance practice 1984-1989

Accounting, auditing and SEC reporting technical partner for Ernst & Young's Southern California Area (Costa Mesa, Irvine, Newport Beach, San Diego, and Riverside offices)
  • Participated in over 100 registration statements, many of which were IPOs
  • Extensive experience in dealing with the staff of the SEC
  • Extensive experience with financial reporting by venture capital financed, merchant bank financed, small cap, and NASDAQ companies
  • Presenter at firm sponsored seminars for clients and others
  • Instructor at firm in-house training programs

Member of firm's Technology / Communications / Entertainment industry practice group
  Extensive experience with unique financial accounting and reporting, auditing, SEC and business issues in the biotech, computer, electronics, internet, medical products, semiconductor and software industries

Firm subject matter specialist in merger and acquisition transactions
  • Representative commercial clients:
    • Broadcom Corporation - 25 acquisitions in a two year period
    • EPS Solutions Corporation - roll-up of 42 entities
    • Rental Services Corporation - 15 acquisitions in a four year period

  • Representative merchant banking and venture capital clients:
    • Freeman Spogli & Co.
    • Kelso & Co.
    • Stonecreek Capital

Expert witness
  • Engaged by counsel for defendants in accounting malpractice and commercial damage claims
  • Testified concerning application of generally accepted accounting principles and generally accepted auditing standards in state and federal litigation as well as in alternative dispute resolution proceedings
  • Representative case: Expert witness for PricewaterhouseCoopers LLP in Micro Enhancements International, Inc. vs. Coopers & Lybrand L.L.P. litigation

Supervised numerous financial statement fraud investigations
  Representative engagements:
    • E Corporation – Expense recognition / failure to provide appropriate level of allowance for doubtful accounts against trade accounts receivables
    • L Inc. – Revenue recognition / concealed product return rights
    • L Video – Intellectual property theft / management led unauthorized duplication and theft
Resumé of Clifford Pike

- of videotape entertainment products. Engagement identified theft, quantified loss, and searched for personal assets of management to recover proceeds from lost sales
- P Inc. – Revenue recognition / shipping cutoff falsification
- P Corporation – Revenue recognition / failure to comply with software revenue recognition standards and concealment
- P Systems, Inc. – Revenue recognition / recording of invoices without receipt of customer order and shipments of products to third-party warehouse in furtherance of fraud
- FS Inc. – Revenue recognition / failure to comply with software revenue recognition standards and recording sales without orders
- T International, Inc. – $35 million cash misappropriation and concealment by officer who served as EVP and CFO

Other Business Experience

Clifford Pike, CPA (after retirement from Ernst & Young)
- Sole practitioner
- Anti-fraud, corporate governance, and financial accounting, consulting with corporations and public accounting firms
- Expert witness
  - Engaged by counsel for defendants in accounting malpractice claims
  - Testified concerning application of generally accepted accounting principles and generally accepted auditing standards in federal litigation
  - Representative case: Expert witness for PricewaterhouseCoopers LLP in securities litigation matters involving Homestore.com

Irvine Sensors Corporation (NASDAQ Small Cap)
- Board of Directors – March 2003 to present
- Chairman of the Audit Committee – March 2003 to present

Professional Credentials

Certified Public Accountant – licensed in California
- Member American Institute of Certified Public Accountants
- Member California Society of Certified Public Accountants
  - President of Orange County Chapter 1984-1985
  - Member of CSCPA Board of Directors 1984-1987
  - Member CSCPA Accounting Principles and Auditing Standards Committee 1979-1982

Association of Certified Fraud Examiners – Associate Member

Education

University of California, Los Angeles
- Bachelor of Science – Business Administration (concentration in accounting) – 1965
- Master of Business Administration (concentration in finance) – 1966

Military Service

U. S. Naval Air Reserve – 1960–1965; eighteen months active duty service; S2F anti-submarine aircraft crewman and aviation electronics technician (E-5)
Appendix B -- Description of Evidence
In Re: Cisco Systems Inc. Securities Litigation

Documents Considered in Forming Opinions by Cliff Pike

<table>
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<th>Hardcopy and Electronic Source Documents</th>
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<td>Expert Report of D. Paul Regan and documents cited therein</td>
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<td>Bloomberg and Factiva data</td>
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<th>Deposition Transcripts and exhibits</th>
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<td>Bartz, Carol</td>
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<td>Brinkman, Darrell</td>
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Analytical Test of Adequacy of Reserve for Future Product Returns

(amounts in thousands of dollars)

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<tr>
<th>Quarter Ended</th>
<th>5% of Cisco's Net Sales</th>
<th>Less in Quarter RMAs at 29.5%</th>
<th>Net Future Product Returns</th>
<th>Less RMAs Not Closed at 10%</th>
<th>Less Warranty at 10%</th>
<th>Less Returned Inventory at 28%</th>
<th>Less Reserve RMAs Issued in Quarter at 20.3%</th>
<th>Required Reserve at Quarter-End</th>
<th>Necessary Quarterly Change in Reserve</th>
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<th>Necessary Quarterly Change in Reserve</th>
<th>Calculated AR R&amp;A Reserve</th>
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</tr>
<tr>
<td>Jan FY00</td>
<td>4,950</td>
<td>46,464</td>
<td>3,345</td>
<td>(1,605)</td>
</tr>
<tr>
<td>Apr FY 00</td>
<td>6,525</td>
<td>47,739</td>
<td>638</td>
<td>(5,888)</td>
</tr>
<tr>
<td>Jul FY00</td>
<td>8,775</td>
<td>67,011</td>
<td>9,636</td>
<td>861</td>
</tr>
<tr>
<td></td>
<td>24,300</td>
<td>17,928</td>
<td>(6,373)</td>
<td></td>
</tr>
<tr>
<td>Oct FY01</td>
<td>9,000</td>
<td>90,651</td>
<td>11,820</td>
<td>2,820</td>
</tr>
</tbody>
</table>

Prepared in connection with litigation
Exhibit X
WORLDWIDE FINANCIAL POLICIES AND PROCEDURES

Approved by: | Effective Date: | Policy Number:
---|---|---
Dennis Powell | October 1999 | 0015

SUBJECT: Revenue Related Reserves & Deferrals
Revision Date: | Revision Number:

CISCO SYSTEMS CONFIDENTIAL FOR INTERNAL USE ONLY

Revenue Related Reserves & Deferrals

I. Purpose

The purpose of the Revenue Related Reserves & Deferrals Policy ("the Policy") is as follows:

- Provide guidelines to identify, establish and maintain all Cisco Systems, Inc. revenue related reserves and deferrals in accordance with US generally accepted accounting principles.
- Define Cisco Systems, Inc. revenue related reserves and deferral accounts and identify the appropriate general ledger account number.
- Ensure all revenue related reserves and deferrals are consistently applied worldwide.

II. Scope

The Policy applies to all worldwide operating units of Cisco Systems, Inc. The Director, Corporate Finance and Accounting should approve, in advance, any variation from the Policy.

III. Owner

Corporate Accounting is responsible for coordinating with Worldwide Financial Services, Worldwide Sales Financial, Customer Advocacy, and the Buy/Sell Entities (Australia, BY, Canada, and Japan) to establish and update the Policy. The Corporate Accounting Group is also responsible for determining whether exceptions to the Policy are acceptable and answering all questions regarding the Policy.

IV. General Accounting Entries

4.1 Income Statement Effect

All revenue related reserves and deferrals should be charged against the suitable product, service, or other revenue account to appropriately reflect the Company's revenues in the income statement.

4.2 Balance Sheet Effect

The offsetting entry should be charged against either an accounts receivable reserve account (asset valuation) or a deferred revenue liability account (obligation) as described below.
V. Accounts Receivable Reserves

The accounts receivables reserves should be established to reflect the fair value of the Company's accounts receivables at a specified point in time. Accounts receivable reserves should reflect the Company's exposure to collect on outstanding accounts receivables and/or to recognize revenue. The following details specific accounts receivable reserves accounts (note: the Cisco group(s) identified in the brackets below the reserve title indicate the responsible party for establishing and booking the described reserve):

5.1 Bad Debt Reserve
(Worldwide Financial Services and Buy/Sell Entities)

Description
The Bad Debt Reserve should be established as an estimate for a specific customer accounts receivable balance as soon as collection is no longer considered probable (likely to occur) and the amount deemed uncollectable is estimable.

Method
Refer to the "Credit Risk Management and Collections Policy" under "Reserves and Write-Off" for the specific methods to determine an uncollectable account and the criteria to be met before credit adjustments and/or write offs are made to release the bad debt expense reserve.

5.2 Lease Receivables Reserve
(Worldwide Financial Services Only)

Description
The Lease Receivables Reserve should be established to cover exposures in regards to Cisco Systems Capital Corporation lease receivables.

Method
Refer to the "Credit Risk Management and Collections Policy" under "Lease Receivables Reserve" for the specific methods to determine the reserve.

5.3 Returns & Allowances Reserve
(Corporate Accounting and Buy/Sell Entities)

The Returns & Allowances Reserve is comprised of two categories:

5.3.1 General Reserve
(Corporate Accounting and Buy/Sell Entities)

Description
The General Reserve should be established as an estimate for unidentified trade accounts receivable exposure at a point in time.

Method
The General Reserve is determined by multiplying an estimated uncollectable percentage (as determined by the Corporate Accounting Group) by gross aged accounts receivable as follows:
<table>
<thead>
<tr>
<th>Gross Aged Accounts Receivable</th>
<th>Estimated Reserve Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>1%</td>
</tr>
<tr>
<td>1-30 days past due</td>
<td>2%</td>
</tr>
<tr>
<td>31-60 days past due</td>
<td>4%</td>
</tr>
<tr>
<td>&gt; 60 days past due</td>
<td>10%</td>
</tr>
</tbody>
</table>

The adequacy of the estimated reserve rate is determined based on review of historical account experience. The rate should be evaluated quarterly to assess the accuracy and adequacy of the estimate.

5.3.2 Returns Reserve
(Corporate Accounting and Buy/Sell Entities)

Description
The Returns Reserve should be established as an estimate for all approved and open products returned to Cisco Systems, Inc. for credit. These product returns may be caused by order error, shipping error, shipping damage, canceled order, trade-in, visual defect, or other similar reasons.

Method
All approved and open returns (excluding distributor stock rotation returns) eligible for credit should be 100% reserved.

5.4 Two-Tier Distributor Reserves
(Worldwide Sales Finance and Buy/Sell Entities)

The Two-Tier Distributor Reserves should be established as an estimate for sales to stocking distributors where exposure may exist regarding revenue recognition and/or the fair value of an accounts receivable balance. It is the Company’s policy to recognize all worldwide two-tier sales only on a sale-through basis to ensure channel exposures are minimized. Two-Tier Distributor Reserves are comprised of the following accounts:

5.4.1 Stock Rotation Reserve
(Worldwide Sales Finance and Buy/Sell Entities)

The Stock Rotation Reserve should be established as an estimate to cover contractual liabilities with stocking distributors for return of products within a specified timeframe and in accordance with predetermined conditions. The Stock Rotation Reserve is comprised of two categories:

5.4.1.1 Stock Rotation General Reserve
(Worldwide Sales Finance and Buy/Sell Entities)

Description
Under certain contractual arrangements, stocking distributors have the right to return up to 10% of their net shipments purchased from Cisco Systems, Inc. during the prior fiscal quarter. Under this arrangement any stock returns requested by the distributor must include a purchase order equal to greater than the shipments returned and must be requested by the 21st calendar day of the first month of each fiscal quarter. The Stock Rotation General Reserve should be established as an estimate to cover these stock rotation exposures.
Method

The Stock Rotation General Reserve is determined by multiplying the current months gross shipments during a fiscal quarter by an estimated reserve rate (approved by Worldwide Sales Finance Group and the Corporate Accounting Group) as follows:

<table>
<thead>
<tr>
<th>Entity</th>
<th>Contractual Rate</th>
<th>Estimated Returns Rate</th>
<th>Estimated Reserve Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>10% X</td>
<td>65% = 6.5%</td>
<td></td>
</tr>
<tr>
<td>BV Buy/Sell Subs</td>
<td>10% X</td>
<td>85% = 8.5%</td>
<td></td>
</tr>
<tr>
<td>CAN Buy/Sell Subs</td>
<td>10% X</td>
<td>85% = 8.5%</td>
<td></td>
</tr>
<tr>
<td>AUS Buy/Sell Subs</td>
<td>10% X</td>
<td>85% = 8.5%</td>
<td></td>
</tr>
<tr>
<td>Japan Buy/Sell Subs</td>
<td>-- X</td>
<td>-- = --</td>
<td></td>
</tr>
</tbody>
</table>

The Stock Rotation General Reserve estimated during the fiscal quarter is released after the 21st day of the first month (upon determination of all approved and open stock rotation returns from the distributors) of each subsequent fiscal quarter and tweaked up to equal approved and open stock rotation returns.

The estimated reserve rate is determined based on review of historical stock rotation returns. The rate should be evaluated quarterly to assess the accuracy and adequacy of the estimate.

5.4.1.2 Stock Rotation Returns Reserve
(Worldwide Sales Finance and Buy/Sell Entities)

Description

In accordance with the distributor stock rotation agreement as described above, the Stock Rotation Specific Reserve should be established as an estimate for all open and authorized distributor stock rotation returns for credit.

Method

All approved and open stock rotation returns eligible for credit should be 100% reserved. State authorizations (beyond 180 days old) should be closed.

5.4.2 Obsolete Product Reserve
(Worldwide Sales Finance and Buy/Sell Entities)

Description

The Obsolete Product Reserve should be established as an estimate to cover contractual exposures with stocking distributors for inventory obsolescence in accordance with predetermined conditions. Contractually, distributors have 30 days from the product obsolescence announcement date to make a claim.

Method

The Corporate Pricing Group will announce product obsolescence or de-listing from the price list. Upon announcement, the Obsolete Product Reserve estimate should be determined based on the obsolete products on hand at the distributor multiplied by the current wholesale price list in order to cover 100% of the exposure. The Obsolete Product Reserve should be released after 90 days from the product obsolescence announcement date.
5.4.3 Price Protection Reserve
(Worldwide Sales Finance and Buy/Sell Entities)

Description
The Price Protection Reserve should be established as an estimate to cover contractual exposures with stocking distributors for subsequent price list reductions affecting inventory on hand at the distributor in accordance with predetermined conditions. Contractually, distributors have 30 days from the price reduction announcement date to make a claim.

Method
The Corporate Pricing Group will announce price reductions from the price list. Upon announcement, the Price Protection Reserve estimate should be determined based on the price-reduced products on hand at the distributor multiplied by the price reduction (i.e. old wholesale price list minus new wholesale price list) in order to cover 100% of the exposure. The Price Protection Reserve should be released after 90 days from the price reduction announcement date.

5.4.4 Promotions Reserve
(Worldwide Sales Finance and Buy/Sell Entities)

Description
The Promotions Reserve should be established as an estimate to cover specific Company initiatives and promotions. Generally, promotions will be undertaken to incent sales of product through the channel in accordance with predetermined conditions. Distributors typically have 30 days from the end of the program to claim the promotional back-end rebate.

Method
Upon announcement of a formal distributor product promotion, the Promotions Reserve should be established based on actual POS (Point of Sale) Reports from the distributor in order to cover 100% of the exposure. The promotional product should be identified from the POS Report and multiplied by the defined back end rebate to establish the reserve. The Promotions Reserve should be released after 90 days from the end of the program.

5.4.5 Sell-Through Reserve
(Worldwide Sales Finance Only)

Description
The Sell-Through Reserve should be established as an estimate to cover worldwide inventory in the channel that has not sold through to the distributor’s customer. Please refer to the Company’s “Revenue Recognition Policy” under “Sales to Two-Tier Distributors”.

Method
The Sell-Through Reserve estimate is determined based on historical two-tier distributor sell through information tracked by the Corporate Channel Finance Group. The Sell-Through Reserve is determined as follows:
5.4.6 Distributor Corporate Reserve
(Corporate Accounting Only)

**Description**
The Distributor Corporate Reserve should be established as an estimate to cover worldwide distributor sell-through exposures, beyond those identified by the Sell-Through Reserve, in order to conservatively and accurately state the Company's consolidated financial statements in accordance with U.S. GAAP and the Company's revenue recognition policy.

**Method**
The Distributor Corporate Reserve estimate is determined based on review of the Sell-Through Reserve and additional exposures such as a major distributor bankruptcy or a catastrophic event. The Distributor Corporate Reserve is determined as follows:

<table>
<thead>
<tr>
<th>Current month distributor sales</th>
<th>Estimated Reserve Rate</th>
<th>Revenue Recognized Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior month distributor sales</td>
<td>75%</td>
<td>25%</td>
</tr>
</tbody>
</table>

The estimated reserve rate should be evaluated quarterly to assess the accuracy and adequacy of the estimate.

VI. Deferred Revenue Liability
(Corporate Accounting and Buy/Sell Railities)

**Description**
Deferred Revenue Liability should be established as an estimate to cover any sales made to a customer where significant contingencies and/or acceptance issues exist as defined in the Company's "Revenue Recognition Policy" under "Recognition Criteria". Deferred Revenue should be classified as a liability (obligation) to the Company until all significant sales contingencies and/or acceptance issues have been met.

**Method**
Deferred Revenue Liability should be communicated to the Revenue Recognition Committee ("the Committee"). The Committee is the final decision point for questions on revenue recognition and is responsible for tracking deferred revenue liability issues worldwide. The Corporate Controller heads the Committee. Please refer to the "Revenue Recognition Policy" under "Responsibilities".

CISCO SYSTEMS CONFIDENTIAL
VII. Other Revenue Related Reserves and Deferrals

Other reserves should be established as an estimate for any specific event or transaction that is considered probable (likely to occur), questions the appropriateness of revenue recognition or the valuation of an accounts receivable balance, and the amount is estimable. The Director, Finance and Accounting should approve other revenue related reserves and deferrals in advance.

VIII. Revenue Related Reserves and Deferrals – Conforming GL Accounts
(All U.S. Corporate and Buy/Sell Entities)

The following are the specific GL balance sheet accounts used to establish revenue related reserves and deferrals and the corresponding GL revenue account. In order for effective worldwide review, these accounts should be used without exception:

<table>
<thead>
<tr>
<th>Description</th>
<th>GL Balance Sheet Account</th>
<th>GL Revenue Account (U.S. Entities)</th>
<th>GL Revenue Account (Non-U.S. Entities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable Reserves</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad Debt Reserve</td>
<td>11520</td>
<td>40109</td>
<td>40109</td>
</tr>
<tr>
<td>Returns &amp; Allowance Reserve (General &amp; Returns)</td>
<td>11530</td>
<td>40109</td>
<td>40109</td>
</tr>
<tr>
<td>Lease Receivable Reserve</td>
<td>11535</td>
<td>40109</td>
<td>N/A</td>
</tr>
<tr>
<td>Distributor Stock Rotation Reserve (General &amp; Returns)</td>
<td>11596</td>
<td>40104</td>
<td>40104</td>
</tr>
<tr>
<td>Distributor Obsolete Product Reserve</td>
<td>11597</td>
<td>40104</td>
<td>40104</td>
</tr>
<tr>
<td>Distributor Price Protection Reserve</td>
<td>11598</td>
<td>40104</td>
<td>40104</td>
</tr>
<tr>
<td>Distributor Promotions Reserve</td>
<td>11599</td>
<td>40104</td>
<td>40104</td>
</tr>
<tr>
<td>Distributor Sell-Through Reserve</td>
<td>11595</td>
<td>40104</td>
<td>N/A</td>
</tr>
<tr>
<td>Distributor Corporate Reserve</td>
<td>11555</td>
<td>40104</td>
<td>N/A</td>
</tr>
<tr>
<td>Other Accounts Receivable Reserve*</td>
<td>115xx</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Deferred Revenue Liability</td>
<td>27007</td>
<td>40109</td>
<td>40109</td>
</tr>
</tbody>
</table>

* Other Accounts Receivable Reserves GL accounts must be approved in advance by the Director, Corporate Finance and Accounting.
In re CISCO SYSTEMS, INC.

SECURITIES LITIGATION

-------------------------/

This Document Relates To:

ALL ACTIONS.

-------------------------/

CONFIDENTIAL

FRCP 30(b)(6) DEPOSITION OF

CISCO SYSTEMS, INC.,

THROUGH

JAMES McKENZIE MacCALLUM

Tuesday, August 26, 2003
covenant, then they would have to -- when they submit
their financials, they would -- they would say, "We are
in violation of this covenant." So that's one form of
documentation.

Did Cisco keep something? I am not sure.

Q And you said that the structured finance person
would generally communicate with the loan administration
person in event of a breach?

A Correct.

Q And was there -- was that done in a written
form, or was it oral?

A I am not sure.

Q Okay. All right.

All right. I would like to talk for a minute
about a situation where the customer doesn't comply with
the terms of the loan, doesn't make the payments, what
have you.

In a situation like that, did Cisco ever
actually reclaim the collateral?

MR. KRISTY: I am going to object to the form
of the question and also on the scope of it. I mean, we
have been listening to these hypothetical questions --
and I know where you are going, because you want to
understand the general processes. And that's what he's
here to testify about, and that's fine.
But when we get into specific situations or specific customers, that's not subject to the notice. And I am not even sure that this is the right witness for knowing what Cisco would do or not do.

So with those caveats in mind, you can ask some of these, but I don't want to kind of go endlessly along these lines.

What he's trying to give you a sense of is kind of the paper trail, lack of a better term. And he may -- you know, there's a million reasons why people -- the covenants are different, million reasons why people may pay. They may all be worked out in different ways. And he is not purporting to be expert on that stuff.

MR. MONTGOMERY: I'm working --

MR. KRISTY: I understand, I understand --

MR. MONTGOMERY: -- out a procedure for, you know, a breach. So...

MR. KRISTY: All I am saying is that there may not necessarily be a procedure. Because it depends on the customer, the loan, the problem, and like any bank, they will handle those things in a variety of ways.

But to the extent paper gets generated about this, you know, hopefully he can tell you about that.

MR. MONTGOMERY: Well, let's find out.

THE WITNESS: Can you repeat the question,
please.

BY MR. MONTGOMERY:

Q What was the procedure at Cisco Capital with regard to collateral when a customer was in breach of a loan?

A Generally we would have the opportunity to reclaim that equipment.

Q And how would you do that?

A How would we reclaim it?

Q Mm-hmm.

A We would go to the customer's site and take away their equipment.

Q Like a Cisco employee would just show up with a truck and pick it up?

MR. KRISTY: Object to the form of the question.

If you have any basis for knowing how Cisco actually administers a particular loan, you can answer; but otherwise, it's not what you have been designated to testify about.

THE WITNESS: Okay. I am not aware.

BY MR. MONTGOMERY:

Q When you say you are not aware, do you mean you are not aware of how Cisco would go about as a procedure to reobtain collateral on a loan in default? Is that
what you mean?
A Correct.
Q Do you know who at Cisco Capital was responsible for reclaiming collateral?
A No, I don't.
Q Was there a procedure in place once collateral was reacquired for dealing with that collateral?
A Um --
MR. KRISTY: Object to the form. I don't know what that means.
But you can answer if you understand it.
THE WITNESS: I mean, if it's -- we could resell it, refurbish it at that point.
BY MR. MONTGOMERY:
Q And was there anyone at Cisco Capital that was responsible for reselling or refurbishing collateral?
A There is a group called the remarketing group.
Q And were they part of Cisco Capital?
A Yeah. But they were formed after the class period.
Q Was there someone performing their -- the equivalent tasks before the group was formed?
A Not that I am aware of.
Q All right.
We talked earlier about the loan administration
REPORTER'S CERTIFICATE

I, ERIC GILLIAM, a Certified Shorthand
Reporter of the State of California, do hereby
 certify:

That the foregoing proceedings were
taken before me at the time and place herein set
forth; that any witnesses in the foregoing
proceedings, prior to testifying, were placed under
oath; that a verbatim record of the proceedings was
made by me using machine shorthand which was
thereafter transcribed under my direction; further,
that the foregoing is an accurate transcription
thereof.

I further certify that I am neither
financially interested in the action nor a relative
or employee of any attorney or any of the parties.

IN WITNESS WHEREOF, I have this date
subscribed my name.

Dated:  September 12, 2003

ERIC GILLIAM, CSR NO. 3338
Exhibit Y
UNited States District Court
Northern District of California
San Jose Division

---00o---

In re: Master File No.
CISCO SYSTEMS, INC., C-01-20418
SECURITIES LITIGATION JW(PVT)

This Document Relates to:
ALL ACTIONS.

Videotaped 30(B)(6) deposition of
CISCO SYSTEMS, INC., by MRINALINI INGRAM,
taken on behalf of Plaintiffs, at 100 Pine
Street, Suite 2600, San Francisco,
California, commencing at 9:37 a.m., Monday,
August 22, 2005, before Deirdre F. Cram,
C.S.R. 9339

eastwood-stein
deposition services & litigation support
550 West C Street, Suite 600
San Diego, CA 92101
619-235-2400
actually calculated on current accounts receivable to make sure that we have the appropriate amount of returns established.

In addition, we also have what we called open RMA reserves. So every reserve that was opened in Cisco and approved was also reserved for, 100 percent. In addition to that, we also had reserves for warranty, and we also had reserves for things like Cisco Capital and special deals. So if there was a particular contract where there was a specific right of return clause, we would reserve for that specifically in the special deals reserve.

Q. Were there any other reserves that Cisco maintained, between August '99 to March of 2001, for direct returns?

A. I can't remember the exact month that we actually created an additional returns reserve called a futures returns reserve. What happened in the third quarter of fiscal year '01, the economy significantly changed, and as part of our normal course of business of evaluating the sufficiency of our reserves, we noticed this increase, and we created a futures returns reserve to account for this.

We could have done it in a couple of ways.
We could have increased the percentage of the 1-2-4-10 in the general reserve, but after we went through the calculation to determine what that increase would be, we decided to actually maintain that calculation and create a reserve called the futures returns reserve.

Q. So prior to the time that you created that future returns reserve, was there a future returns reserve at Cisco?

A. Yes. It was part of the general reserve, the 1-2-4-10. It was ensuring that any reserves are associated with the accounts receivable at that time so we don't have any timing differences.

Q. So why did you say that you created a future returns reserve if one already existed?

MR. ROCKEY: Objection. Misstates her testimony.

THE WITNESS: Yeah. I think what I said was that we could have increased the percentage of the 1-2-4-10, but going through the calculation to determine what we would increase, we determined that that calculation was pretty good, and we decided to just maintain a separate reserve for that, instead of increasing the 1-2-4-10. We could have done it either way.
Q. So how was the return that was the
component of the general reserve calculated?
A. So, it wasn't calculated. Again, we
verified whether or not the 1-2-4-10 reserve was
sufficient to cover the returns activity. Between
that and the open RCA reserve, again, we also have
the two-tier reserves and the warranty reserves,
special deals reserving, et cetera. We make sure
that the adequacy of all of our returns was
sufficiently covered by all of those reserve
accounts.

Q. Was there a metric that was used to
evaluate the sufficiency?
A. Not a metric. We really look at
historical credit memo activity to ensure that, you
know, we didn't see any spikes happening in the
credit memo activity, then, actually, a good example
of that is when a spike did occur. That's when we
actually created that additional calculation to
increase the level of reserves.

Q. Who, specifically, was responsible for
calculating the returns reserve that we're discussing
right now?
A. Other than the names I just gave you?
Q. Yeah.
Q. The initial analysis performed by Jim McCallum used a six-month rolling average. Are you aware of that?

A. He had lots of stages of his evaluation before he came up with the right answer. So it depends on where in the stage you’re referring to.

Q. It’s true, isn’t it, that Cisco ultimately settled on a 12-month rolling average to calculate the future returns reserve? Isn’t that correct?

A. I don’t recall exactly, but I believe so. It will be in the close binders.

Q. Do you have any understanding as to why Cisco chose a 12-month rolling average over a six-month rolling average?

A. Twelve months is more conservative. When you look at the level of returns that come in, most of them do happen within six months, but there are still returns that can occur from that six month to 12-month period. So it’s a more conservative calculation to hold that out to 12 months instead of shortening it to six months.

Q. You testified earlier that Cisco experienced a spike of returns in January and February of ’01; is that correct?

A. I didn’t testify to that. I know there
Exhibit Z
In re:  
CISCO SYSTEMS, INC.,  
SECURITIES LITIGATION  

This document relates to:  
ALL ACTIONS.  

VIDEOTAPED DEPOSITION OF JAMES McKENZIE MacCALLUM  

Wednesday, August 10, 2005
A. Just looking at the timing, it looks like I sent it to him before he replied back, so I just was clarifying for him.

Q. And was it true that Cisco was not fully reserved for non-two-tier distributor sales returns?

A. Based on my original calculations that were drafted up in that memo it did look that way, but after further analysis we determined that we were okay.

MS. WEAVER: Okay. And I'll mark as Exhibit 1094 an email bearing Bates Number CIS-PPNPF-0595850.

(Deposition Exhibit Number 1094 was marked for identification)

BY MS. WEAVER:

Q. Is Exhibit 1094 an email that you sent to Mrinalini Ingram while you were at Cisco?

A. Yes, it is.

Q. And do you see that the middle email in Exhibit 1094 is yet another response to Phuc Tran and that's dated 12:44 p.m.?

A. Yes.

Q. And you wrote "Phuc, another addendum to my previous emails, we have the 1, 2, 4, 10 returns and allowance reserve which is partly set up to cover
return reserves. We are assessing the sufficiency of our reserves." Do you see that?

A. Yes.

Q. And what were you referring to in the 1, 2, 4, 10 returns?

A. That's that general reserve we discussed previously, so obviously this is -- I mean, I'm moving pretty fast.

It's a work in process. I've done my memo and I'm looking at the numbers.

Probably acted a little -- little prematurely in putting numbers in the memo and emailing Phuc without having finalized my analysis.

Q. And you forwarded this email to Mrinalini Ingram, is that correct?

A. Yes.

Q. And why?

A. I can't remember if I copied her on the other ones.

I think I had copied her and at least on 1093, so I probably just -- I maybe forgot to copy her on this one, yes, so keeping her in the loop.

MS. WEAVER: I'll mark as Exhibit 1095 a document bearing Bates numbers CIS-PPNPF-0125584.

(Deposition Exhibit Number 1095)
STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

I, Mary Hogan, CM, Certified Shorthand Reporter, do hereby certify:

That the witness in the foregoing deposition was by me duly sworn; that the deposition was then taken before me at the time and place herein set forth; that the testimony and proceedings were reported stenographically by me and later transcribed under my direction and supervision; that the foregoing is a true record of the testimony and proceedings.

In witness whereof, I hereunto set my hand and affixed my signature this 12th day of August, 2005.

Mary Hogan

MARY HOGAN, CM, CSR NO. 5386