

**UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF ILLINOIS  
EASTERN DIVISION**

LAWRENCE E. JAFFE PENSION PLAN, On )	Lead Case No. 02-C-5893
Behalf of Itself and All Others Similarly )	(Consolidated)
Situated, )	
	) <u>CLASS ACTION</u>
Plaintiff, )	
	) Judge Ronald A. Guzman
vs. )	Magistrate Judge Nan R. Nolan
	)
HOUSEHOLD INTERNATIONAL, INC., et )	
al., )	
	)
Defendants. )	
_____ )	

**DECLARATION OF KIRSTEN L. FLANAGAN, CPA IN SUPPORT OF THE CLASS'  
RESPONSE TO THE HOUSEHOLD DEFENDANTS' MEMORANDUM OF LAW IN  
SUPPORT OF THE RETURN OF CERTAIN ARTHUR ANDERSEN DOCUMENTS  
AND CROSS-MOTION TO COMPEL PRODUCTION OF CERTAIN DOCUMENTS  
PROVIDED TO OUTSIDE AUDITORS BY HOUSEHOLD DEFENDANTS**

I, Kirsten L. Flanagan, CPA, hereby declare and state as follows:

1. I am a Certified Public Accountant and a member of the American and Pennsylvania Institutes of Certified Public Accountants. I am a manager at the accounting firm of Shechtman Marks Devor PC (“SMD”), which offers accounting, tax and consulting services.

2. I previously worked at Ernst & Young LLP, a public accounting firm. My responsibilities included planning, organizing, administering and supervising all phases of audits of primarily public financial institutions and financial service organizations, as well as performing other financial engagements for clients in a variety of different industries.

3. At SMD, I have performed consulting work in relation to several lawsuits alleging federal securities laws violations, specifically relating to auditing, accounting or issues raised by the Securities and Exchange Commission (“SEC”) pertaining to some of the largest public companies in the world and their auditors. In connection with my performance of these services, I regularly review and analyze audit workpapers and SEC filings. Based on my combined experience, I am familiar with the contents of auditor workpapers and the manner in which auditors prepare such workpapers.

4. SMD has been retained by Class counsel in the above matter as a consultant regarding accounting, auditing and financial statement reporting issues.

5. I submit this Declaration in Support of the Class’ Response to the Household Defendants’ Memorandum of Law in Support of the Return of Certain Arthur Andersen Documents and Cross-Motion to Compel Production of Certain Documents Provided to Outside Auditors by Household Defendants. I understand that Household International, Inc. (“Household” or the “Company”) and Arthur Andersen LLP (“Andersen”) consider certain previously produced documents (the “Disputed Andersen Documents”) to be privileged and protected from disclosure. Prior to Andersen’s assertion of privilege, SMD had already reviewed and analyzed the Disputed

Andersen Documents. I understand that the Class is also moving to compel Household to produce certain other similar documents shared with the Company's outside auditors – Andersen and KPMG LLP – most of which, according to Household's privilege log, were prepared "in connection with audit of Household's financial statements" (the "Disputed Household Documents"). I have personal knowledge of the facts set forth below, and could and would competently testify to them if called upon to do so.

6. I have reviewed and am familiar with the following:

- Motion of Arthur Andersen LLP for Determination of the Court as to the Return of Privileged Documents Inadvertently Produced to Plaintiffs and to Set a Schedule for Further Briefing by the Parties
- Household Defendants' Memorandum of Law in Support of Arthur Andersen LLP's Motion for the Return of Inadvertently Produced Privileged Documents (or "Defs' Mem.")

#### **SUMMARY OF OPINIONS**

7. I have reviewed and analyzed the Disputed Andersen Documents. Based upon this review, and in light of my experience and familiarity with the application of Generally Accepted Accounting Principles ("GAAP") and the conduct of Generally Accepted Accounting Standards ("GAAS") examinations, it is my opinion that the Disputed Andersen Documents were obtained/prepared in the ordinary course of Andersen's audits and were an essential component underlying the auditors' ability to effectively analyze and evaluate whether the financial statements were prepared in accordance with GAAP. Further, it is my opinion that had Andersen not obtained the Disputed Andersen Documents grouped into Category One (*see* ¶36 *infra*), Andersen likely would not have obtained the sufficient competent evidential matter necessary to have issued an unqualified opinion as it did for fiscal years 1999, 2000, and 2001.

8. Given the descriptions provided by the Household Defendants in the privilege log, the Disputed Household Documents that are the subject of the cross-motion appear to be documents

substantially similar to the Disputed Andersen Documents prepared in the ordinary course of auditing or reviewing Household's financial statements.

## **FINANCIAL REPORTING**

### **Fundamental Accounting**

9. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practices at a particular time. SEC Regulation S-X states that financial statements (both annual and interim) filed with the SEC that are not prepared in compliance with GAAP are presumed to be misleading and inaccurate, despite footnote or other disclosure. 17 C.F.R. §§210.4 01(a)(1) and 210.10-1(a). Under GAAP, a basic objective of financial reporting is that useful information be provided to current and potential investors, creditors and other users in a manner comprehensible to those who have a reasonable understanding of business and economic activities. Financial Accounting Standards Board Statement of Financial Accounting Concept ("FASCON") No. 1.

10. Additionally, reliability is a primary quality that makes accounting information useful for investment decision-making. FASCON No. 2 defines reliability as the "quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." Moreover, to be reliable, "information must have representational faithfulness and it must be verifiable and neutral." FASCON No. 2.

11. Furthermore, information should be complete, which means that nothing material should be left out that may be necessary to ensure that the financial statements validly represent relevant underlying events and conditions. FASCON No. 2, ¶79. Completeness of information also affects its relevance. Relevance of information is adversely affected if a relevant piece of information is omitted, even if the omission does not falsify what is shown. FASCON No. 2.

### **Required Disclosures in Financial Statements**

12. It is management's responsibility to ensure that its financial statements are prepared in accordance with GAAP. Statement on Accounting Standard ("AU") §110, ¶3, AU §504, ¶3. Footnote disclosures are an essential element of financial statements that have "long been viewed as an integral part of financial statements prepared in accordance with generally accepted accounting principles." FASCON No. 5. Thus, financial statements and their related footnotes when taken together must satisfy the aforementioned fundamental accounting concepts.

13. AU §431 ¶2 emphasizes the significance of disclosures in financial statements prepared in conformity with GAAP stating, among other things, that:

An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time.

14. Further, management's omission of information required under GAAP necessitates the auditor to express a qualified or an adverse opinion and provide the information in his report if practicable. AU §431 ¶3.

### **Disclosures Regarding Pending or Threatened Litigation in Financial Statements**

15. Household is, and during the period at issue in the litigation was, a party to various legal proceedings arising from ordinary business activities relating to its operations. Certain of these actions are, or were, class actions seeking damages in very large amounts, including claims for violations of laws and/or unfair treatment of consumers (*see, e.g.*, Item 3, Legal Proceedings, from Household's 2001 Report on Form 10-K/A).

16. GAAP defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss (or gain) to a company. Financial Accounting Standards Board Statement ("FAS") No. 5, ¶1, entitled *Accounting for Contingencies*, provides the guidance for the recording and disclosure of contingencies relating to pending or threatened litigation. Pending or threatened litigation is an example of such a contingency. FAS No.

5, ¶4. According to FAS No. 5, an estimated loss from a loss contingency must be accrued by a charge to income if information available prior to issuance of the financial statements indicates (1) it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and (2) the amount of loss can be reasonably estimated. Further, the accounting rules require a company to make certain relevant disclosures such that investors can understand a company's potential liability (loss), and so that the financial statements are not misleading.

17. Under FAS No. 5, if no accrual is made or the exposure is greater than the amount accrued, disclosure in footnote of the nature of the contingency and an estimate of the loss shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.

## **ROLE OF AN AUDITOR**

### **Public Watchdog**

18. The federal securities laws require that balance sheets and profit and loss statements be certified by an independent public or certified public accountant. 15 U.S.C. §77a (Schedule A of the Securities Act of 1933); *see also generally* Regulation S-X, 17 C.F.R. §§210, *et seq.* These laws requiring publicly-traded companies to have their financial statements audited annually by independent accountants, which in essence, have made accountants the investing public's "gatekeepers" to the public securities markets. Isaac C. Hunt, Jr., SEC Commissioner, *Accountants as Gatekeepers – Adding Security and Value to the Financial Reporting System* (Oct. 26, 2001). Thus, it is important for accountants to ensure that financial statements and supporting disclosures are fairly stated in accordance with GAAP.

19. The SEC has long emphasized that the audit function must be meaningfully performed and the accountants' independence not be compromised. *Relationships Between Registrants and Independent Accountants*, SEC Accounting Series Release No. 296, 1981 SEC

LEXIS 858, at \*\*8-9 (Aug. 20 1981). Additionally, the United States Supreme Court has affirmed the accountants' responsibility as "watchdog":

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. *This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. . . .*

*United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (emphasis in original).

20. Members of the American Institute of Certified Public Accountants ("AICPA") have responsibilities to all those who use their professional services. Accordingly, the AICPA Code of Professional Conduct ("Code of Conduct" or "ET") states that members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism. The Code of Conduct states that those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. ET §53, Article II, 3.

#### **Auditor Responsibility in Evaluating Pending or Threatened Litigation**

21. An auditor is responsible for conducting an audit in accordance with GAAS and expressing an opinion based on that audit on the compliance of an entity's financial statements, including the footnotes contained therein, with GAAP. AU §337, entitled *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, specifically addresses procedures an auditor must perform concerning pending or threatened litigation:

Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters.

22. An independent auditor's procedures in the ordinary course of an audit require the auditor to obtain from management a description and evaluation of litigation, claims, and

assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished. That communication should include those matters referred to legal counsel, and should result in assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by FAS No. 5. AU §337, ¶5.

23. Upon obtaining management representations about contingencies covered by FAS No. 5, and the disposition of any potential losses pertaining thereto, an auditor's primary means of confirming this information is to obtain a letter from a company's lawyer that corroborates management's information concerning litigation, claims and assessments. AU §337, ¶8.

24. GAAS recognizes that an auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention in this area. AU §337, ¶6. Accordingly, the auditor should request the company's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments. *Id.*

25. AU §337, ¶8 also provides that "evidential matter obtained from the client's inside general counsel or legal department may provide the auditor with the necessary corroboration."

26. Further, an auditor should document the conclusions reached as a result of responses obtained in a conference relating to matters covered by the audit inquiry letter. AU §337, ¶10.

### **Competent Evidential Matter**

27. In performing an audit in accordance with GAAS, an auditor must obtain sufficient competent evidential matter. AU §326. Further, in obtaining that competent evidential matter, an auditor cannot rely solely on management representations. AU §333. An auditor's primary means of corroborating management's representation pertaining to litigation, claims and assessments is to obtain a letter from the company's lawyer, *i.e.*, the Disputed Andersen Documents. It is this

communication from the company's lawyer that provides the evidential matter required by GAAS. If there is a restriction placed on the scope of an auditor's work, such as restricting the ability to obtain sufficient competent evidential matter to support management's assertions about litigation, claims and assessments (including its presentation or disclosure in the financial statements), the auditor may be required to qualify his opinion or to disclaim an opinion. AU §508.

### **Audit Workpapers**

28. Andersen was required by GAAS to create and maintain working papers (also referred to as "workpapers") and other documents that contain evidence regarding the assertions made in Household's financial statements.

29. Working papers are prepared in the ordinary course of an audit, are included in the auditor's files, and provide the principal support for an auditor's report. AU §339, ¶2. GAAS define working papers as follows:

Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor.

AU §339, ¶3.

30. Under GAAS, the information contained in working papers constitutes the principal record of the work that the auditor has done and the conclusions that he has reached concerning significant matters. AU §339, ¶1.

31. All of these efforts are employed with the objective of satisfying the fundamental responsibilities thrust upon an independent auditor. Specifically, the third Standard of Field Work under GAAS states, in relevant part:

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.

AU §150, ¶2.

32. Workpapers include an accumulation of both (a) the auditors documentation of procedures performed and (b) other competent evidential matter obtained, *i.e.*, the underlying factual data on which an auditor bases his conclusions:

Most of the independent auditor's work in forming his or her opinion on financial statements consists of obtaining and evaluating evidential matter . . . .

AU §326, ¶2.

33. In a securities fraud action, where allegations of accounting fraud exist, frequently auditor workpapers and other communications need to be examined to determine the evidentiary support and information that was disclosed by management at the time of the audit.

34. In addition, workpapers are generated and designed with the expectation that they will be used as a whole. As a result, segregating, withholding or redacting particular papers from the file takes them out of meaningful context. Among other things, it results in an illogical arrangement of documents, missing cross-referenced or related documents, and incomplete information about issues or about how conclusions were reached. This, in turn, could ultimately lead to misinterpretation of, or an inability to meaningfully interpret, the documents that are provided.

**Audit Workpapers, Including Audit Letters, Are Obtained and Prepared in the Ordinary Course of Public Company's Annual Audit**

35. In Household Defendants' Memorandum of Law in Support of Arthur Andersen LLP's Motion for the Return of Inadvertently Produced Privileged Documents, defendants are requesting that the lead plaintiff return the Disputed Andersen Documents. Defendants group the Disputed Andersen Documents into three categories.

36. Category One documents (Documents 2-3, 5-6, 8-9, 11-12 and 14-15) are described as opinion letters written by Kenneth H. Robin, Household's Senior Vice President, General

Counsel, and Corporate Secretary, to Andersen (the “General Counsel Opinion Letters”). Defs’ Mem. at 2. With respect to the General Counsel Opinion Letters, I note the following:

- These documents are required to be obtained by the auditor in accordance with GAAS. *See* ¶¶21-34, *supra*.
- These documents were part of Andersen’s working papers prepared in the ordinary course of its audit. *See* ¶¶15, 17, 28, 34, *supra*.
- These documents comprise the evidential matter supporting Andersen’s independent examination. *See* ¶¶25-27, *supra*.

37. Category Two documents (Documents 1, 4 and 10) are described by defendants as internal Andersen memos written to Andersen’s files, based largely on discussions with Ken Robin and Mark Leopold, Esq., Household’s Assistant General Counsel, on the subject of the contents and issues contained in the General Counsel Opinion Letters described above and comprising Category One. With respect to Category Two documents, I note the following:

- These documents are required to be prepared by the auditor in accordance with GAAS. *See* ¶¶21-34, *supra*.
- These documents were part of Andersen’s working papers prepared in the ordinary course of its audit. *See* ¶¶15-17, 28-34, *supra*.
- These documents comprise the evidential matter supporting Andersen’s independent examination. *See* ¶¶25-27, *supra*.

38. Category Three documents (Documents 7, 13, 16 and 17) are described by defendants as draft and final internal Household letters, written by and/or to internal Household counsel, requesting and detailing the process for creating the General Counsel Opinion Letters described above and comprising Category One above. With respect to Category Three documents, I note the following:

- These documents are required to be obtained by the auditor in accordance with GAAS. *See* ¶¶21-34, *supra*.
- These documents were part of Andersen’s working papers prepared in the ordinary course of its audit. *See* ¶¶15-17, 28-34, *supra*.

- Even though two of the documents were not signed by Steven McDonald and one of the documents has the word “Draft” on it, Andersen had possession of these documents evidencing actual receipt by Andersen. It is evident therefore, that Andersen deemed these documents, in addition to others, to be part of the principal support for its audit report. I further note that if these specific documents were materially different than any “final” version, it would be counterintuitive for Andersen to have included these “draft” versions in its workpapers in lieu of the final version(s).

39. Andersen, in the ordinary course of its audits for Household, utilized a “Litigation, Claims, & Assessments” form. This form, in addition to its purported goal of addressing GAAS requirements pertaining to litigation, claims and assessments, provides the following:

The engagement team should keep in mind that due to the nature of litigation, claims and assessments, the risk of material misstatement cannot be effectively and efficiently reduced through tests of controls. Hence, *responses from external legal counsel to letters of inquiry are needed primarily to corroborate management’s assertions reflected in the accruals for and disclosures of loss contingencies.*

(Emphasis added.)

40. Based upon the foregoing, it is my opinion that the documents at issue here were obtained or prepared in the ordinary course of an audit or review.

I declare under penalty of perjury under the laws of the United States that the above is true and correct. This declaration was executed on the 25th day of May, 2006 at Philadelphia, Pennsylvania.

  
KIRSTEN L. FLANAGAN, CPA

DECLARATION OF SERVICE BY EMAIL AND BY U.S. MAIL

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and employed in the City and County of San Francisco, over the age of 18 years, and not a party to or interested party in the within action; that declarant's business address is 100 Pine Street, Suite 2600, San Francisco, California 94111.

2. That on May 26, 2006, declarant served by electronic mail and by U.S. Mail the **DECLARATION OF KIRSTEN L. FLANAGAN, CPA IN SUPPORT OF THE CLASS' RESPONSE TO THE HOUSEHOLD DEFENDANTS' MEMORANDUM OF LAW IN SUPPORT OF THE RETURN OF CERTAIN ARTHUR ANDERSEN DOCUMENTS AND CROSS-MOTION TO COMPEL PRODUCTION OF CERTAIN DOCUMENTS PROVIDED TO OUTSIDE AUDITORS BY HOUSEHOLD DEFENDANTS** to the parties listed on the attached Service List. The parties' email addresses are as follows:

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I declare under penalty of perjury that the foregoing is true and correct. Executed this 26th day of May, 2006, at San Francisco, California.

/s/ Monina O. Gamboa

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MONINA O. GAMBOA

HOUSEHOLD INTERNATIONAL (LEAD)

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