

## Author's Note

This case focuses on an issue that formed part of Enron's legacy: how should "off-balance sheet" vehicles be used and accounted for? In theory, this issue was addressed by the Financial Accounting Standards Board in their rule FASB ASC 810-10: "Variable Interest Entities. The Citigroup SIV case suggests that the disclosure problems associated with such vehicles persist.

More specifically, the case discusses the dilemma of "creativity" associated with pushing the limits on accounting rules. Citi was an innovator in the use of SIVs. By 2007 it had been deploying them for 20 years. Using SIVs allowed Citi to relieve capital constraints, make more loans, book more fees and report a higher Return on Equity. For many years this must have seemed a smart practice. Rules, such as ASC 810-10, were successfully wired around, and the architects of such "financial engineering" were duly rewarded. However, the case depicts what happens when markets turn. It is at that point that accounting judgments rendered in calm markets start to look problematic. Just when credit is most precious, the requirements for revised disclosures bite hardest, and the weight of past disclosure decisions hangs heavy on the responsible management.

Gary Crittenden is one of those managers. As Citigroup's CFO, he is responsible for the firm's SEC filings. He's also legally liable for material misstatements and omissions under securities law, including SOX.

Crittenden's challenges are threefold. He must decide if Investor Relations draft statement is factually accurate and complete. If not, he must consider revisions. Second, any revisions must be reconciled with Citi's past disclosures, or else past errors must be admitted. Third, the firm must consider how to present its adverse news in a manner that doesn't exacerbate its financing problems. For Crittenden, this may require action plans that go beyond rewording IR's disclosure statement.

This case is based largely on the SEC's "Cease and Desist" order directed at Crittenden and IR's Arthur Tidesley. Supplemental information comes from contemporaneous reports in the financial press, especially Bloomberg's coverage, and from investor litigation against Citigroup filed in the U.S. Southern District. The draft IR statement is based upon the actual press release issued by Citigroup on October 1, 2007. There is no public record of Crittenden questioning or revising an earlier IR draft. The case imagines him doing so in order to provide students with an opportunity reconsider his dilemmas and devise alternate solutions. Crittenden resigned along with CEO Prince one month later.

The case raises important questions about Citi's longtime auditor, KPMG. That firm is conspicuous by its absence in accounts of these disclosure issues. Missing too is Citi's outside counsel, who must have been advising Prince and Crittenden on securities law requirements. Their failures here are noteworthy examples that the Enron "gate-keeper" problem has not been fixed.

Finally, this case should be considered in the light of the two other Citigroup cases presented in this volume. Collectively these present a disheartening portrait of serial violations and weak governance. Citigroup seems to tarnish the reputations of even the most formidable of financial leaders, from John Reed to Sandy Weill to Robert Rubin. The firm's enduring inability to reform itself raises serious questions of whether Citi is not only too big to fail, but too big to manage.

## Notes

1. Citigroup Expects Substantial Decline in Third Quarter Net Income; [www.citi.com/citi/press/2007/071001a.htm](http://www.citi.com/citi/press/2007/071001a.htm), October 1, 2007
2. Ibid.
3. Securities and Exchange Commission, *Order Instituting Cease and Desist Proceedings in the Matter of Gary L. Crittenden and Arthur H. Tildesley, Jr.*; July 29, 2010, pg. 4
4. Ibid., pg. 4
5. Ibid., pg. 3
6. Ibid., pg. 4
7. *Report of the Special Investigation Committee of the Board of Directors of Enron Corporation* (the Powers Committee Report), February 1, 2002, pp. 52-53
8. Financial Accounting Standards Board, *FASB ASC 810-10: "Variable Interest Entities*, pp.
9. *Citigroup SIVs draw \$7.6 billion of Emergency funds*; [www.bloomberg.com/apps/news?pid=newsarchive&sid](http://www.bloomberg.com/apps/news?pid=newsarchive&sid), November 6, 2007
10. *Reckless Endangerment*, pp. 274-276
11. *All the Devils are Here*, 2010, pg. 257
12. Citigroup, Inc. (C) Q2 2007 Earnings Call July 20, 2007 10:00 AM ET
13. Ibid.
14. Ibid.
15. *All the Devils are Here*, pg. 300
16. Securities and Exchange Commission, *op. cit.*, pp. 8-10
17. Ibid., pg. 9
18. Ibid., pp. 9-10

# Attachment 5

Citibank 2007 Q1-Q3 Financial Results			
Income Statement			
	Reclassified 3 months Q1 Mar-30-2007	Reclassified 3 months Q2 Jun-30-2007	Reclassified 3 months Q3 Sep-30-2007
For the Fiscal Period Ending			
<b>Total Revenue</b>	<b>22,495.0</b>	<b>23,010.0</b>	<b>17,059.0</b>
Salaries and Other Empl. Benefits	8,671.0	8,682.0	7,595.0
Amort. of Goodwill & Intang. Assets	-	-	-
Selling General & Admin Exp., Total	3,125.0	3,415.0	3,666.0
Total Other Non-Interest Expense	2,461.0	2,214.0	3,142.0
<b>Total Non-Interest Expense</b>	<b>14,257.0</b>	<b>14,311.0</b>	<b>14,403.0</b>
<b>EBT Excl. Unusual Items</b>	<b>8,238.0</b>	<b>8,699.0</b>	<b>2,656.0</b>
Restructuring Charges	(1,377.0)	(63.0)	(35.0)
<b>EBT Incl. Unusual Items</b>	<b>6,861.0</b>	<b>8,636.0</b>	<b>2,621.0</b>
Income Tax Expense	1,846.0	2,570.0	492.0
<b>Earnings from Cont. Ops.</b>	<b>5,015.0</b>	<b>6,066.0</b>	<b>2,129.0</b>
<b>Net Income</b>	<b>5,012.0</b>	<b>6,226.0</b>	<b>2,212.0</b>
Pref. Dividends and Other Adj.	16.0	14.0	6.0
<b>NI to Common Incl Extra Items</b>	<b>4,996.0</b>	<b>6,212.0</b>	<b>2,206.0</b>
<b>NI to Common Excl. Extra Items</b>	<b>4,952.0</b>	<b>5,929.0</b>	<b>2,103.0</b>
<b>Per Share Items</b>			
Basic EPS	\$10.24	\$12.44	\$4.49
Basic EPS Excl. Extra Items	10.15	11.87	4.28
Weighted Avg. Basic Shares Out.	487.7	499.3	491.6
Diluted EPS	\$9.98	\$12.44	\$4.41
Diluted EPS Excl. Extra Items	9.89	11.87	4.2
Weighted Avg. Diluted Shares Out.	496.8	499.3	501.1
Dividends per Share	\$5.4	\$5.4	\$5.4
Payout Ratio %	53.8%	43.2%	NA

Source: [www.capitaliq.com](http://www.capitaliq.com)

## **Attachment 6**

### **Legal Guidelines for Public Communications by Senior Executives**

This note is intended to provide background regarding pertinent laws governing public statements made by executives of companies whose securities are listed on public exchange markets.

The principal governing laws are the Securities Act of 1933 and the Securities Exchange Act of 1934. Both are federal laws passed in the wake of the 1929 stock market crash. The former lays out the requirements for companies to issue securities to the investing public (and lays out the process for private placements). The latter regulates the securities markets, broker dealers, and establishes the reporting requirements for public companies.

Section 10 of the 1934 Act requires companies to file quarterly and annual reports (10-K, 10-Q, 8-K) and establishes both civil and criminal penalties for making 'materially misleading' statements in these reports. This statutory provision forms the basis for SEC Rule 10b-5 which prohibits not only misleading statements but also omissions of 'material' information. This rule applies to the purchase or sale of public securities. Typically, public companies find themselves technically in the mode of continuously offering or purchasing their securities; this happens not only as a function of the occasional share or bond offering, but also as a result of employee stock option issuance/redemption, pension/benefit plan activities or share repurchase programs. When public companies find themselves in such mode, the public statements of virtually any officer or director can be considered relevant to an 'offering' and subject to scrutiny for 'materially misleading' statements or omissions.

Section 20 of the 1934 Act defines a special category of 'controlling person'. A company CEO clearly fits into this category. These individuals bear personal liability if any of the required company reports are materially in error. Their only defense is for the 'controlling person' to prove there was no reason for them to know that the report was erroneous or misleading.

'Controlling persons' attempting such a defense against an SEC allegation should bear in mind that they may be inviting charges of violating fiduciary responsibilities under state law. Senior executives will need to explain how they were discharging their fiduciary responsibilities to know what was happening at their firm, but did not have reason to know that public reports of their results contained materially misleading information or omissions.

More recently, senior executives have had to consider their exposure under ERISA laws governing employee benefit plans. There have been cases where executives have been charged with breach of fiduciary responsibilities for not



## Attachment 4

### Summary of FASB ASC 810-10: "Variable Interest Entities"

#### Overview of VIE guidance, as amended by ASU 2009-17 and ASU 2010-10

A reporting entity that holds a direct or indirect (explicit or implicit) variable interest in a legal entity must determine whether the guidance in the "Variable Interest Entities" subsections of ASC 810-10 applies to that legal entity before considering other consolidation guidance, such as ASC 810-20, "Control of Partnerships and Similar Entities." However, if a reporting entity does not have a direct or indirect (explicit or implicit) variable interest in a legal entity, then the reporting entity is not the primary beneficiary of that legal entity and is not required to provide disclosures for that legal entity under ASC 810-10, "Variable Interest Entities" subsections.

Under the amended guidance in ASC 810-10, "Variable Interest Entities" subsections, a legal entity is a variable interest entity (VIE) if any of the following conditions exists:

- The total equity investment at risk in the legal entity is not sufficient to permit the entity to finance its activities without additional subordinated financial support
- The legal entity's total equity investment at risk does not provide its holders, as a group, with all of the following characteristics:
  - The power through voting or similar rights to direct the activities that most significantly impact the legal entity's economic performance
  - The obligation to absorb the expected losses of the legal entity
  - The right to receive expected residual returns of the legal entity
- Both of the following conditions exist:
  - Voting rights of some equity investors are not proportional to their obligation to absorb expected losses and / or right to receive expected residual returns
  - Substantially all the activities of the legal entity involve, or are conducted on behalf of, a single investor with disproportionately few voting rights

A reporting entity that holds a variable interest in a VIE and has both of the following characteristics of a controlling financial interest in a VIE is the primary beneficiary of the VIE:

- **Power:** The power to direct the activities of the VIE that most significantly affect the VIE's economic performance

this pipeline flowing was regarded as the key to rising profits. However, as Citibank's subprime business grew, the capital demanded to support this business was also growing – and at a rate that was beginning to curtail both the mortgage business and other business lines.

To unblock this pipeline, Citi landed on the idea of developing Structured Investment Vehicles. Starting in 2003, a sizeable portion of Citi's subprime mortgage assets was directed into these SIVs.

## Citibank Structures and Launches SubPrime SIVs

Structured Investment Vehicles were introduced by Citibank in 1988, and since used for a variety of purposes. Citi's growing mortgage business suggested another application. The idea was to construct a family of SIVs to act as dedicated buyers of Citi's RMBS/CDOs; this held three attractions. First, it created a ready-made destination for Citi's mortgage securities factory. Second, it promised to expand Citi's investor base for these products. Finally, the SIVs promised to ameliorate the Citi capital constraints. In sum, SIVs as final destinations for subprime securities promised to be hugely value creating.

However, Citibank discovered there were problems to overcome before these benefits could be harvested. The problems involved issues which Citi would have to address for the SIVs to work as intended.

The basic SIV structure was crafted as follows:

1. Citi would set up a separate legal entity
2. the bank would sell a small amount of venture equity to third parties, thus creating independent ownership
3. the SIV would then buy subprime assets, predominately CDOs, from Citi
4. the SIV would sell asset backed commercial paper (CP) to investors, using the proceeds to pay Citi for the subprime assets; and
5. Citi would contract to manage the SIV going forward.

A core problem here was the mismatch between SIV assets and funding. The SIVs would own assets whose maturities stretched out to 30 years while its funding consisted of 30–60 day CP. Given the SIVs minimal equity, any failure to rollover CP would present the vehicles with a funding crisis. Either the SIVs would have to sell long term assets, perhaps at marked-down prices, or fail to honor a commercial paper redemption.

This problem was particularly acute because Citi was planning something ambitious; it was going to target sales of SIV commercial paper to Money Market Funds (MMFs). Accomplishing this would greatly expand the pool of subprime investors. MMFs are the brokerage house equivalent of bank checking accounts, and their depositors expect their funds to be both