

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES SECURITIES
AND EXCHANGE COMMISSION,

Plaintiff,

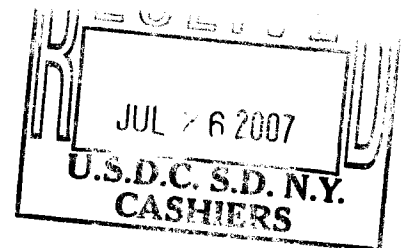
v.

CARDINAL HEALTH, INC.,

Defendant.

Civ. No. _____

ECF CASE



COMPLAINT

Plaintiff, the United States Securities and Exchange Commission ("Commission"),

alleges for its Complaint as follows:

SUMMARY

1. From at least September 2000 through at least March 2004, defendant Cardinal Health, Inc. ("Cardinal" or the "Company") engaged in a fraudulent earnings and revenue management scheme and other improper accounting and disclosure practices. Cardinal engaged in this conduct in order to present a false picture of its results of operations to the financial community and the investing public – one that matched Cardinal's publicly disseminated earnings guidance and analysts' expectations, rather than its true economic performance. Through these practices, the Company materially overstated its operating revenue, earnings and growth trends in certain earnings releases and filings with the Commission.

2. Cardinal, through the conduct of members of its corporate management, managed its reported revenue and earnings by: (a) inflating reported operating revenue by misclassifying over \$5 billion of bulk inventory sales as operating revenue; (b) selectively accelerating, without

disclosure, the payment of vendor invoices in order to prematurely record a cumulative total of \$133 million in cash discount income; (c) improperly establishing a general reserve account and improperly adjusting reserve accounts, which misstated earnings by over \$65 million; and (d) improperly classifying \$22 million of expected litigation settlement proceeds to increase operating earnings. In addition, on one occasion, Cardinal intentionally transferred inventory within business units in order to avoid a negative impact on year-end reported earnings due to the application of its last-in-first-out (“LIFO”) method of inventory valuation. Further, the Company failed timely to disclose the impact of a change in the method of applying its LIFO accounting principle. Cardinal also prematurely recognized millions of dollars in revenue from Pyxis (“Pyxis”), a wholly-owned subsidiary the Company featured as an important growth driver.

3. Due to the practices described above, between its fiscal years (“FY”) 2001 and 2004, Cardinal misrepresented its trends in reported operating revenue and earnings. During this period, Cardinal’s public claims of 16 consecutive years of 20% or higher growth in earnings per share before special items (“EPS”), and 77 consecutive quarters in which it “met or beat guidance,” were untrue. In addition, the Company’s 15 earnings releases and earnings conference calls, its 15 periodic reports and more than 10 registration statements filed with the Commission during this period contained materially false and misleading statements and omissions of material information.

4. When engaging in the practices described above, Cardinal circumvented internal accounting controls. Cardinal also failed to maintain a system of internal accounting controls sufficient to prevent material misstatements in its books, records, accounts and financial statements and to provide reasonable assurances that the Company’s financial statements were prepared in conformity with Generally Accepted Accounting Principles (“GAAP”). As a result,

Cardinal's books, records and accounts did not fairly and accurately reflect the Company's transactions.

5. During the course of the Commission's investigation of this matter, Cardinal's Audit Committee conducted an internal investigation. On October 26, 2004, based on the findings of its Audit Committee's investigation, Cardinal restated its financial results for its FYs 2000 to 2003 and for the first three quarters of FY 2004. In its restatement, Cardinal disclosed that it had improperly classified approximately \$1.2 billion of bulk revenue as operating revenue, that the Company had an undisclosed practice of accelerating payment of vendor invoices at the end of certain reporting periods, which improved operating results for those periods, and that certain non-recurring expenses in FY 2002 were partially offset by a \$23 million benefit during the period resulting from changes in Cardinal's LIFO calculation for generic products. The restatement also reduced the Company's net earnings by a cumulative total of \$65.2 million, due to the Company's adjustments to reserves and other accruals, which were restated as a result of misapplications of GAAP, other errors or an absence of substantiation. In addition, the Company reversed, reclassified and recognized in a later period \$22 million of expected litigation settlement proceeds it had previously recognized during the second quarter of FY 2001 and the first quarter of FY 2002, and reduced its FY 2003 operating earnings by \$5.3 million to correct the intentional avoidance of a LIFO charge resulting from the Company's improper transfer of inventory between business units. The Company also disclosed, for the first time, that it had prematurely recognized an indeterminable amount of Pyxis revenue and that a material weakness existed in Cardinal's internal controls, based in part on the inappropriate application of Cardinal's bulk revenue classification policy during several quarters of FY 2002 and 2003.

6. By engaging in the conduct described above, Cardinal violated the antifraud, reporting, books and records, and internal controls provisions of the federal securities laws. Through this action, the Commission requests that the Court, among other things: (1) permanently enjoin defendant Cardinal from further violations of the federal securities laws; (2) order defendant Cardinal to disgorge certain gains from its conduct violating the federal securities laws; and (3) order defendant Cardinal to pay a civil monetary penalty.

JURISDICTION AND VENUE

7. The Commission brings this action pursuant to Section 20(b) of the Securities Act of 1933 (“Securities Act”) [15 U.S.C. § 77t(b)] and Section 21(d) of the Securities Exchange Act of 1934 (“Exchange Act”) [15 U.S.C. § 78u(d)].

8. This Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)] and Sections 21(e) and 27 of the Exchange Act [15 U.S.C. §§ 78u(e) and 78aa]. The defendant, directly and indirectly, used the means or instrumentalities of transportation, interstate commerce, or of the mails, or the facilities of a national securities exchange in connection with the transactions, acts, practices and course of business alleged in this Complaint.

9. Certain of the acts, practices and courses of conduct constituting the violations of law alleged in this Complaint occurred within this judicial district and, therefore, venue is proper pursuant to Section 22(a) of the Securities Act [15 U.S.C. § 77v(a)] and Section 27 of the Exchange Act [15 U.S.C. § 78aa]. Cardinal, directly and indirectly, has engaged in, and unless restrained and enjoined by this Court will continue to engage in, transactions, acts, practices and courses of business that violate Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)], Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78j(b), 78m(a),

78m(b)(2)(A) and 78m(b)(2)(B)] and Exchange Act Rules 10b-5, 12b-20, 13a-1, 13a-11 and 13a-13 [17 C.F.R. §§ 240.10b-5, 240.12b-20, 240.13a-1, 240.13a-11 and 240.13a-13].

DEFENDANT

10. Cardinal, a Fortune 20 company, is an Ohio corporation with headquarters in Dublin, Ohio. Cardinal's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act, and trades on the New York Stock Exchange. At all times relevant to this Complaint, Cardinal was a diversified provider of products and services in the health care industry, and its businesses were classified into four reporting segments: Pharmaceutical Distribution and Provider Services ("Pharmaceutical Distribution"), Pharmaceutical Technologies and Services ("Pharmaceutical Technologies"), Medical Products and Services and Automation and Information Services, which included Pyxis. Cardinal's fiscal year ends on June 30. For FY 2001 through 2004, Cardinal reported total revenues of \$47 billion, \$51 billion, \$56 billion, and \$65 billion, respectively.

I. CARDINAL CLOSELY MONITORED SEGMENT AND CONSOLIDATED PERFORMANCE

11. Cardinal carried out its earnings and revenue management scheme and other improper accounting and disclosure practices within the context of a detailed budgeting, forecasting and internal reporting process for operating earnings, revenue and net income. Cardinal's corporate management pushed the business segments to achieve higher earnings growth by setting aggressive financial targets, and a segment's earnings was a main factor Cardinal used in determining management's bonuses. Throughout the fiscal year, Cardinal's corporate management closely monitored the Company's segment and consolidated financial performance, to assess whether it was in line with internal expectations and the external guidance from Cardinal on which analysts based their projections. Cardinal's goal was to meet or exceed

its revenue and earnings guidance, including year-over-year quarterly EPS growth of 20% or more.

12. As a result of this detailed and continuous monitoring, Cardinal's corporate management knew when the monthly forecast for a business unit or segment was less than its budgeted expectations. Cardinal referred to this as a "gap." When it identified gaps, the Company identified or developed "initiatives" (*i.e.*, actions to take to improve financial performance) to close the gaps in order to meet analysts' expectations. A number of these initiatives involved fraudulent and improper accounting or disclosure practices.

II. CARDINAL'S FRAUDULENT AND OTHER IMPROPER ACCOUNTING AND DISCLOSURE PRACTICES

A. Cardinal Misclassified over \$5 Billion of Bulk Sales as Operating Revenue

1. Cardinal Historically Treated Low-Margin Bulk Sales From Pharmaceutical Distribution as Bulk Revenue

13. At all relevant times, Pharmaceutical Distribution was Cardinal's largest segment, generally representing over 80% of the Company's consolidated total revenue and over 40% of its consolidated total gross profits. Pharmaceutical Distribution divided its business during the relevant period between "direct store door" business and the "Brokerage" business.

14. During the relevant period, Pharmaceutical Distribution's basic business was buying pharmaceutical products in full case quantities (bulk) and breaking them down to customized orders and delivering them to pharmacies and other provider customers. Cardinal classified revenues from this direct store door business as operating revenue. During the relevant period, direct store door business generally consisted of sales by Cardinal directly to customers out of inventory Cardinal held at its warehouses. Cardinal historically profited from price

increases that occurred between the time it bought the inventory from manufacturers and the time it sold the inventory to customers. This was a “buy-and-hold” profit model.

15. The Brokerage business consisted of sales of bulk product to customer warehouses. Certain bulk sales went directly from the manufacturer to Cardinal’s customer. Cardinal also ordered bulk product from the manufacturer for its customer, received the product on a Cardinal loading dock, and then shipped it to the customer, usually within 24 hours. During the period relevant to this Complaint, these two types of bulk sales had virtually no profit margin and minimal holding and handling costs to Cardinal. Cardinal’s compensation for these bulk sales primarily consisted of interest earned on cash between the time Cardinal received payment from the customer until the time that Cardinal made payment to the manufacturer.

16. During the relevant time period, Cardinal reported its revenue, along with the associated cost of sales, as two separate line items, one being operating revenue and the other being bulk sales to customer warehouses (“bulk revenue”). Historically, bulk revenue included sales of bulk product, as described above.

17. As Cardinal’s corporate management understood, investors and analysts focused on Cardinal’s operating revenue, rather than its bulk revenue, to evaluate the Company’s financial performance. Therefore, Cardinal sought to report high operating revenue and high operating revenue growth rates, as compared to prior quarters and fiscal years. By highlighting operating revenue, Cardinal made clear to investors and analysts that operating revenue, for both the Company and for Pharmaceutical Distribution, was a key measure of the Company’s performance.

18. From September 1998 through June 2001, Cardinal consistently reported operating revenue growth rates, as compared to the year-ago quarter or fiscal year, of 15% or higher for the

Company and 20% or higher for Pharmaceutical Distribution. During this period, Cardinal also reported quarterly and annual EPS growth of 20% or higher, as compared to the year-ago quarter or fiscal year.

19. In the Fall of 2001, Cardinal and Pharmaceutical Distribution began to experience downward pressure on their operating revenue, operating revenue growth rates and earnings.

20. Beginning in the quarter ended December 31, 2001, Cardinal responded to the pressure on its operating revenue by misclassifying billions of dollars of almost zero profit margin bulk sales as operating revenue. Cardinal implemented three initiatives, which it did not disclose, to inflate its faltering operating revenue and operating revenue growth, even though the initiatives also materially reduced its operating gross margins as a percentage of operating revenue.

**2. Cardinal Implements an Undisclosed
“24-Hour Rule” Initiative to Reclassify Certain Bulk Sales**

21. In November 2001, Cardinal created and began to follow an undisclosed internal practice whereby it classified revenue from the sale of bulk product as operating revenue, provided the bulk product was in its possession for more than 24 hours prior to being shipped (“the 24-Hour Rule”). Cardinal created the 24-Hour Rule for the purpose of inflating reported operating revenue and operating revenue growth rates, which were slowing at the time. This initiative did not create any new revenue, but, instead, shifted revenue from the bulk revenue line to the operating revenue line.

22. Unbeknownst to investors and analysts, the 24-Hour Rule overstated Cardinal’s reported operating revenue for 10 consecutive quarters, from the quarter ended December 31, 2001, through the quarter ended March 31, 2004, and overstated Cardinal’s reported operating revenue growth rates for six out of eight quarters during FY 2002 and 2003. During this time

period, the 24-Hour Rule overstated Cardinal's reported operating revenue by approximately \$2 billion (\$466 million during FY 2002, \$1 billion during FY 2003 and \$526 million during the first three quarters of FY 2004).

3. Cardinal Uses the "24-Hour Lever" Initiative To Further Inflate Reported Operating Revenue

23. Soon after implementing the 24-Hour Rule initiative, Cardinal began to implement another initiative to inflate its operating revenue results. During the quarter ended December 31, 2001, the Company began intentionally holding certain bulk inventory orders on Cardinal's premises for longer than 24 hours (instead of shipping them in less than 24 hours as would otherwise have occurred) solely to convert the sale of this product from bulk revenue to operating revenue (the "24-Hour Lever"). Cardinal used the 24-Hour Lever to shift revenue from the bulk revenue line to the operating revenue line for the purpose of fraudulently inflating reported operating revenue and operating revenue growth rates. Cardinal did not disclose its use of the 24-Hour Lever.

24. Members of Cardinal's corporate management decided when to start and stop the 24-Hour Lever, basing such decisions on the strength or weakness of quarterly sales, in comparison to the Company's operating revenue and operating revenue growth rate targets. As a result, Cardinal did not apply the 24-Hour Lever in every quarter, and did not use it throughout an entire quarter when it was applied. For instance, in a February 19, 2003 e-mail, a then member of Cardinal's corporate management asked a Pharmaceutical Distribution employee what was the "latest date" that Cardinal could "turn on the 24hr. sales lever and achieve a meaningful benefit for [the] quarter." Cardinal's use of the 24-Hour Lever also depended, in part, on how strong or weak the Company's quarterly earnings were, since Cardinal was concerned that it would appear anomalous to analysts and investors if Cardinal reported strong

operating revenue alongside weak operating earnings. Cardinal used the 24-Hour Lever to achieve a certain operating revenue result, as evidenced in a March 15, 2003 e-mail in which a then member of corporate management noted the decision to turn on the 24-Hour Lever “for the remainder of March, in order to achieve 10% growth in the segment...”, and indicated that members of corporate management were “monitoring it on a daily basis.”

25. Unbeknownst to investors and analysts, the 24-Hour Lever fraudulently overstated Cardinal’s reported operating revenue and operating revenue growth rates during two quarters of FY 2002 and two quarters of FY 2003. During these four quarters, the 24-Hour Lever overstated the Company’s reported operating revenue of approximately \$48.5 billion by \$1.2 billion (\$414 million during the two relevant quarters of FY 2002 and \$813 million during the two relevant quarters of FY 2003). In particular, during the quarter ended December 31, 2002, Cardinal improperly classified \$673 million of bulk sales as operating revenue through the use of the 24-Hour Lever. This represented 5.30% of Cardinal’s total reported operating revenue for the quarter and 6.39% of Pharmaceutical Distribution’s total reported operating revenue for the quarter.

**4. Cardinal’s Undisclosed “Just-in-Time” Initiative
Converts Bulk Revenue to Operating Revenue**

26. Beginning in the quarter ended March 31, 2002, Cardinal implemented a third initiative, called “Just-in-Time” (“JIT”), that artificially converted bulk revenue to operating revenue. Under JIT, Cardinal, based on past customer buying trends, placed orders for bulk product in advance of anticipated customer orders. Cardinal then received the bulk product into its inventory and held the product until a customer placed an order. In this way, Cardinal could hold bulk product for longer than 24 hours and convert the sales to operating revenue. Cardinal

did not disclose this practice to the public and did not inform its customers of the program during its implementation.

27. JIT shifted revenue from the bulk revenue line to the operating revenue line and was used to inflate Cardinal's reported operating revenue and operating revenue growth rates.

28. Unbeknownst to investors and analysts, JIT overstated Cardinal's reported operating revenue for nine consecutive quarters, from the quarter ended March 31, 2002, through the quarter ended March 31, 2004, and overstated Cardinal's reported operating revenue growth rates for four out of eight quarters during FY 2002 and 2003. During this time period, JIT overstated the Company's reported operating revenue by approximately \$1.8 billion (\$482 million during the last two quarters of FY 2002, \$1.2 billion during FY 2003 and \$118 million during the first three quarters of FY 2004).

5. The Material Impact of the 24-Hour Rule, 24-Hour Lever and JIT Initiatives on Cardinal's Reported Operating Revenue

29. From the quarter ended December 31, 2001, through the quarter ended March 31, 2004, the three operating revenue initiatives combined inflated the portion of Cardinal's revenues that were classified as operating revenue by over \$5 billion: \$1.4 billion in FY 2002 (3.07% of total reported operating revenue), \$3 billion in FY 2003 (5.97% of total reported operating revenue), and \$644 million in the first three quarters of FY 2004 (1.53% of total reported operating revenue). On a quarterly basis, the combined overstatement of reported operating revenue on a consolidated basis ranged from 1.22% to 8.96% during this period. On a segment basis, the three initiatives overstated Pharmaceutical Distribution's reported operating revenue by approximately 3.75% in FY 2002, 7.32% in FY 2003, and 1.89% in the first three quarters of FY 2004. On a quarterly basis, the combined overstatement of Pharmaceutical Distribution's reported operating revenue ranged from 1.50% to 10.80% during this period.

30. Cardinal's use of the three initiatives peaked during the quarter ended December 31, 2002, and their impact was dramatic. In that quarter, Cardinal misclassified approximately \$1.1 billion of bulk sales as operating revenue as a result of the three initiatives. This represented 8.96% of Cardinal's total reported operating revenue and 10.80% of Pharmaceutical Distribution's reported operating revenue.

31. The combined impact of the three initiatives overstated Cardinal's reported operating revenue growth rates, as compared to the prior year. As a result, the Company misleadingly portrayed its trend in reported operating revenue growth. For example, without the initiatives, Cardinal's FY 2002 operating revenue growth would have been 11.31%, instead of the 14.83% Cardinal reported, representing a 31.12% overstatement of consolidated operating revenue growth. Similarly in FY 2003, Cardinal's operating revenue growth would have been only 10.27%, instead of the 13.68% Cardinal reported, representing a 33.20% overstatement of consolidated operating revenue growth. On a quarterly basis during FY 2002 and 2003, the consolidated growth rate was overstated through the three initiatives between 16.73% and 148.68%. The impact of the three initiatives on Pharmaceutical Distribution's reported operating revenue growth rates was even greater. Without the initiatives, Pharmaceutical Distribution's FY 2002 operating revenue growth would have been 12.22%, instead of the 16.59% Cardinal reported, representing a 35.76% overstatement. In FY 2003, Pharmaceutical Distribution's operating revenue growth without the initiatives would have been only 9.44%, instead of the 13.65% Cardinal reported, representing a 44.60% overstatement. On a quarterly basis during FY 2002 and 2003, the three initiatives overstated Pharmaceutical Distribution's operating revenue growth rate between 18.66% and 203.81%. Finally, the 24-Hour Rule, 24-Hour Lever and JIT