

COPY

ORIGINAL
FILED
06 SEP 14 AM 9:21
RICHARD W. WIEKING
CLERK U.S. DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

1 HELANE L. MORRISON (Bar No. 127752)
2 CARY S. ROBNETT (Bar No. 160585)
3 PATRICK T. MURPHY (NY Bar No. 2685717)
4 murphyp@sec.gov
5 CAROLYN SAMIERE (Bar No. 118353)
6 samierec@sec.gov

7 Attorneys for Plaintiff
8 SECURITIES AND EXCHANGE COMMISSION
9 44 Montgomery Street, Suite 2600
10 San Francisco, California 94104
11 Telephone: (415) 705-2500

E-Filing

12 UNITED STATES DISTRICT COURT
13 NORTHERN DISTRICT OF CALIFORNIA
14 SAN JOSE DIVISION

HRL

15 SECURITIES AND EXCHANGE COMMISSION,
16 Plaintiff,
17 v.
18 DIANE KAYSER,
19 Defendant.

Civil Action No. 06-5635

COMPLAINT

20 Plaintiff Securities and Exchange Commission (the "Commission") alleges:

21 SUMMARY OF THE ACTION

22 1. This case involves false financial reporting by Diane Kayser, the former Chief
23 Financial Officer ("CFO") of Excelligence Corp., a distributor of children's educational products
24 headquartered in Monterey, California. In February and March 2005, Kayser inflated Excelligence's
25 fiscal year 2004 operating income through a series of fraudulent journal entries in Excelligence's
26 books. Her purpose was to mislead investors by making them think that Excelligence had achieved
27 its financial target for operating income in the 2004 fiscal year when in reality it had not. Kayser
28 covered up her misconduct by concealing documents, making misrepresentations to Excelligence's
auditors, KPMG LLP ("KPMG"), and circumventing Excelligence's controls designed to ensure
accurate financial reporting.

1 Section 12(g) of the Exchange Act [15 U.S.C. § 78l(g)], which was listed on the NASDAQ National
2 Market.

3 FACTUAL ALLEGATIONS

4 **A. Kayser Pushed Her Staff to Meet Excelligence's Financial Targets.**

5 9. Soon after becoming Excelligence's Chief Financial Officer in September 2004,
6 Kayser focused the Finance Department on meeting the Company's financial targets, or "guidance,"
7 for the 2004 fiscal year. As Kayser was aware, Excelligence had communicated to stock market
8 analysts and other members of the public that it expected to report annual operating income of
9 between \$3 million and \$6 million. Kayser told several employees that she believed that if
10 Excelligence met its operating income guidance she would receive a financial bonus.

11 10. In order to bring Excelligence's operating income within the guidance range, Kayser
12 directed her staff to look for credits or other accounting entries that would improve the Company's
13 annual operating income by reducing operating expenses. Kayser pressured her staff to find what she
14 called "good guys," positive book adjustments, and strongly discouraged or belittled employees who
15 found "bad guys," the journal entries that reduced operating income.

16 **B. Kayser Hides Unpaid Invoices and Manipulates Accounts**

17 11. In the first weeks of February 2005 while the process of finalizing Excelligence's
18 fiscal year 2004 financial statements was underway, an Excelligence employee discovered a group of
19 unpaid invoices for inventory the Company had received from its vendors that should have been
20 accrued as a liability and processed for payment according to Excelligence's accounts payable
21 policies. Rather than allow the invoices to be reviewed for payment processing, Kayser placed them
22 in her office and told employees that the invoices should not be removed. Although employees told
23 Kayser that vendors had been calling the Company demanding payment for inventory received by the
24 Company, Kayser kept the stack of invoices in her office, telling her staff "no touching, no seeing."

25 12. In late February, KPMG conducted a search at Excelligence for unprocessed expense
26 invoices, which would have encompassed those that Kayser had hidden. The purpose of this search,
27 which was routinely conducted in connection with Excelligence's year-end audit, was to ensure that
28 all of the Company's liabilities were properly recorded in the Company's books and records and

1 reported in its financial statements. Although Kayser saw the search being conducted, and although
2 she knew she had an obligation to tell KPMG about the unprocessed invoices in her office, she failed
3 to do so. She later told an employee that she had decided not to tell KPMG about the hidden
4 invoices.

5 13. By hiding the invoices from KPMG, Kayser diverted them from Excelligence's routine
6 processing, which involved recording the expenses reflected on the invoices in Excelligence's books
7 and records and paying them. Kayser's concealment of the invoices also gave the false appearance
8 that the expenses did not exist or had already been paid.

9 **C. Kayser Makes Unsupported Journal Entries to
10 Boost Operating Income and Meet Guidance**

11 14. On or around February 22, 2005, Kayser became aware that the Company had
12 conducted its routine physical inventory count and determined that it was \$150,000 less than was
13 currently recorded on its books. As Kayser was aware, generally accepted accounting principles
14 ("GAAP") required that the difference between the inventory amounts be recorded as a \$150,000
15 reduction in earnings. In order to avoid the reduction to Excelligence's operating income that would
16 result from such a charge, between February 22 and March 2, 2006, Kayser created and recorded
17 three improper journal entries to ensure that operating income would remain above the \$3 million
18 guidance threshold.

19 15. Kayser first recorded a journal entry that reduced the inventory expense accrual, which
20 tracked inventory that Excelligence had received but had not been paid for, by unilaterally removing
21 all accrued inventory expenses for inventory received by Excelligence between July and December
22 2004. She then recorded a second journal entry that restored only the inventory expense accrual for
23 inventory received by Excelligence in the month of December 2004. Kayser had been informed by
24 Excelligence employees that these journal entries were improper due to the unprocessed vendor
25 invoices hidden in Kayser's office and that they contravened Excelligence's historical policy of
26 accruing for six months of inventory expenses. The reduction to the inventory expense accrual
27 allowed Kayser to record a third journal entry that reduced the inventory on Excelligence's books by
28 \$116,000 below that determined by the routine physical inventory count. Together, the three journal
entries produced a \$116,000 positive credit to income on Excelligence's financial statements. Kayser

1 signed the three journal entries only after Excelligence's Controller refused to do so. As a result of
2 these journal entries, Kayser artificially boosted Excelligence's operating income by \$266,000,
3 consisting of the \$116,000 positive credit and the avoided negative \$150,000 charge to earnings.

4 **D. Kayser Misleads KPMG and Circumvents Internal
5 Controls to Cover Up Her Fraud**

6 16. In order to cover up her wrongdoing, Kayser made multiple false statements to and
7 concealed material facts from KPMG relating to the journal entries and the hidden unprocessed
8 invoices. Kayser told KPMG that the reduction of the inventory expense accrual was proper because
9 the Company accrues only one month of expenses rather than the six months that constituted the
10 account at year end. She also falsely told KPMG that the portion of the inventory expense accrual
11 that she wished to eliminate had been paid and no vendors were calling despite her knowledge to the
12 contrary. Kayser additionally told KPMG that an employee's mistake had resulted in bookkeeping
13 errors relating to the inventory expense accrual. Kayser, however, had previously been told by two
14 different employees that there were no errors in the inventory expense accrual. Further, Kayser failed
15 to disclose to KPMG the hidden invoices and the fact that she changed the accounting methodology
16 of the inventory expense accrual by reducing it to one month.

17 17. Kayser further deceived KPMG by signing a letter to KPMG, on behalf of
18 Excelligence, in which she falsely represented, among other things, that in connection with the 2004
19 fiscal year audit, Excelligence had discussed all material matters and made all relevant account
20 records available to the auditors and not circumvented internal controls.

21 18. In addition, Kayser circumvented internal controls designed to ensure the accurate
22 reporting of Excelligence's finances. She secretly reduced the inventory expense accrual from six
23 months to one month and diverted inventory expense invoices from routine processing. As a result,
24 Excelligence understated operating expenses and overstated operating income.

25 **E. Kayser Signs and Certifies False Financial Statements**

26 19. Aided by Kayser's fraudulent journal entries, Excelligence's actual operating income
27 for the fiscal year ended December 31, 2004, \$2,859,000, was artificially inflated by \$266,000, or
28 9.3%, to \$3,125,000, which exceeded the Company's guidance threshold of \$3,000,000. On March
14, 2005, Excelligence reported the false operating income in a Form 8-K report filed with the

1 Commission, and in a related press release. After the close of trading on March 14, 2005 following
2 the Company's earnings announcement, Excelligence's stock price closed at \$5.42 a share, which
3 represented a 5.47% increase over the prior trading day's closing price of \$5.14. Excelligence also
4 reported the false operating income information in its 2004 fiscal year financial statements, which
5 was incorporated in the Company's Form 10-K report for the fiscal year ended December 31, 2004
6 filed with the Commission on March 16, 2005.

7 20. On May 12, 2005, Excelligence filed with the Commission its financial statements for
8 the first quarter of 2005 in the Company's Form 10-Q report. Expenses relating to the hidden
9 invoices that should have been reported in fiscal year 2004 instead were improperly reported in the
10 first quarter of 2005. Kayser's failure to timely process and report expenses relating to the 2004 fiscal
11 year caused the Form 10-Q to be inaccurate.

12 21. Kayser signed Excelligence's 2004 Form 10-K report for the quarter and fiscal year
13 ended December 31, 2004, and the Company's Form 10-Q report for the first quarter of 2005 despite
14 her knowledge that the operating income and certain expense entries included in those reports were
15 false due to her fraud. In addition, she signed false certifications of those reports. Each certification
16 stated that the income statements and other financial information in the related report "fairly present
17 in all material respects the financial condition, results of operations and cash flows" of Excelligence
18 Learning Corporation, although Kayser knew that each of the reports was misleading. In addition, as
19 to each report, Kayser certified that Excelligence had disclosed all instances of fraud, whether or not
20 material, involving management or others with responsibility over internal controls, although she had
21 failed to disclose her fraud in manipulating Excelligence's accounts, books and records and in hiding
22 inventory invoices.

23 **F. Subsequent Events**

24 22. In July 2005, Excelligence's Audit Committee initiated an internal investigation after
25 learning about an employee's allegations that Kayser had hidden documents from KPMG. In the
26 course of the investigation, Kayser stated to the Audit Committee that she had withheld inventory
27 expense invoices from KPMG. She also stated that she instructed the recording of the journal entries.
28

1 28. By reason of the foregoing, Kayser violated, and unless restrained and enjoined, will
2 continue to violate Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 [17 C.F.R.
3 § 240.10b-5].

4 SECOND CLAIM FOR RELIEF
5 (False Sarbanes-Oxley Certifications – Violation
6 of Rule 13a-14 under the Exchange Act)

7 29. The Commission realleges and incorporates by reference Paragraphs 1 through 25,
8 above.

9 30. As Excelligence's Chief Financial Officer, defendant Kayser signed false certifications
10 pursuant to Rule 13a-14 under the Exchange Act [17 C.F.R. § 240.13a-14] which were included in
11 Excelligence's annual report filed on Form 10-K on March 16, 2005, and in a report on Form 10-Q
12 for the first quarter of 2005 filed on May 12, 2005. In such certifications, defendant Kayser falsely
13 stated, among other things, that: (a) the report did not contain any untrue statement of a material fact
14 or omit to state a material fact necessary to make the statements made, in light of the circumstances
15 under which such statements were made, not misleading; (b) the financial statements, and other
16 financial information included in the report, fairly presented in all material respects the financial
17 condition, results of operations, and cash flows of Excelligence as of, and for, the period presented in
18 the report; and (c) she had disclosed to Excelligence's auditors all significant deficiencies in the
19 design or operation of Excelligence's internal controls and any fraud, whether or not material, that
20 involved management or other employees who had a significant role in Excelligence's internal
21 controls.

22 31. By reason of the foregoing, Kayser has violated and, unless restrained and enjoined,
23 will continue to violate Exchange Act Rule 13a-14 [17 C.F.R. §240.13a-14].

24 THIRD CLAIM FOR RELIEF
25 (Circumventing Internal Accounting Controls—Violation of
26 Section 13(b)(5) of the Exchange Act)

27 32. The Commission realleges and incorporates by this reference Paragraphs 1 through 25,
28 above.

SIXTH CLAIM FOR RELIEF

(False Reports Filed with the Commission—Aiding and Abetting Violations
of Section 13(a) of the Exchange Act and Rules 12b-20,
13a-1, 13-11 and 13a-13 Thereunder)

41. The Commission realleges and incorporates by this reference Paragraphs 1 through 25, above.

42. Based on the conduct alleged above, Excelligence violated Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, 13a-11 and 13a-13 hereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11 and 240.13a-13], which obligate issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to file with the Commission accurate annual, quarterly and current reports.

43. By engaging in the conduct alleged above, Kayser knowingly provided substantial assistance to Excelligence's filing of materially false and misleading reports with the Commission.

44. By reason of the foregoing, Kayser aided and abetted violations by Excelligence of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11 and 240.13a-13]. Unless restrained and enjoined, Kayser will continue to aid and abet such violations.

SEVENTH CLAIM FOR RELIEF

(Inaccurate Books and Records—Aiding and Abetting Violations of
Section 13(b)(2)(A) of the Exchange Act)

45. The Commission realleges and incorporates by this reference Paragraphs 1 through 25, above.

46. Based on the conduct alleged above, Excelligence violated Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)], which obligates issuers of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.

47. By engaging in the conduct alleged above, Kayser knowingly provided substantial assistance to Excelligence's failure to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect its transactions and dispositions of its assets.

1 48. By reason of the foregoing, Kayser has aided and abetted violations by Excelligence of
2 Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)]. Unless restrained and
3 enjoined, Kayser will continue to aid and abet such violations.

4 EIGHTH CLAIM FOR RELIEF
5 (Inadequate Internal Accounting Controls—Aiding and Abetting
6 Violations of Section 13(b)(2)(B) of the Exchange Act)

7 49. The Commission realleges and incorporates by this reference Paragraphs 1 through 25,
8 above.

9 50. Based on the conduct alleged above, Excelligence violated Section 13(b)(2)(B) of the
10 Exchange Act [15 U.S.C. § 78m(b)(2)(B)], which obligates issuers of securities registered pursuant to
11 Section 12 of the Exchange Act [15 U.S.C. § 78l] to devise and maintain a sufficient system of
12 internal accounting controls.

13 51. By engaging in the conduct alleged above, Kayser knowingly provided substantial
14 assistance to Excelligence's failure to devise and maintain a sufficient system of internal accounting
15 controls.

16 52. By reason of the foregoing, Kayser has aided and abetted violations by Excelligence of
17 Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)]. Unless restrained and
18 enjoined, Kayser will continue to aid and abet such violations.

19 PRAYER FOR RELIEF

20 WHEREFORE, the Commission respectfully requests that this Court:

21 I.

22 Enjoin Kayser from directly or indirectly violating Sections 10(b) and 13(b)(5) of the
23 Exchange Act [15 U.S.C. §§ 78j(b) and 78m(b)(5)], and Rules 10b-5, 13a-14, 13b2-1 and 13b2-2
24 thereunder [17 C.F.R. §§ 240.10b-5, 240.13a-14, 240.13b2-1 and 240.13b2-2], and from aiding and
25 abetting violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C.
26 78m(a), 78m(b)(2)(A) and 78m(b)(2)(B)] and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder
27 [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11 and 240.13a-13];
28

1 II.

2 Prohibit Kayser, pursuant to Section 21(d)(2) of the Exchange Act [15 U.S.C. § 78u(d)(2)],
3 from serving as an officer or director of any entity having a class of securities registered with the
4 Commission pursuant to Section 12 of the Exchange Act [15 U.S.C. § 781] or that is required to file
5 reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)];

6 III.

7 Order Kayser to pay civil penalties pursuant to Section 21(d) of the Exchange Act [15 U.S.C.
8 § 78u(d)].

9 IV.

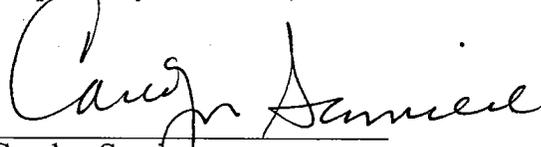
10 Retain jurisdiction of this action in accordance with the principles of equity and the Federal
11 Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that
12 may be entered, or to entertain any suitable application or motion for additional relief within the
13 jurisdiction of this Court.

14 V.

15 Grant such other and further relief as this Court may determine to be just and necessary.

16
17 DATED: September 13, 2006

Respectfully Submitted,

18 

19
20 Carolyn Samiere
21 Attorney for Plaintiff
22 SECURITIES AND EXCHANGE COMMISSION
23
24
25
26
27
28