

Case 08-9
Fraud and Illegal Acts

We have been hired to perform an audit of Jersey Johnnie's Surfboards Inc. (the "Company"), which is an SEC registrant. Before completing the December 31, 2005, audit of the Company, Harry Hodad, the engagement partner, received a call from Tom Tube, the Company's director of ethics and compliance. Mr. Tube said that the Company's outside service provider that receives calls to the Company's ethics and compliance hotline had informed him directly that the hotline had received a call alleging certain accounting improprieties as well as concerns about management's overall commitment to accurate financial reporting. The transcript of the call was provided to the engagement partner and is included as Attachment I.

Required:

- What steps should management, the Board of Directors, or the Audit Committee of the Board of Directors take in response to allegations of possible fraud or illegal acts?
- What steps should the audit engagement team take in response to allegations of possible fraud or illegal acts?

Additional Information:

The Audit Committee hired independent legal counsel, Moore, Billings & Co., PLC, to investigate the allegations of possible fraud or illegal acts. Counsel's draft report is included as Attachment II.

Required:

- Was the scope of the independent investigation sufficient? Why or why not?
- If the audit engagement team determines that the scope of the investigation is not sufficient to support the preliminary conclusions reached, what additional procedures or inquiries might the engagement team suggest?
- If those charged with governance or management fail to give this matter the appropriate level of consideration or take the steps necessary under the circumstances, what considerations should the audit engagement team give to the implications of possible fraud or illegal acts on the conduct of the audit?

TRANSCRIPT

OPERATOR: Hello, my name is Jill Shubee and you have reached the Jersey Johnnie's Surfboards Inc. ethics and compliance hotline. How may I help you this evening?

CALLER: Hello, I'd rather not give my name . . . is that all right?

OPERATOR: Of course, there is no need for you to provide your name. Our goal here is to make you as comfortable as possible throughout this process. All conversations are kept strictly confidential. A transcript of our conversation will, however, be prepared and sent directly to the director of ethics and compliance for review and further consideration.

CALLER: Okay, I'm comfortable with that.

OPERATOR: So how can I help you?

CALLER: Well, I've become aware of a transaction that I'm not sure was accounted for correctly. I started asking questions about how we had accounted for it, and the CFO seemed to become very irritated. He told me I didn't understand all of the facts relating to this transaction and said I should "stay out of it."

Here's what I know: for years now, we've been working with this one independent sales representative in Mexico, Juan Sinaloa, who had developed local relationships and facilitated the sales of our products. From what I've heard, he also seems to be well-connected to local government officials in that area. What seemed strange to me, however, was an invoice I noticed that was dated December 31, 2005, our year-end. The invoice was addressed to Mr. Sinaloa. The reason this was strange was that we had never recognized any revenue associated with products shipped to Mexico until Mr. Sinaloa presented a confirmed sales order and those products were shipped. It seemed like we made an exception in this case. We do have distributors, but all of those relationships are supported by a distributor agreement that's negotiated by our legal department and approved by the VP of sales and the CEO. I hadn't seen a distributor agreement between the Company and Mr. Sinaloa.

OPERATOR: Is that all?

CALLER: No, there's more. When I first started asking the CFO questions about this transaction, he told me that the VP of sales had personally been working with Mr. Sinaloa to transition him to a distributor relationship. He claimed there was plenty of correspondence between the Company's CEO, legal department, and himself that provided evidence of related negotiations that had started during the third quarter. He also indicated that a distributor

agreement had been executed just before year-end but had just not yet been filed with the other distributor agreements.

Look, I may be overreacting here! I'm not sure that there's anything wrong or that anyone has done anything intentionally. I just know that we really struggled to meet budget this year and this invoice really helped us out. The other thing is that I feel like I can't question things like this. The CFO has a very controlling personality and he gets very upset when I or others ask too many questions. He's pretty intimidating! I heard that the former controller resigned because of a run-in with the CFO, but that was before I started with the Company.

OPERATOR:

Thank you, I think I've got it. Now let me review the facts with you as I've recorded them and then we'll talk about how we might get back in touch with you should there be any follow-up questions. Please hold and I'll be right back . . .

PRELIMINARY DRAFT — FOR DISCUSSION PURPOSES ONLY**March 15, 2006****Moore, Billings & Co., PLC****I. Background Information**

On the basis of interviews and the review of documentation, we developed the following understanding of the facts and circumstances surrounding the December 31, 2005, sales transaction in question.

In October of 2005, the Company was notified by Juan Sinaloa that a customer was interested in purchasing a very significant amount of its products. Although Mr. Sinaloa had orally agreed to the terms of the transaction with the customer, he had not yet received a sales order. Mr. Sinaloa requested that the Company ship the products to him so that he could fill the order immediately once a sales order was received.

We understand that discussions had been initiated (before year-end) with Mr. Sinaloa to transition his relationship with the Company from that of an agent to a distributor. Per our discussions with the CFO, we understand there were two primary causes for this transition. First, Mr. Sinaloa had been seeking to increase his commission because of the volume of prior sales he had negotiated for the company and the expected increases in future sales. Second, related specifically to the December 31, 2005, sale, we understand that the customer's general manager was on vacation and would not be able to sign the customer's purchase order before year-end. As a result of these factors, the Company's VP of sales orally approved the transition. A distributor agreement was drafted and signed by all parties after year-end.

Before the execution of the distributor agreement, Mr. Sinaloa was responsible for soliciting orders for the Company's products and submitting those orders to the Company for fulfillment. Mr. Sinaloa did not take delivery of or title to the products. Under the terms of the distributor agreement, Mr. Sinaloa would now submit orders to the Company and take delivery of and title to the products. The distributor agreement specifically indicates that there is "no right of return." As a distributor, we estimate that Mr. Sinaloa would earn at least a 3 percent higher commission on sales of the Company's products. Payment terms are not documented in the distributor agreement with Mr. Sinaloa, but would be 60 days (based on terms with other distributors).

II. Scope of Work

As agreed with the chairman of the Audit Committee, we performed the following procedures during the course of our investigation.

A. Document Collection

The review included the collection and review of relevant paper and electronic documents relating to the December 31, 2005, sale of products to Mr. Sinaloa.

Specifically, we requested and received documentation from the VP of sales and the CEO regarding this transaction.

B. Interviews

In addition to reviewing documentation, we conducted interviews with the VP of sales, the CFO, and the CEO. Because Mr. Sinaloa lives in Mexico, our interview with him was by telephone.

C. Accounting Review

Because the timing of the transaction was unusual, we made specific inquiries into management's intent in negotiating the transition of Mr. Sinaloa's relationship. We confirmed with the Company the level of compensation that Mr. Sinaloa received for the transaction. We also confirmed with management that no employee of the Company actively participated in or influenced the management of Mr. Sinaloa's newly formed distribution business. We understand that Mr. Sinaloa has requested an extension of the Company's standard 60-day payment terms; however, management has informed us that it intends to deny this request. We also understand that, as of the date of this preliminary report, the Company has not entered into any additional sales transactions with Mr. Sinaloa.

III. Preliminary Conclusions

Based on the preliminary findings of our investigation, it appears that a distributor agreement was executed with Mr. Sinaloa before year-end, as evidenced by the existence of e-mails and other documentation regarding ongoing negotiations with Mr. Sinaloa to transition his relationship with the Company.

We found no evidence that the transaction was a product of any inappropriate conduct by the management of the Company or that it lacked substance or legitimate business purpose. We are also unaware of any oral or other side agreements that would influence the Company's accounting for the December 31, 2005, transaction.