Journal of Economics, Finance and Management Studies

ISSN (print): 2644-0490, ISSN (online): 2644-0504

Volume 5 Issue 06 June 2022

Article DOI: 10.47191/jefms/v5-i6-26, Impact Factor: 6.274

Page No. 1751-1759

An Auditor's Duty to Scrutinize a Client's Revenue Resulting from "Bill and Hold" Sales: A Legal Case Study of U.S. Securities and Exchange Commission v. Winemaster

Stephen Errol Blythe

Professor of Accounting and Business Law, College of Business, Tarleton State University, Fort Worth, Texas USA

ABSTRACT: This is a case study of U.S. Securities and Exchange Commission v. Winemaster, a federal cause of action filed in 2021. The case is ongoing and a final judgment has not been entered in this case. After the case was filed by the plaintiff Securities and Exchange Commission (SEC), two of the corporate officer defendants filed motions to dismiss. The court denied the defendants' motions to dismiss the case, and the case meticulously explains why the defendants' motions were denied. The specific issues discussed include: (a) legal elements of several types of securities fraud claims; (b) the effect of the Private Securities Litigation Reform Act upon the pleading of complicity of corporate officers in securities fraud; (c) how SEC Rule 10b-5 affects a company's officers; (d) the legal requirements which would justify the inclusion of "bill and hold" (b&h) sales in the revenue of a company; (e) the legal duty of corporate officers to maintain a system of internal accounting controls; (f) whether the three corporate officer defendants were required to have accounting expertise in order to be held liable for securities fraud; and (g) implications for auditors emanating from this case.

KEYWORDS: Securities fraud, "bill and hold" sale, overstated revenue.

I. GENERAL PROBLEM

The problem in this article is to study the legal case of U.S. Securities and Exchange Commission v. Winemaster and to focus on: factors indicative of overvaluation of a firm's revenue due to recognition of b & h sales, how a business firm's internal controls (or lack thereof) impact a securities fraud case, the legal elements required to prove several types of securities fraud, whether it is essential for a defendant in a corporate securities fraud case to have accounting knowledge or accounting expertise in order to have actual knowledge of an accounting violation, and implications for auditors emanating from this case.

II. REVIEW OF THE LITERATURE: WHETHER A FIRM'S REVENUE RESULTING FROM A "BILL AND HOLD" SALE IS LEGALLY RECOGNIZABLE OR IS A FORM OF ILLEGAL SECURITIES FRAUD.

Only a handful of business journals have addressed this issue. Lord (2010) briefly mentioned "bill and hold" (b&h) sales as one form of corporate fraud in a general call for academics to be more mindful of fraud issues. Alturki (2020) listed b&h sales as one type of occupational fraud that is perpetrated inside business processes, and described business processes as being crucial in the attainment of an organization's strategies to achieve organizational goals. Erguden (2020) analyzed whether Turkish tourism companies were in compliance with International Financial Reporting Standards relating to recognition of revenue, and used b&h sales as one example of a practice which would violate those standards.

Law journals have covered the issue of b&h sales somewhat more than business journals. Warren (2003) discussed the corporate counsel's perspective on a firm's revenue recognition and b&h transactions. Fisher (2003/2004) covered what corporate counsels failed to do regarding revenue recognition and b&h sales in the Enron and other scandals that occurred around the turn of the millennium. Weiss & Berney (2004) gave advice on how to restore investor trust in auditing standards and accounting principles in the aftermath of those scandals. Whitestone (2005), also writing in the wake of those scandals, explained the issue of whether principles-based accounting standards were more effective at preventing financial fraud. Deming (2006) highlighted the efficacy of the Foreign Corrupt Practices Act in prevention of white-collar crime. Hill (2012), writing in the aftermath of the 2008 Financial Crisis, analyzed whether the post-crisis regulatory reforms would be effective in curbing illegal or unethical behavior of bankers. Prior to the case covered in this article, a total of 12 U.S. legal cases have dealt with the issue of b&h sales. In most of these cases, b&h sales was a tangential issue, not the primary issue.

In the Mattel case (1974), the SEC brought suit against a firm for using b&h sales to overstate reported income by $10.5 million; the SEC issued a declaratory judgment against the firm and ordered them to cease and desist this misleading scheme. In the Salzman case (1986), the U.S. Bankruptcy Court in New York City ruled that the debtor company had forged bills of lading for which merchandise had not been shipped; the plaintiff lender had advanced funds to the debtor in reliance upon the validity of the assigned receivables. In the Electro-Catheter case (1987), the SEC filed a suit against the firm for overstating its income by $1.4 million by improperly reporting or causing to be reported six b&h transactions, representing $4.5 million in purported revenue, at times when no sales should have been reported under generally accepted accounting principles (GAAP); the court noted that b&h sales are highly unusual in the catheter industry because of the limited shelf life of many products and the resultant need to ship goods as soon after manufacture as possible to the ultimate end-user. In the Cammer case (1989), the court found a business firm to have overstated its revenue using b&h sales; the court noted that b&h sales are recognizable as revenue only when there is a sound business justification, such as the failure of the customer to instruct the company as to where and when to ship the goods. In the Sunbeam case (1999), a group of stockholders brought suit against several officers and directors of the firm, alleging knowing or reckless conduct that resulted in overstatement of corporate revenue using b&h transactions; the court dismissed some of the defendants because they were somewhat removed from the day-to-day operations of the corporation, but they other defendants were not dismissed. In the Holmes case (2001), a stockholder brought suit against the corporation, its directors and executives, and its auditor; plaintiff alleged that b&h transactions had been improperly used to inflate income, but the auditor avoided liability because it had taken preventive measures to stop the accounting fraud. In the Shubert case (2005), a bankruptcy trustee successfully sued a creditor for breach of contract, alleging that the creditor refused to pay for services provided by the debtor; using its power as the larger of the two companies and as debtor's lender, the creditor coerced the debtor to purchase unneeded products to inflate the creditor's revenues. In the Todd case (2006), the SEC sued the chief executive officer (CEO) and chief financial officer (CFO) of a corporation for securities fraud; one of the claims was that defendants had issued a false management representation letter to the auditor, but the court held that the change in loan loss reserve was a change in estimate, rather than a change in accounting principle, such that it did not require disclosure. In the Cohen case (2007), the SEC sued a corporate CFO for securities fraud, alleging he accelerated revenue to meet earnings goals which resulted in material misrepresentations in the reporting of corporate income; the CFO obtained money from investors based on the overstated income, falsified books and records, filed misleading reports with the SEC and others, failed to implement internal controls, and made false statements to corporate auditors. In the Bison case (2009), the Chapter 11 bankruptcy debtor was granted authorization to attempt to attain post-petition secured financing; the debtor showed a need for cash in order to maintain its business relationships and that the financing was essential to its continued viability. In the Geswein case (2011), the SEC successfully sued a corporation's former Director of Accounting for securities fraud involving the use of b&h transactions. In the Doshi case (2015), a group of stockholders sued a corporation for overstating revenue using b&h sales and for failure to prevent theft of inventory resulting in overstatement of inventory on the balance sheet. In the Morning Star case (2020), the U.S. Tax Court found that a corporation's tax return was erroneous because the production costs claimed actually should have been recognized in another tax year; the court also noted that 30% of the corporation's customers had b&h contracts with the firm, but this type of b&h arrangement was acceptable because it was done at the request of and with the permission of the customers.

Missing from the literature is a study of a recent legal case: (a) explicitly stating the legal requirements for recognition of b&h sales as legitimate revenue of a firm, and (b) in which corporate officers illegally recognize b&h sales in order to achieve a publicly announced revenue guidance goal. This study will fill that gap and will enrich the literature.

III. SPECIFIC OBJECTIVES

The objectives of this article are to analyze the legal case of U.S. Securities and Exchange Commission v. Winemaster and to: (a) explain the elements of a case of securities fraud pursuant to the Securities and Exchange Act of 1934, and tell how the corporate officer defendants in this case allegedly violated that statute; (b) describe the effect of the Private Securities Litigation Reform Act on a plaintiff's pleading of a securities fraud claim, and tell how that statute affects the plaintiff's pleadings in this case; (c) explain SEC Rule 10b-5 and tell how the corporate officer defendants in this case allegedly violated Rule 10b-5; (d) explain the plaintiff SEC's perspective as to whether the corporate officer defendants in this case are liable for securities fraud; (e) explain when a corporation is legally allowed to recognize revenue from a b&h sale, and when such recognition becomes a form of securities fraud; (f) tell whether a corporate officer defendant accused of securities fraud must have accounting expertise in order to be held liable; and (g) state implications for auditors emanating from this case.

IV. RESEARCH METHOD: A CASE STUDY OF U.S. SECURITIES AND EXCHANGE COMMISSION v. WINEMASTER A. Facts of the Case

Power Solutions International, Inc. (PSI) is a U.S. publicly-traded corporation that manufactures and sells engines. During 2014 and 2015, PSI was finding it difficult to meet its revenue targets. Despite its extensive marketing efforts, sales remained low because of a lack of demand for its products. This led PSI to artificially inflate its revenue numbers by fraudulently accounting for several transactions. As a result, PSI's sales on its income statements during those two years was overstated by $29.8 million.

In 2021, the U.S. Securities and Exchange Commission (SEC) filed a securities fraud lawsuit against three of PSI's officers. The defendants are: (1) the CEO, Gary Winemaster (Winemaster); (2) Craig Davis (Davis), the Vice President of Sales; and (3) James Needham (Needham), the General Manager for Industrial Products. The lawsuit alleged that these officers had violated the Securities Exchange Act (Exchange Act) s 10(b) by overstating the amount of the firm's sales in the financial statements; the lawsuit also alleged the officers had violated SEC Rule 10b-5 by filing audited financial statements with the SEC in 2014 and 2015, with knowledge that the revenue in those financial statements was materially misstated (Winemaster case, pp. 1-2).

B. Pursuant to the Securities Exchange Act of 1934, What Are the Legal Elements of a Securities Fraud Case?

In the aftermath of the stock market crash of 1929 and the Great Depression which followed, two federal U.S. statutes were enacted pertinent to regulation of the sale of securities (stocks and bonds) on stock exchanges: the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 statute regulated initial public offerings of securities. The 1934 statute regulated public offerings of securities following the initial offering, and it also created the Securities and Exchange Commission (SEC), the federal agency charged with enforcement of the 1933 and 1934 statutes. These two statutes are inapplicable to private corporations, i.e., those corporations whose securities are not traded on a public exchange.

Under Section 18a of the Exchange Act, in order to plead a case of securities fraud, a plaintiff is required to state that: defendant made a materially false or misleading statement; the statement was contained in a document filed pursuant to the Exchange Act or any rule or regulation thereunder; plaintiff relied on the false statement; and plaintiff thereby incurred a loss.

In this case, plaintiff SEC, acted in its role of protecting the general public, sued three corporate officers: Winemaster, Davis and Needham. The SEC alleged the three officers committed securities fraud by: (a) making false statements in the audit report; (b) filing the audit report with the SEC; (c) the audit report was read by investors; (d) investors relied on the false statements in the audit report by purchasing the PSI stock; and (e) the investors thereby incurred a financial loss (Winemaster case, pp. 45-52).

C. What is the Effect of the Private Securities Litigation Reform Act (PSLRA) on a Plaintiff's Pleading of a Securities Fraud Claim?

The PSLRA, a federal securities statute enacted in 1995, was designed to prevent unwarranted or frivolous lawsuits from being filed, which can be expensive, time-consuming and can reduce the efficiency of the legal system. The PSLRA requires a plaintiff to state with particularity the circumstances constituting defendant's fraud or mistake. Conclusory allegations are insufficient. Plaintiffs must comply with stringent pleading requirements, to wit: they must allege specific fraudulent statements made by defendant, that the statements were made recklessly or intentionally, and that they relied upon the false statements and thereby incurred a financial loss because of the fraud. Before the PSLRA was enacted, plaintiffs could reasonably file a lawsuit simply because the price of a security had changed significantly (Chen, 2020).

In this case, plaintiff complied with the stringent pleading requirements of the PSLRA because plaintiff stated with specificity how the three defendants committed securities fraud. (Winemaster case, headnotes 3 and 15).

D. What Is the Significance of SEC Rule 10b-5 In This Case?

SEC Rule 10b-5 broadly prohibits publicly-traded corporations' fraudulent and deceptive practices and untrue statements or omissions of material facts in connection with the purchase or sale of any security. Unlike Section 18 of the Exchange Act, this provision applies to any information released to the public by the issuing corporation, including press releases and annual and quarterly reports to stockholders. In this case, SEC Rule 10b-5 was allegedly violated in 2014 and 2015 when PSI filed inaccurate financial statements with the SEC (Winemaster case, pp. 72-75).

E. Why Are PSI's Internal Controls, Or Lack Thereof, Significant In This Case?

It is illegal for any publicly-traded firm to knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or accounting required to be kept under s 13(b)(2) of the Exchange Act. Accordingly, the defendants, as officers of the firm, had a legal duty to maintain an effective system of internal accounting controls (Winemaster case, headnote 32 and pp. 92-93).

F. When Should a Business Firm's Revenue Be Recognized?

According to GAAP, revenue should be recognized on a company's books when it is realized, realizable and earned. PSI stated in its SEC's filings that its policy was to recognized revenue upon transfer of title and risk of loss to the customer, which is typically when products are shipped, provided there is persuasive evidence of an arrangement, the sales price is fixed or determinable and management believes collectability is reasonably assured. However, PSI admitted that sometimes non-standard terms or side arrangements relating to a particular sale could affect PSI's ability to recognize revenue while maintaining consistency with GAAP requirements. An excellent example of a non-standard transaction is a b&h sale (Winemaster case, p. 7, italics added).

G. What is a "Bill and Hold" Sale?

Typically, as noted above, a business firm should book a sale in the accounting records on the shipping date of the goods. However, a b&h sale is an exception to this policy. In a b&h transaction, the sale is recorded in the books before the goods are shipped. Ordinarily, GAAP forbids the recognition of revenue emanating from a b&h transaction; this is because the firm is recognizing revenue that has not yet been earned, the sales figure on the income statement will be inflated, and the income will be overstated. All of this will mislead readers of the financial statements. Because of the detrimental effects caused by b&h sales, the law presumes they are an illegal form of securities fraud. However, in exceptional circumstances, b&h sales may be held to be in compliance with GAAP and will be legal. Those exceptional circumstances are covered next and are the primary focus of this article (Winemaster case, pp. 7-8).

H. Pursuant to Generally Accepted Accounting Principles, What Exceptional Circumstances Must Be Present In Order For Revenue To Be Properly Recognized From a "Bill and Hold" Sale?

The requirements to be met for proper recognition of revenue from a b&h sale are stringent and strictly applied: (1) the risks of ownership must pass to the buyer at the time of the b&h transaction; (2) the buyer must have made a definite commitment to purchase the goods; (3) the buyer, not the seller, must have requested that the transaction be implemented on a b&h basis; (4) the buyer must have a substantial business purpose for placing the order on a b&h basis; (5) the future delivery date of the goods must be fixed and definite; (6) the future delivery date must be reasonable and consistent with the buyer's substantial business purpose for the b&h transaction; (7) the seller must not retain any specific performance obligations related to the sale; and (8) the goods must be complete and ready for shipment at the time of the b&h transaction. (Winemaster case, headnote 1, italics added).

I. Was PSI Justified in Recognition of the Revenue From the "Bill and Hold" Sale to Customer A?

No. The general rules under GAAP, covered above, mandate that a b&h sale cannot be recognized as revenue if the seller, not the buyer, has requested the b&h arrangements. In this case, PSI requested the buyer to accept the b&h arrangements and to agree to advance recording of the sale on the books before the goods were shipped. The sales department knew it had a duty to inform the accounting department of the non-standard terms of the b&h sale, but it failed to do so. (Winemaster case, pp. 6-7).

J. Did Winemaster have Responsibilities with Respect to the Financial Statements and the Internal Control System?

Yes. As CEO, Winemaster was responsible for reviewing and approving PSI's consolidated financial statements and approving, signing and certifying PSI's periodic public reports, including SEC Forms 10-K and 10-Q. When signing each of the SEC reports, Winemaster certified that each report did not include any material misstatements or omissions and fairly presented, in all material respects, PSI's financial condition for the reporting period. Additionally, Winemaster was responsible for establishing and maintaining PSI's internal accounting controls (Winemaster case, pp. 3-4).

K. Did Winemaster Make False Statements in the Management Representations Letter He Sent to the Auditor?

Yes. At the end of each quarter in 2015, Winemaster signed a management representations letter to PSI's auditor that included false statements because of PSI's improper recognition of revenue. Specifically, each letter certified that the financial information for that quarter was presented in accordance with GAAP, there was no fraud or suspected fraud affecting PSI, there were no material transactions that had not been properly recorded in the accounting records, there were no undisclosed side agreements, and the firm had informed the auditor of all uncorrected misstatements. At the time he signed these letters, Winemaster knew that there were undisclosed side arrangements regarding the sales for which PSI improperly recognized revenue and also regarding the right to return the goods for a refund (Winemaster case, pp. 27-28).

L. In View of the Fact That Customer B Had a Right To Return the Purchased Goods, Should PSI have Recognized the Revenue from the Customer B Sales?

No. The sales contract with Customer B gave the buyer the right to return the goods, although the right of return clause was indefinite. Winemaster did not inform the accounting department or anyone else at PSI of the indefinite right of return prior to filing SEC Form 10-Q for the first quarter of 2015. GAAP provides that a firm is not allowed to recognize revenue when a right of return exists unless the firm can reasonably estimate the amount of future returns. In this case, PSI had no way of estimating returns or knowing whether Customer B’s intended customer would ultimately cancel its order. Accordingly, PSI’s recognition of the sales to Customer B violated GAAP and further misleadingly inflated the sales figure on the income statement (Winemaster case, pp. 12-13).

M. Did PSI Try To Conceal the Details of Its Customer C Sales?

Yes. When PSI’s accounting department tried to collect from Customer C the $10 million it agreed to pay for the engines purchased in the second quarter of 2015, Customer C refused based on the provisions of the Customer C Letter Agreement. PSI’s Controller studied the Letter and concluded it was a consignment of goods instead of a sale, and this meant the revenue should have been deferred, not recognized immediately. This led the Controller to state that the firm’s financial statements for the second quarter of 2015 would have to be restated, with the sales and the income reduced.

In late January 2016, Customer C’s Chief Operating Officer (COO) emailed Needham regarding the sale from the third quarter of 2015 that PSI had booked for $4.3 million. The COO reminded Needham that the firms did a $3 million dollar deal, but PSI “upped the price so it made your numbers look better.” When Needham conferred with Davis about this matter, Davis told him to have Customer C pay the $3 million and “not reference anything at this point in time.” Needham then told Customer C to pay only the $3 million and that PSI would make an adjustment for the other $1.3 million at a later time. Davis explained to Winemaster that the deal was actually for $3 million and Customer C was going to “short pay” by the amount of $1.3 million, and that was a problem they had to address. Needham was obviously concerned that PSI’s accounts receivable department would ask Customer C why it had not paid the full amount of $4.3 million.

Needham wanted to find a solution that would take care of the problems relating to the sales to Customer C in the second and third quarters. He proposed that PSI should trade a write-off of the $1.3 million balance from the third quarter sale and price incentives for future purchases in exchange for Customer C’s payment of the $10 million balance from the second quarter sale over six months. However, Customer C’s COO balked at this idea and refused to connect the second quarter sale to the third quarter sale, stating that this would “raise all sorts of red flags around here.” PSI next tried to get Customer C to make a $5 million payment on the balance in return for PSI’s subsidization of the Customer C’s cost of capital, but this offer was also refused.

When PSI’s Controller found out about all of this, he wrote a letter to PSI’s Chief Financial Officer (CFO) and stated that the firm may have committed fraud by booking the additional $1.3 million in revenue from the third quarter sale to Customer C. Whereupon, the CFO discussed this with Winemaster, who insisted that PSI “doesn’t do business like that.” Winemaster also told the CFO he would meet with Customer C to discuss the matter. In April 2016, Winemaster and Needham developed a plan to prepare fake documents to send to Customer C to justify the $4.3 million price it had invoiced. In these documents, they claimed that more expensive domestic EPA-certified engines had been delivered to Customer C, not the less expensive international non-certified engines, because PSI did not have the international engines in stock. In reality, however, the engines sent to Customer C were the cheaper international engines, not the more expensive domestic engines. Winemaster sent the fake document to PSI’s CFO, who reminded him that the auditors would soon be there and they would be making inquiries about the $1.3 million discount. The CFO also stated that the discount should be returned and the income should be restated, but Winemaster declined to do so. He also never sent the fake document to Customer C.

On April 14, 2016, Winemaster and Needham met with Customer C and pressured C to pay for the engines in the second quarter. Winemaster threated to stop selling C additional engines or parts if it did not pay. This could have had a significant detrimental impact on C because PSI was the only supplier of the engines it used to power its generators, so C agreed to make a $5 million payment. In return, Winemaster agreed that PSI would subsidize C’s cost of capital on the $5 million payment for six months and would allow C to return $4 million of products. After the meeting, Winemaster told the CFO an untrue statement that C would pay $5 million immediately and pay the balance by the end of 2016, and the CFO so informed the accounting department. But the CFO and the accounting department were never told about the inducements (a capital subsidy and a right of return) Winemaster had given C (Winemaster case, pp. 28-34).

N. Did PSI Try To Conceal the Details of its Customer D Sales?

Yes. In April 2016, a dispute arose between PSI and Customer D regarding the sale of 3 generators to D in the fourth quarter of 2015. This dispute began when PSI refused to accept the return of Customer C's engines. D contacted Needham and reminded him that D had issued a purchase order to PSI at PSI's request so that PSI could book the sale before the end of 2015. He also stated that the return of the engines would be used as a credit towards the purchase of the 3 generators. Obviously, if the engines were not allowed to be returned, then the credit would not be given. If that happened, D told PSI it would not be complying with the purchase order D had issued for the generators.

Several weeks later, PSI's CFO sent an email to Winemaster expressing concern about the impending audit. He predicted that when the auditors came and discovered the details surrounding the sale to Customer D, they would insist on deletion of those sales from the income statement and issuance of a restatement of the financial statements. However, Winemaster settled the dispute with D in August 2016 when D agreed to take delivery of the 3 generators and pay for them. But at the insistence of Winemaster, D did not issue a new purchase order but merely supplemented the original purchase order issued in December 2015 (Winemaster case, pp. 34-36).

O. In PSI's Internal Investigation, Did Winemaster Give False Explanations For Some of the Transactions Under Investigation?

Yes. Due to an employment dispute, PSI's COO resigned from the firm in May 2016. Shortly afterwards, the former COO sent a letter and a draft complaint to PSI's Board of Directors, alleging that PSI's top management directed sales staff to "channel stuff" and "pull-up" sales from 2016 to inflate PSI's 2015 revenues so that the firm would not miss its target sales figure. The former COO cited the sales to Customer C and Customer D. In response, the Board of Directors and its Audit Committee confronted Winemaster about the allegations. He denied the allegations and promised to instruct the Chief Legal Officer and the CFO to investigate the matter.

In July 2016, the CFO sent the former COO's complaint to the auditor. The auditor stated it would not approve the firm's 10-Q until it received the results of the internal investigation. The investigation took place in August 2016. Winemaster made the following false statements to the investigators: that the $1.3 million shortfall relating to the Customer C sale was due to a "misunderstanding." The auditor was unconvinced and refused to sign the second quarter 2016 Form 10-Q (Winemaster case, pp. 36-38).

P. In Response to the SEC Investigation, Did Winemaster Attempt to Conceal Some of the Wrongful Transactions?

Yes. The SEC issued a document preservation notice and subpoena to PSI in August 2016. In September, Winemaster told the firm's Vice President of Advanced Product Development that because of the SEC investigation, PSI would need to rectify its outstanding accounts receivable from Customer C; Winemaster told the Vice President to find a buyer for C's excess engine inventory so that C would be able to pay its outstanding balance for the second and third quarter transactions. Later in 2016, Winemaster ordered the purchase of 60 generators from Customer C that contained PSI engines; however, PSI did not have potential customers for the generators and that purchase was only made to encourage C to pay its outstanding balance so that PSI could cover up its accounting shenanigans.

Additionally, Winemaster and Davis attempted to hide the right of return given to Customer B relating to its $7.8 million purchase in the first quarter of 2015. They instructed PSI's sales staff to help Customer B resell the engines to another PSI customer after Customer B attempted to return the engines to PSI in 2017 (Winemaster case, pp. 38-39).

Q. What Was the Total Amount of Inflated Revenue Revealed by PSI's Restated Financial Statements?

Between August 4, 2016 and April 7, 2017, PSI issued its restatements in several Form 8-K reports. On January 27, 2017, after the firm's independent investigation uncovered more details regarding the improper recognition of revenue from 2014 and 2015, PSI's auditor resigned. In its Form 10-K filed in 2017, the restated financial statements resulted in a total reduction of $29.8 million for the fourth quarter of 2014 through the fourth quarter of 2015 (Winemaster case, pp. 39-40).

R. Should PSI's Officers' Bonuses Be Impacted by PSI's Issuance of a Restatement of Its Financial Statements?

Yes. Pursuant to s 304 of the Sarbanes-Oxley Act, if a publicly-traded company is required to issue an accounting restatement because the firm has violated financial reporting requirements pursuant to the securities fraud laws, the CEO and CFO must reimburse the firm for any bonus or other incentives received. Accordingly, Winemaster's $280,000 bonus should be disgorged from him and returned to PSI (Winemaster case, headnote 34).

S. Did Any "Shotgun" or "Puzzle" Pleading Occur In This Case?

No. Defendants Winemaster and Needham contended that the SEC's complaint improperly relied on so-called "shotgun" and "puzzle" pleading. They complain that both forms of pleading are improper in a complex securities fraud case because they fail to adequately inform each Defendant of what alleged conduct gives rise to the claims against him.

"Shotgun" pleading refers to a practice of each count in a complaint incorporating by reference all preceding paragraphs and counts of the complaint notwithstanding that many of those facts are not relevant to that count. In some circumstances, a shotgun style of pleading can prevent the opposing party from being able to prepare a response or make the burden of doing so more onerous. But the mere fact that a complaint's counts incorporate by reference each of the preceding factual allegations does not make the complaint an impermissible shotgun pleading, so long as the complaint gives proper notice to defendants of the claims against them. In the present case, plaintiff did not group multiple defendants together and fail to state which defendant made each fraudulent statement or engaged in fraudulent conduct. Defendants were given adequate notice. There is no shotgun pleading in plaintiff's complaint.

"Puzzle" pleading refers to a pleading style that forces the Court and defendants to piece together exactly which of the defendant's statements the plaintiff is alleging were untrue or misleading, and what allegations contradict those statements. Such a pleading can improperly place the burden on the Court to sort out the alleged misrepresentations and then match them with the corresponding adverse facts. The net effect of a puzzle pleading may be to leave the defendants or the Court turning from page to page in an attempt to link the alleged statements to the background that supposedly makes them false or misleading. In the present case, the Court had no difficulty in identifying the false statements linked to the claims. It is clear how Winemaster and Needham's actions contributed to the alleged fraud. In other words, the Court was not required to make a great effort to determine which statements the SEC is alleging are misleading and which alleged facts support the SEC's claims. There is no puzzle pleading in plaintiff's complaint (Winemaster case, pp. 42-44).

T. Did the SEC Successfully State a Claim Against Needham for Aiding and Abetting Securities Fraud?

Yes. Section 20(e) of the Exchange Act provides that the SEC may consider any person who knowingly or recklessly gives substantial assistance to another person engaged in violation of the Exchange Act to be an aider and abettor. The SEC must specifically allege: (1) there is a primary violation of securities law; (2) the aider and abettor generally was aware that his actions were part of an overall course of conduct that was illegal; and (3) the aider and abettor substantially assisted in the primary violation (Winemaster case, headnote 26). In the present case, Needham personally negotiated a deal in which Customer C would submit a \$4.3 million purchase order while he verbally assured C that the true price it would pay was only \$3.0 million. According to the SEC ruling, Needham issued the direction "in order to make PSI's revenue numbers look better for the quarter." Needham committed a deceptive act by allowing the sale to be recorded at a higher price while simultaneously entering into a side verbal agreement at a reduced price in order to artificially inflate the revenue from the sale. Furthermore, Needham never informed PSI's accounting department about the actual amount of the sale. Needham claimed there was no deception because he disclosed the terms of the sale to his superiors. However, that does not excuse his conduct because the two superiors he referenced—Winemaster and Davis—were participants in the fraud scheme (Winemaster case, pp. 78-79).

U. Did the SEC Successfully State a Claim Against Winemaster For Control Person Liability?

Yes. In securities fraud law, control person liability may be used to one defendant vicariously liable for the securities violations committed by another. Section 20(a) of the Exchange Act lists the elements of control person liability. To simplify the explanation, the U.S. Seventh Circuit has expressed a 2-prong test for determination of control person liability: (1) the control person must have actually exercised general control over the operations of the fraudulent firm; and (2) the control person must have had the power or ability—even if not exercised—to control the specific transaction or activity that is alleged to give rise to liability (Winemaster case, headnote 28).

In this case, the SEC seeks to hold Winemaster liable for the two transactions in which he was not directly involved—the sale to Customer A and the sale to Customer D. The knowledge and actions of a firm's employees are generally imputed to the firm when the acts are performed within the scope of their authority; Davis and Needham were acting within their authority when they committed the unlawful acts. Allegations that corporate employees have engaged in fraud does not immunize the firm or its CEO from liability for the knowing deception; Winemaster, as CEO of the firm, is responsible for the other employees' fraudulent acts (Winemaster case, pp. 92-95).

V. Are the Three Corporate Officer Defendants Required to Have Accounting Expertise in Order to Be Held Liable For Securities Fraud?
No. They are not required to be accounting experts in order to be held liable for securities fraud. In this case, there is ample evidence that the three defendants were aware that the acts they engaged in were unlawful. For example, Winemaster signed and certified each filing despite knowing that revenue had been improperly recognized (Winemaster case, pp. 94-95 and headnote 24).

W. Did the Court Deny Winemaster and Needham's Motions To Dismiss?
Yes. (Winemaster case, pp. 2-3 and 33).

X. What Was the Final Outcome in This Case?
This litigation is ongoing.

V. CONCLUSIONS AND IMPLICATIONS FOR AUDITORS

A. The elements of a securities fraud case pursuant to the Exchange Act are: a materially false statement of defendant contained in a document filed with the SEC; the false statement was relied upon by plaintiff; and this caused plaintiff's financial loss.

B. SEC Rule 10b-5 requires publicly-traded corporations to be honest and forthright in information they disseminate to the public. This rule is broader than Section 18 of the Exchange Act and applies not only to statements filed with the SEC, but also to press releases and quarterly and annual reports issued to stockholders.

C. The elements of control person liability in a securities fraud case are: the control person must have actually exercised general control over the operations of the fraudulent firm; and the control person must have had the power or ability—even if not exercised—to control the specific transaction or activity that is alleged to give rise to liability.

D. The elements of aiding and abetting securities fraud are: there is a primary violation of securities law; the aider and abettor was aware this his actions were part of an overall course of conduct that was illegal; and the aider and abettor substantially assisted in the primary violation.

E. The Private Securities Litigation Reform Act requires a plaintiff to comply with stringent pleading requirements and he must allege: specific fraudulent statements made by defendant; the statements were made recklessly or intentionally; and plaintiff justifiably relied upon the statements, thereby incurring a financial loss.

F. A publicly-traded company has a legal duty to maintain an effective system of internal accounting controls.

G. Revenue should be recognized when it is realized, realizable and earned. Ordinarily, this will the date the goods are shipped.

H. A "bill and hold" (b&h) sale is one in which the sale is recorded in the books before the goods are shipped.

I. In these exceptional circumstances, revenue from a "bill and hold" sale may be recognized: (1) the risks of ownership must pass to the buyer at the time of the b&h transaction; (2) the buyer must have made a definite commitment to purchase the goods; (3) the buyer, not the seller, must have requested that the transaction be implemented on a b&h basis; (4) the buyer must have a substantial business purpose for placing the order on a b&h basis; (5) the future delivery date of the goods must be fixed and definite; (6) the future delivery date must be reasonable and consistent with the buyer's substantial business purpose for the b&h transaction; (7) the seller must not retain any specific performance obligations related to the sale; and (8) the goods must be complete and ready for shipment at the time of the b&h transaction.

J. The revenue from goods that are sold with a right of return should not be recognized unless the amount of returns can be reasonably estimated.

K. If a publicly-traded company is compelled to issue a restatement of its financial statements, the company's officers who received a bonus during the restatement period should return it to the company.

L. A corporate officer defendant is not required to be an accounting expert in order to be held liable for securities fraud.

M. Implications for auditors emanating from this case include: (1) "bill and hold" sales must be stringently scrutinized, and there should be a presumption of non-recognition unless each and every one of the exceptional circumstances (covered in item I, above) are present; (2) goods that are sold with a right of return should also be examined carefully, and the revenue from them should not be recognized unless the amount of returns can be reasonably estimated; (3) a client's management representation letter should also be parsed, with the auditor looking for untruthful or misleading statements as possible indicators of material misrepresentations or fraud in the financial statements; (4) the auditor should analyze any untruthful or misleading statements made by a client's officers during internal or external investigations because they may also be possible indicators of material misrepresentations or fraud in the financial statements; and (5) if a client is forced to issue a restatement of its financial statements, the client's officers who received a bonus during the restatement period should return it to the client.

REFERENCES

1) Alturki, A. (2020). Multi-Dimensional Fraud Detection Metrics in Business Processes and their Application. 11:9 International Journal of Advanced Computer Science and Applications 5-15.
2) Cammer v. Bloom, 1989 U.S. Dist. LEXIS 19284 (N.J. 1989). [Cammer case]
3) Chen, J. (2020). Private Securities Litigation Reform Act. Investopedia, https://www.investopedia.com/terms/p/pslra.asp .
4) Deming, S. (2006). Symposium 2006: The Changing Face of White-Collar Crime: The Potent and Broad-Ranging Implications of the Accounting and Record-Keeping Provisions of the Foreign Corrupt Practices Act. 96 Journal of Criminal Law &Criminology 465.
5) Doshi v. Gen. Cable Corp.,2015 U.S. Dist. LEXIS 9306 (E.D. Ky., N. Div. 2015). [Doshi case]
6) Erguden, E. (2020). Analysis of Tourism Companies Listed in Istanbul Stock Exchange According to IFRS-15 Standard. 9:1 International Journal of Finance & Banking Studies 47-57.
7) Fisher, W. (2003/2004). Where Were the Counselors? Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis. 39 Gonzaga Law Review 29.
8) Hill, C. (2012). Bankers Behaving Badly? The Limits of Regulatory Reform. 31 Review of Banking & Financial Law 675.
9) Holmes v. Baker, 166 F.Supp.2d 1362 (S.D. Fla. 2001). [Holmes case]
10) In re Bison Bldg. Materials, LLC, 2009 Bankr. LEXIS 5077 (S.D. Bankr., Houston Div. 2009). [Bison case]
11) In re Salzman, 61 B.R. 878 (S.D.N.Y. 1986). [Salzman case]
12) In re Sunbeam Securities Litigation, 89 F.Supp. 1326 (S.D. Fla. 1999). [Sunbeam case]
13) Lord, A. (2010). The Prevale2009nce of Fraud: What Should We, As Academics, Be Doing To Address the Problem? 9:1 Accounting and Management Information Systems 4-21.
14) Morning Star Packing Co., L.P. v. Commissioner, T.C. Memo 2020-142 (U.S. Tax Ct. 2020). [Morning Star case]
15) Shubert v. Lucent Techs., Inc. (In re Winstar Communs, Inc.), 348 B.R. 234 (Del. Bankr. 2005). [Shubert case]
16) U.S. Securities and Exchange Commission v. Cohen, 2007 U.S. Dist. LEXIS 28934 (E.D. Mo, E. Div. 2007). [Cohen case]
17) U.S. Securities and Exchange Commission v. Geswein, 2011 U.S. Dist. LEXIS 111904 (N.D. Ohio, E. Div. 2011). [Geswein case].
18) U.S. Securities and Exchange Commission v. Mattel, Inc., 1974 U.S. Dist. LEXIS 6489 (D.C. 1974). [Mattel Case]
19) U.S. Securities and Exchange Commission v. Electro-Catheter Corp. 1987 U.S. Dist. LEXIS 1071 (D.C. 1987). [Electro-Catheter Case]
20) U.S. Securities and Exchange Commission v. Todd, U.S. Dist. LEXIS 107919 (S.D. Cal. 2006). [Todd case]
21) U.S. Securities and Exchange Commission v. Winemaster, 2021 U.S. Dist. LEXIS 58750 (N. Dist. Ill., E. Div. 2021). [Winemaster Case]
22) Warren, M. (2003). Revenue Recognition and Corporate Counsel. 56 SMU Law Review, 56, 885.
23) Weiss, M. & Berney, E. (2004). Essay: Restoring Investor Trust in Auditing Standards and Accounting Principles. 41 Harvard Journal on Legislation 29.
24) Whitestone, D. (2005). Note & Comment: The Response to Enron in the United States and Canada: Are Principles-Based Accounting Standards More Effective at Preventing Financial Fraud? 11 Southwestern Journal of Law and Trade in the Americas 381.