Evergreen: An Educational Case Study on the Record-keeping Requirements that Apply to SEC Registrants

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ABSTRACT

An educational case study using a real-world example to teach the record-keeping requirements of the Exchange Act of 1934 (the Act) that apply to all Securities and Exchange Commission (SEC) registrants. Evergreen Networks is a US-based company whose primary business model involves designing, manufacturing, and selling computer networking equipment worldwide. Furthermore, the common stock of Evergreen is registered with the SEC under the Act according to Section 12(b), and it is actively traded on a US stock exchange. Additionally, Evergreen Networks has offices around the world and has established a network of local experts. Evergreen contracts with the local experts (known as network conduits) to identify end-users and assist in selling network solutions as well as providing technical support to new and existing customers. Evergreen failed to maintain adequate accounting records as required by the Exchange Act of 1934 (known as the "Act"). Additionally, Evergreen's internal controls failed to provide reasonable assurance that controls effectively prevented unauthorized access to Evergreen's assets and transaction-level data. The case study provides a classroom exercise and teaching notes for discussing collusive and fraudulent behavior. Further, the case study highlights the importance of internal controls and segregation of duties as preventive measures against fraudulent behavior.

Keywords: Employee Fraud, Collusion, SEC, Exchange Act of 1934, Internal Controls, Segregation of Duties, Corporate Governance

INTRODUCTION

As a recent accounting graduate of State College, you are excited about starting your career as an external auditor for Bean, Counter, and Ledger LLC. After completing the mandatory new hire on-boarding process, the partner of Human Resources (HR) has stopped by your cubicle to introduce himself and welcome you to the firm. After exchanging pleasantries, the partner indicates that over 50% of the firm's clients are registered with The SEC. As a result, all new hires are required to complete a case study involving internal controls and document requirements applicable to SEC registrants. After completing the case study, the partner indicated that you would be ready for your first auditing engagement. You stated that you are eager to get started:

BACKGROUND

Evergreen Networks is a US-based company whose primary business model involves the design, manufacturing, and sale of computer networking equipment throughout the world. Furthermore, the common stock of Evergreen is registered with the Securities and Exchange Commission (SEC) under the Exchange Act of 1934 (the Act) in accordance with Section 12(b), and it is actively traded on a US stock exchange. Additionally, Evergreen Networks has offices around the world and has established a network of local experts. Evergreen contracts with the local experts (known as network conduits) to identify end-users and assist in selling network solutions as well as providing technical support to new and existing customers.

FACTS

In early 2010, Evergreen sales employees in Eastern Europe approached senior management about increasing sales discounts. The sales employees argued that the concessions were necessary to remain competitive and avoid losing market share. After consideration, the Senior management in the home office consented to the sales team request and authorized the sales discounts. Once approved, Evergreen's sales employees approached the local network conduits and convinced them not to pass the sales discounts on to the end-user. Instead, they persuaded the network conduits to create a separate off-book account ("OBA") known as funds to hold the erroneous sales discounts.

As a result of the collusion between the network conduits and Evergreen's sales force, erroneous sales discounts accumulated in the OBA held by the network conduits; this transaction structure allowed the Evergreen employees in Eastern Europe to avoid recording the funds in the OBA in Evergreen's accounting records (general ledger), leading to an inconsistent application of GAAP and misleading financial statements. Furthermore, the existence of the OBA provided Evergreen employees the opportunity to use the funds at their discretion without the knowledge of Evergreen senior management. Also, it allowed the sales team in Eastern Europe to circumvent Evergreens travel and entertainment policies and itinerary approval. For example, the travel itineraries submitted by the Eastern European sales team to Evergreen networks for approval were often misleading and inaccurate. The travel itineraries did not include the actual reason or cost of the trips and often understated the amount of entertainment that was planned.

The accumulated funds in the OBA allowed Evergreen employees, in cooperation with the network conduits, to fund lavish trips for business owners, customer employees and their families, high ranking government officials, and other influential decision-makers. Most of these trips had little to no business purpose and often exceeded the limits established by Evergreen's travel and entertainment policies. Additionally, the trips were often to locations where Evergreen had no business operations, manufacturing facilities, or no related industry conferences. A few examples of the international tourist locations visited included Rome, London, New York City, and San Francisco.

Additionally, trip itineraries included expensive excursions to theme parks, wineries, safaris, and included meals and entertainment for customers and their family members. According to the eastern European sales employees, the sole purpose of these trips and entertainment was to improve the business relationship with customers and government officials. For example, in an email requesting authorization to use the OBA to fund a two-week multi-national vacation for an end-customer employee, an Evergreen salesperson stated, "the purpose of the trip is to improve our relationship with the company, which will lead to an increase in sales next quarter." Another Evergreen staff requested permission to take a government official on a ten-day trek across the US, stating, "The trip is crucial to the approval of future contracts."

In late 2011, Evergreen's senior management learned of the OBA and the real purpose of the sales discounts. Evergreen's corporate policies require all economic transactions to be recorded with a journal entry and posted to Evergreen's general ledger. As a result of the revelation, Evergreen senior management instructed the sales employees to terminate these practices immediately. However, the practices did not stop; instead, they continued through 2016 as the Eastern European sales employees increased their efforts to conceal the plot with the network conduits by using personal email addresses instead of corporate email addresses. Thus, furthering the fraudulent practice of diverting the erroneous sales discounts into the OBA held by the network conduits.

Finally, In 2016, after learning that the securities and exchange commission was conducting an investigation, Evergreen's management conducted their internal investigation. They discovered that the sales employees had continued the practice of diverting discounts into the OBA and had continued using the prohibited OBA to fund travel and entertainment for customers and government officials. As a result of the internal investigation, Evergreen revised its compliance policies and enhanced its corporate governance over the compliance group with the addition of a Chief Compliance Officer.

REQUIREMENTS

1. Describe the recordkeeping requirements of SEC registrants?
2. When did the Securities and Exchange Act of 1934 add recordkeeping requirements?
3. Did Evergreen violate these requirements?
4. Describe the internal control requirements of the Securities and Exchange Act of 1934?
5. Did Evergreen violate the internal control requirements of the Securities and Exchange Act of 1934?

TEACHING NOTES

Summary

Evergreen was a global network company that failed to maintain adequate accounting records as required by the Exchange Act of 1934 (known as the "Act"). Additionally, Evergreen's internal controls failed to provide reasonable assurance that controls were effective in preventing unauthorized access to Evergreen's assets and transaction-level data[1].

Target Audience

Upper level or master's level auditing class or business law class.

Teaching Objectives:

The student should be able to:

- Describe and discuss the recordkeeping requirements of the Securities and Exchange Act of 1934.
- Identify violations of the recordkeeping requirement of the Securities and Exchange Act of 1934.
- Describe and discuss the internal control requirements of the Securities and Exchange Act of 1934.
- Identify violations of the internal control requirements of the Securities and Exchange Act of 1934.

Requirements:

1. Describe the recordkeeping requirements of SEC registrants?

Section 13(b)(2)(A) of the Securities and Exchange Act of 1934 requires issuers (publicly traded companies) to maintain adequate accounting records, including creating a system of bookkeeping, maintaining records, and appropriate accounts that accurately and fairly reflect the transactions and disposition of the issuer's assets in reasonable detail.

2. When were these requirements added to the Securities and Exchange Act of 1934, and why?

The requirements of Section 13(b)(2)(A) of the Securities and Exchange Act of 1934 were added in 1977 when Congress passed the Foreign Corrupt Practices Act (FCPA).

During the investigation of the Watergate scandal, "off-book" bribes to foreign officials were discovered. As a result, Congress passed the Foreign Corrupt Practices Act, which included a requirement that companies maintain records that accurately reflect all transactions of the company.

[1] The background for this case was based on Accounting and Auditing Enforcement Release No. 4069, dated August 29, 2019. The names were changed and some facts were embellished or created for educational purposes.

3. Did Evergreen violate these requirements?

Yes. The records maintained by Evergreen did not fairly reflect the transactions of the company.

4. What are the internal control requirements of the Securities and Exchange Act of 1934?

Under Section 13(b)(2)(B) of the Securities Exchange Act of 1934, issuers are required to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

i. Transactions are executed in accordance with management's general or specific authorization.
ii. Transactions are recorded as necessary
    a. to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and
    b. to maintain accountability for assets.
iii. Access to assets is permitted only in accordance with management's general or specific authorization; and
iv. The recorded accountability for assets is compared with existing assets at reasonable intervals, and appropriate action is taken with respect to any differences.

5. Did Evergreen violate the internal control requirements of the Securities and Exchange Act of 1934?

Yes. Evergreen violated Section 13(b)(2)(B) of the Securities and Exchange Act of 1934 because it did not devise and maintain internal accounting controls over the approval processes for incremental discounting and travel that were sufficient to provide reasonable assurances that access to assets and transactions were executed in accordance with management's authorization.

REFERENCES

Securities and Exchange Act of 1934, 15 USC § 78.

Securities and Exchange Commission (SEC), *Accounting and Auditing Enforcement Release No. 4069*, August 29, 2019, Washington, DC: SEC.