NutraCea, Inc. – A Revenue Recognition Case Study

Taylor Corey
Daniel Russell
Arundhati Rao
Charles Martin
All of Towson University, Towson, MD 21252

Case Synopsis

NutraCea, Inc., originally established as RiceX Company in the early 1990s was in the right place at the right time. The company specialized in the stabilization of rice bran and the production of a nutritious ingredient that could be used in animal feed. The demand for such technology grew dramatically when the U.S. government decided agricultural waste needed to decrease, and the best way to do this was to recycle the so-called "waste" materials. Around the same time customers became more health conscious, creating a demand for nutrient rich foods. While the market for its products and technology was growing rapidly, the company suffered from numerous internal problems. There was heavy dependence on few executives who were unethical and overbearing; they forced their will on others and focused on increasing their own wealth. Contracted sales were not fulfilled due to insect infected raw materials, creating a cash flow problem and worsening the company's financial situation. Unfortunately to address the cash flow problems and meet the expectations of financial analysts, the company actively engaged in fraud with an outside party to book sales. Obviously the fraud was hidden from their auditors. Eventually the auditor found the fraud and demanded restatement of financial statements; this triggered inquiries by the Securities and Exchange Commission (SEC), a big drop in stock price and a class action lawsuit.

Introduction

Patricia McPeak founded The RiceX Company. RiceX specialized in the stabilization of rice bran and the production of a nutritious ingredient that can be used in animal feed (William Reed Business Media, 2005). The demand for the company's products grew dramatically when the U.S. government decided agricultural waste needed to decrease, and the best way to do this was to recycle the so-called "waste" materials (Townsend, 2007).

The processing of rice is complicated because of the inedible outer layer, called the hull, and the inner shell, called the rice bran. Once the inedible hull is removed, the remaining form of the grain including the rice bran is brown rice. Underneath the rice bran is the part of the grain that humans consume in the form of white rice (Riviana Food Inc., 2010). The rice bran is the most nutritious layer of the kernel. However, it contains lipase, an enzyme that causes the oil in the rice to spoil soon after the hull is removed (NutraBio, 2012).

Prior to current technological innovations, the rice bran had to be completely removed before the rice could be usable for consumption. This generated over 60 million tons of agricultural waste each year (Townsend, 2007). RiceX had a solution. The company created a stabilization process for the rice bran, which allowed it to become a main ingredient in animal feed (William Reed Business Media, 2005). The stabilization increased the shelf life of the rice byproduct by deactivating the lipase in the rice bran. The output of RiceX's stabilization process is called SBR - stabilized rice bran (NutraBio, 2012).

In 2000, Patricia McPeak founded another company called NutraCea, Inc. NutraCea took the stabilization of RiceX's SBR to another level, by developing a product that could be used for human consumption (William Reed Business Media, 2005). This new product had an extended shelf life, was loaded with nutrients, and was hypo-allergenic and gluten free (Townsend, 2007).

NutraCea's merger with RiceX in 2005 allowed the company to dominate the industry. NutraCea no longer had to purchase its own raw materials and the company's production grew. Additionally, there was an increased demand for whole grains like brown rice at the turn of the century because of the rise in the publicity of their health benefits. One of the main benefits of products containing SBR was the reduction of cholesterol problems (William Reed Business Media, 2005).

The four main distribution channels for NutraCea after the merger were ingredient sales for human food, ingredient sales for animal food, nutraceuticals, and international food aid. NutraCea's clients included many household names, such as General Mills, Kellogg's, Stouffer's, and Purina. The international distribution channel marked NutraCea's participation in corporate social responsibility. The company donated SBR to third-world countries such as Guatemala, El Salvador, and Malawi. Through these efforts, NutraCea strived to diminish malnutrition across the world (Townsend, 2007). These ethical acts certainly did not foreshadow the future of NutraCea's financial difficulties and fraud.

Major Events

Now that it had established a niche and had bright visions of future successes, NutraCea made Bradley Edson CEO of the company in October 2005 (SEC v. NutraCea, 2011). He had previously served on the board, and as President. As a former CEO of a smaller nutraceutical company, Edson brought experience and status to the table as the new CEO. Also hired in 2005 by the company were CFO Todd Crow and Senior Vice President Margie Adelman. Patricia McPeak remained on board as a director. In 2007, Joanne Kline became the company's controller and Scott Wilkinson was made the director of financial services (SEC v. NutraCea, 2011). NutraCea was quite dependent upon this group of executives for its success, and this dependency, along with the inherent risks brought with it, created the perfect storm for the rapid downfall of the company. It is important to understand the increased risk an independent auditor assumes when a business suffers from high inherent risk. Inherent risk refers to the likelihood that an auditor will arrive at an inaccurate audit conclusion based on the nature of the client's business (Whittington and Pany, 2016). Financial statements are susceptible to material misstatement due to environment and external factors, prior-period misstatements and/or susceptibility to fraud. Some environment and external factors that can lead to high inherent risk are rapid changes (making inventory obsolete), expiring patents (leading to aggressive competition), state of the economy (recessions hurt almost everyone), and availability of financing. Prior-period misstatements could be mistakes made in the past that are carried over to the current period. Some assets, e.g., cash and inventory, are more susceptible to theft and fraud. Strong internal controls help mitigate inherent risks. However the assumption is that the top management wants to mitigate the loss from these risks and are not deliberately ignoring or trying to bypass these risks.

Also in 2005, NutraCea decided to leave behind its auditor, Malone & Bailey, PC and hired a new independent auditor, Perry-Smith, LLP in 2006. In its 8-K report to notify the shareholders of the change in independent auditors, NutraCea noted that "*there were no disagreements between NutraCea and Malone on any manner of accounting principles or practices, financial statement disclosure, or auditing scope or procedure,*" suggesting that the change was made in good conscience by all parties (WikiInvest, 2007). This claim was substantiated by both companies issuing unqualified audit opinions: Malone for the year ended December 31, 2005 and Perry-Smith for the year ended December 31, 2006 (SEC v. NutraCea, 2011).

However all was not well. In retrospect, NutraCea faced many obstacles that created the pressure to perpetuate the fraud. In its 2006 financial statements, the company listed two risk factors that hinted at the risk for fraudulent activity brewing. The risks were *"We are dependent on key employees and consultants,*" and "*We have not yet achieved positive cash flow*" (SEC v. NutraCea, 2011). The company had been amassing millions of dollars of net operating losses, including over $23 million dollar loss in 2004. In fact, 2006 was the only year that NutraCea was able to generate income; this raised everyone's expectations and created additional pressures to meet earnings targets via illegitimate means. Poor financial performance and poor/unethical tone at the top created the perfect storm for the financial fraud that followed in 2007.

Development of the Fraud

By the second quarter in 2007, NutraCea was struggling to report numbers that met its target earnings goals. Because of a strong desire to meet these goals passed down from the top by CEO Bradley Edson, the company stopped at nothing to make the reported figures what they wanted. NutraCea tried to recognize $2.6 million in sales to several customers in the first quarter of 2007, but had been unsuccessful due to Perry-Smith's refusal to allow them to recognize the revenue and requiring that they reverse the entries (SEC v. NutraCea, 2011). As a result, first quarter sales targets fell short by nearly 50%. In order to make up for this shortfall, and unable to convince Perry-Smith that the sales should have been booked, Edson decided that further measures would be necessary.

In the second quarter of 2007 Edson approached Bi-Coastal Pharmaceutical Corp and asked the company president to issue purchase orders for $2.6 million of product (SEC v. NutraCea, 2011). The company had no intention of purchasing products from NutraCea, and Edson promised Bi-Coastal that "*he had several avenues of potential distribution for these products and that [Bi-Coastal] was never going to take possession of them and that at a later date [Edson] was going to sell the products to a third party*" (SEC v. NutraCea, 2011). With these sales on the books, the transactions would allow the company to report the necessary revenue to meet its target earnings goals, and not raise any red flags for the independent auditors. Bi-Coastal's president agreed to create the false purchase orders, and the foundations for the fraudulent scheme were laid out.

In order to perpetrate the "fraudulent sale," Edson negotiated with NutraCea's former COO a one million dollar loan so that Bi-Coastal could make the down payment for the purchase of the NutraCea product (SEC v. NutraCea, 2011). Edson and the former COO also had the Bi-Coastal president alter the personal financial records of the company's owners, so that their net worth was reported at $20 million; $15 million dollars in excess of the true net worth (SEC v. NutraCea, 2011). This enabled Edson to fraudulently recognize the sales necessary to meet the second quarter earnings targets, and earned hefty bonuses.

Edson was not the only management executive aware of the fraud. CFO Todd Crow was informed by NutraCea's former COO of the loan made to Bi-Coastal, but Crow refused to listen at the time. Jeanne Kline was also made aware that this had occurred, and when she attempted to deliver the information to Crow, he infamously was quoted saying "*No, no, no, no, no, no, no, no, no. I don't want to hear it*," while covering his ears (SEC v. NutraCea, 2011). Despite his attempts to feign ignorance, he was most certainly aware of what had taken place. He and Edson signed and filed the 10-Q report with the SEC for the second quarter of 2007. All the while, Perry-Smith was not made aware that these transactions had taken place, and no disclosure was made in the financial statements that were released.

In the third quarter, Edson's desire to meet the earnings goals again caused another act of fraudulent sales recognition to take place. NutraCea booked a sale of over $1.9 million dollars to a customer, ITV Global, Inc. for its product Rice n Shine (SEC v. NutraCea, 2011). Margie Adelman was ordered by Edson to obtain a letter from ITV confirming that it would have receipt of the entire order by December 31, 2007 (SEC v. NutraCea, 2011). However, as events began to unfold, it became clear that there was a very small likelihood that the product would be produced by the end of the year making the recognition of the entire sale in the fourth quarter illegitimate.

Not only was the sale illegitimate, but the product was actually not manufactured well into 2008. ITV even posted on its website that Rice n Shine was on backorder, prompting a response from Edson saying "*what a bunch of jerks*" (SEC v. NutraCea, 2011). Additionally, the third-party manufacturer requested replacement of some of the materials needed to create the product. Because of these stalls in delivery of the goods, ITV refused to pay the entire invoice which was booked in 2007 well into 2008. All of these factors, and her own sense of ethics, caused Adelman to become hesitant to book the entry for the sale of Rice n Shine to ITV, taking her fears to Kline and Scott Wilkinson, who both shared her hesitations (SEC v. NutraCea, 2011). Crow, however, was dismissive of the issue, pushing the blame onto the third party manufacturers. Despite their fears, the company booked the entire sale in the fourth quarter, and did not mention it to Perry-Smith or disclose it in the notes to the financial statements. Edson and Crow signed off on the management letter to Perry-Smith, as well as the financial statements which were released to the SEC; thereby, sealing their fate as conspirators in this attempt to falsely book sales revenues.

Effects of and Reactions to the Fraud

A couple years later, Perry-Smith discovered what had happened in 2007. After evaluation by the audit committee and Perry-Smith, the decision was made that restatement of NutraCea's 2007 and 2008 financial statements was necessary. The company's announcement of restatement in 2009 kicked off the SEC's investigation of NutraCea's transactions. With the assistance of Perry-Smith, NutraCea worked to respond to the SEC's request for documentation. (Engredea News & Analysis, 2009).

As a result of the announcement of the restatements and the SEC investigation, NutraCea's stock price plunged over 50% from its price at the start of 2009 to $42 per share by the end of the week. The week of the announcement alone, shares fell by almost $30. This instigated the formation of a class action lawsuit by shareholders against NutraCea in 2010. The plaintiffs claimed that NutraCea issued misrepresentations to the market and artificially inflated the market price by recording false sales. The settlement of the lawsuit involved NutraCea's insurance company creating a settlement fund of $1,500,000 to pay claims to class members (Stanford Law School, 2010).

It was not until January 13, 2011 that the SEC officially charged NutraCea and various executives and employees for participating in the accounting fraud. The scheme involved $2.6 million in false sales, which led to the overstatement of revenues by 35%. Parties charged included Bradley D. Edson, former CEO; Todd C. Crow, former CFO; Margie Adelman, former Senior VP and Secretary; Joanne D. Kline, former Controller; and Scott Wilkinson, former Director of Financial Services. All of the parties neither admitted nor denied the charges, but agreed to settle the SEC's charges. Edson agreed to pay a $100,000 penalty and reimburse NutraCea $350,000 in bonuses he received in 2008 (SEC v. NutraCea, 2011).

NutraCea began to restructure even before the company was officially charged in 2011. Bradley Edson resigned from his position as CEO in March 2009, shortly after the announcement of the need for restatement. After Edson was charged, NutraCea's new CEO expressed that the company was pleased to claim the stock options and bonuses back from Edson, and to move forward as a company without him (Dow Jones Newswires, 2011). Additionally, Perry-Smith was dismissed from its position as the external auditor in May 2010.

Naturally, the SEC had a reaction to the NutraCea case, as any large fraud case has the potential to damage the reputation of the SEC and the US Attorney's Office. US Attorney Ann Birmingham Scheel explained in a FBI press release on April 16, 2012, *"The SEC was created during the peak of the Great Depression to restore investor confidence in our national capital markets by requiring publicly traded companies to provide investors truthful and reliable information about their business. The US Attorney's Office will continue to work with our law enforcement partners to dismantle and prosecute complicated securities fraud schemes designed to hide the truth from investors who rely on the financial markets to help secure their futures."*

When a large fraud case occurs, there is always the possibility that investors will lose faith in the SEC and regulatory agencies. After the NutraCea fraud, it was vital for the SEC to release a statement in order to maintain confidence in the market.

Epilogue

"*We are pleased to have resolved this matter. It has been a time consuming and expensive process. During the course of the SEC investigation, our management and Board of Directors have cooperated fully with the SEC.*" W. John Short, the CEO of NutraCea, expressed his relief in 2011 after the company had come to a settlement with the SEC regarding the NutraCea fraud (William Reed Business Media, 2011).

After the resignation of Bradley Edson, Short took over as president and CEO in 2009. Also in 2009, John Quinn became the chairman of the Board of Directors. Short and Quinn worked together to restructure NutraCea and the company's financial reporting procedures and internal controls (Yahoo! Finance, 2012).

In October 2012, NutraCea announced that the company would be changing its name to RiceBran Technologies. Short expressed that the name better represented the company after its transformation. With the name change to RiceBran Technologies, the company also aimed to migrate away from NutraCea's shattered reputation. Part of the restructuring included adding two new members to the board. One of the new members, David Goldman, also became the Chairman of the Audit Committee. He helped boost RiceBran's credentials with his 35-year experience with Deloitte & Touche (Yahoo! Finance, 2012).

The current auditor of RiceBran Technologies is BDO USA, LLP. BDO has been the auditor since the dismissal of Perry-Smith in 2010. The firm has been with RiceBran through its legal troubles and Chapter 11 bankruptcy, so BDO is very familiar with the company (RiceBran Technologies, 2009).

Following the bankruptcy process, NutraCea emerged from the wreckage ready to start fresh. Short expressed his new visions for the future, saying, *"We are pleased to announce our new corporate name - RiceBran Technologies. Coupled with our long-standing tag line - nutrition by nature - our new name clearly defines who we are and what we do. Earlier this year we completed a three-year portfolio transformation from a multi-divisional business operator to complete focus on our Rice Bran Bio-Refining business model. RiceBran Technologies aptly describes our focused approach to that rice bran-centric business model" (Yahoo! Finance, 2012).*

With this in mind, the company worked to separate itself from its past difficulties. With the transformation, RiceBran Technologies is becoming one of the world's leading producers of rice bran. RiceBran has become an international company with alliances all over the world. The company has a completely new management team since the NutraCea fraud, with strategic goals for the company. (RiceBran Technologies, 2013). However the company continues to struggle financially. In November 2013, the company went through a 1:200 stock split. In November 2015 the stock is trading at $2.11.

Questions

1. What are the three elements of the fraud triangle? Give at least one example of each element from the NutraCea case.
2. What is the primary audit objective for accounts receivable? How could Perry-Smith have tested this objective? How is it possible that even after completing the appropriate tests that Perry-Smith still did not discover the false sales?
3. Edson and Crow signed off on NutraCea's financial statements even though they were aware of the revenue fraud that was occurring. Does the Sarbanes Oxley (SOX) Act apply to this situation? What are the implications of the Act for Edson and Crow?
4. What is (are) the accounting standard(s) that articulate the correct method for recognizing sales similar to the two improperly recorded by NutraCea in 2007? How did NutraCea violate these standards? Would your answer change based on the new revenue recognition standards adopted by FASB effective for accounting periods beginning after year December 15, 2017?
5. Should Perry-Smith have included the going concern paragraph in the 2007 report, and should the Company have included a Note in the 2007 financial statements?
   Hint: Review the financial statements on Edgar before answering this question.
   http://www.sec.gov/Archives/edgar/data/1063537/000114420407015919/v069799_10k.htm
   http://www.sec.gov/Archives/edgar/data/1063537/000114420408015917/v107141_10k.htm
6. How could Perry-Smith have better planned for the audit of the 2007 financial statements with proper consideration of the risk of material misstatement due to fraud?

Instructor's Notes

Case Description

This case study investigates the accounting aspects of a financial statement fraud as it relates to revenue recognition and how it could have been detected and prevented. It is based on real events that transpired in a publicly traded company; the fraudulent acts of the top executives resulted in a class action lawsuit by the shareholders which was settled in court, fines and penalties against several top executives of the firm, bankruptcy and eventual reorganization of the firm.

This case is best suited for a graduate Auditing class. Depending on the size of the class and number of cases to be worked on during the semester, this case can be done in teams; maximum three to four students per team. The students should read the case, review the financial statements, and applicable accounting standards before it is discussed in class. The students can expect to spend two to three hours researching the case and answering the questions. The instructor should present a brief overview of the case in class; this should be followed by a presentation of answers to questions by the students. At least one hour of classroom time needs to be devoted to this case in order to ensure a thorough discussion of all the accounting issues that need to be addressed.

1. **What are the three elements of the fraud triangle? Give at least one example of each element from the NutraCea case.**

   The elements of the fraud triangle are known as fraud conditions in the standards. PCAOB AU Section 316 states, "First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act." Altogether, the elements pressure, opportunity, and rationalization form the fraud triangle (Association of Certified Fraud Examiners, 2015).

   Each of these elements of the fraud triangle was present in the NutraCea case. Primarily, the pressure on NutraCea was largely attributable to the company's cash flow problems. In 2006, one of the risk factors noted was that the company had yet to earn positive cash flow. The company was swimming in millions of dollars of net loss, and the executives had to find a way to make the company prosper. Another related pressure involved NutraCea's strong desire to meet earnings targets, and the continuous struggle the company faced in meeting previous targets. After the first quarter of 2007, NutraCea's sales were 50% below the target.

   Bradley Edson and the other executives also had the opportunity to incorrectly record these sales. Another noted risk factor was the company's heavy reliance on certain NutraCea executives and employees. This may have given the perpetrators excessive power in the organization, creating the opportunity to commit fraud. Another opportunity was Edson's relationship with the Bi-Coastal executives. In order to convince Bi-Coastal to aid NutraCea in this fraudulent plan, it is likely that Edson had a personal relationship with someone at Bi-Coastal that allowed him to extend his influence further than normal. These were allegations made by the SEC based on the accusations made by Ms. Joanne Kline, the former controller of NutraCea, Inc.

   Rationalization is a more personal element of the fraud triangle. While it is not specifically mentioned in the case, it is likely that Edson and the other executives rationalized the fraud in a number of different ways. It can be argued that Crow rationalized this fraud by pretending that he didn't even know about it. Other rationalizations include the possibility that Edson was going through with the fraud in order to earn bonuses to support his family or that the executives desired to meet earnings targets that would result in bonuses for this one year.

2. **What is the primary audit objective for accounts receivable? How could Perry-Smith have tested this objective? How is it possible that even after completing the appropriate tests that Perry-Smith still did not discover the false sales?**

   "The primary objectives for the auditors' substantive tests of receivables and revenue are to substantiate the existence of receivables and the occurrence of revenue transactions" (Whittington and Pany, 2016). It is imperative for the auditors to verify that the revenue recorded exists from a valid transaction.

In proving the existence of accounts receivable, the auditor must ensure that the amounts recorded on the client's books actually exist. The auditor accomplishes this by sampling receivables and then confirming customer balances. Positive confirmations usually work best in order to have the highest confidence that the customer agrees with the confirmation amount (AU 330). Generally, the customer is likely to respond if the amount on the client's book is overstated for that customer, because no one would want to pay more than they owe.

AU 330.12 explains, *"Accounts receivable confirmations are likely to be more effective for the existence assertion than for the completeness and valuation assertions."* In confirming a client's year-end receivables, the auditor is trying to accomplish the audit objective of existence. Because the auditor wants to ensure that accounts receivable is not overstated, it is important to verify all recorded receivables actually exist by sending confirmations.

In the NutraCea case, Perry-Smith could have tested the existence of the revenue recorded by sending an accounts receivable confirmation to Bi-Coastal. However, confirmations may not detect all revenue frauds. Since Bi-Coastal was an accomplice in the NutraCea fraud, it is likely that Bi-Coastal would confirm the $2.6 million sale. When the third party is aware of and involved in the fraud that is taking place, confirmations are an unsuccessful method of detecting false sales. Still, by completing the confirmation process, Perry-Smith would have exercised due professional care.

3. **Edson and Crow signed off on NutraCea's financial statements even though they were aware of the revenue fraud that was occurring. Does the Sarbanes-Oxley (SOX) Act apply to this situation? What are the implications of the Act for Edson and Crow?**

The Sarbanes-Oxley Act of 2002 (SOX) was passed by Congress in response to an increase in corporate fraud in the US. The goal of SOX was to boost investor confidence in the market by requiring firms to abide by strict regulations that would protect investors. Section 302, Corporate Responsibility for Financial Reports, is one of the most prominent sections of the Act. This section, among other things, states, *"(1) the signing officer has reviewed the report; (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements […] not misleading; (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer."*

Clearly, Edson and Crow violated Section 302 of the Sarbanes-Oxley Act of 2002 when they signed off on the statements, knowing that they did not accurately represent the company. SOX Section 906 explains the penalties for violating Section 302*: "Whoever […] willfully certifies any statement […] knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both."* By violating SOX Section 302, Edson and Crow could have been fined up to $5,000,000 or imprisoned for up to 20 years. Edson and Crow were fortunate to receive a much lighter penalty.

4. **What is (are) the accounting standard(s) that articulate the correct method for recognizing sales similar to the two NutraCea improperly recorded in 2007? How did NutraCea violate these standards?** Would your answer change based on the new revenue recognition standards adopted by FASB effective for accounting periods beginning after year December 15, 2017?

   Staff Accounting Bulletin (SAB) 104 states, *"The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:*
   • Persuasive evidence of an arrangement exists
   • Delivery has occurred or services have been rendered,
   • The seller's price to the buyer is fixed or determinable, and
   • Collectability is reasonably assured."

   From this, it is clear that collectability was not reasonably assured for the first transaction that NutraCea recorded with Bi-Coastal. Edson had to set up the loan from the former COO so that the client could make the down payment, and he also instructed them to restate top management's personal financial statements to create the appearance of the ability to repay the $2.6 million loan. In fact, Bi-Coastal was not in a position to purchase an order of this size, making collectability not reasonably assured.

   SAB 104 also states, *"The staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement."* Typically this occurs when a product is delivered to the customer's delivery site (if the terms of the sale are "FOB destination") or when a product is shipped to the customer (if the terms are "FOB shipping point"). The Commission has set forth criteria to be met in order to recognize revenue when delivery has not occurred. These include:

   a. The risks of ownership must have passed to the buyer;
   b. The customer must have made a fixed commitment to purchase the goods, preferably in written documentation;
   c. The buyer, not the seller, must request that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
   d. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e.g., storage periods are customary in the industry);
   e. The seller must not have retained any specific performance obligations such that the earning process is not complete;
   f. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
   g. The equipment [product] must be complete and ready for shipment.

   A number of violations are present in the second sale of $1.9 million illegitimately recognized by NutraCea, as evidence by SAB 104. That the inventory had not been completed and were not yet ready for shipment is the most obvious. In fact, NutraCea was still in contact with their supplier well into the year after the sale was recorded to complete the manufactured product.

The new standard *Revenue from Contracts with Customers*, adopts an asset-liability approach as the basis for revenue recognition; this approach is consistent with the conceptual framework approach to recognition. FASB establishes the following **core principle**: Recognize revenue to depict the transfer of promised goods or service to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. A company would apply the following **five steps** to achieve the core principle:

a. Identify the contract with a customer
b. Identify the performance obligations in the contract
c. Determine the transaction price
d. Allocate the transaction price to the performace obligations in the contract
e. Recognize revenue when (or as) the reporting organization satisfies a performance obligation.

Revenue recognition principle: recognize revenues in the accounting period in which the performance obligation is satisfied.

Nutracea would have violated the fifth step of achieving the core principle of the new revenue recognition standards. Therefore, Nutracea's violation of accounting standards would be the same under the rules in force in 2007 as well as the new standard to be implemented for accounting periods beginning after December 15, 2017.

5. **Should Perry-Smith have included the going concern paragraph in the 2007 report, and should the Company have included the Note in the 2007 financial statements?**
Hint: Review the financial statements on Edgar before answering this question.
http://www.sec.gov/Archives/edgar/data/1063537/000114420407015919/v069799_10k.htm
http://www.sec.gov/Archives/edgar/data/1063537/000114420408015917/v107141_10k.htm

PCAOB AU 341.02 states, *"The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as a reasonable period of time). The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in Auditing Standard No. 15, Audit Evidence."* It also says,

> *"In performing audit procedures such as those presented in paragraph .05, the auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may*

have significance only when viewed in conjunction with others. The following are examples of such conditions and events:

- *Negative trends—for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios."*

This suggests that a consideration of the ability of NutraCea to continue as a going concern would certainly have been justified. Because of their inability to generate net profits, and their admitted difficulty to produce positive cash flows, the going concern consideration was very much in question. The PCAOB standards also help to show how the two fraudulent transactions recorded by NutraCea in 2007 impact what the auditors decide to report. It is not unreasonable to suggest that had the fraudulent sales not been recorded, Perry-Smith may have included the going-concern paragraph in their report. Additionally, the eventual bankruptcy of the company also suggests that the going-concern of the company was truly in jeopardy.

6. How could Perry-Smith have better planned for the audit of the 2007 financial statements with proper consideration of the risk of material misstatement due to fraud?

PCAOB AU 316.11 states, *"Although fraud usually is concealed and management's intent is difficult to determine, the presence of certain conditions may suggest to the auditor the possibility that fraud may exist. For example, an important contract may be missing, a subsidiary ledger may not be satisfactorily reconciled to its control account, or the results of an analytical procedure performed during the audit may not be consistent with expectations."* AU 316.54 also states,

"The following are additional examples of audit procedures that might be performed in response to assessed fraud risks relating to fraudulent financial reporting:
Revenue recognition: Because revenue recognition is dependent on the particular facts and circumstances, as well as accounting principles and practices that can vary by industry, the auditor ordinarily will develop auditing procedures based on the auditor's understanding of the entity and its environment, including the composition of revenues, specific attributes of the revenue transactions, and unique industry considerations. If there is an identified fraud risk that involves improper revenue recognition, the auditor also may want to consider:

- *Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.*
- *Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements. For example, acceptance criteria,*

delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

- *Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.*
- *Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.*
- *For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded."*

This suggests that the auditors should have anticipated the potential for fraud to occur, and attempted to identify whether or not management had made any attempts to record false numbers. It seems that Edson's arguments with the auditors about recording the $2.6 million sales in the earlier part of the year should have caused them to be on the lookout for transactions that were similar in nature and/or amount. Also, AU 316.54 makes some suggestions for how to test revenue transactions for fraud, including being present for shipment of goods recorded as sales. A test such as this one would have revealed that the $1.9 million sale of Rice n Shine had not actually occurred. It appears that the auditors' consideration of the risk of material misstatement due to fraud could have been enhanced, and had this been done, it possibly would have revealed the fraudulent activity of which management was guilty.

References

Association of Certified Fraud Examiners. (2015). "*The Fraud Triangle*." http://www.acfe.com/fraud-triangle.aspx.

Dow Jones Newswires. (August 1, 2011). "*SEC Charges NutraCea, Former Executives in Alleged Accounting Scheme.*" http://www.foxbusiness.com/markets/2011/01/13/sec-charges-nutracea-executives-alleged-accounting-scheme/

Engredea News & Analysis. (February 22, 2009). "*NutraCea to Restate Financial Statements for 2007 and 2008.*" http://newhope360.com/supply-news-amp-analysis/nutracea-restate-financial-statements-2007-and-2008

FASB ASC 606, "*Revenue from Contracts with Customers*." (2014)

FBI Press Release. (April 16, 2012) "*Former NutraCea CEO Indicted for Securities Fraud*," https://www.fbi.gov/phoenix/press-releases/2012/former-nutracea-ceo-indicted-for-securities-fraud

NutraBio. (2012). "*Rice Bran Facts.*" http://www.ricebranproducts.com/rice-bran-facts

NutraCea. (June 1, 2010). Form 8-K.
http://biz.yahoo.com/e/100601/ntrz.pk8-k.html
Public Company Accounting Oversight Board. (2013). AU Section 316.
http://pcaobus.org/standards/auditing/pages/au316.aspx
Public Company Accounting Oversight Board. (2013). AU Section 330.
http://pcaobus.org/standards/auditing/pages/au330.aspx
Public Company Accounting Oversight Board. (2013). AU Section 341.
http://pcaobus.org/standards/auditing/pages/au341.aspx
RiceBran Technologies. (July 29, 2009). Form 8-K.
http://idc.api.edgaronline.com/efx_dll/edgarpro.dll?FetchFilingConvPDF1?SessionID=SYAIHbFeXPbL1_v&ID=7423135
RiceBran Technologies. (2013). *"RiceBran Technologies."*
http://www.ricebrantech.com/
Riviana Food, Inc. (2010). "*How Rice is Processed.*"
http://www.riviana.com/how_rice_is_processed.html
Stanford Law School. (2010). "*NutraCea*."
http://securities.stanford.edu/1042/NTRZ09_01/
Townsend, James. (November 2007) "*Nurturing a Vision to Nourish the World. Functional Ingredients*" Functional Ingredients, Issue 70, p. 48.
US Securities and Exchange Commission. (2002). *Sarbanes-Oxley Act of 2002.*
http://www.sec.gov/about/laws/soa2002.pdf
US Securities and Exchange Commission. (2003). *Staff Accounting Bulletin No. 104.*
http://www.sec.gov/interps/account/sab104rev.pdf
US Securities and Exchange Commission v. NutraCea et al. (January 13, 2011) United States District Court, District of Arizona
http://www.sec.gov/litigation/complaints/2011/comp21819.pdf
Whittington, Ray and Kurt Pany, (2016) "*Principles of Auditing and Other Assurance Services*" McGraw-Hill Higher Education (2016).
William Reed Business Media. (April 6, 2005). "*NutraCea-RiceX Merger to Grow Global Rice Bran Market."*
http://www.nutraingredients-usa.com/Suppliers2/NutraCea-RiceX-merger-to-grow-global-rice-bran-market
William Reed Business Media. (January 19, 2011). "*NutraCea Settles with SEC Over Alleged Accounting Irregularities."*
http://www.nutraingredients-usa.com/Suppliers2/NutraCea-settles-with-SEC-over-alleged-accounting-irregularities
WikiInvest (May 21, 2007). "*NutraCea Changes Independent Auditors*."
http://www.wikinvest.com/stock/NUTRACEA_(NTRZ)/Change_Independent_Auditor
Yahoo! Finance. (October 11, 2012). "*NutraCea Announces Name Change to RiceBran Technologies (TM) and Addition of New Directors."*
http://finance.yahoo.com/news/nutracea-announces-name-change-ricebran-120100627.html