Case Study:
Oteal Pharmaceuticals

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About the Anti-Fraud Collaboration

The Anti-Fraud Collaboration is dedicated to advancing the discussion of critical anti-fraud efforts through the development of thought leadership, awareness programs, educational opportunities, and other related resources focused on enhancing the effectiveness of financial fraud risk management.

The Anti-Fraud Collaboration was formed in October 2010 by the Center for Audit Quality (CAQ), Financial Executives International (FEI), The Institute of Internal Auditors (The IIA), and the National Association of Corporate Directors (NACD).

CAQ CENTER FOR AUDIT QUALITY

The CAQ is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs. For more information, visit www.thecaq.org.

fei financial executives international

FEI is the leading advocate for the views of corporate financial management. Its more than 10,000 members hold policymaking positions as Chief Financial Officers, Treasurers and Controllers at companies from every major industry. FEI enhances member professional development through peer networking, career management services, conferences, research and publications. Members participate in the activities of 65 chapters in the US. FEI is headquartered in Morristown, NJ, with an office in Washington, DC. For more information, visit www.financialexecutives.org.

IIA The Institute of Internal Auditors

The IIA is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today has more than 200,000 members from more than 170 countries and territories. The IIA's global headquarters are located in Lake Mary, Fla. U.S.A. For more information, visit www.theiia.org or www.globaliia.org.

NACD

NACD empowers more than 20,000 directors to lead with confidence in the boardroom. As the recognized authority on leading boardroom practices, NACD helps boards strengthen investor trust and public confidence by ensuring that today's directors are well-prepared for tomorrow's challenges. World-class boards join NACD to elevate performance, gain foresight, and instill confidence. Fostering collaboration among directors, investors, and corporate governance stakeholders, NACD has been setting the standard for responsible board leadership for 40 years. To learn more about NACD, visit www.NACDonline.org.

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Jodi Craft felt work had become extremely busy the past few months since her promotion to Chief Accounting Officer (CAO) at Oteal Pharmaceuticals. Craft, previously Controller for one of Oteal's larger core prescription drug divisions, had been promoted following the unexpected departure of her predecessor. While Craft worked diligently to advance her career during her two years at Oteal, she did not anticipate moving into the CAO role so quickly. Her promotion came just weeks before Oteal's second quarter financial statements were to be filed. Craft was excited about the opportunity and was determined to do her best to live up to the trust Oteal's executive team had placed in her.

While Craft believed that Oteal's control environment was generally well functioning, she saw some opportunities for improvement. For example, Craft had observed that:

+ internal controls over financial reporting, in certain newer markets, needed improvement;
+ occasionally, transactions were not supported by sufficient or timely documentation;
+ decision making and approval authority were unclear (primarily due to unclear lines of reporting in finance and operations, and lack of approval matrix); and
+ shortcuts were at times taken to expedite matters (timely action often took precedence over following policy and procedures).

Craft planned to address these issues once she was more settled in her role.

With Oteal's quarterly financial statement filings due in two days, Craft was put to the test when her team discovered a potentially troubling financial reporting issue. Two years earlier, Oteal had opened a new sales office—the South American region—and begun directly selling its products outside of the United States for the first time. Oteal executives believed the new market brought the potential for significant growth, and already the region's sales had reached 3 percent of total company revenue. Craft had concerns that operational risks from the South American unit were not adequately mitigated by Oteal's financial controls and that corporate oversight over local operations was limited. Craft was specifically concerned that control weaknesses could create opportunities for local employees to manipulate revenue. At the same time, she knew there were cultural differences that she did not understand, and she did not want to come down hard in a way that would disrupt the emerging business. Now, however, Craft's accounting manager had just discovered information indicating that Oteal's South American region head had promised a distributor pricing discounts and product return rights beyond what was allowed in the contract if the distributor would place a large order and get it in before the end of the quarter. Craft needed to decide her next steps quickly before the filing deadline.

OTEAL PHARMACEUTICALS OVERVIEW

Oteal was a publicly traded pharmaceutical company with $2.1 billion in revenues. It was founded in New Jersey in the early 1990s as a spinoff from a leading pharmaceutical company. At the time of its launch, it sold several prescription drugs used to treat dermatological conditions. For most of its first two decades, Oteal enjoyed steady but modest growth in its key market segments. The company directly manufactured and sold its products in the United States and South America. For most other international sales, it had licensed its products to other pharmaceutical manufacturers.

THE EXECUTIVE TEAM

Sid Martens, CEO: Martens joined Oteal six years earlier as the company looked to strengthen its senior management ranks as part of its succession planning strategy. Martens had worked in the industry for decades, had held several senior executive roles in marketing and sales, and had a track record of success. The board of directors selected him to be CEO four years earlier because its members believed Martens had the drive to accelerate growth and the personal charisma to lead the company.

Martens' executive team included the following individuals:

+ **Thad Frizzel, Executive Vice President (EVP) of Sales and Marketing:** Martens hired Frizzel to head sales and marketing four years earlier. Martens wanted someone who could energize the sales force, develop innovative licensing agreements, and move faster. Frizzel, with decades of experience in the industry at successful and often faster-growing companies, fit that bill. Likewise, Frizzel chose to join Oteal because he saw the opportunity to help scale a business and play a leadership role in making that happen.

+ **Carmelo Branco, Chief Financial Officer:** Branco had been with Oteal for 10 years prior to becoming CFO five years earlier. He was Martens' only direct report whom Martens had neither hired nor promoted. Prior to joining Oteal, Branco worked for other pharmaceutical manufacturers, where he had helped with several acquisitions. Martens wanted someone in the CFO role who had experience in acquisitions in case such opportunities came to Oteal; otherwise, Martens felt that finance would likely not play a key role in his growth plans for the company.

+ **Merlin Qualls, General Counsel:** Qualls had served in this position for eight years. He primarily managed the various contracts, legal matters, and lawsuits arising out of the normal course of business as a pharmaceutical manufacturer. He had a small in-house team that handled a wide range of issues and used outside counsel and consultants as needs arose. During Qualls' tenure, Oteal had enjoyed a quiet stretch on the legal front with no significant corporate investigations, litigation, compliance, or regulatory issues.

+ **Dan Wilmont, Chief Risk and Compliance Officer:** Wilmont was hired recently to lead the company's Global Compliance (the Office of Business Integrity and Ethics) and Enterprise Risk Management organizations. Prior to joining Oteal, Wilmont had been a litigation partner with a multinational law firm and an Assistant US Attorney.

BOARD OF DIRECTORS

Oteal's board consisted of nine directors, including Martens:

+ **Chet Lundy** was the Board Chair. Lundy has been an independent director for 10 years and Board Chair for the past eight years. When Lundy first joined the board, he was impressed with Oteal's steady growth, without scandal or drama. It was Lundy, however, who first expressed the idea that perhaps Oteal had become complacent and its stock price had not grown in line with its peers. While "no drama" was certainly important, Lundy felt a public company CEO had more responsibilities than that. He soon convinced the majority of the directors that they should look for someone with a vision to expand the company's drug pipeline and enhance marketing efforts to obtain higher growth and investor returns. This led to the hiring of Martens.

+ **Rose Causey** chaired the audit committee. Causey, a CPA, was one of two recent additions to the board. She was part of the audit committee at another public company, but she had not been a committee chair prior to Oteal. Previously, Causey had been a CFO at a large consumer health products company.

- Joining Causey on the audit committee were two former executives—both of whom had been on the Oteal board for many years, but were recent additions to the audit committee. Causey found her committee members to be competent—they both had significant financial knowledge, one had been a CFO, and both had some training in accounting—but neither had been an accountant nor had previous audit committee experience. Because she was new to the board and as a Committee Chair, she was not yet comfortable pushing for change among her long-tenured peers. Developing close relations with the new CAO and with the internal audit team were also on her agenda once she got settled.
- Three other directors predated the hiring of Martens while the ninth director joined the board at its most recent annual meeting.
- Six of the directors, including Lundy, had executive careers at US companies; one had spent most of her career in Europe, and one was a retired medical doctor and hospital administrator.

The directors worked well together. While Lundy had the strongest voice and led most discussions, the other directors respected the way he ran the board and his work on behalf of shareholders.

CULTURE

After joining the company, Martens had found Oteal to be a professionally run organization. It had talented individuals in all key positions, a mix of newer and long-tenured executives and managers, and a culture of meeting goals and expectations. People seemed to genuinely enjoy working with one another and there was a high degree of trust among the team at Oteal. The company also had a "do the right thing" attitude that drove decision making—everyone knew examples of business that had been delayed or turned away to ensure compliance with Oteal's strict code of conduct.

What bothered Martens about Oteal, however, was its lack of ambition. Oteal had been plugging along for years, almost always doing okay, but never doing great. He felt that Oteal's strong balance sheet and reputation in the industry put it in a position to be something more. The day he was named CEO, he gathered his senior team and described his vision:

> **Sid Martens:** It is an honor to be named CEO and have the opportunity to lead Oteal into what I believe can be a brighter future. We are a strong company, but we can be even stronger and we are ready to take the next steps to become an innovator and overtake our competitors. To achieve this, it can't be business as usual. We must move faster, set higher targets, take more risks, and ask more of ourselves and of our teams. We must no longer accept modest performance as being satisfactory performance. So, let's push ourselves, push one another, and go shake things up. If we are successful, I believe we will bring greater returns to our shareholders and to ourselves, and isn't that what we are here for?

TWO YEARS EARLIER: ENTERING SOUTH AMERICA

Throughout its history, Oteal had sold its commercialized drugs directly to distributors in the United States, while in international markets it had licensed its products to other pharmaceutical companies—it had not manufactured or sold products internationally itself. This had been a simple model for Oteal to earn revenue without incurring the costs or risks of operating in unfamiliar international markets. These license revenues accounted for less than 5 percent of Oteal's total revenues.

Since joining Oteal, Frizzel was constantly on the lookout for new ways to grow the business. Recently, Oteal's research division found that some of the company's noncore products could be used to treat medical conditions more common in South American countries than in the rest of the world. Historically, Oteal would pursue such business through licensing deals. Frizzel, however, increasingly believed that Oteal should be bolder and open its own regional sales operation in South America. Rather than licensing its products to other pharmaceutical companies (many of which relied on an established network of distributors), Oteal would sell its own products through these same distributors. Selling directly to distributors would enable Oteal to retain better control of its products and achieve potentially higher sales and profits. After a number of informal conversations, Frizzel asked Martens to hold an executive team meeting to make a decision on this issue. Frizzel recalled the meeting.

CEO Sid Martens: As you know, Thad's licensing team has found a Brazilian pharmaceutical company that is willing to license our noncore products with terms similar to what we have had in other markets. Merlin's legal team is almost done checking the company out, and if we go this route, licensing revenues could start next quarter. But Thad wants to talk about a new plan. Thad?

EVP of Sales and Marketing Thad Frizzel: Oteal has been doing licensing deals for years. And like the company of old, it has been low risk and modestly successful. But we have never made much money on these deals. I think we are missing a bigger opportunity. If a licensing deal does not help us much, why don't we instead open a new South American region ourselves and use distributors to try to drive growth there in the way we are starting to do in our home market?

General Counsel Merlin Qualls: That sounds interesting, but let's not underestimate the challenge. It will require significant time and focus on the medical regulatory requirements, including formulary approvals and pricing, in each country. It will also require us to form new relationships with foreign distributors, develop completely new contracts, expand our compliance department, and overcome language and cultural barriers. We would definitely need more resources and expertise in the legal function.

CFO Carmelo Branco: I agree with Merlin that the challenges will be real. Our accounting team in particular would be hard pressed and would also need more resources. We don't know much about doing business in South America. But overall, I am supportive of our efforts to grow the business and understand that doing so will require us to take risks.

EVP of Sales and Marketing Frizzel: I understand there are challenges. I know my sales team would welcome the challenge and it would be a big boost to morale. I have confidence that Merlin and Carmelo can work out the legal and accounting bugs as we go. I think we should do this. And Sid, people still talk about that speech you gave about shaking things up when you became CEO.

CEO Martens: I appreciate everyone's input. I took this job to push Oteal to the next level, and this is an opportunity to do that. Not hearing any major objections, let's make this happen. I will have no trouble convincing the board. They keep asking when we are going to do something big. But let's not lose sight of our primary market in the process. And finally, I know opening a new region will require new resources, but let's not let the administrative budget get ahead of the revenues. We still must make our financial targets while we pursue this new business.

Frizzel got started immediately. One of his direct reports, Alejandro Almanza, who headed Oteal's Western sales district, began to split his time between the United States and Brazil. Oteal's Western district was the company's largest and most successful region, and Almanza felt he had developed a strong team that could perform well in his periodic absences.

Almanza had never lived or worked in South America, but he spoke enough Portuguese to carry a simple conversation. From Brazil, Almanza assisted the regulatory team in seeking drug approval and pricing, and he connected with several distributors in the region. Almanza soon focused on BX Dovata Distributors (Dovata) as the most promising. Dovata, headquartered in São Paulo, was a mid-sized distributor looking to grow. Founded in the 1990s, it purchased health-related products from manufacturers and resold them to retail pharmacies and health centers throughout major markets in South America. Oteal would be Dovata's first supplier from the United States, and Dovata executives were excited by the opportunity.

Almanza spent time touring Dovata's operations, visiting its retail clients, and meeting with company executives. Several Dovata executives spoke English, and Almanza soon felt he was developing a good relationship with them. Oteal set up a team at its headquarters made up of legal and sales personnel to develop a distributor contract defining the relationship between the two companies. For Qualls' legal team, the primary focus was on ensuring that Oteal and the distributor met the regulatory requirements for selling pharmaceuticals in Brazil. Throughout the contract negotiations, Almanza played a coordinating role between Oteal's team and a similar team at Dovata.

Four months after Almanza's first trip to Brazil, Oteal made its first shipment to Dovata. In the following months, Almanza opened a small office in São Paulo and hired a few local administrative staff. He had underestimated how much time and attention the region would demand of him, and he was determined to hit all of his targets in his Western district as well. He recalled a conversation with his boss, Frizzel.

Alejandro Almanza: We seem to be off to a strong start in South America. Now that we are making actual sales, shipping product, and earning revenues, we need to strengthen our team in São Paulo. We also need to find someone to run it. I've been going down and back for nearly a year and want to refocus on my Western district. It is difficult to be in two places at once.

Thad Frizzel: You have done well and the executive team has noticed. But you have our first distributor and a team in São Paulo; what additional personnel do you need?

Almanza: We are sales people, Thad, and you know I don't want anything to slow us down, but there is a lot happening. Until our products develop a stronger, more predictable demand, Dovata is reluctant to give us large ongoing orders. Mostly we are making a lot of smaller sales when Dovata is convinced it can sell to a particular customer. The product packaging, mix, quantities, and shipping instructions are different each time. We have a contract, but we are also developing trust that goes beyond the contract. We need some local people working for us who are familiar with the way business works in South America to provide strong oversight and to stay on top of all this. We also need someone who can move us beyond Brazil.

Frizzel: The executive team agrees that we need to hire a local manager to run the São Paulo office and get you back to the States. However, in terms of hiring more local staff, right now the sales don't justify the expense. We have people at headquarters doing this for our US market, and it is the same business in South America. And a few of our staff members speak Spanish or Portuguese. We will just have to get by for now with the people we already have.

Almanza: I understand, but I am not sure it is the same business at all.

One year after entering Brazil, Oteal hired Antonio Sosa to run its South American region. Sosa, who was born in Brazil and had lived there for most of his life, was an experienced sales manager who had worked in consumer products, including over-the-counter products. In his previous position, he had a reputation for getting things done and being able to function with remote oversight. Sosa, who reported to Frizzel, spoke Portuguese and Spanish fluently.

Frizzel impressed upon Sosa the importance of finding more distributors and growing Oteal's business in the region in order to hit the sales targets. In his early months, Sosa took time to get up to speed on how Oteal's business worked with Dovata and then began looking for distributors outside of Brazil. By the end of his first year, Sosa had found five distributors in five other South American countries.

INTERNAL AUDIT

Hunter Esposito, a CIA, headed Oteal's internal audit team. Esposito reported functionally to the board's audit committee and administratively to the CFO, though in practice he worked most closely with Branco. Esposito provided the audit committee with formal, required reporting, but he had not developed a close relationship with Causey, who was still new in her role—in fact, Esposito had never had a one-on-one meeting with Causey.

The internal audit team evaluated the effectiveness of Oteal's internal controls and accounting processes to meet regulatory requirements, manage risk, and protect against financial statement fraud. Esposito's team, in conjunction with Branco, developed and followed an annual plan for testing controls throughout the company, but with a focus on its primary business areas as identified by Branco. Esposito had received no feedback on the annual plan from Oteal's audit committee, a fact that Esposito attributed to the recent turnover on the committee.

Esposito had three direct reports. He had requested funding to hire more staff, invest in technology, and conduct training on auditing foreign operations, but Branco turned him down. Esposito understood that, with Oteal's practice of running lean teams, combined with the fact that internal audit rarely turned up anything of significant concern, it would be difficult for Branco to approve his request for a budget increase. Because of his budget limitations, on the few occasions when internal audit discovered a problem, Esposito relied more than he would have liked on the specific business unit in question to address and self-remediate identified issues with limited follow-up.

CHIEF RISK AND COMPLIANCE OFFICER

Much of Wilmont's time had been spent evaluating and reinforcing policies related to healthcare practitioner interactions in compliance with regulatory and industry guidelines (including interactions via third parties) as well as the process for monitoring regulatory approvals. Wilmont had begun to establish a distributor compliance program, including the future use of external resources where necessary, to assist in executing compliance audits. While Wilmont viewed compliance audits as central to his three-year plan to establish an effective compliance program, he thought it was too early to conduct useful audits. More time was necessary to train employees and strengthen Oteal's culture of compliance. Wilmont also planned to upgrade the company's existing compliance hotline. He viewed the hiring of a compliance officer devoted to South America's operations as a high priority; however, his first-year budget was limited.

EXTERNAL AUDIT

Abbay Associates, a US-based, mid-sized public company audit firm, had served as Oteal's external auditor. Abbay's partners considered themselves and the firm to be generalists, loose with their client acceptance procedures, and willing to take on riskier public clients. Abbay historically had not found any significant problems with Oteal—all of its financial statements had been filed on time and Oteal had never restated any of its financial statements.

Lucas Hentix served as Audit Partner for the Oteal account for three years and had recently assigned Lacey Thao, a new manager, to run the day-to-day activities of Abbay's engagement team at Oteal. Thao knew that Abbay ran an efficient operation with small audit teams. It made the work demanding but also required her to play a hands-on role in the audit, not just manage it, which was something she enjoyed. As for running the Oteal audit, Thao would have liked more oversight and support from Hentix, especially as it related to obtaining resources and building her team, but she understood that he had many clients, some with reporting deadlines similar to Oteal, and limited resources to offer.

Thao felt that Oteal was a client with fairly standard financial statements. She did wish, however, that they moved a bit faster. To Thao, Oteal's personnel often seemed rushed, yet nothing from Oteal ever came early, and Thao's team had to track down missing documentation more often for Oteal than for Abbay's other clients. Further, her main point of contact within Oteal had already changed twice in her short time on the account, making it even harder to get what she needed quickly.

Thao was concerned about Oteal's expansion in South America. Abbay focused primarily on US public companies. When its clients had material non-US operations, Abbay partnered with qualified auditors to assist. Last year, Oteal's South American operation was not material, and with one distributor, seemed to be slow growing. The quick addition of distributors throughout South America, however, and the new potential for rapid growth, had caught Abbay off guard. Thao and her team had researched the matter and had scheduled training, but they still lacked experience. Abbay had a junior auditor who was fluent in Portuguese and two employees spoke Spanish, but none of these three were on Thao's team. Thao also questioned Oteal's capabilities. For example, she had recently asked Hentix if anyone at Oteal spoke fluent Portuguese or Spanish. Hentix replied that he thought some of the support staff did.

CONCERNS IN ACCOUNTING

Craft had joined Oteal at about the same time the company entered South America. She had not been involved much in the South American market at the time, but now, two years later, hardly a day went by without her hearing something about the company's newest region. After three months of being the CAO, however, Craft felt she was barely keeping up with all she had to learn and do in her new role.

Craft understood that operating a successful business was difficult. There were always pressures—to perform, to hit targets, to make a sale, to serve customers, to keep costs in line, to meet regulatory requirements, and a million other things. She saw her job as Chief Accounting Officer as creating and enforcing the right rules and practices to ensure Oteal met its regulatory requirements as they related to financial reporting and to help educate Oteal's employees on the importance of doing so. Until recently, the concerns she had discovered had largely been minor policy violations, which she felt she needed to stay on top of in order to prevent bad practices from becoming an acceptable way of working and to head off any serious problems.

As Craft became more familiar with Oteal's activities in South America, however, her level of concern increased. One area of concern was the due diligence Oteal had undertaken relating to Dovata. Oteal had looked into Dovata on its own, and supplemented that research by engaging a consulting firm to perform further due diligence. No serious matters arose: neither Dovata nor its officers had been involved in any significant legal or regulatory issues; the company was financially sound; and it earned a good reputation among its customers, suppliers, creditors, and investors. What concerned Craft was that Dovata had never worked with a US public company. Oteal had created a contract defining what Dovata must do to meet its requirements, but Craft had little sense of whether Dovata understood the importance of those requirements or how much time and effort it would take Oteal's personnel to ensure Dovata met them. Oteal's US distributors occasionally missed a contract provision, but Craft saw these as one-off occurrences in an otherwise well-functioning system. Craft was less confident with Dovata.

Craft saw that the report from the consulting firm contained a section about US companies venturing overseas. It contained several recommendations, including the following: "be sensitive to cultural dynamics"; "no matter where people live, they don't want to be micromanaged from afar"; "assume good intentions and respect"; and "it will take time to develop mutual understandings on how to work together." Craft agreed with the intent but wondered what it meant for maintaining control over the financial statements.

Craft also had questions about the contract. She knew the contract had been developed by a joint team from the legal department and from sales and marketing. The team had been involved with many contracts before, but never with a foreign distributor. Craft noted that the contract, including its terms and conditions, was not the same as contracts Oteal had used for its US distributors. She also saw no evidence that her predecessor had reviewed the contract. Nor did it seem that Oteal had consulted with external legal counsel with experience in such contracts.

Craft reviewed the contract and much of it seemed reasonable; however, two items caught her eye. First, it did not state that Dovata was an agent of Oteal and therefore had to abide by Oteal's policies or follow US laws and regulations, including those prohibiting bribery and corruption. Second, contracts between manufacturers and distributors often gave the manufacturer the right to conduct audits of the distributor as necessary to ensure it was abiding by the terms of the contract. This included the right to inspect facilities and review the internal documents including the books and records of the distributor as related to Oteal products or interactions on behalf of Oteal. The contract with Dovata did not include a right-to-audit clause or anti-bribery and anti-corruption considerations. Craft had yet to review the contracts with the five newest distributors.

Craft had other concerns as well, so she scheduled a video conference with Branco, who generally worked remotely, to discuss them.

Jodi Craft: Thank you for connecting with me Carmelo, I know you are quite busy these days.

Carmelo Branco: Yes, it has been busy. I have a meeting with Sid in a little while, what is on your mind?

Craft: I have some concerns about our operations in South America. Sales there have been increasing, which is great, but I am worried about how well that part of our business is under control or how well it is even understood. Our due diligence of Dovata made very little note of the fact that Dovata has never worked with a US manufacturer, and some aspects of our contract with them seem unusual. On top of that, our manager on the ground there, who just joined the company, is the only one of us who really speaks the language or knows the local culture, but does he know ours? We are new at this, Dovata is new at this, and it feels like we are learning from each other. My fear is that if there is a problem, it will be on us.

Branco: Wow, you are throwing a lot at me there. Why don't you contact my assistant to schedule an appointment with me when I have more time? Maybe write up a list of what you don't understand and we can go through them one at a time. I'll admit this is all new to us, but the pace is picking up around here. Sid is already talking about opening a region in Europe and setting higher growth targets company-wide. We need to get comfortable with some temporary uncertainty as the company moves ahead in a more aggressive manner. This will be good for all of us. Besides, I trust that our colleagues in legal and in sales and marketing went through everything carefully with Dovata. Thad especially has a lot at stake here. Let's reconnect when I have more time, but let's be careful about calling something a problem unless we are confident it is one. And as CAO, a lot of this is yours to figure out.

Several days after her meeting with Branco, Craft came across Garth Reet, one of her accounting managers, conversing with one of his colleagues who sounded tense and unhappy. She called Reet into her office later that day to see what was going on.

Jodi Craft: I saw you talking earlier, that did not look like a fun conversation.

Garth Reet: It was nothing out of the ordinary these days. Some of our people feel like they are falling behind because they are chasing down details we shouldn't have to be chasing. I don't blame them. It seems everyone is busy these days because of our growth and corners are getting cut, documentation is missing or incomplete, and accounting is left to figure out what is going on.

Craft: I thought we were getting the documentation issue under control after we sent out some reminders?

Reet: We were, especially in the US, but when things took off in South America, things started slipping there. And there is an attitude problem as well. In the past, when we had to follow up with sales, they always apologized and quickly got back to us with what we needed. Now, we seem to get more back talk from them, questioning us about whether we really need everything we are asking for. My subordinate, a junior accountant, had just got off the phone with Antonio Sosa when you saw us. Antonio implied he was too busy making sales to immediately have every document we were bothering him about, and he said something about some of the deals are just done verbally. With the way he treats us, some on my team are even reluctant to call him.

Craft: How often has that happened?

Reet: A few times, I think. The first time I spoke with Antonio, I wasn't sure what to make of him. He told me, "Oteal hired me to be in Brazil because you have no experience here. I know how to do business in South America. You need to trust me to get it done."

Craft: I will look into this. Let's talk again tomorrow afternoon. I know you are very busy, but before then can you spend a couple of hours to summarize what you see happening in South America? Talk to your team and get their input too. We need to understand this better.

Reet: Thanks. By the way, I spoke with my friend in internal audit. I hear that they have yet to conduct a full audit of the South American region. Internal audit wants to give the new region more time to get settled and see if their sales take off before shifting their audit plans. And they haven't figured out what to do with the foreign language documents they might encounter.

After Reet left, Craft reflected on the conversation. She thought about calling Sosa, but she had never met him. She was out of the office when he came to headquarters last month, and before that she was never on his agenda when he came to the United States. Craft did not want her first conversation with him to be a problem. She decided to speak with Frizzel instead, who she knew was very interested in the growth happening in South America. She thought about including her boss, Branco, since he was a peer to Frizzel, but her recent conversation with him left her feeling that this was her problem to solve.

Jodi Craft: Thad, thank you for meeting with me. First, let me congratulate you on the sales growth—things really seem to be moving for us. But I want to talk to you about some problems my accounting team is having with the South American region, and with Antonio in particular.

Thad Frizzel: Thank you, Carmelo mentioned that you had some concerns. I am not too worried; I think some difficulties should be expected as we accelerate our growth in new areas. Regarding Antonio, he is a real mover, though it has been a challenge for him to meet our ambitious targets. And with Sid saying last quarter how proud he was of everyone that we exactly hit our analyst forecasts for the sixth consecutive quarter, I think Antonio wants to show he can do his part. What did you want to talk about?

Craft: I don't know Antonio or much about business norms in South America, but my team tells me we regularly have to chase down documentation, the contracts are unclear, some of the deals are done verbally, and—most concerning—he does not respect my people. We are looking into a few things now.

Frizzel: How important is this right now? I know we need to follow procedures, but Antonio is still learning how to work for a US company and we have made it clear to Antonio that this is a big opportunity for Oteal and for him. I can talk with him, but he has a lot on his plate and I want to give him as much leeway as I can.

Craft: I would appreciate it if you spoke with him. We can't cut corners on this. It has the potential to impact our financial statements. On a related topic, how is Dovata doing? Do you trust them? I don't feel we really know Dovata as well as we should, nor the new distributors either. Everything can't be codified in a contract. We need to know they feel the same way we do about doing the right thing and our responsibilities as a public company. I know we have provided them with a copy of our code of conduct, but I don't know if that is enough.

Frizzel: Dovata is doing great, though I think it has been a mutual learning experience. You remember that Alejandro Almanza got us started with Dovata and developed a great relationship with his contact there. When Alejandro returned to the US, however, his contact left Dovata shortly thereafter. Antonio is now rebuilding a personal connection with Dovata. It will come around; we just need to give it time. I haven't been down to meet the new distributors, but I plan to soon.

AFTERNOON MEETING

Jodi Craft: Thank you again, Garth. What have you found? Do we have a problem?

Garth Reet: I am not sure if there is a real problem or whether I am just worrying too much, but in the past few days we have noticed several issues in South America that just seem odd. I wish I had more time to dig into them, but with the quarter winding down I just don't. Here is what we have found so far, but one of my accountants is looking for a document she recalled seeing and will stop by if she finds it.

Reet went on to describe his concerns. Just before the end of the previous quarter, Oteal had rush-shipped several orders to one of its new distributors in South America. These were the first orders for this particular distributor, and Reet did not consider them unusual at the time. Yesterday afternoon, however, Reet noticed that Oteal had once again rushed-shipped several more orders to the same distributor as the quarter was winding down. His curiosity raised, Reet looked at the order history for the distributor and saw that the quarter-end shipments accounted for nearly half of the distributor's total orders. Looking further, Reet saw that the distributor had returned 30 percent of the previous quarter-end orders citing packaging errors—an unusually large packaging issue and return percentage—just a few weeks into the new quarter. Reet noted that the 30 percent figure represented 10 percent of total South American sales. Finally, the two quarter-end orders were shipped to two different locations in the same city. Reet wondered why a small distributor would manage its inventory in that manner.

A second issue related to contract differences. In addition to the Dovata contract, Reet had seen only one other contract from the region. The Dovata contract called for Dovata to purchase products from Oteal and then resell them to retailers. Under this contract, Dovata could return products to Oteal within 30 days for almost any reason, and thereafter for limited specified reasons such as defects. The other contract provided Oteal's distributor with much broader return rights beyond the 30 days—including allowing returns for products in distributor warehouses that were approaching expiration. Reet was concerned that selling products with different return rights created revenue recognition challenges and increased the chance for accounting errors. Both contracts set minimum quarterly and annual sales targets and were renewable on an annual basis. When Reet asked to see all the contracts, someone from Oteal's São Paulo unit emailed two to him but noted they were in Portuguese and that they were still in the process of being translated. Reet, who did not speak Portuguese, could see, however, that the contracts were significantly different in length from each other and from the Dovata contract. The São Paulo staff member made no mention of the remaining three contracts that Reet assumed existed with the other South American distributors. Reet also asked a member of Qualls legal team for the contracts and received back the same ones he had obtained from São Paulo, along with a note that they would get back to him with the others.

A third issue related to pricing. Historically, Oteal's products had a list price and a defined set of performance-based criteria under which Oteal might discount the price. For example, buyers that made large or repeated orders, paid early, or hit a target typically received discounted pricing as described in an approved pricing table. It appeared to Reet, however, that Sosa offered discounts under other circumstances and at rates not found in the pricing table. He also may have honored pricing for targets that had not been met by the distributor. Reet wondered whether Sosa was offering discounted prices to encourage new distributors to place orders because none of the new distributors had yet earned discounts by meeting performance criteria. Oteal's sales function sometimes agreed to nonstandard pricing, but such agreements typically came with transparency at headquarters and sufficient documentation. Reet was not seeing either from South America.

Finally, Reet saw that Oteal was shipping product to South America, but distributor payments did not always arrive in a timely manner. Oteal contracts typically required payment within 60 days. As he scanned through documentation from one South American distributor, he saw a 90-day payment term.

RED FLAG

As Craft and Reet finished going over Reet's findings, his accountant walked in and handed them a letter from Sosa to one of the newer distributors. Reet told Craft that he sometimes asked a staff member with foreign language skills to translate documents into English when they had time, but not all such documents got translated. In this letter, the accountant had circled two sentences (at right).

Craft sat back in her chair and considered her next actions.

If you can double the size of this next order, and get it in before the end of the quarter, we can (1) increase the discount for your orders next quarter by 10 percent, and (2) extend the return period on products you can't move by 60 days beyond what is stated in our contract and included on our invoices. If necessary, we can allow you to exceed your credit limit to complete this order quickly.

Characters

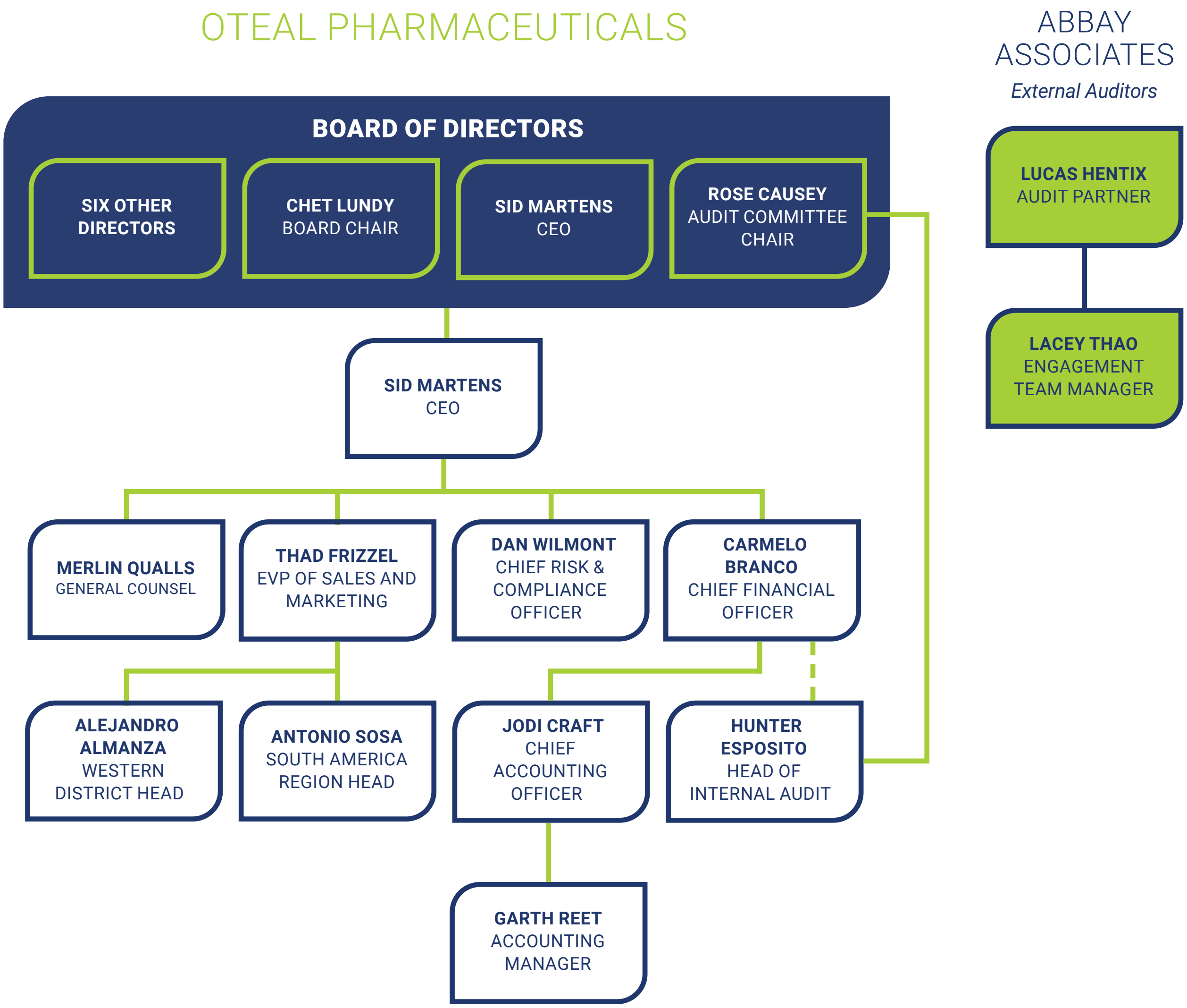
OTEAL PHARMACEUTICALS

- **Sid Martens**, Chief Executive Officer (CEO)
  - **Thad Frizzel**, Executive Vice President (EVP) of Sales and Marketing
    - **Alejandro Almanza**, Western District Head, reports to EVP of Sales and Marketing
    - **Antonio Sosa**, South America Region Head, reports to EVP of Sales and Marketing
  - **Carmelo Branco**, Chief Financial Officer (CFO)
    - **Hunter Esposito**, Head of Internal Audit, reports to audit committee, dotted line to CFO
    - **Jodi Craft**, Chief Accounting Officer (CAO), reports to CFO
      - **Garth Reet**, Accounting Manager, reports to CAO
  - **Merlin Qualls**, General Counsel
  - **Dan Wilmont**, Chief Risk and Compliance Officer
- **Chet Lundy**, Board Chair
- **Rose Causey**, Audit Committee Chair

ABBAY ASSOCIATES

- **Lucas Hentix**, Audit Partner
  - **Lacey Thao**, Engagement Team Manager for Oteal account

Organization chart



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