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Public Company Accounting Oversight Board

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ORDER INSTITUTING DISCIPLINARY PROCEEDINGS, MAKING FINDINGS, AND IMPOSING SANCTIONS

In the Matter of Williams & Webster, P.S., Kevin J. Williams, CPA, and John G. Webster, CPA,

Respondents.

PCAOB Release No. 105-2007-001

June 12, 2007

Summary

By this Order, the Public Company Accounting Oversight Board ("Board" or "PCAOB") is censuring Williams & Webster, P.S., barring Kevin J. Williams, CPA from being an associated person of a registered public accounting firm,[1/] and suspending John G. Webster, CPA from being associated with a registered public accounting firm for a period of one (1) year from the date of this Order. The Board is imposing this sanction on the basis of its findings concerning the respondents' violations of PCAOB rules and standards in connection with an audit of the financial statements of one issuer client during 2004.

I.

The Board deems it necessary and appropriate, for the protection of investors and to further the public interest in the preparation of informative, fair, and independent audit reports, that disciplinary proceedings be, and hereby are, instituted pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002 ("Act") and PCAOB Rule 5200(a)(1) against Williams & Webster, P.S. ("W&W"), Kevin J. Williams, CPA ("Williams"), and John G. Webster, CPA ("Webster") (collectively, "Respondents").

[1/] Williams may file a petition for Board consent to associate with a registered public accounting firm after two (2) years from the date of this Order.

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II.

In anticipation of institution of these proceedings, and pursuant to PCAOB Rule 5205, Respondents have submitted Offers of Settlement ("Offers") that the Board has determined to accept. Solely for purposes of these proceedings and any other proceedings brought by or on behalf of the Board, or to which the Board is a party, and without admitting or denying the findings herein, except as to the Board's jurisdiction over them and the subject matter of these proceedings, which is admitted, Respondents consent to entry of this Order Instituting Disciplinary Proceedings, Making Findings, and Imposing Sanctions ("Order") as set forth below.

III.

On the basis of Respondents' Offers and information obtained by the Board in this matter, the Board finds[2/] that:

A. Respondents

1. W&W is an accounting firm incorporated in the state of Washington and licensed by the State of Washington Board of Accountancy (license no. 3552). W&W is registered with the Board pursuant to Section 102 of the Act and PCAOB Rules. Its office is located in Spokane, WA.

2. Williams, 59, of Spokane, WA, is a certified public accountant licensed by the State of Washington Board of Accountancy (license no. 13648). He is the founding shareholder of W&W and at all times relevant to this matter was the principal shareholder of W&W and an associated person of W&W, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i). Williams was the lead engagement partner on the audit that is the subject of this Order.

[2/] The findings herein are made pursuant to the Respondents' Offers and are not binding on any other person or entity in this or any other proceeding. The sanctions that the Board is imposing on Williams and on Webster in this Order may be imposed only if a respondent's conduct meets one of the conditions set out in Section 105(c)(5) of the Act, 15 U.S.C. § 7215(c)(5). The Board finds that Williams's conduct and Webster's conduct described in this Order meet the condition set out in Section 105(c)(5)(A), which provides that such sanctions may be imposed in the event of "intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable statutory, regulatory, or professional standard."

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3. Webster, 50, of Spokane, WA, is a certified public accountant licensed by the State of Washington Board of Accountancy (license no. 11301). He was a shareholder of W&W from 1996 until 2006 and at all times relevant to this matter was an associated person of W&W, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i). Webster was the concurring review partner on the audit that is the subject of this Order.

B. Respondents Violated PCAOB Auditing Standards in Auditing the 2003 Financial Statements of Diatect International Corporation

Summary of Violations

4. In connection with the preparation or issuance of an audit report, PCAOB rules require that a registered public accounting firm and its associated persons comply with the Board's auditing standards.[3] Under the Board's auditing standards, an auditor may express an unqualified opinion on an issuer's financial statements only when the auditor has formed such an opinion on the basis of an audit performed in accordance with PCAOB standards.[4] Among other things, those standards require that an auditor exercise due professional care, exercise professional skepticism, and obtain sufficient competent evidence to afford a reasonable basis for an opinion regarding the financial statements.[5] In connection with the audit of the fiscal year ("FY") 2003 financial statements of Diatect International Corporation ("Diatect"), Respondents failed to exercise due professional care, failed to exercise professional skepticism, and failed to obtain sufficient competent evidence to afford a reasonable basis for an opinion regarding the financial statements.

5. In particular, Williams failed to perform adequate audit procedures and failed to exercise due care and professional skepticism in the evaluation of evidential matter related to (1) Diatect's reported gain on the sale of mining rights; and (2) its reported revenue with respect to products for which a right of return existed. Webster failed to exercise due professional care and objectivity in the performance of his concurring partner review of the audit. Specifically, during the audit Webster raised issues about apparent departures from U.S. generally accepting accounting principles

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[3] See PCAOB Rules 3100, 3200T.

[4] See AU § 508.07, Reports on Audited Financial Statements.

[5] See AU § 150.02, Generally Accepted Auditing Standards; § 230, Due Professional Care in the Performance of Work; and § 326, Evidential Matter.

("GAAP") and documented his concerns in a memorandum to Williams one month before the audit report date, but then he concurred with W&W's decision to issue its unqualified audit report even though those issues remained inadequately addressed.[6/]

The Audit of Diatect's 2003 Financial Statements

6. Diatect is a California corporation based in Heber City, Utah. Its common stock is registered with the United States Securities and Exchange Commission ("Commission") under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and is quoted on the Pink Sheets. Diatect's public filings disclose that, at all times relevant to this matter, it was in the business of producing a variety of insecticide products. At all relevant times, Diatect was an issuer as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

7. W&W was engaged as Diatect's independent auditor from 2000 through November 2004. W&W issued an audit report dated April 14, 2004, that was included in Diatect's Form 10-KSB/A filed with the Commission on April 29, 2004 and May 17, 2004, in which W&W expressed an unqualified audit opinion on Diatect's consolidated financial statements for FY 2003 and 2002. The report stated that the Company's financial statements present fairly, in all material respects, the Company's financial position, results of operations, and cash flows in conformity with GAAP.

Diatect's Sale of Mining Claims

8. According to minutes of a meeting of Diatect's board of directors, in 2001, four members of Diatect's management and their spouses acquired four unpatented mining claims from the U.S. Bureau of Land Management ("BLM Claims"). The minutes reflect that the BLM Claims covered 640 acres of land in Oregon that contained diatomaceous earth, a naturally occurring substance used in insecticide products that Diatect marketed and sold. The minutes also reflect that the Company intended to prepare the "appropriate quitclaim deeds" to transfer ownership of the BLM Claims to Diatect. Diatect recorded the BLM Claims on its FY 2001 balance sheet at the acquisition cost of $540.

[6/] Before W&W issued the audit report, Webster concluded that, among other things, no matters had come to his attention that would cause him to believe that the financial statements were not in conformity with GAAP or that the audit was not performed in accordance with PCAOB standards. Based on this conclusion, he approved W&W's issuance of its audit report. In this Order, that conduct is described as Webster concurring with W&W's decision to issue its audit report.

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9. Two years later in July 2003, Diatect submitted second quarter financial information to W&W for review in which management had marked up the value of the BLM Claims to $34,584,000 based on a 1991 geologist's report ("1991 Geologist Report"). In response, Respondents told Diatect that in order to record a gain on the asset, it needed to sell the BLM Claims. A few days later, Diatect entered into a transaction to sell 90% of its BLM Claims for $31,125,600, or 90% of the marked up value. The buyer was a newly formed shell company called Diatomaceous Earth Deposits of Virginia, LLC ("DEDV") owned by Michael P. McQuade ("McQuade"), an outside director and shareholder of Diatect. Because McQuade was a Diatect director and sole owner of DEDV, the sale of the BLM Claims was a related party transaction.[7/]

10. DEDV paid no cash at the time of the transaction. Instead, Diatect accepted an 18-year promissory note ("Note") for the full purchase price. No payments under the Note were due until 2005. Diatect recorded a gain of $15,562,800, or 50% of the sale price, in its financial statements for the quarter ending September 30, 2003.[8/] The Company reduced the gain to $12 million in its FY 2003 financial statements.[9/] At year end, the Note represented 74% of the Company's reported assets and the gain was equal to 159% of its reported income before taxes.

11. During the FY 2003 audit, Williams became aware of significant facts indicating that Diatect's accounting for the BLM Claims transaction may have departed from GAAP. Specifically, Williams became aware of information indicating (1) that there may not have been a sale because the incidents of ownership of the BLM Claims may not, in substance, have been transferred to the buyer;[10/] and (2) that even if the

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[7/] See Statement of Financial Accounting Standards ("SFAS") No. 57, *Related Party Disclosures*, at ¶ 1 and Appendix B.

[8/] Prior to the transaction, the BLM Claims were recorded on Diatect's balance sheet at $940, reflecting the 2001 acquisition cost and annual fees Diatect had paid since 2001 to maintain the claims.

[9/] The $12 million gain was based on Respondents' calculation of the present value of the Note using a 20% discount rate.

[10/] Determining whether a nonperforming asset has been transferred in substance involves an assessment as to whether "the risks and rewards of ownership have been transferred." Codification of Commission Staff Accounting Bulletins ("SAB") Topic 5.V, Question 1 (relating specifically to certain transfers of nonperforming assets by financial institutions). Circumstances that may indicate that the incidents of

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incidents of ownership had, in substance, transferred to the buyer, collection of the sale price may not have been reasonably assured. Either way, the information raised the possibility that Diatect should not have recognized a gain on the purported sale.[11] The audit work papers reflect Williams's understanding that DEDV had no financial investment in the BLM Claims, having made no down payment. Williams also concluded that DEDV did not have the financial means to pay the Note because it was a newly formed shell company with no operations or assets, and payment of the Note was not guaranteed by McQuade or others. As Williams described in the work papers, "[b]uyer is newly formed entity, with no operating history, no financial statements and no experience in minerals extraction. This represents substantial risk of nonperformance on note."

12. Williams also was aware of facts indicating that there was substantial doubt as to whether DEDV could generate sufficient income from the BLM Claims to pay the Note. The work papers reflect Williams's conclusion that Diatect had never mined the property or otherwise generated any revenue from the BLM Claims. In an e-mail dated one month before W&W's audit report, one of Diatect's outside directors reported that DEDV "has not presented a business plan, financials, or an operation plan for the mine—no schedule for investment or ramping up." The e-mail requested that W&W prepare a letter to Diatect management setting forth any concerns the auditors' had related to, among other things, the BLM Claims transaction. In a letter to Diatect the following day, Williams questioned whether it is "realistic to expect that a minerals site—as yet not producing—can actually generate 7 million in cash in only 18 months in order to make the first note payment to Diatect?"

13. Williams failed to properly address these issues during the audit. No procedures were performed to determine whether Diatect owned the BLM Claims, even though Board meeting minutes reflect that four members of Diatect's management and their spouses acquired the BLM Claims, not Diatect. No inquiries were made of DEDV

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ownership, in substance, have not been transferred to the buyer, include (1) the absence of a significant financial investment by the buyer; and (2) that repayment of the debt that constitutes the principal consideration in the transaction is dependent on future successful operations of the business. See id. (incorporating factors described in SAB Topic 5.E, relating to divestiture of business operations).

[11] Profit is deemed to be realized when a sale is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. See Accounting Research Bulletin No. 43, Ch. 1A at ¶ 1.

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or McQuade concerning the transaction, DEDV's apparent lack of investment in the BLM Claims, DEDV's ability to repay the Note, or DEDV's ability to successfully mine the BLM Claims. Instead, Williams relied on Diatect's management's representations concerning DEDV's operational and financial plans. Under the circumstances, including the related party nature of the transaction, such reliance on management representations was insufficient to support the audit opinion.[12/] Although Williams informed Diatect in writing that he wanted to review the due diligence documentation "in order to objectively evaluate the collectibility of this enormous receivable," Williams neither received nor reviewed such documentation. Moreover, W&W received a confirmation reply, stating that the original amount of the Note was $15,562,800, which was only 50 percent of the Note's stated value. Although the reply contradicted Diatect's management's representations, Williams failed to address this inconsistency. Finally, Williams failed to obtain or review the 1991 Geologist Report, even though it was incorporated into the BLM Claims sale agreement and he was urged to review the report by one of Diatect's directors who described it to Williams in November 2003 as the "'maximus opus' on the mine." In the audit work papers, Williams identified the 1991 Geologist Report and a 1996 unsigned letter by a second geologist ("1996 Letter") concerning the BLM Claims as supporting the value of the Note's collateral.[13/] Williams, however, made no effort to contact either geologist or to otherwise determine whether the 8 and 13 year-old reports accurately reflected the current value of the BLM Claims.

[12/] See AU § 334.07 & .09, *Related Parties* ("The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity." "The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management."); AU § 9334.18 ("The risk associated with management's assertions about related party transactions is often assessed as higher than for many other types of transactions because of the possibility that the parties to the transactions are motivated by reasons other than those that exist for most business transactions.").

[13/] Despite using the conclusions of both the 1991 Geologist Report and the 1996 Letter as evidential matter concerning the value of the BLM Claims, Williams did not perform procedures to ascertain the qualifications of the geologists, the geologists' relationships to Diatect, or the methods or assumptions used by the geologists. PCAOB standards required Williams to perform such procedures in order to use the geologists' conclusions as evidential matter. See AU § 336, *Using the Work of a Specialist*. Williams also failed to identify and analyze the circumstances giving rise to the 1996 Letter, why the 1996 Letter was not signed, or whether the 1996 Letter covered the same mining claims Diatect purportedly sold in 2003.

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14. Webster, as the concurring partner reviewer, was aware of significant questions relating to Diatect's accounting for the BLM Claims transaction. In September 2003 and February 2004, the Commission staff issued comments on an SB-2 registration statement Diatect had filed ("SB-2 Comments").[14] The SB-2 Comments raised questions concerning the BLM Claims transaction, which Webster addressed in a W&W internal memorandum to Williams dated March 18, 2004 ("Webster Memo"). The Webster Memo noted that DEDV was "thinly capitalized and may not be able to finish the development [of the mine] within two years to generate an income stream."[15] The Webster Memo also noted that any gain could be "deemed not to be recognized until cash or a close substitute is received." Webster, however, concurred with W&W's decision to issue its audit report even though these issues were not properly addressed.[16]

Diatect's Revenue Recognition and Accounting for Product Returns

15. According to Diatect's public filings, it recognized revenue when it shipped product to its customers, and its customers could return product at any time and receive a credit for the full amount. Respondents became aware of evidence suggesting that Diatect's revenue recognition practices may not have complied with GAAP, including evidence that (1) certain transactions recorded as sales may in fact have been consignments; (2) Diatect may have lacked the ability to make a reasonable estimate of future returns, thus making it inappropriate to recognize revenue upon shipment; (3) Diatect failed to establish any reserve for estimated future returns; and (4) Diatect failed to reduce revenue for product returns.

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[14] Respondents received the SB-2 Comments from Diatect before W&W's April 14, 2004 audit report was issued.

[15] SAB Topic 5.U describes considerations that may cause the SEC staff to question gain recognition on a sale to a highly leveraged business (relating specifically to sale of a business or operating assets), including considerations that were present in Diatect's sale of the BLM Claims to DEDV. This accounting guidance was included in W&W's work papers.

[16] In 2005, Diatect restated its FY 2003 financial statements, reversing the $12 million gain, explaining that it "considered the agreement to be non-substantive as the buyer is thinly capitalized and has only made minimal investments in the property." See Diatect's 2004 10-KSB/A filed with the Commission on May 6, 2005.

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16. During the FY 2003 audit, Williams became aware of evidence that transactions Diatect recorded as sales were in fact consignments.[17/] Diatect promoted its products to various high school chapters of the Future Farmers of America ("FFA") under its "Got Bugs" fundraising program. Diatect's reported sales to various FFA chapters represented approximately 35% of total sales in FY 2002 and 12% in FY 2003. During the FY 2003 audit, Williams obtained copies of Diatect's marketing materials, contracts, and remittance forms for the "Got Bugs" program. The marketing materials describe the program as "Risk Free—Free shipping. No out of pocket expense. Pay only for what you've sold." The contracts permitted the FFA chapters to remit the purchase price "weekly as product is sold," and the remittance forms were consistent with consignment payment terms. In addition, W&W documented the results of conversations with Diatect's customers evidencing that at least 50% of the accounts receivable selected for confirmation were the result of consignment arrangements, not sales.[18/] The confirmation results were sent to Diatect, and Williams documented the consignment issue in a letter to Diatect's management: "Many audit items which we have endeavored to confirm are either not coming back to us or not as expected. Many more are coming back with problems (e.g., consignments rather than sales) and need your firm's attention to satisfactorily resolve."

17. In addition, even to the extent that Diatect's transactions were sales, Williams was aware of evidence that Diatect's practices may not have complied with GAAP concerning product sales where a right of return exists. First, revenue from such sales can be recognized at the time of the shipment (Diatect's practice) only if, among other things, the company has the ability to make a reasonable estimate of future returns.[19/] Williams was aware of the presence of factors that GAAP identifies as tending to impair the ability to make such estimates, but he performed no evaluation to determine whether Diatect had that ability.[20/] Second, if revenue is recognized at the

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[17/] Products shipped pursuant to a consignment arrangement "are not sales and do not qualify for revenue recognition until a sale occurs." SAB Topic 13.A.2, Question 2.

[18/] W&W also received accounts receivable confirmation replies from some customers that expressly indicated a consignment arrangement during the FY 2002 audit.

[19/] See SFAS 48, *Revenue Recognition When Right of Return Exists,* at ¶ 6(f); SAB Topic 13.A.4(b), Question 5.

[20/] For example, in audited financial statements for FY 2002 and 2001, Diatect disclosed that it lacked a sufficient sales history to be able to establish an

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time of shipment, the company must establish a reserve for estimated future returns.[21] Williams was aware that Diatect did not establish a reserve for estimated future returns as of December 31, 2003, even though it had a history of receiving significant product returns.[22]

18. Finally, Williams was aware that Diatect's accounting for actual product returns was inconsistent with comments Diatect had received from the Commission staff. In its September 2003 SB-2 Comments, the Commission staff questioned Diatect's revenue recognition policy and, among other things, suggested that Diatect record product returns as a reduction of revenue. In response, Diatect added a footnote disclosure to its FY 2002 and 2001 financial statements that sales credits were treated as a reduction of revenues, but then reclassified its FY 2001 product returns as an increase to cost of sales in the financial statements included in its Form SB-2/A filed with the Commission on January 22, 2004. In its February 2004 SB-2 Comments, the Commission staff commented that Diatect should record product returns as a decrease to revenue, not an increase in cost of sales. Despite the Commission staff's SB-2 Comments, Diatect classified its FY 2003 returns – which totaled 28% of reported sales – as bad debt expense. Even though Williams was aware of the views expressed by the Commission staff on the proper accounting for the product returns, he performed no analysis to assess the appropriateness of the different accounting that Diatect used.

19. As part of his concurring review, Webster became aware of each of these revenue recognition issues, two of which he addressed in the Webster Memo. Aware of the Commission's SB-2 Comments, Webster informed Williams that the "S.E.C. is going to be adamant that [the 2001 and 2003 product returns] are treated as sales returns." Webster also noted that Diatect's return policy may be an obstacle to recognizing

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estimate for returns and allowances. See Diatect's Form SB-2/A filed with the Commission on January 22, 2004. Diatect's 2003 financial statements include no such disclosure, but Williams failed to assess whether circumstances had changed such that Diatect did, in 2003, have an ability to establish such an estimate. Williams was also aware, as described below, that Diatect had not, in fact, established any allowance for returns.

[21] See SFAS 48 at ¶ 7.

[22] Williams was aware, for example, that Diatect's product returns in 2003 totaled approximately $211,000 or 28% of reported sales.

revenue on sales at the time of shipment. Webster, however, concurred with W&W's decision to issue its report even though those issues remained inadequately addressed.

IV.

In view of the foregoing, and to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports, the Board determines it appropriate to impose the sanctions agreed to in Respondents' Offers. Accordingly, it is hereby ORDERED that:

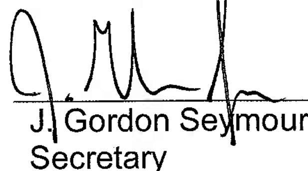
A. Pursuant to Section 105(c)(4)(E) of the Act and PCAOB Rule 5300(a)(5), Williams & Webster, P.S. is censured;

B. Pursuant to Section 105(c)(4)(B) of the Act and PCAOB Rule 5300(a)(2), Kevin J. Williams is barred from being an associated person of a registered public accounting firm, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i);

C. After two (2) years from the date of this Order, Williams may file a petition, pursuant to PCAOB Rule 5302(b), for Board consent to associate with a registered public accounting firm;

D. Pursuant to Section 105(c)(4)(B) of the Act and PCAOB Rule 5300(a)(2), John G. Webster is suspended for one (1) year from the date of this Order from being an associated person of a registered public accounting firm, as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i)

ISSUED BY THE BOARD.



J. Gordon Seymour
Secretary

June 12, 2007