Press Release

SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud

U.S.-Based Audit Committee Chair Charged for Complicity in Scheme

FOR IMMEDIATE RELEASE
2014-47

Washington D.C., March 11, 2014 — The Securities and Exchange Commission today charged an animal feed company and top executives with conducting a massive accounting fraud in which they repeatedly reported fake revenues from their China operations in order to meet financial targets and prop up the stock price.

The SEC alleges that four executives in China orchestrated the scheme at AgFeed Industries Inc., which was based in China and publicly traded in the U.S. before merging with a U.S. company in September 2010 and spreading its operations between the two countries. With the bulk of its hog production operations in China, the executives used a variety of methods to inflate revenue from 2008 to mid-2011, including fake invoices for the sale of feed and purported sales of hogs that didn't really exist. They later tried to cover up their actions by saying the fake hogs died. Because fatter hogs bring higher market prices, they also inflated the weights of actual hogs sold and correspondingly inflated the sales revenues for those hogs.

The SEC also charged a company executive and a company director in the U.S. with scheming to avoid or delay disclosure of the accounting fraud once they learned about it in 2011 while engaged in efforts to raise capital for expansion and acquisitions. The director, K. Ivan (Van) Gothner, was chair of AgFeed's audit committee. He sought advice from a former director and company advisor who responded in e-mail communications that there was "not just smoke but fire" and recommended that AgFeed hire professional investigators guided by outside legal counsel. However, Gothner ignored the recommendation and internalized the situation while false financial reporting continued.

The SEC also reached a settlement with another U.S.-based company executive and a cooperation agreement with a different executive in the U.S. The eight executives involved in the SEC's case are no longer at AgFeed, which is headquartered in Hendersonville, Tenn., and has filed for bankruptcy.

"AgFeed's accounting misdeeds started in China, and U.S. executives failed to properly investigate and disclose them to investors," said Andrew J. Ceresney, director of the SEC's Division of Enforcement. "This is a cautionary tale of what happens when an audit committee chair fails to perform his gatekeeper function in the face of massive red flags."

The SEC's complaint filed in U.S. District Court for the Middle District of Tennessee charges executive chairman Songyan Li, CEO Junhong Xiong, CFO Selina Jin, and controller Shaobo Ouyang as the management in China behind the scheme, which began in 2008 after AgFeed acquired 29 Chinese farms for its new hog production division. The inflated numbers that included sales of fake hogs and bloated weights of actual hogs were recorded in a fake "outside" set of books that the company provided to its outside auditors. The "inside" real set of books contained accurate, lower revenue numbers that were hidden from auditors. Li, Xiong, Jin, and Ouyang caused AgFeed to report false revenues of approximately $239 million.

According to the SEC's complaint, U.S. management learned of the accounting fraud by early June 2011, but failed to take adequate steps to investigate and disclose it to investors. Gothner and the CFO who replaced Jin after the merger, Edward J. Pazdro, specifically learned that AgFeed's China operations kept two sets of accounting books and that Ouyang had admitted to the fraud. Gothner and Pazdro even obtained a partial copy of the two sets of books as well as a memo from AgFeed's in-house counsel from China that concluded – based on witness accounts and documentary evidence – that the company was involved in a widespread accounting fraud. The memo noted that two sets of accounting books were maintained "in order to make AgFeed's revenue and net income look better." The memo concluded that Xiong and Jin had directed the accounting fraud, and Xiong had ordered the destruction of the second set of books.

The SEC alleges that instead of fulfilling their responsibilities as the company's stewards of financial reporting, Gothner and Pazdro failed to conduct or prompt the company to conduct any further meaningful investigation into the misconduct. Not only did they fail to disclose the fraud to investors or law enforcement, but Gothner and Pazdro instead engaged in efforts to spin off the company's feed division and raise capital for expansion and acquisitions that would enable profits for AgFeed and them personally. Even as additional red flags arose in June and July 2011, they failed to take appropriate actions. They misled AgFeed's outside auditor and caused the company to issue false and misleading press releases and SEC filings.

"Officers and directors have an obligation to exercise diligence and ensure that their financial reporting is accurate," said Julie Lutz, director of the SEC's Denver Regional Office. "Despite learning about false and misleading financial information, AgFeed executives failed to come clean with investors or law enforcement."

The SEC's complaint charges AgFeed, Xiong, Li, Jin, Ouyang, Gothner, and Pazdro with violating or aiding and abetting violations of the anti-fraud, reporting, books and records, and internal controls provisions of the federal securities laws. Xiong, Li, Jin, Ouyang, Gothner, and Pazdro also are charged with making false statements to AgFeed's outside auditors. The SEC's complaint seeks disgorgement of ill-gotten gains plus prejudgment interest as well as financial penalties and officer-and-director bars. The SEC also seeks to suspend Jin, Ouyang, and Pazdro from practicing as accountants on behalf of any publicly-traded company or other entity regulated by the SEC.

AgFeed's former chairman and interim CEO John A. Stadler separately consented to an SEC order barring him from acting as an officer or director and requiring him to pay a $100,000 penalty and cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-11, 13a-13, 13a-14, 13b2-1, and 13b2-2 thereunder. He neither admitted nor denied the findings in the order.

AgFeed's former CFO Clayton T. Marshall, who replaced Pazdro, entered into a cooperation agreement with the SEC. The terms of his settlement reflect his assistance in the SEC's investigation and anticipated cooperation in the pending court action. Marshall agreed to be suspended from practicing as an accountant on behalf of any publicly-traded company or other entity regulated by the SEC for a period of at least five years. Without admitting or denying the findings, he consented to an SEC order requiring him to cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-13, 13a-14, 13b2-1, and 13b2-2 thereunder. Whether a financial penalty should be imposed against Marshall will be determined at a later date.

AgFeed consented to an SEC order pursuant to Section 12(j) of the Exchange Act that revokes the registration of each class of its securities. The SEC's case against AgFeed in federal court is continuing.

The SEC's investigation was conducted by Michael Cates, Rachael Clarke, Donna Walker, and Ian Karpel of the Denver Regional Office. The SEC's litigation will be led by Nancy Gegenheimer and Gregory Kasper.

###

Related Materials

- SEC complaint
- SEC order - Stadler
- SEC order - Marshall