

## Sales go rogue

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### ABSTRACT

After trading closed on August 7, 2017, GlobalSCAPE Inc. announced that following its audit committee's investigation of dubious sales transactions, the company will restate previously issued 2016 annual financial statements and 2017 first quarter financial statements. This case illustrates the importance of corporate governance, regulation, and internal control as mechanisms to deal with fraud. Students will be able to identify some of the critical parties involved in corporate governance and understand the role of effective corporate governance in deterring fraud. The case will also help students to understand how the provisions of the Sarbanes–Oxley Act of 2002 are devised to help prevent frauds. Finally, the case is designed to help students to identify fraud risk factors and to appreciate the importance of internal control over financial reporting.

Keywords: Financial statement fraud, corporate governance, internal control, fraud risk, audit committee.

## INTRODUCTION

*“That’s your mulligan. You’re not going to miss again”* ...with that, the meeting ended, and their woes began. After trading closed on August 7, 2017, GlobalSCAPE Inc. announced that following its audit committee’s investigation of dubious sales transactions, the company will restate its previously issued 2016 annual financial statements and 2017 first quarter financial statements.

### The Company

Founded in 1996, GlobalSCAPE Inc. is headquartered in San Antonio, Texas. The company’s products aid clients in securely exchanging and transferring sensitive and proprietary information. The company has sold its products to thousands of organizations and over one million individual consumers worldwide. The current CEO, Matthew Goulett, believes that the mission of GlobalSCAPE is to serve businesses of all sizes across all geographic locations. To this end, the firm operates several branches in key international markets, with agents strategically located to provide prompt client service. GlobalSCAPE’s management constantly looks for new opportunities to expand and develop products and services to meet the company’s targets, focusing mainly on developing markets.

GlobalSCAPE’s primary business is selling and supporting managed file transfer (MFT) software for enterprises. This technology facilitates data transfer across a computer network within a single organization or between multiple computer networks in multiple organizations. The company has multiple revenue streams from its Managed File Transfer (MFT) products that include:

- Perpetual software licenses that allow customers to install the software in their information systems environment.
- Cloud-based, hosted SaaS solutions that the company sells on an ongoing subscription basis resulting.
- Maintenance and Servicing.
- Professional services for product customization and integration.

GlobalSCAPE historically receives a substantial portion of orders from its customers and generates a substantial portion of revenue during the last few weeks of each quarter<sup>1</sup> (GlobalSCAPE Inc, 2017).

### The Executive Team

The President and CEO at GlobalSCAPE, Inc. is Matthew (Matt) Goulett. Matt joined the firm in 2013, bringing nearly 20 years of experience in the networking, security, and storage industries. Before his role as CEO, Matt served as VP of Sales, responsible for global sales and marketing, strategy, engineering, research and development, and quality assurance teams. During his tenure as VP of Sales, Matt’s sales and marketing team generated the highest revenue growth in the company’s history. He is a dedicated and highly driven individual who expects the highest performance from himself, those he works with, and the business. His goal was to establish GlobalSCAPE as a market leader. As such, he expected his managers to work hard to meet the

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<sup>1</sup> The firm cites seasonality as one of its risk factors in its 2016 annual report.

company's goal. In particular, he was focused on sustaining growth in revenue and earnings at an accelerated rate.

In 2016, while announcing the promotions of Daniel (Dan) Burke to Vice President of Worldwide Sales, and Adam Snider to Vice President of Operations, Matt stated;

“Dan and Adam are incredibly talented individuals who have been vital to the recent success and growth of Globalscape. While we have worked tirelessly to break a number of the company's revenue records in the past few years, we have a challenging mission ahead of us to continue to propel Globalscape forward. I undoubtedly believe that Dan and Adam's experience, vision, and leadership will help raise and set the bar for our sales and operations teams for many years to come.” (GlobalSCAPE Inc., 2016)

Executives and managers who met the standards set by Matt were sure to share in the rewards by way of bonuses and other performance-based incentives. However, those who fell short of expectations were assured of having no future with the company.

GlobalSCAPE Inc. had a six-member executive team led by Matt. The team included the chief financial officer, the vice president of technical services, the vice president of worldwide sales, the vice president of operations, and the head of administrative services.

Before his role as VP of Worldwide Sales, Dan served as Enterprise Sales Manager from the time he joined the company in July 2013. In his role as VP of Worldwide Sales, Dan was responsible for leading and overseeing all direct and channel sales teams for GlobalSCAPE.

### **Organizational Culture**

The organizational culture at GlobalSCAPE provided a challenging, productive, engaging, and professionally rewarding work environment (GlobalSCAPE, 2017). Matt created excitement around the company while promoting a culture of commitment to high targets, teamwork, and cooperation. He also encouraged a sense of shared responsibility and empowerment. Following his example, employees often worked long hours to achieve ambitious targets. Many employees indicated that they enjoyed working in the innovative and mission-driven environment GlobalSCAPE promoted. For the third consecutive year and fifth time in the last seven years, the firm was ranked number three among twenty-nine small organizations on the Best Places to Work in IT list. GlobalSCAPE offered several programs and initiatives to recruit and retain talent, including competitive benefits, compensation, and performance-based incentives (GlobalSCAPE Inc., 2016).

The company rewarded high performance of its sales personnel through payment of commissions that were based on sales of products and services. Additionally, the company had incentive awards for employees that were based on the achievement of certain qualitative objectives such as customer and employee satisfaction, and compliance with regulatory requirements (Globalscape Inc., 2016).

### **THE INVESTIGATION: TRUTH EMERGES**

The audit committee's investigation revealed that Dan and the sales team were under severe pressure to meet sales targets. In a quarterly management meeting, Dan explained that his team would not be able to meet the sales forecast for the third quarter of 2016. That notwithstanding, management insisted that the team work toward achieving that quarter's previously set sales goals. As Dan had predicted, his team could not meet the third quarter sales

target, and at that point, he was reportedly told, “That’s your mulligan. You’re not going to miss again” (Mosbrucker, 2018) Given the inability to meet the third quarter sales target, Dan was under severe pressure to meet sales targets in the fourth quarter as the sales reported in the fourth quarter was critical to the company achieving sales and earnings targets for fiscal year 2016. Another reason for the severe pressure on Dan and the sales team to achieve 2016 fourth quarter targets was that the chairman of the audit committee (David L. Mann), and the chairman of the board of directors (Thomas Brown), planned to sell a substantial amount of shares in early 2017.

In order to boost sales in the fourth quarter, Dan and an undisclosed collaborator engaged in a practice known as stocking orders. Stocking orders was the practice of getting customers to purchase GlobalSCAPE’s software in earlier periods than they will typically purchase the software. Customers were encouraged to purchase software in earlier periods through incentives that were part of informal side-agreements but excluded from the sale agreements with customers. The informal side-agreements were hidden from the external auditors and undisclosed in GlobalSCAPE’s 2016 annual report filing. GlobalSCAPE’s fourth quarter sales was significantly boosted by the stocking orders but there was still a shortfall between the sales that had been booked and projected sales. To make up for the shortfall in sales, Dan booked a fictitious sale that enabled him to meet his sales target and receive a sales commission. The fictitious sale also enabled GlobalSCAPE to report sales in its 2016 annual report filing that met projected sales for fiscal year 2016.

Soon after GlobalSCAPE’s external auditors (RSM) conducted the audit of the 2016 year-end financial statements, they were fired and the company hired BDO as its new external auditor. In May 2017, unknown to the newly hired external auditor, the company’s audit committee began to investigate Dan’s questionable sales schemes with the help of outside counsel and forensic accountants. In July 2017, BDO found out about the audit committee’s investigation and advised the chair of the audit committee, David L. Mann, that they needed to engage a sufficiently independent outside counsel to conduct the investigation as the outside counsel that was hired had a conflict of interest. According to BDO, the outside counsel had a conflict of interest because of previously conducting substantial work for GlobalSCAPE and having an ongoing working relationship with the company. However, GlobalSCAPE’s audit committee disagreed with BDO and rather dismissed BDO as external auditor on August 1, 2017.

Following the dismissal of BDO, the company announced on August 7, 2017 that it will restate its 2016 financial statements as well as the financial statements for the first quarter of 2017. According to the restatement announcement, the discrepancy caused by the questionable sales schemes resulted in an overstatement of accounts receivables for fiscal year 2016 and 2017 by \$403,000 and \$396,000, respectively. Additionally, revenues for fiscal year 2016 was overstated by \$396,000. Therefore, accounts receivables in the company’s 2016 financial statements was reduced from \$6.964 million to \$6.561 million. Moreover, total revenues and net income for fiscal 2016 were reduced from \$33.336 million to \$32.940 million and \$3.951 million to \$3.734 million, respectively. Finally, accounts receivables on the 2017 first quarter balance sheet was reduced from \$5.499 million to \$5.103 million (GlobalSCAPE, 2017).

## **EPILOGUE**

On August 9, 2017, shareholders filed a class action lawsuit against GlobalSCAPE and its CEO, board chairman, audit committee chairman, and other top management officers. In

October 2017, Dan resigned his position as VP of Worldwide Sales and subsequently pleaded guilty to wire fraud. In November 2017, GlobalSCAPE's external auditors resigned, citing their inability to rely on management's representations. On September 13, 2018, GlobalSCAPE agreed to settle the class action for \$1.4 million without admitting any wrongdoing.

## REQUIREMENTS

The case questions will help you to understand the importance of corporate governance, regulation, and internal control as mechanisms to address fraud. You will be required to explain provisions of the Sarbanes–Oxley Act of 2002 that are devised to help prevent frauds. You will also be required to identify fraud risk factors. Another requirement will be to analyze financial statements and identify indicators of possible misstatements. You will also be required to identify critical parties involved in corporate governance and explain the role of corporate governance in deterring fraud. Finally, you will be required to discuss internal control failures that allow for fraud to be perpetrated and provide recommendations for remediating ineffective controls.

## Questions

1. Explain any two requirements in the Sarbanes–Oxley Act of 2002 that are designed to help prevent financial statement fraud. How could the SOX requirements you identified have deterred the reporting of questionable sales transactions and fictitious sales by GlobalSCAPE?
2. Describe the “tone at the top” at GlobalSCAPE, Inc. How could the “tone at the top” you described have contributed to the possible occurrence of fraud?
3. Discuss how GlobalSCAPE's organizational culture could create an enabling environment for the perpetration of fraud.
4. Briefly discuss the risk factors that could have alerted GlobalSCAPE's external auditors about the questionable sales transactions and the fictitious sales.
5. Using the financial statements of GlobalSCAPE Inc. for 2015 to 2017, determine if there were any unusual trends that could indicate the occurrence of fraud.
6. Identify two critical parties involved in GlobalSCAPE's corporate governance and explain their role in either facilitating or deterring the questionable sales transactions and fictitious sales.
7. Briefly discuss the internal control failures that provided opportunities for Dan and his accomplice to book the questionable sales transactions and fictitious sales.
8. What recommendations would you make to strengthen GlobalSCAPE's internal controls?

## CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

### Case Learning Objectives

The case is intended to facilitate students' understanding of the importance of corporate governance, regulation, and internal control as mechanisms to deal with fraud. The case is also designed to encourage students to think critically about fraud risk factors and how to prevent fraud in an organization.

At the end of this case, students should be able to;

1. Describe the fraud triangle and identify fraud risk factors
2. Identify critical parties involved in corporate governance
3. Explain the role of effective corporate governance in deterring fraud
4. Explain the importance of the control environment in providing the foundation for the functioning of internal control throughout an organization
5. Identify examples of control environment deficiencies
6. Explain how the Sarbanes–Oxley Act of 2002 (SOX) is designed to help prevent financial statement fraud
7. Explain how ineffective internal controls provide opportunities to commit fraud.

### Implementation Guidance<sup>2</sup>

This case is suitable for an undergraduate-level auditing course. The case can be used to reinforce coverage of corporate governance, regulation, and internal control as mechanisms to deal with fraud. It may also be used as an introductory case for a graduate-level audit course. For graduate students, a less structured class discussion is suggested. At the undergraduate level, a more structured class discussion based on the discussion questions is recommended. It is recommended that students have access to the case at least a week before the scheduled class session (Naumes and Naumes, 2014). This will allow them to acquaint themselves with the related concepts and the issues in the case.

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<sup>2</sup> Instructors may contact the authors by email for a copy of the detailed teaching notes.

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