I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against AXM Pharma, Inc. (“AXM” or “Respondent”).

II.

In anticipation of the institution of these proceedings Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds that:
SUMMARY

This case involves a financial reporting fraud at AXM Pharma, Inc. ("AXM") during its second quarter of 2005 (the quarter ended June 30, 2005). Specifically, AXM, through its management, improperly recognized approximately $2.8 million in revenues on a series of sales to a distributor in Asia. These sales, on their face, clearly failed to meet several of the fundamental criteria for revenue recognition under Generally Accepted Accounting Principles ("GAAP"). As a result of the inclusion of this improperly recognized revenue, AXM reported revenues of over $3.2 million for the quarter, overstating its revenue by over 970 percent, and reported net income for the quarter of approximately $179,000, instead of a net loss of approximately $1.46 million.

RESPONDENT

1. AXM Pharma, Inc. is a Nevada corporation with principal executive offices in City of Industry, California. Its main operations are in the People’s Republic of China. AXM, through a wholly owned subsidiary in the People’s Republic of China, is a manufacturer of pharmaceutical and nutraceutical products. At all relevant times, AXM’s common stock was registered with the Commission pursuant to Sections 12(b) of the Exchange Act and was listed on the American Stock Exchange ("AMEX") under the symbol “AXJ.” The AMEX delisted AXM in June 2006, and its common stock is currently quoted on the Pink Sheets.

BACKGROUND

2. Prior to the quarter ended June 30, 2005, AXM’s primary business operations consisted of producing and selling pharmaceutical products in the People’s Republic of China. In 2002, AXM shut down its existing factory and began construction on a new factory. Consequently, without a production facility, from 2002 through the quarter ended March 31, 2005, AXM’s revenues had declined virtually to the point of nonexistence.

3. In January 2004, to generate revenue while its factory was out of operation, AXM obtained a license to sell certain Sunkist-branded vitamin products. These products were to be produced by third parties in the United States and sold in Asia via a distributor.

4. Between March and May 2005, AXM entered into distribution agreements with three subsidiaries of a Hong Kong-based company (the “Asian Distributor”) to sell the Sunkist products in Hong Kong, Taiwan, and Shanghai. Each of the agreements provided for payment to AXM after the Asian Distributor sold the goods to its customers, and specified that the transfer of title occurred upon delivery to the Asian Distributor’s warehouse. The agreements also gave the Asian Distributor a right of return for expired and other goods.

5. Pursuant to these agreements, from March through June 2005, AXM received purchase orders from the Asian Distributor for Sunkist products totaling $2.8 million. AXM recognized revenue for the full amount of these purchase orders on its financial statements for the quarter ended June 30, 2005.
IMPROPER REVENUE RECOGNITION IN THE SECOND QUARTER OF 2005

6. None of the $2.8 million from these product “sales” should have been recognized as revenue in the second quarter of 2005 because the Asian Distributor had the right to return the goods and did not have to pay AXM Pharma until after reselling the goods. Moreover, $1.9 million of the goods also did not meet the criteria for revenue recognition because AXM had not even delivered the product by the close of the quarter.

Right of Return

7. Statement of Financial Accounting Standards No. 48 ("SFAS 48") provides that where a seller grants a right of return, revenue may be recognized, only if the two following conditions, among others, are met: (1) the buyer has paid the seller and the obligation is not contingent on resale of the product; and (2) the amount of future returns can be reasonably estimated.

8. AXM did not meet either of the conditions under SFAS 48 because the Asian Distributor’s obligation to pay AXM was contingent on the resale of the products. AXM never obtained any evidence that the Asian Distributor sold any of the goods before the end of the second quarter and, in fact, no such sales took place.

9. AXM also failed to meet the requirement under SFAS 48 that returns be reasonably estimated. AXM and the Asian Distributor had no history selling the products or similar products. Moreover, AXM had no history working with the Asian Distributor. Thus, given AXM’s lack of historical experience with similar types of sales of similar products, it could not reasonably estimate future product returns. SFAS 48, therefore, precluded AXM from recognizing revenue during the second quarter of 2005.

10. GAAP provides “profit is deemed to be realized when a sale in the ordinary course of business is effected.” Accounting Research Bulletin No. 43, ("ARB 43"), Chapter 1A ¶ 1. Moreover, revenue should not be recognized until such time as the revenue is realized or realizable and earned. Statement of Financial Accounting Concepts No. 5 ("Concept No. 5"), ¶ 83. These conditions “are usually met by the time product or merchandise is delivered . . . to customers.” Concept No. 5, ¶ 84(a). Thus, AXM should not have recognized revenue of $1.9 million on product that it had not delivered as of the close of its second quarter.

MATERIAL MISSTATEMENT OF REVENUE AND NET INCOME

11. On July 21, 2005, AXM issued a press release stating that it expected to “post a quarterly profit” and that it had “shipped and booked sales in excess of $3.1 million in the second quarter.” AXM attached the press release as an exhibit to a Form 8-K filed with the Commission on July 21, 2005. On that day, the trading volume on AXM’s common stock increased more than ten-fold, and AXM’s stock price increased by 18% to $1.58 from the previous day’s close of $1.34.

12. On August 15, 2005, AXM filed the Form 10-Q for its second quarter of 2005. The financial statements contained in the Form 10-Q included revenues of $3.2 million and net
income of $179,000. In its Management Discussion and Analysis section ("MD&A") of the Form 10-Q, AXM described its second quarter results as “the best sales quarter in its history.”

13. The same day that AXM filed its Form 10-Q, AXM touted the record-setting quarter through another press release, at a conference call discussing the results for the quarter, and in a Form 8-K containing a transcript of the conference call.

14. On October 31, 2005, AXM announced that it would restate its 2005 second quarter results. AXM’s restated second quarter results ultimately reported revenues of only $329,000 and a loss of $1.5 million.

15. AXM’s chief executive officer, who also served as acting chief financial officer, resigned in October 2005.

**LEGAL ANALYSIS**

**Violations of Antifraud Provisions of the Exchange Act**

16. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit the making of misstatements or omissions of material fact in connection with the purchase or sale of a security. A fact is material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Information concerning a company’s financial condition and profitability is material information. See, e.g., SEC v. Murphy, 626 F.2d 633, 653 (9th Cir. 1980). AXM’s material misstatements included overstating revenue for the second quarter of 2005 by over 970 percent and falsely reporting net income rather than a substantial loss for the quarter.

17. Scienter is required to establish a violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Aaron v. SEC, 446 U.S. 680, 701-02 (1980). Scienter is “a mental state embracing intent to deceive, manipulate, or defraud.” Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). Recklessness satisfies the scienter requirement. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc). In making the false statements contained in the Form 10-Q, and in press releases and conference calls, AXM’s management acted intentionally or recklessly. Specifically, AXM management knew or recklessly disregarded information showing that a significant portion of the product had not been delivered to the Asian Distributor’s subsidiaries by the end of the second quarter. Furthermore, management knew that the Asian Distributor’s subsidiaries had no obligation to pay AXM until they sold the products to their customers. Management’s scienter is imputed to AXM. See SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1089 n.3 (2d Cir. 1972). As a result, AXM violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

**Reporting Violations**

18. Section 13(a) of the Exchange Act and Rules 13a-11 and 13a-13 require issuers of securities registered pursuant to Section 12 of the Exchange Act, such as AXM, to file with the Commission accurate current and quarterly reports, respectively. An issuer violates these provisions if it files a report that contains materially false or misleading information. See SEC v.
IMC International, Inc., 384 F. Supp. 889, 893 (N.D. Tex.), aff’d mem., 505 F.2d 733 (5th Cir. 1974). Rule 12b-20 under the Exchange Act similarly requires that these reports contain any additional material information necessary to make the required statements made in the reports not misleading. As described above, AXM filed a 2005 second quarter Form 10-Q with misstated financial statements and filed Forms 8-K that misstated AXM’s second quarter revenues. Thus, AXM violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-11, and 13a-13 thereunder.

Record-Keeping Violations

19. Section 13(b)(2)(A) of the Exchange Act requires reporting companies registered pursuant to Section 12 of the Exchange Act to “make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions . . . of the issuer.” As described above, AXM violated Section 13(b)(2)(A) of the Exchange Act by including entries in its books and records improperly recording revenue from the Sunkist sales.

Internal Control Violations

20. Section 13(b)(2)(B) of the Exchange Act requires reporting companies to devise and maintain a system of internal accounting controls sufficient to reasonably assure that transactions are recorded and financial statements are prepared in conformity with GAAP. AXM violated Section 13(b)(2)(B) of the Exchange Act by having no internal controls to assure that it accounted for its revenue correctly.

AXM’S REMEDIAL EFFORTS

21. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in AXM’s Offer.

Accordingly, it is hereby ORDERED that Respondent AXM cease and desist from committing or causing any violations and any future violations of Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-11, and 13a-13 thereunder.

By the Commission.

Nancy M. Morris
Secretary

5