Sino-Forest Fraud – Audit Challenges in China

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In mid-2011, Sino-Forest Corporation was a company with timber operations in China, including tree plantation (holding of timber for appreciation and/or harvesting), log and wood products trading, and manufacturing of wood products. Its shares were traded on the Toronto Stock Exchange (TSE) under the TRE symbol, with a total market capitalization in U.S. dollars of $4.2 billion at a share price of $18.21. However, in a research report dated June 2, 2011, Carson Block, the director of research of Muddy Waters, LLC, alleged that Sino-Forest Corporation was a reverse takeover (RTO) fraud,[1] “a multi-billion dollar Ponzi scheme . . . accompanied by substantial theft”, and estimated the real value of a share to be less than $1.[2] Sino- Forest share prices plummeted; the Ontario Securities Commission (OSC) investigated the company’s auditor, Ernst & Young, who subsequently settled a class action lawsuit with Sino-Forest’s shareholders for $117 million; PricewaterhouseCoopers was called in by Sino-Forest to substantiate its assets, but the company went bankrupt. Muddy Waters was sued for $4 billion for defamation in 2012, but the lawsuit has not proceeded.

The Muddy Waters Research Report

In the Introduction and Executive Summary of *Research Report*,[3] Carson Block makes the following allegations:

- Sino-Forest Corp. (traded on the TSE as TRE since 2010) has always been a fraud since it reported excellent results from early joint ventures even though the joint ventures never went into operation.
- TRE’s sales transactions for standing timber were fabricated. For example, reported sales in Yunnan province exceeded “the applicable harvesting quotas by six times,” and “transporting the harvested logs would have required over 50,000 trucks driving on two-lane roads winding through the mountains from this remote region, which is beyond belief (and likely road capacity).”
- “TRE massively exaggerates its assets.” Purchases of trees for planting have been overstated, few legitimate agents have been used, and “the other agents appear to have

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[1] In a reverse takeover, a deal is made wherein a private company causes a public company (whose shares are traded on a stock exchange) to take over the private company so that its owners receive shares in the public company and can thereby gain access to capital markets to raise funds through public share offerings from the public company. In effect, the owners of the private company obtain a stock exchange listing by a reverse takeover without going through the scrutiny or effort required for an initial public listing and share offering.
[2] Muddy Waters Research Report, June 2, 2011, http://www.muddywatersresearch.com/research/tre/initiating-coverage-treto.
[3] Ibid., 1–3.

been laundering money for TRE—moving large amounts of money to an undisclosed subsidiary of TRE and a trading company that TRE does business with. We also see clear evidence that TRE has falsified its books."

- In order to raise funds, TRE engaged Jakko Pöyry, a valuations company, to provide credible valuation reports on growing trees. However, TRE has been "all the while giving Pöyry manipulated data and restricting the scope of its work." According to the Research Report, Pöyry has been allowed to inspect "only 0.3% of [TRE's] purported holdings."
- TRE was using offshore companies, including "at least 20 British Virgin Island entities" that obscure the transparency of company operations.
- Forged documents were being used and were not detected by the auditors.
- TRE's Board of Directors, Audit Committee, and auditors were not sufficiently familiar with the politics, industry practice, language, and culture of the People's Republic of China.

The Reaction

Not surprisingly, Sino-Forest rejected these allegations, but the company's share price plunged 82% during July before rallying somewhat.[4] In addition, on June 6, 2011, Sino-Forest announced that an independent committee (IC) had been set up to review the Muddy Waters allegations. PricewaterhouseCoopers (PwC) was hired to conduct an independent investigation.[5] On August 15, it was announced that the PwC report would be delayed to the end of the year, and on August 26, the OSC suspended trading of TRE, stating that the company "appears to have engaged in significant non-arm's-length transactions which may have been contrary to Ontario securities laws and the public interest."[6]

On November 15, 2011, the IC issued an interim report that stated that PwC, whose report was due out by the end of December, had confirmed most of the cash balances expected in Hong Kong and in the rest of China. The IC had confirmed a total of 293 cash accounts in Hong Kong, "representing 100% of the expected cash position" in that city, and had confirmed twenty-eight of the 267 accounts elsewhere in China, "representing approximately 81% of the expected cash position in China."[7] However, there were "significant challenges in verifying the company's

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[4] Christopher Donville and Matt Walcoff, "Sino-Forest Shares Surge after Wellington Management Discloses 11.5% Stake," *Bloomberg*, July 5, 2011, accessed July 2, 2013, at https://www.bloomberg.com/news/articles/2011-07-04/wellington-controls-11-5-of-sino-forest-as-timber-producer-s-stock-drops.

[5] "Sino-Forest Corporation Announcement: SINO-Forest Independent Committee Appoints PricewaterhouseCoopers," June 6, 2011, accessed July 2, 2013, at http://www.kmlaw.ca/site_documents/A-125%20-%20-Sino%20Press%20Release%20-%20June%206,%202011%20-%20SF%20Independent%20Committee%20Appoints%20Pricewaterhousecoopers.pdf.

[6] OSC Alleges Fraud at Sino-Forest, CBC News, August 26, 2011, accessed Jan. 23, 2020, at https://www.cbc.ca/amp/1.1068664.

[7] ""Sino-Forest Announced Findings of the Independent Committee," CNW Canada Newswire, Jan. 31, 2019, accessed Jan. 23, 2020 at https://www.newswire.ca/news-releases/sino-forest-releases-final-report-of-the-independent-committee-509527541.html.

timberland holdings" particularly since, in some areas of China, a plantation rights certificate (PRC), which reflects landownership in a computerized land titles system, had not yet been issued.[8] "The [interim] report [also] noted that there was incomplete or inadequate record creation and retention practices, no integrated accounting system and employees conducted company business from time to time using personal devices and non-corporate email addresses."[9] The Board of Directors also concluded that they could not release the company's third-quarter results that were due on November 14, 2011, until outstanding issues had been resolved.[10]

Not surprisingly, the interim report did not stabilize the situation, which quickly degenerated. On January 10, 2012, Sino-Forest announced in a press release "that it still [could not] release the third quarter financial statements because it [had not] been able to determine the nature of certain relationships between the company and its business partners."[11] Moreover, "the circumstances that could cause the company to be unable to release the Q3 results could impact the company's historic financial statements. *For this reason, the company cautions that the company's historic financial statements and related audit reports should not be relied upon*."[12] As a result, the company began "scrambling to convince a majority of holders of two of its bond issues not to tip the company into default. It needs a majority to agree to grant the company waivers from default after it failed to release its financial results and skipped a $9.8-million interest payment in December."[13]

On March 30, 2012, Sino-Forest filed for bankruptcy protection in Canada to give it time under court supervision to make a deal with creditors.[14] On the same date, Sino-Forest sued Muddy Waters and Carson Block for $4 billion ($3.5 billion for defamation, punitive damages of $400 million, and another $100 million for the cost of investigative "the tortious false allegations").[15] The suit alleges that Muddy Waters, along with 100 unnamed hedge funds, set up short positions in Chinese companies with listings on Western stock exchanges. The suit then alleges the group would put out "what is popularly described as a 'bear attack' on the companies" in the form of a report with a "veneer of truth" that would create a "cataclysmic effect on the

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[8] Ibid.

[9] "Sino-Forest Report Disputes Fraud Allegations," *CBC News*, November 15, 2011, accessed July 2, 2013, at http://www.cbc.ca/news/business/story/2011/11/15/sino-forest-fraud-report.html.

[10] "Sino-Forest Announced Findings of the Independent Committee."

[11] Andy Hoffman, "Sino-Forest Warns Historic Financial Documents Should Not Be Relied Upon," *The Globe and Mail*, January 10, 2012, accessed July 3, 2013, at http://www.theglobeandmail.com/globe-investor/sino-forest-warns-historic-financial-documents-should-not-be-relied-upon/article1358189.

[12] Ibid., emphasis added.

[13] Ibid.

[14] "Sino-Forest Files for Bankruptcy Protection," *BBC News*, accessed July 2, 2103, at http://www.bbc.co.uk /news/business-17569840.

[15] David Benoit, "Dow Jones Company from Sino-Forest Sues Muddy Waters for $4 Billion," *Wall Street Journal*, March 30, 2012.

stock price,"[16] which would allow Muddy Waters and other hedge funds to profit by filling their short positions at depressed stock prices.

On December 3, 2012, a hearing was held by the OSC into allegations against the company auditors, Ernst & Young.

On December 10, 2012, the Ontario Superior Court approved a transaction whereby the assets of Sino-Forest Corp. were transferred to the company's bondholders, [17] and on January 30, 2013, a new company, Emerald Plantation Holdings Limited, was formed to receive those assets.[18]

OSC Allegations against Ernst & Young LLP

According to the Statement of Allegations presented at the December 3, 2012, hearing, the OSC alleged that Ernst & Young did the following:

- Failed to perform sufficient audit work to verify Sino-Forest's ownership of its most significant assets.
- Failed to perform sufficient audit work to verify the existence of Sino-Forest's most significant assets.
- Failed to undertake their audit work on the Sino-Forest engagement with a sufficient level of professional skepticism.

Moreover, Ernst & Young failed to comply with Canadian generally accepted accounting standards (GAAS) although the firm had filed a number of documents with the OSC representing that they had done so.[19]

The discussion contained in the Statement of Allegations is very informative, particularly in regard to the following audit requirements:

Generally Accepted Auditing Standards

28. As set out in GAAS, an auditor's objective is to identify and assess the risks of material misstatement, whether due to fraud or error, in an entity's financial statements. An auditor can achieve this objective by understanding the entity and its environment, including the entity's

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[16] Ibid.

[17] Peter Koven, "Judge Approves Sino-Forest Restructuring despite Opposition from Funds," *Financial Post,* December 12, 2011, accessed July 2, 2013, at http://business.financialpost.com/2012/12/11/judge-approves-sino-forest-restructuring-despite- opposition-from-funds.

[18] See http:// www.emeraldplantationholdings.com, accessed July 3, 2013.

[19] *Statement of Allegations*, OSC Hearing, In the Matter of the Securities Act, R.S.O. 1990, c. S.5 as Amended—and—in the Matter of Ernst & Young LLP, December 3, 2012, Sections 2–4, accessed July 2, 2013, at https://www.osc.gov.on.ca/en/Proceedings_soa_20121203_ernst-young.htm.

internal controls. This understanding provides the auditor with a basis for designing and implementing responses to the assessed risks.

(a) Sufficient Audit Evidence Required

29. GAAS requires auditors to obtain reasonable assurance that the entity's financial statements are free from material misstatements. Reasonable assurance is a high level of assurance. It is achieved when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to a low level and to provide a reasonable basis to support the content of the audit report. The sufficiency of the audit evidence gathered by the auditor is influenced by the level of materiality set for the audit and the level of risk associated with the audit.

30. The sufficiency and the appropriateness of the audit evidence gathered by the auditor are interrelated. Sufficiency is the measure of the quantity of the audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of misstatement. That is, the higher the assessed risks, the more audit evidence is likely to be required. The quantity of audit evidence needed is also affected by the quality of the audit evidence. That is, the higher the quality of the audit evidence, the less audit evidence may be required.

31. Obtaining more audit evidence, however, may not compensate for its poor quality. Appropriateness is the measure of the quality of the audit evidence; that is its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of the audit evidence is influenced by its source and by its nature, and is dependent on the circumstances in which it is obtained.

(b) Professional Skepticism Required

32. GAAS requires auditors to plan and perform their audits using professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism requires a questioning attitude which is alert to conditions which may indicate possible misstatement due to error or fraud. Professional skepticism requires an auditor to conduct a critical assessment of the audit evidence.

33. Professional skepticism requires the auditor to be alert to, amongst other things:

a. audit evidence that contradicts other audit evidence obtained;
b. information that brings into question the reliability of documents and responses
c. to inquiries;
d. conditions that may indicate possible fraud; and circumstances that suggest the need for additional audit procedures in addition to those required by minimum written professional standards.[20]

The SOA goes on to detail how, in the OSC's opinion, Ernst & Young did the following:

[20] Ibid.

- Failed to adequately address ownership of timber:
    - Due to flawed purchase contracts: failure to collect al l relevant documents, and to note that locations of timber were not specific. (SOA Sections 40–41); and failure to note that the same survey firm prepared all timber surveys throughout the PRC.
    - Due to an insufficient understanding of the company's legal claim to its Purported Assets (Section 44), and to appreciate the limits of a legal opinion (the Jingtian Opinion) discussing the legal regime relating to forestry assets (Section 46); and so did not follow up when and in such ways as appropriate.
- Failed to adequately address the existence of timber and the audit risks inherent in that the company did not make cash payments for the acquisition of Purported Assets as evidenced by:
    - limited and ineffectual site visits (Section 52) and
    - inappropriate reliance on periodic valuations prepared by Pöyry Forest Industry Ltd. Relative to GAAS requirements (Sections 54–58)
- Failed to conduct its audits with a sufficient level of skepticism (Sections 59–60).
- Failed to properly structure the audit team so that Chinese speaking personnel were represented at all levels rather than relying on translated documents from which some important information was missing (Sections 61–63).[21]

Ernst & Young has denied the OSC allegations.

The Aftermath

On December 5, 2013, the OSC announced that its hearing to determine the veracity of its allegations of fraud against Sino-Forest and its executives, originally scheduled for June 2013, would be further delayed until September 2, 2014.[22]

On a separate but related matter, Ernst& Young was the subject of a $9.18 billion class-action lawsuit launched by Sino-Forest shareholders who charged audit negligence. Ultimately, Ernst & Young made a $117 million deal to settle the lawsuit. Some shareholders were unhappy with the settlement, which blocked further lawsuits, but the Ontario Court of Appeal rejected a challenge to this settlement on June 26, 2013.[23]

Muddy Waters continues to investigate and reveal fraudulent activity in other companies. It lists its track record of uncovering business fraud, accounting fraud, and fundamental problems,

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[21] Ibid. See sections noted in the OSC Statement of Allegations.

[22] Barbara Shecter, "OSC Hearing to Test Fraud Allegations against Sino-Forest Delayed," *Financial Post*, December 5, 2013, accessed December 30, 2103, at http://business.financialpost.com/news/fp-street/osc-hearing-to-test-fraud-allegations-against-sino-forest-delayed.

[23] Jeff Gray, "Auditors' Sino-Forest Settlement Stands," *The Globe and Mail*, June 27, 2013, B7, http://www.theglobe-andmail.com/report-on-business/industry-news/the-law-page/ontario-court-approves-117-million-settlement-with-sino-forest-auditors/article10044252.

including important Sino-Forest events, on its Web page at http://www.muddywatersresearch.com/track-record. It will continue to be an important force as it fulfills its stated purpose as follows:

“Speaking Truth to Power

In the face of egregious market inefficiencies, Muddy Waters refuses to be deterred by the financial marketplace’s insider titans. We speak truth to power, even when the message is unpopular or threatening to the status quo, and often when nobody else is willing to do so.”[24]

Questions

1. Do you think that a professional accountant should have been professionally skeptical enough to detect the first six allegations made by Carson Block in his *Research Report*?
2. What possible reasons could there be for members of the audit team not identifying the issues and/or facts underlying the six allegations?
3. What accounted for the fact that Carson Block, who is not a professional accountant, could have found and understood the issues and/or facts underlying the six allegations, when several professional accountants did not?
4. What red flags embedded in the case description should have triggered heightened professional skepticism in the minds of professional accountants on the audit team?

Additional questions are available in the source publication: *Business & Professional Ethics for Directors, Executives & Accountants*, 9e, Leonard J. Brooks & Paul Dunn, published by Cengage Learning, Inc., ©2021, ISBN: 978-0-357-44188-6.

[24] See Muddy Waters website, accessed December 30, 2013, at http://www.muddywatersresearch.com.

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