How solid are audits by reputable firms?

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Past fraudulent accounting cases here and abroad suggest that, the odds are, the next one is audited by one such outfit

AN ISSUE manager told me recently that once, he went through the list of S-chips or China companies listed on the Singapore Exchange and found about half of them to have good potential.

I asked what he meant by 'good potential'.

'For me, good potential means good business models, in sectors that are still growing strongly, and with sound management,' he said. 'And I would go so far to say there were companies where the cash per share sometimes exceeded market value.'

'But then, you question whether the cash is really there?' I asked.

'Well, everybody keeps throwing that back at me. Then I say look at the bottom, who signed it. If it's Ernst and Young, what are you saying then?

'And I think the SGX actually put up a statement saying that they have reviewed and they are satisfied (with the bank balances of these Chinese companies).

'I don't think they would dare put up statements like that if they haven't actually looked and assured themselves. This is a common question, but it is a lazy question.

'So you ask yourself: Are they the top-tier auditors? If yes, dare they allow these things to happen? It's their reputation, you know,' the issue manager said.

Well, the thing is, sometimes it is not a question of whether these top-tier auditors 'allowed' accounting shenanigans to happen under their noses. Sometimes, they might have been hoodwinked themselves, or might not have been that alert to the minor signs here and there.

How else do we explain the fact that PricewaterhouseCoopers, one of the world's largest accountancy firms, missed a systematic US$1 billion fraud at Satyam, the Indian information technology outsourcing giant, for as long as seven years?

B Ramalinga Raju, the former chairman of Satyam, shocked the world in early 2009 when he confessed to inflating the company's profitability, which led to more than US$1 billion in fictitious cash and other assets on its books.

The 'cash pile' that Satyam did possess was, in fact, just US$78 million, Mr Raju disclosed in a letter to the board.

Satyam's bogus accounts had been audited by Price Waterhouse, the India-based auditor which is a member firm of PricewaterhouseCooper International, since the financial year 2000-2001.

The company's balance sheet as at March 31, 2008 was signed off by Srinivas Talluri, a partner of Price Waterhouse in Hyderabad, the southern Indian city where Satyam is based.

In Singapore, Oriental Century requested a suspension of its shares after KPMG contacted the

company's chief financial officer on March 9, 2009, saying that it had difficulties seeking the reconfirmation of the bank balance and that there were doubts about the authenticity of a bank confirmation received earlier by KPMG.

Wang Yuean, the executive chairman and chief executive officer of the company, subsequently confessed to the board that he had over the years inflated sales and cash balances and had diverted unspecified sums to an interested party.

Oriental Century was listed in mid-2006. KPMG - a big and reputable international accounting firm - has been its independent auditor since then.

In the 2007 annual report, KPMG gave the opinion that Oriental Century Group's consolidated financial statement and the balance sheet of the company 'are properly done up in accordance with the provisions of the Act and Singapore Financial Reporting Standards to give a true and fair view of the state of affairs of the Group and of the Company as at Dec 31, 2007'.

It also expressed the opinion that 'the accounting and other records required by the Act to be kept by the Company have been property kept in accordance with the provisions of the Act'.

More recently, China Milk Products Group announced that it had the cash to repay its bondholders some US$146 million after they exercised their early put option to sell back the bonds to the company. The snag was that it hadn't received clearance from China's State Administration of Foreign Exchange (SAFE) to remit US$170.6 million in principal and interest payments out of the country.

But in February, after the resignation of its chief financial officer, company secretary and an independent director, China Milk admitted that it did not have enough cash in its bank accounts outside China to repay its bondholders.

Last week, it changed its statement again to say that it had enough cash to repay the US$170 million debt. In its last two audited balance sheets as at March 31, 2009 and March 31, 2008, the cash and bank balances were listed as 1.63 billion renminbi (US$240 million) and 1.74 billion renminbi respectively. The notes to the accounts, however, did say that the cash was deposited in banks in the People's Republic of China and hence was not freely convertible into foreign currencies.

But then, one wonders why China Milk took on the debts when it has such a big pile of idle cash sitting around in the banks in the PRC.

Grant Thornton is China Milk's external auditor.

Other S-chips which have reported accounting irregularities such as China Sun-Bio Chem and Fibrechem had PricewaterhouseCoopers and Ernst & Young as their auditors. However, it was E&Y which said that it couldn't finalise an audit of Fibrechem's trade receivables and cash balances for the year ended Dec 31, 2008 that subsequently led to the suspension of Fibrechem.

E&Y was appointed Fibrechem's external auditor at a special general meeting in September 2008 to replace Deloitte & Touche, not too long after the latter was reappointed the company's auditor on April 29, 2008.

Deloitte was Fibrechem's external auditor for the year ended Dec 31, 2007.

Meanwhile, numerous accounting fraud cases in the West also happened under the watch of reputable external auditors. This leads us to only one conclusion: a good brand name external auditor does not always guarantee fair and accurate accounting representation by the companies they audit.

An extension of that logic is that: if all auditing firms are equally likely to miss the detection of accounting frauds, then the probability is such that firms with more clients are more likely to see their names associated with fraudulent companies!

I've done a tally to see which firms have the biggest audit market share among the S-chips. The firm with the biggest market share is Grant Thornton in Hong Kong with a 17 per cent share, or 25 companies. Deloitte & Touche is second at 13.6 per cent or 20 companies. E&Y comes in third with 11.6 per cent share or 17 companies. Foo Kon Tan Grant Thornton in Singapore and KPMG are tied at fourth position with 8.2 per cent market share, or 12 companies each.

Hence, the next accounting irregularity, if ever there is one, has a very high chance of being audited by one of the five firms mentioned above!

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