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re: The Auditors

A China Fraud Dissected: Part 2 AgFeed's Auditors

By [Francine](#) • Feb 28th, 2014 • Category: [Latest](#), [Pure Content](#), [The Big 4 And Globalization](#)

"The optimist proclaims that we live in the best of all possible worlds; and the pessimist fears this is true." [James Branch Cabell](#) in his 1926 novel "The Silver Stallion."

An excellent, [long read](#) by Dune Lawrence at Bloomberg last December describes how the AgFeed fraud was discovered and why the company eventually delisted its own common stock from NASDAQ to avoid a mandatory delisting by the exchange. In [July of 2013](#), the company filed for [Chapter 11 bankruptcy](#). Lawrence's story provides the background you'll need to appreciate what I'm going to talk about next. See [Part 1 Milton Webster, AgFeed Audit Committee Member and Whistleblower](#), on this blog for more on this case.

Goldman Parks Kurland Mohidin LLP (Goldman) is the CPA firm that provided accounting services to AgFeed from at least 2007 to November 2010.

McGladrey & Pullen LLP (McGladrey) replaced Goldman as AgFeed's independent auditor in November 2010 and continued in that capacity through the end of the period that is subject to the litigation. According the second amended complaint for [Lawrence Blitz v. AgFeed Industries, Inc., Goldman Kurland & Mohidin LLP, McGladrey & Pullen LLP](#):

On September 13, 2010, AgFeed announced that it had completed its acquisition of M2P2, a major hog producer in the United States. In connection with the merger, M2P2's chairman, Defendant Stadler, became a director of AgFeed, and was elevated to Chairman and CEO of the entire Company only a few months later. Defendants Stadler and Gothner acted to consolidate control of the Company by its American directors and executives, by naming an American (Defendant Pazdro) to be CFO and retaining a known American accounting firm (Defendant McGladrey) to be the Company's external auditor.

[RSM China](#), the mainland China network firm for McGladrey & Pullen, says it is the 2nd largest firm of audit, tax and consulting in China and would benefit greatly from the [impending ban by the SEC](#) on the China Big Four and the former BDO firm, Dahua. [RSM Nelson Wheeler](#), the RSM Hong Kong network firm, was the auditor of ERA Mining Machinery Ltd, the Chinese mining equipment firm bought by Caterpillar Inc.. [Caterpillar later alleged accounting fraud](#) at an ERA subsidiary, Siwei, and took a \$580 million writedown on the purchase. ERA had absorbed Siwei through a reverse merger takeover in 2010.

Both Goldman and McGladrey are registered with the PCAOB, have been inspected more than once and continue to produce audit opinions for public issuers. The most recent inspection results for McGladrey, covering the same period as its engagement with AgFeed, were dismal.

From [Compliance Week](#):

Nearly two years after it began inspecting McGladrey in 2011, the Public Company Accounting Oversight Board [published its report](#) saying half of the audits it checked were deficient.

The PCAOB inspected 16 audits at McGladrey from August 2011 through December of that year and found problems with eight of the audits, in some cases numerous problems in a single audit. Many of the problems related to revenue recognition, allowances for loan losses, accounts receivable, taxes, inventory, and internal control over financial reporting.

In terms of the failure rate, McGladrey's 2011 report was a little worse than the [2010 report](#), where PCAOB inspectors checked 19 audit files and found problems with 9.

Goldman's record for audit deficiencies is even worse.

A PCAOB [report issued in August 2011](#) covered an inspection that was conducted between November 9, 2009 and November 23, 2009. The PCAOB looked at 4 engagements and found significant deficiencies with 2. Goldman has 1 office in Encino California that, in 2009, had 4 partners supervising ten professional staff auditing 24 public company issuers.

A more recent inspection, [dated January 2013](#), says that there are now only 3 partners, but a few more staff, 13, signing off on even more public company issuer audits, 27. The PCAOB inspection, running from November 28, 2011 to December 2, 2011 looked again at 4 public company issuer audits and, this time, found significant deficiencies in 3 of them.

This seems to be a case of going in the wrong audit quality direction. In fact, the plaintiffs believe one of the deficiencies noted in report issued in 2011 is about Agfeed.

From the [second amended complaint](#):

First, Goldman outsourced virtually all of the fieldwork to a third-party entity, BETL and/or Anshun, and lacked reasonable assurance that BETL and/or Anshun had adequately determined the fair value of assets, including property, equipment and inventory in the hog business and accounts

receivable and a corresponding allowance for doubtful accounts in the animal feed business. Indeed, in a review of a Goldman audit of AgFeed by the PCAOB, the PCAOB's investigators found that the audit "included deficiencies of such significance that it appeared to the inspection team that the Firm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements." See PCAOB Release No. 104-2011-224.36

Plaintiffs are informed and believe that the audit in question involved AgFeed. While the PCAOB Release does not expressly indicate that the Goldman audit found to be deficient was an AgFeed audit, the attached correspondence indicates that the audit involved the mispricing of breeder hogs and hog breeding equipment in a manner that could only refer to AgFeed. In particular, those assets referred to in the PCAOB Release track perfectly with those assets later found to be misstated in AgFeed's hog business. Moreover, Plaintiffs are aware of no other Goldman clients involved in the breeding hog business.

There is no indication on either the SEC or PCAOB website of an investigation of Goldman or its partner Mohidin. Is this one going to end badly, too, like the [Gately case](#)? PCAOB Chairman James Doty explains, in a speech in March 2011, the huge obstacle the regulator faces because of litigation secrecy requirements imposed by the Sarbanes-Oxley law:

Under the Sarbanes-Oxley Act as it exists today, the Board's enforcement proceedings are non-public, unless the Board finds there is good cause for a proceeding to be public and the parties consent to public proceedings. The auditors and audit firms that we charge with violating PCAOB auditing standards, or with other types of violations, have little incentive to consent to opening the case against them to public view.

On the contrary, the fact that, absent consent, our enforcement proceedings are required to be secret creates a considerable incentive to litigate, rather than settle. Litigation postpones — often for several years — the day on which the public learns that the Board has charged the auditor or firm and the nature of those charges. This secrecy has a variety of unfortunate consequences. Interested parties, including investors, audit committees, issuers and other auditors, are kept in the dark about alleged misconduct. Investors are unaware that companies in which they have invested are being audited by accountants who have been charged by the Board.

A case that recently became public only after the completion of SEC review of the Board's decision provides a good example. **In Gately & Associates, the firm issued 29 additional audit reports on public company financial statements between the commencement of the Board's proceeding and the public disclosure of the Board's charges, which did not occur until the SEC affirmed the Board's decision to expel the Gately firm from public company auditing and allowed the Board's sanction to take effect.**

That information, had it been available, could have made a difference to client and investor decisions regarding the firm or the companies it audits.

Two China-based audit firms support Goldman and derive the majority of their revenue from Goldman. They are also registered with the PCAOB and have never been inspected given China's prohibitions on physical inspections of Chinese audit firms by US regulators. Both firms continue to support Goldman.

That raises the question: How could McGladrey, and especially Goldman, be the principal auditor of AgFeed, signing the opinion in the US when a material portion of the revenue and assets, and the work done to audit them, is in China? And why did Goldman have two smaller firms in China splitting the work?

From [the second amended complaint](#):

Goldman also provided accounting services to at least three other companies associated with Chinese stock promoter Tianbing "Benjamin" Wey ("Wey"), whose New York Global Group ("NYGG") was closely affiliated with AgFeed during the Class Period. Furthermore, Goldman engagement partner Mohidin, through his prior firm, Kabani & Co, provided accounting services to at least eight other Wey-promoted stocks. Goldman was responsible for auditing AgFeed's books and records, and falsely certified that its 2008 and 2009 annual financial statements filed with the SEC conformed with GAAP.

In addition to its own alliance with Wey, Goldman retained third-party Chinese accounting firms Beijing Ever Trust CPAs Co., Ltd. (BETL) and Beijing AnShun International CPAs Co., Ltd. (AnShun) to do what it needed done on the ground in China. The [second amended class action complaint alleges](#) BETL and Anshun were also under Wey's influence. BETL and Anshun worked out of the same Chinese office building as Wey. The [complaint also says](#) BETL shared a computer server with Wey's NYGG. BETL and AnShun were the go-to firms for field work on audits of Wey-promoted companies and, therefore, the go-to China firms of Kabani and Goldman at Mohidin's direction. Working for Mohidin was the primary source of BETL and Anshun revenues, [according to the complaint](#).

As of September of 2013, Goldman and its partner Mohidin's prior firm, Kabani & Co, accounted for 10 of the total of the US-listed companies that have made disclosures in regulatory filings of serious fraud allegations, according to [this analyst's calculations](#). Mohidin is still producing opinions for Chinese US-listed companies even though it seems he's the PCAOB-sanctioned CPA with the most potentially fraudulent clients, second only to the partners at the giant firm of Deloitte & Touche Tohmatsu China.

Under different circumstances we might think that Goldman's Mohidin was deliberately breaking the AgFeed audit down into small pieces so neither firm exceeded the threshold for required PCAOB registration. The Sarbanes-Oxley Act and PCAOB standards say an audit firm must be registered with the PCAOB to prepare or issue, *or to play a substantial role in the preparation or furnishing of*, an audit report with respect to any US issuer.

What is the rule? The PCAOB's defines "substantial role" in PCAOB Rule 1001(p)(i) as an auditor who performs "the majority of audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute **20% or more of the consolidated assets or revenues of such issuer** necessary for the principal accountant to issue an audit report on the issuer."

BETL and Anshun, however, are both registered with PCAOB, albeit they've never been inspected by the regulator, given China's prohibition on physical inspections by the PCAOB.

Professor [Paul Gillis has suggested](#) some Chinese audit firms and their principal audit firm sponsors might play the game of splitting big audits into smaller pieces if the [SEC's ban on the Big Four goes into effect](#), especially if the ban is across the board, covering multinationals with operations in China and not just Chinese companies listed in the US.

Prior to the purchase of the Tennessee business in 2010, AgFeed's Chinese revenues and assets made up the vast majority of the income statement and balance sheet. One smaller Chinese firm could play the role of Plan A firm and the other Plan B, in case of problems with the first, but at least one would have crossed the AU 543 threshold that argues a Chinese audit firm not the Goldman in the US, should be signing AgFeed's audit opinion.

I explained the problem in detail in [a recent post](#):

Audit Practice Alert No. 6 at 2 noted that “in a 27-month period ending March 31, 2010, at least 40 U.S. registered public accounting firms with fewer than five partners and fewer than ten professional staff issued audit reports on financial statements filed with the SEC by companies whose operations were substantially all in the China region.”

The PCAOB’s recent re-proposal [of its standard for disclosure of other participating audit firms or experts](#) cites an example—a small US-registered public accounting firm signed an auditor’s report for an issuer based in China even though “the audit procedures performed by the other firm [based in China] constituted substantially all of the audit procedures on the issuer’s financial statements.”

Additional [recent enforcement actions](#) against US-based audit firms who signed audit reports for US-listed Chinese companies say those firms failed to properly audit Chinese companies.

What’s the PCAOB auditing standard regarding which firm can sign the audit in a multi-firm audit? [AU543.02](#).

The auditor considering whether he may serve as principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the audit may have been performed by other auditors. In the latter case, he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements. In deciding this question, the auditor should consider, among other things, the materiality of the portion of the financial statements he has audited in comparison with the portion audited by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he audited in relation to the enterprise as a whole. [As modified, September 1981, by the Auditing Standards Board.]

[Gillis addressed this](#) when explaining why companies won’t be able to choose to simply switch the signatures on Big Four Chinese audits opinions to Hong Kong if the mainland firms are banned:

Many people have asked me if the Big Four could circumvent the [SEC ban](#) by having the U.S. or Hong Kong firms sign the audit opinions. The short answer is no, and for several reasons.

In order for a U.S. or Hong Kong firm to serve as the principal auditor who is allowed to sign the report, the firm [has to comply with AU543].

In plain English, that means that in order to sign, you actually have to do the audit, or most of it. The firms cannot just sign the report in the U.S. or Hong Kong; the U.S. or Hong Kong firms must actually do the audit.

The [second amended compliant claims](#) that “Goldman and Mohidin are insulated from the reputational effects felt by other auditors who perform shoddy audit work” such as BETL and Anshun.

Goldman and Mohidin will continue to have lucrative relationships with Chinese reverse merger companies so long as they satisfy Wey. Thus, where other auditors seek to cultivate a reputation for probity and independence, Goldman and Mohidin seek to cultivate Wey’s good opinion of them and their usefulness to Wey’s purposes.

One of the most difficult things anyone suing an auditor has to prove is that the audit firm and/or its partners had anything to gain by being an aider, abettor, or co-conspirator in a fraud perpetrated by a client. In the [Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 \(7th Cir. 1986\)](#) case which involved the old Ernst & Ernst firm, the judge observed that the case “against an aider, abettor, or conspirator may not rest on a bare inference that the defendant ‘must have had’ knowledge of the facts. The plaintiff must support the inference with some reason to conclude that the defendant has thrown in his lot with the primary violators.”

Later, in 1990, in the [DiLeo v. Ernst & Young](#) case related to the failure of Continental Illinois National Bank, the judge accepted this argument and took it “to the bank”, expressing a strong belief that an audit firm and its partners will, above all, think about the firm’s and their own reputations first. Almost every case that touts the auditors’ sacred reverence for reputation as a defense cites DiLeo v. EY.

An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years’ audits could not approach the losses E & W would suffer from a perception that it would muffle a client’s fraud. And although the interests of E & W’s partners and associates who worked on the Continental audits may have diverged from the firm’s, see [AMPAT/Midwest, Inc. v. Illinois Tool Works, Inc., 896 F.2d 1035, 1043 \(7th Cir.1990\)](#), covering up fraud and imposing large damages on the partnership will bring a halt to the most promising career. E & W’s partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with Continental.

I don’t buy it.

Is it irrational to believe that auditors are capable of acting capriciously, in a self-interested manner and, perhaps, like any other human being, against the law? Are auditors the [market eunuchs in our capitalist system](#), immune from the influence of financial incentives? I think we’ve seen enough auditor-blessed Chinese frauds and [audit partner inside traders](#) just in the last five years to force reconsideration of such a [Pollyannaish](#) view. It’s time to stick a fork in this anachronistic idea of our profession and say, finally, that it’s done.



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3 Responses »

1. Steven Paulich on [February 28th, 2014 at 11:27 am](#):

Francine,

Thank you for reporting on Agfeed. As a shareholder, I'm at a loss with this company because there is absolutely no financial reporting coming out of this company for the past four years and nothing with regards to it's day to day operations and bankruptcy.

I hope to read more.

Thanks again,
Steven Paulich

2. [Francine](#) on [February 28th, 2014 at 11:36 am](#):

@ Steven Paulich

My pleasure. My understanding is that it is moving along in the bankruptcy proceedings but I hope through my articles to give the SEC and PCAOB investigations a big giant nudge.

Next up are the parts about Protiviti and the role of Latham & Watkins law firm.

3. [Fraud Files Forensic Accounting Blog » Benjamin Wey Threatens Investigative Reporter Francine McKenna](#) on [April 3rd, 2014 at 11:34 am](#):

[...] In February, Ms. McKenna wrote about the auditors of AgFeed, a Chinese company involved in an elaborate accounting fraud. In March 2014, the Securities and Exchange Commission charged the company and its top executives with fraud: 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. [...]

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• About the author

 Francine McKenna (@retheauditors) is the Transparency Reporter at MarketWatch.com, a Dow Jones publication, where her work is also featured frequently in the Wall Street Journal. McKenna had more than twenty-five years of experience in consulting and professional services including tenure at two Big 4 firms, both in the US and abroad before becoming a journalist. Look for her prior columns, "[Accounting Watchdog](#)" at Forbes.com and "[Accountable](#)" at American Banker. For more information, click "About" at the bottom of this page. For more information contact Francine McKenna, fmckenna@mckennapartners.com

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