

SINO-FOREST CORPORATION: THE CASE OF THE STANDING TIMBER

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ABSTRACT

The Sino-Forest Case provides a real-world example of financial misstatement and audit failure.² The case encompasses related parties, auditing procedures for tangible assets, and internal controls. Sino-Forest Corporation was engaged primarily in the purchase and sale of standing timber in the People's Republic of China (PRC). The principal executive office was in Hong Kong and its securities were traded on the Toronto Stock Exchange until 2011. The management of Sino-Forest created a complex web of subsidiaries and related entities whereby it controlled the purchase and sale of standing timber in widely dispersed regions of the PRC. Sino-Forest personnel created false documents related to these transactions, which were materially misstated in the company's financial statements. Sino-Forest auditors failed to properly recognize and deal with these misstatements, despite concerns expressed by members of the audit team about a lack of evidence regarding the standing timber assets. As a result of these problems, the company was delisted from the Toronto Stock Exchange and is now defunct.

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² Unless otherwise noted, this case is based on four Ontario Securities Commission (OSC) Enforcement actions related to Sino-Forest and its auditor (OSC 2012a, OSC 2012b, OSC 2014a, OSC 2014b).

SINO-FOREST CORPORATION HISTORY AND BACKGROUND

Sino-Forest Corporation was a company engaged in forestry-related businesses in the People's Republic of China (PRC). Their last annual report (Sino-Forest 2011a, p. 2) states that:

Its principal businesses include the ownership and management of plantation forests, the sale of standing timber and wood logs and the complementary manufacturing of downstream engineered-wood products.

The principal executive office was in Hong Kong. Because Sino's securities were traded on the Toronto Stock Exchange,³ the company was a registered issuer with the Ontario Securities Commission, and its financial statements were therefore prepared in accordance with Canadian generally accepted accounting principles (GAAP).⁴ For the issues presented in this case, there are no material differences between Canadian and US GAAP.

Sino-Forest was co-founded in 1994 by Allen Chan, a Hong Kong national and graduate of Hong Kong University. Allen Chan's background is varied and unique, spanning journalism, government, and business. His interest in the potential to develop forestry as a profitable business was aroused after the United Nations 1992 Earth Summit in Rio de Janeiro. As his reputation in the field grew, he became a member of a top advisory committee on forestry to China's parliament. He was also a vice president of China's National Forestry Industry Federation. These positions reflected his standing within the forestry business in China.

The company's capital and assets appeared to have materially expanded from 2003 to 2010. During this period, Sino-Forest raised \$3.0 billion through the issuance of debt and equity securities to support its expansion. By March 2011, the company's market capitalization was CDN \$6.0 billion. In its September 2009 reports, Sino-Forest claimed 757,000 hectares⁵ of trees under management and another 700,000 hectares of trees which they asserted to control through rights to acquire the timberland. The total land that Sino-Forest said they controlled was roughly five times the size of the country of Luxembourg. As the company reported increasing profits, its share price rose from CDN \$5.75 in June 2006 to CDN \$25.30 in March 2011, an increase of 340%.

In June 2011, warnings of fraud by Carson Block, a private analyst and founder of Muddy Waters Research, caused the stock price to drop precipitously. Alan Chan responded to the allegations in various forums, one of which can be seen on a YouTube video.⁶ At this time, the Board of Directors created an independent Committee to investigate the alleged wrongdoing.

³ Other than the listing on the Toronto Stock Exchange, the company had no material connection to Canada.

⁴ Beginning in 2011, most Canadian companies began switching to International Financial Reporting Standards (IFRS). The change to IFRS does not materially affect the implications of this case.

⁵ One hectare is equal to approximately 2 ½ acres of land.

⁶ Available at: <https://www.youtube.com/watch?v=apjGBEtA9Uc&t=206s>

The British Virgin Islands (BVI) Business Model

“浑水摸鱼” (Muddy waters make it easy to catch fish), Chinese proverb.

The corporate structure of Sino-Forest appeared to be typical and straight-forward throughout the period of concern identified by the Ontario Securities Commission (i.e., June 30, 2006 – January 11, 2012). As presented in Figure 1, the company had two operating divisions: Wood Fiber and Manufacturing. Wood Fiber was the dominant division and was involved in two lines of business: Standing Timber and Trading of Wood Logs. The Standing Timber business was by far the larger line of business, contributing 75% of Sino-Forest’s revenue and holding 80% of its assets. Standing Timber’s business activities were conducted using two groups of subsidiaries: the Wholly Foreign-Owned Enterprises (WFOE), which represented only about 5% of total sales, and the British Virgin Island subsidiaries (BVI).

The BVI subsidiaries were incorporated in the British Virgin Islands; their business model was more complex than that of the WFOEs, and will be referred to as “the BVI Model.” Sales through this business model represented over 70% of Sino’s total sales.⁷ Under the BVI model, Sino-Forest did not acquire or cultivate timber land. Instead, the BVI subsidiaries purportedly contracted with timber suppliers located in China to acquire standing timber. The BVI subsidiaries then purportedly contracted to sell the timber to two types of customers: authorized intermediaries (who Sino-Forest asserted would sell the timber on to other customers) and peripheral or nominee customers (who would presumably hold onto or use the timber themselves). Both types of customers were located in the PRC. In reality, the suppliers and customers that Sino-Forest’s BVI subsidiaries did business with were comprised of a complex group of people and entities all of which were associated with Sino-Forest (i.e., related parties). All or most of the purchases of timber and timber lands from suppliers and the sales of standing timber under the BVI model were transacted among related parties.

While the suppliers and customers in the BVI Model were not part of the official legal structure of Sino-Forest, they were related parties nonetheless through what were known as “caretakers” (see Figure 2). Well in the background, these “caretakers” were, for the most part, employees or former employees of Sino-Forest. They acquired controlling interests in the suppliers and the authorized intermediaries and peripheral customers, who were in fact entities related to and controlled by executives at Sino-Forest.

For example, one of Sino-Forest’s major authorized intermediaries (i.e., customers) was Dongkou, which allegedly purchased \$125 million in standing timber from Sino-Forest in 2008. Dongkou was actually owned by two employees of Sino-Forest, and the purchase contracts from Dongkou (Sino-Forest’s purported customer) were actually prepared by employees of Sino-Forest (OSC 2012a, ¶ 66 to 70). One of Sino-Forest’s major suppliers was also controlled by the

⁷ Because the BVI subsidiaries represented the bulk of the timber revenue and the area misstated, the case focuses on the BVI aspect of Sino-Forest’s business.

company. Yuda Wood was Sino-Forest's largest supplier, accounting for 18% of all purchases made under the BVI model, and purportedly the recipient of \$650 million from Sino-Forest. The company was founded and capitalized by members of Sino-Forest's management, who also controlled Yuda's bank accounts (OSC 2012a ¶ 61 to 65).

Standing Timber Revenue

Table 1 illustrates the significance of the BVI Model in terms of the revenue generated from standing timber assets. BVI subsidiaries bought and sold these assets to produce revenue for Sino-Forest. In 2010, only five customers accounted for 100% of the revenue Sino-Forest had in the BVI Model.

Sino-Forest's revenue recognition policy for standing timber sales was stated in its 2007 financial statement as follows (Sino-Forest 2008, p. 29):

Revenue from standing timber is recognized when the contract is entered into which establishes a fixed and determinable price with the customer, collection is reasonably assured and the significant risks and rewards of ownership have been transferred to the customer.

The Staff of the Corporate Finance Branch of the Ontario Securities Commission wrote a letter to the CFO of Sino-Forest on May 13, 2008 indicating concerns about the revenue policy disclosure and requesting confirmation that the "significant risks of ownership are transferred to the customer [when] the contract is signed" (OSC 2014a, ¶ 75).

The cash flows from the revenue transactions were also unusual and are presented in the diagram on Figure 3. Normally, the buyer of goods pays the company that sold them the goods (i.e., the seller). The company selling the goods can then use the resources provided by its customers to purchase more goods or for other purposes. The amount of cash paid by customers is unlikely to equal the amount of cash paid to suppliers. However, Sino-Forest did not collect cash from its customers. Instead, they told their customers to pay the supplier directly, purportedly to pay for Sino-Forest's purchases of additional standing timber. Because of this unusual arrangement, the cash inflows and outflows were not recorded in Sino-Forest's books.

Standing Timber Assets

At December 31, 2010, Sino-Forest reported total timber holdings of 799,700 hectares with a total value of US \$3.1 billion, 80% of which were held in the BVI Model. Sino-Forest used purchase contracts to acquire standing timber from a small group of suppliers that in 2010 numbered only six vendors. Each purchase contract was intended to have attachments in four appendices. The appendices were to contain:

- Plantation Rights Certificates or other ownership documents;
- Farmers' Authorization Letters; and

- Two appendices giving the Timber Survey Reports including stock volume and a resource quality survey.

Plantation Rights Certificates provide evidence that the holder has ownership rights to property while the Farmers' Authorization Letters signify that title has passed from the original owner. In fact, these documents were never found with the purchase contracts because Sino-Forest did not have them. Furthermore, specific locations of standing timber were not clearly identified in the purchase contracts or in the Timber Survey Reports as required.

AUDIT ISSUES RELATED TO SINO-FOREST'S STANDING TIMBER ASSETS

Ernst & Young, LLP, Canada (EY) was Sino-Forest's auditor from August 2007 until April 2012. EY's audit report on Sino-Forest's 2010 Financial Statement is presented in Exhibit 1. EY's audit plan recognized that there was higher inherent risk of misstatement regarding Sino-Forest's assets. In their audits of the Standing Timber Assets, EY's main procedures involved physical observation of the timberland (site visits), gathering evidence about the value assigned to the timberland, and obtaining legal opinions for Sino-Forest's claims of ownership and control of the timberland.

Sino-Forest's timber assets were widely scattered throughout China. The OSC states that "Ernst and Young performed only very limited site visit" to inspect the assets. The OSC indicates that the extent of the site visits was insufficient in light of the higher assessed risk of misstatement regarding these assets (OSC 2012b, ¶ 52).

Sino-Forest engaged Poyry Forest Industry Ltd., a firm based in the PRC, to provide periodic valuations of its timber holdings. On a sampling basis, Poyry counted and measured the trees to determine the appropriate valuation. Poyry's valuation reports contained a disclaimer that they should not be relied upon by anyone other than Sino-Forest and were only for Sino-Forest's valuation purposes. EY auditors accompanied the Poyry staff on a limited number of site visits and observed their activities. However, EY did not have any role in selecting which locations Poyry considered. After these site visits, an auditor on the engagement team asked another auditor on the team "[h]ow do we know that the trees that Poyry is inspecting (where we attend) are actually trees owned by the company? E.g. could they show us trees anywhere and we would not know the difference?" The other auditor answered "I believe they could show us trees anywhere and we would not know the difference..." (OSC 2012b, ¶ 58). There was no follow-up to this e-mail exchange.

With regard to Sino-Forest's claims to ownership or control of the timberland, EY requested that Sino-Forest obtain a legal opinion regarding their claims to the timber. The opinion was prepared by Sino-Forest's corporate counsel located in the PRC (Jingtian & Gongchen) on March 10, 2008, and was considered by EY during their audit of the financial statement for the period ended December 31, 2007. The opinion discussed the legal requirements for claims to forestry assets, including Plantation Rights Certificates and Farmers' Authorization Letters. Jingtian also noted in their Timber Survey Reports that they were unable to obtain or

review these Plantation Rights Certificates or Farmers' Authorization Letters. No updated legal opinion was provided to EY after March 2008.

INTERNAL CONTROL ISSUES

In the Management Discussion & Analysis (MD&A) for the 2010 financial statements dated March 15, 2011, the management of Sino-Forest included the following disclosure as part of its "Disclosure Control and Procedures and Internal Controls Over Financial Reporting" (Sino-Forest 2011b, p. 27):

The success of the Company's vision and strategy of acquiring and selling forestry plantations and access to a long-term supply of wood fibre in the PRC is dependent on senior management. As such, senior management plays a significant role in maintaining customer relationships, negotiating and finalizing the purchase and sale of plantation fibre contracts and the settlement of accounts receivable and payable associated with plantation fibre contracts. This concentration of authority, or lack of segregation of duties, creates risk in terms of measurement and completeness of transactions as well as the possibility of non-compliance with existing controls, either of which may lead to the possibility of inaccurate financial reporting. By taking additional steps in 2011 to address this deficiency, management will continue to monitor and work on mitigating this weakness.

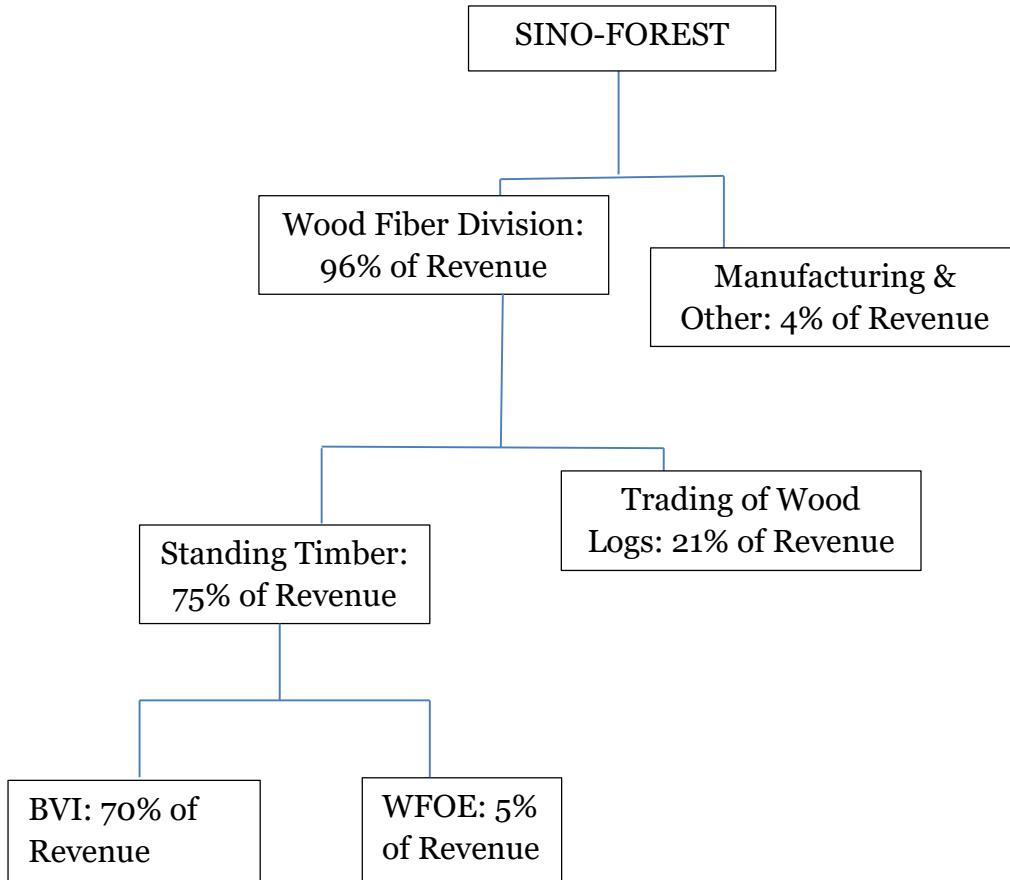
Similar disclosures were made in the MD&A of financial filings from 2006 – 2009. Sino-Forest failed to disclose the nature and extent of these issues, in particular the concentration of authority through related party control of suppliers, authorized intermediaries, and peripheral entities. Additionally, the company failed to disclose its role in the fraudulent creation and execution of purchase and sales contracts.

Table 1
Sino-Forest Revenue 2007-2010 (US\$ in millions)⁸

| | 2007 | 2008 | 2009 | 2010 | Total |
|--|--------------|--------------|--------------|---------------|----------------|
| BVI Model Revenue | 501.4 | 644.9 | 882.1 | 1326.0 | 3,354.4 |
| WFOE Model Revenue | <u>20.1</u> | <u>40.5</u> | <u>72.1</u> | <u>75.2</u> | <u>207.9</u> |
| Total Standing Timber Revenue | 521.5 | 685.4 | 954.2 | 1,401.2 | 3,562.3 |
| Sino-Forest Total Revenue | 713.9 | 896.0 | 1,238.2 | 1,823.5 | 4,771.6 |
| BVI Model Revenue as a percent of Total Revenue | 70% | 72% | 71% | 69% | 70% |

⁸ Data obtained from OSC (2012b).

**Figure 1: Sino-Forest Organizational Structure:
Standing Timber Division, Auditor's View**



**Figure 2: SINO-FOREST SUBSIDIARIES AND OTHER RELATED ENTITIES:
Standing Timber Division, Sino Forest View**

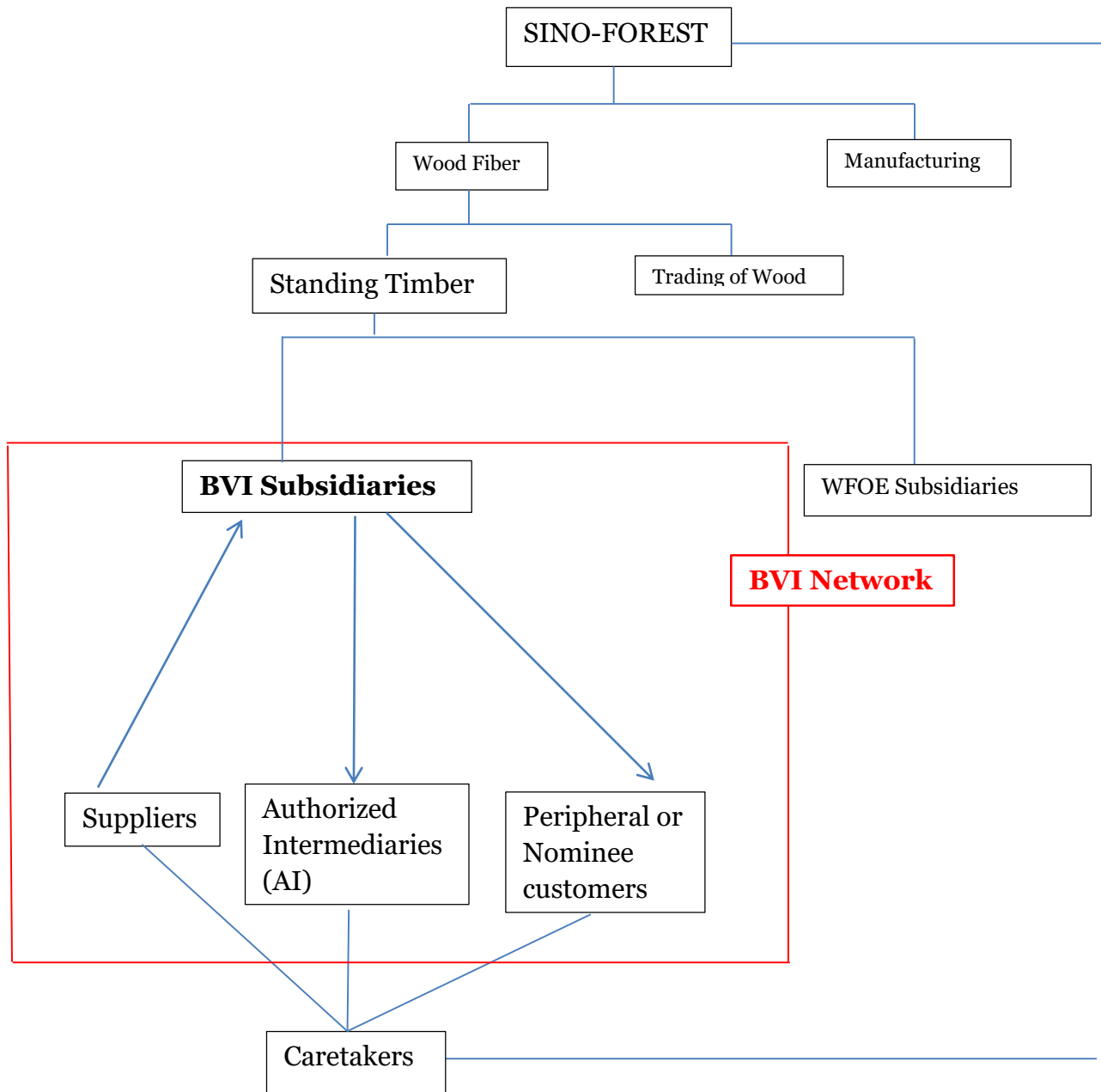
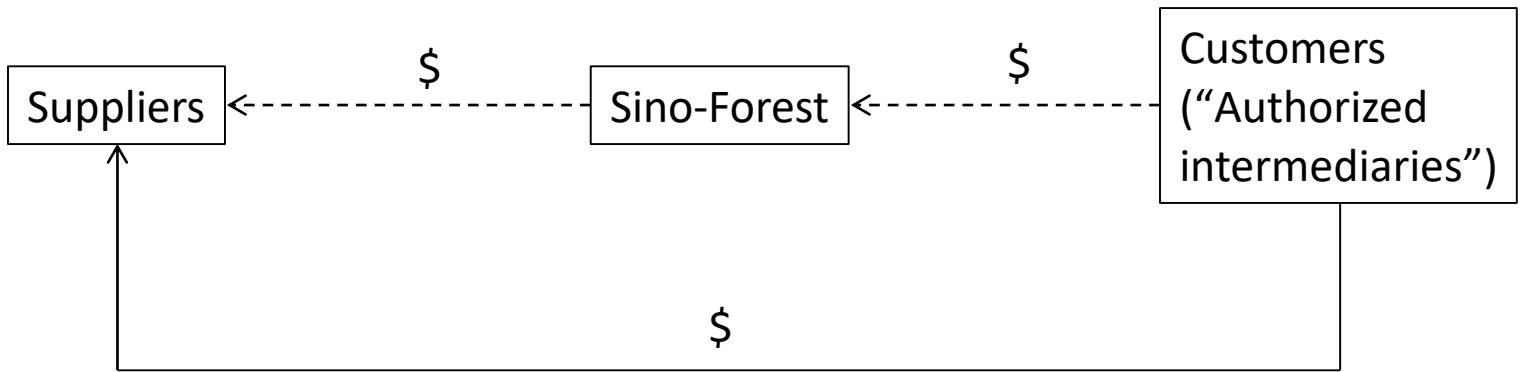


Figure 3
Purported Cash Flows



←————— Cash flows asserted by Sino-Forest
←----- Usual business cash flows

Exhibit 1
EY's Final Audit Report on Sino-Forest's Financial Statements

Independent Auditors' Report

To the shareholders of Sino-Forest Corporation

We have audited the accompanying consolidated financial statements of Sino-Forest Corporation, which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of income and retained earnings, comprehensive income and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness on the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Sino-Forest Corporation as at December 31, 2010 and 2009 and the results of its operations and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Toronto, Canada,
March 14, 2011.

Ernst & Young LLP
Chartered Accountants
Licensed Public Accountants

THE COLLAPSE AND THE AFTERMATH

As the fraud continued and the stock price rose, the company came to the attention of Carson Block, founder and principal of Muddy Waters Research, a financial research firm that investigates business fraud, accounting fraud, and fundamental business problems. Block's father inquired of Mr. Block whether Sino-Forest would be a good investment. Using his knowledge of the Chinese business environment and his analytical and research skills, Block determined that Sino-Forest was operating in a fraudulent manner. He warned his father against the investment and made his research findings public in June 2011.

Sino-Forest filed for bankruptcy protection from its creditors on March 30, 2012. Sino-Forest stock was delisted from the Toronto Stock Exchange on May 9, 2012. Its stock was cancelled on March 4, 2013 and investors received no consideration for their shares (Emerald Plantation, 2017). Most of company's assets were transferred to a successor organization owned by Sino-Forest's creditors. At the end of 2013, the creditor-controlled successor company declared the standing timber assets to be worthless (Kevon 2016).

In March, 2013 EY paid \$117 million to settle claims of Sino-Forest investors. In September 2014, EY settled the allegation of audit misconduct with the Ontario Securities Commission by paying a \$5 million fine and reimbursing \$1.5 million of expenses incurred by the Commission in its investigation. David Horsley, the former CFO of Sino-Forest paid a \$700,000 fine to the OSC and agreed to a permanent bar on being an officer or director of any other Canadian publicly-traded company.

Lawsuits and regulatory filings continue at this date. The legal cases against Mr. Chan and four other top executives of the company were presented in April, 2016 (Koven 2016). The resolution of the cases against these executives is still unknown at this time.

CASE QUESTIONS

While Sino-Forest used Canadian GAAP to prepare its financial statements, and EY used Canadian GAAS to conduct its audit, for simplicity, you may use US GAAP and the PCAOB standards to answer the following questions:

1. The organizational structure of Sino-Forest was more complex and opaque than the auditors realized. The auditors claimed that the nature of the related parties and their relationship to the purchase and sales contracts was not disclosed to them. Explain how related party transactions can affect the auditor's risk assessment. What procedures should an auditor use to try to identify related party activities such as those conducted by Sino-Forest?
2. Other than the complexity of Sino-Forest's organization structure and related party transactions (addressed in question 1), evaluate inherent risk for the audit of Sino-Forest Corporation. What are the specific characteristics associated with Sino-Forest that support your evaluation?

3. Explain the “lack of segregation of duties” mentioned in the excerpt from Sino-Forest’s MD&A. How could this lack of segregation affect the auditor’s control risk assessment? Why were the company’s disclosures about the lack of segregation deemed inadequate by the OSC?
4. Given your assessment of inherent risk and control risk above, what is the effect on detection risk? What implications does the level of detection risk have for the auditor’s substantive testing process?
5. Explain how the unusual cash flow arrangement documented in Figure 3 may affect the audit process for both revenue and the standing timber assets.
6.
 - a. For the standing timber assets, identify and rank order three (3) management assertions that the auditor would be most concerned with.
 - b. What procedures did the auditor use to audit the fair presentation of standing timber and what assertions were the procedures intended to provide evidence for? Was the evidence sufficient and appropriate?
7. What factors should an auditor consider before relying (to any degree) on work of outside experts? With regard to the two “independent” experts, Poyry and Jingtian, how might their use affect the auditor’s report? Were they appropriate for use in the audit? Why or why not?

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the “For Contributors” page of the journal website, <http://gpae.wcu.edu>.

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