

Report alleges possibility Sino-Forest 'an accounting fiction'

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A report by one of the country's leading forensic accounting firms alleges there is a "serious possibility" Sino-Forest Corp.'s entire standing timber business in China is "an accounting fiction."

The report by Rosen & Associates Ltd. was commissioned by lawyers pursuing a potential class action against the company on behalf of investors. It was recently filed in Ontario Superior Court. The allegations have not been proven. A spokesman for Sino-Forest said the company had no comment.

The document is part of hundreds of pages of new court filings, the latest salvo from lawyers acting for investors who lost billions when the company was stung by fraud allegations that caused its stock to crash last year.

The accounting report, signed by accountants Alan Mak and Al Rosen, takes aim at Sino-Forest's auditors, Ernst & Young LLP and BDO McCabe Lo Ltd. Both firms are named as defendants along with the company in the potential class-action lawsuit.

The Rosen report says Sino-Forest's financial statements from 2006 to 2010 were "grossly overstated" and alleges the company had a "disconcerting business model" that included interrelationships among the company and its suppliers and a lack of independent verification of its forestry holdings. The report alleges the company engaged in a misleading "manipulation" of its cash flows.

The authors of the report say their findings "corroborate our strong suspicion that the entire standing timber trade business was a carefully-constructed fiction from an accounting perspective."

In what it calls a "misleading" violation of Canadian accounting rules, Mr. Mak and Mr. Rosen write, Sino-Forest overstated its cash flows from operating activities by excluding the cost of timber that it says it sold each year.

Instead of counting timber as inventory, Sino-Forest considered its timber purchases as long-term investments – despite being in the business of frequently selling its holdings. Its auditors "accepted the inappropriate and misleading timber acquisition and sale reporting each year," the report states.

"Overall, it is our opinion that E&Y and BDO seriously failed to fulfill their basic obligations to test Sino-Forest's significant financial statement assertions," the report reads. Ernst & Young recently resigned as auditor.

For the year 2010, Ernst & Young's audit report said the company's "cash flows from operating activities" were \$840-million (U.S.), but the report alleges they were just a fraction of that amount, or \$94-million. Investors "were led to believe that Sino-Forest was far more successful in generating operating cash revenue than was actually the case," the report reads.

Peter Griffin, a lawyer for Ernst and Young, said in an e-mail that the firm "believes that the claims against it are without merit" and "will vigorously defend itself against all such claims and will deal with these allegations before the court at the appropriate time."

Peter Greene, a lawyer for BDO, slammed the report by Mr. Mak and Mr. Rosen, saying it contained inaccuracies. He said BDO Hong Kong was not involved in audits relevant to the case and should not have been named as a defendant.

"With respect to Mr. Rosen the opinions in his report are based upon wild factual speculation or alleged facts which are just wrong," Mr. Greene said in an e-mail. "I look forward to cross-examining him on his report."

In addition to the accounting report, the filings include an affidavit sworn by Stephen Gowan Chandler, a former chief inspector with the commercial crime bureau of the Royal Hong Kong Police, that alleges Sino-Forest engaged in undisclosed related party transactions.

Among other deals, Sino-Forest engaged in an undisclosed related party transaction with one of its executives named Chen Hua or Hua Chen, Mr. Chandler alleges. Citing Administration of Industry and Commerce (AIC) records, he says Ms. Chen was a major shareholder of a subsidiary of a company called Homix Limited when Sino-Forest bought Homix in 2010.

In September of 2011, The Globe and Mail reported similar filings after reviewing records from China. A report by an independent committee of Sino-Forest directors said it found evidence that Ms. Chen was not a shareholder of the Homix subsidiary at the time of the acquisition.

The possibility of related party transactions with business partners has been a central part of the Sino-Forest saga. Despite more than seven months of work and spending \$50-million, the independent committee was unable to unravel the relationships between Sino-Forest and many of the companies that supply and sell its trees in China.

Facing fraud allegations by the Ontario Securities Commission and an investigation by the RCMP, Sino-Forest's business has been effectively frozen, the company has said. It was granted protection from its creditors last month and has put itself up for sale.