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Accounting "Gaps": Empirical Evidence from a Case Study

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Accounting "Gaps": Empirical Evidence from a Case Study

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Abstract

In the last few years, accounting frauds have had serious consequences on stakeholders. Enron and WorldCom in the U.S.A., Parmalat in Italy can be taken as examples of this phenomenon. Royal Ahold, a food Dutch corporation operating in the grocery retailing and wholesaling, was the first European firm involved in an accounting scandal. In 2003 auditors discovered several accounting irregularities and they had to restate 2000 and 2001 earnings. Wrongly reporting promotional allowance, joint ventures, goodwill and other minor accounts, managers misstated the financial reports for more than €800 million. This scandal involved lack of transparency in financial reports, corporate governance issues, investments in completely different businesses, accounting rules divergences, outsiders' role and government bodies' reactions. In this paper I will study the main accounting irregularities and I will analyze the reasons why auditors failed to prevent and detect financial misstatements.

Keywords: accounting fraud, auditing, international accounting standards

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Introduction

Many of the biggest accounting scandals happened during the last decade. *In primis*, Enron (2001) and WorldCom (2002) accounting issues have had serious consequences on all stakeholders. For example, in the first case, company's stock price fell from €67 to 20 cents in few months and it caused the failure of Arthur Andersen, one of the largest auditing firms (one of the "Big 5"). Public opinion pushed the U.S. government to react and on the 30th July of 2002 the Sarbanes-Oxley Act was issued. Some big accounting scandals, usually followed by bankruptcy, also occurred in Europe, like Parmalat (an Italian dairy and food firm) and Royal Ahold (a Dutch supermarket). The Parmalat fraud is still the biggest that has ever taken place in Europe in modern time, with a €14 billion hole in the accounts (Moloney & Pizzo, 2010). At the same time, the *Royal Ahold case* has been defined as *Europe's Enron.* The Royal Ahold accounting scandal involved misstatements and lack of transparency in financial reports, corporate governance issues, fiscal problems, undefined accounting rules, outsiders' role, government bodies' reactions and bad acquisitions (De Jong, DeJong, Mertens, & Roosenboom, 2007; Knapp & Knapp, 2007). On the other hand, the risk of bankruptcy has always been quite low and the firm drew up a very good recovery plan which has led the company to the actual positive financial results.

Starting from the investigation of Ahold history in section 2, I will review the literature on accounting scandals, I will discuss the methodology and the research questions. In section 5 I will study the main accounting irregularities and the role of auditors and suppliers in this fraud. In the end I will present my conclusions.

Ahold History

Koninklijke Ahold NV's history began in 1887 when Albert Heijin established his first grocery in Oostzaan, North Holland. In 1977, it entered in the U.S. market buying BI-LO supermarket for roughly €60 million. During the expansion period (1989-2001), the management's objective has been to lead the firm to be a big multinational able to challenge corporations like Wal-Mart and Carrefour (Table 1). In the 1990s, growth rate objective (EPS) was 15% per year, 10% from internal and 5% from external growth. Annual bonuses were linked to this target: despite the relative stability of the food industry, this goal was achieved (at least at the beginning) thanks to the acquisitions in the USA and in Europe. Ahold acquired 97 companies in 26 countries all over the world (De Jong, DeJong, Mertens, & Roosenboom, 2007) even if the attempt to enter the big Asian market failed dramatically just three years after the opening of the first store in 1997. The last big operation before the accounting scandal has been the acquisition of U.S. Foodservice in 2000, the second largest American food distributor, which served more than 130.000 customers and accounted sales for €2,8 billion (Bickerton, 2000). Ahold paid an incredible premium of 42% and the deal was supposed to increase the EPS from 15% to 17-20%. As you can see from Table 2, the increase in the income was, until 2001, very high, especially compared to the results of the main competitors. Despite this *global* expansion, the company focused its attention mainly on two markets: the Dutch market, which couldn't guarantee the growth rate required because there were very few expansion opportunities and the American market (Table 3). Stocks were traded in Amsterdam, New York, Zurich and Brussels.

Table 1. *Top Ten Global Supermarket Retail (US$B/Euro€B; FY2000)*

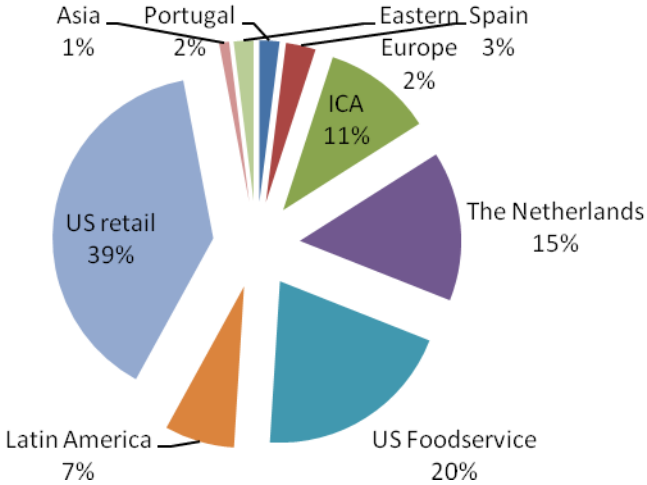
Source: Coriolis Research

Table 2. *Financial Data according to Financial Reports*

Year	Net income (€ thousands)	Variation	Earnings per share (€)	Variation
1980	23.534,40	-	0,18	-
1989	88.304,30	275,21%	0,32	78%
1990	110.408,80	25,03%	0,38	19%
1991	125.159,40	13,36%	0,42	11%
1992	138.422,00	10,60%	0,45	7%
1993	155.698,30	12,48%	0,45	0%
1994	186.841,60	20,00%	0,52	16%
1995	207.187,40	10,89%	0,57	10%
1996	286.982,00	38,51%	0,65	14%
1997	423.753,60	47,66%	0,80	23%
1998	547.198,60	29,13%	0,93	16%
1999	752.198,60	37,46%	1,15	24%
2000	1.115.991,00	48,36%	1,51	31%
2001	1.113.521,00	-0,22%	1,75	16%

Source: Annual Ahold report (Dutch GAAP)

Table 3. *Ahold Sales Break Down 2001*



Source: European food retail

On the 4th April 2002, Ahold NV announced (Cramb, 2002) that net earnings, according to US GAAP, were much lower (-89%) than those disclosed under Dutch GAAP published the previous month, mainly because goodwill had to be differently reported.[1] In the following second-quarter results Ahold reported its first net loss of €195,5 million caused by the depreciation of the Argentinean subsidiaries. Despite these negative signs, Ahold did not stop the expansion program.

On the 24th February 2003 the company admitted that U.S. Foodservice division had overstated income in 2001 and 2002 by wrongly recording discounts from suppliers, also known as promotional allowances. The difference was initially supposed to be of €390 million. Ahold also affirmed that it had to restate previous financial results because it had wrongly consolidated five companies into the group's accounts. Reactions were very strong: share prices fell of 63% in Amsterdam and Standard & Poor's Corp[2] and Moody's Investors Service Inc[3] immediately downgraded company's debt ranking to junk status. These accounting irregularities were discovered by Ahold's auditor, Deloitte&Touche, during the 2002 year-end audit. In the end, irregularities concerning U.S. Foodservice division amounted to €880 million. New smaller accounting irregularities (€22 million) were found in the financial reports of U.S. supermarket chain Tops Markets.

By the end of 2003, the new management set a three years financial plan and a strategy to restore value and confidence into shareholders. The company decided to focus its business on the Central European market but still the main markets remained U.S., which generated 71% of the sales of the group, and The Netherlands (Table 4). In 2005 Ahold finally settled a U.S. class-action

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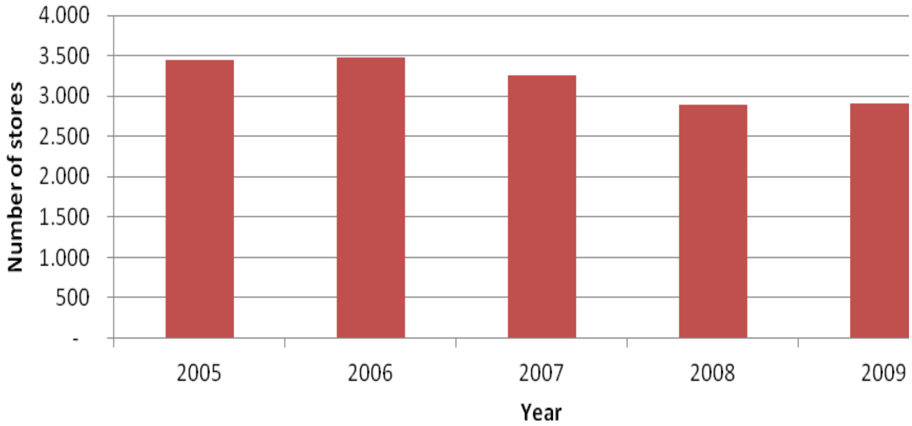
[1]After being listed at the New York Stock Exchange, Ahold was required to draw up financial reports according to U.S. GAAP.
[2]From BBB to junk.
[3]From Baa3 to B1.

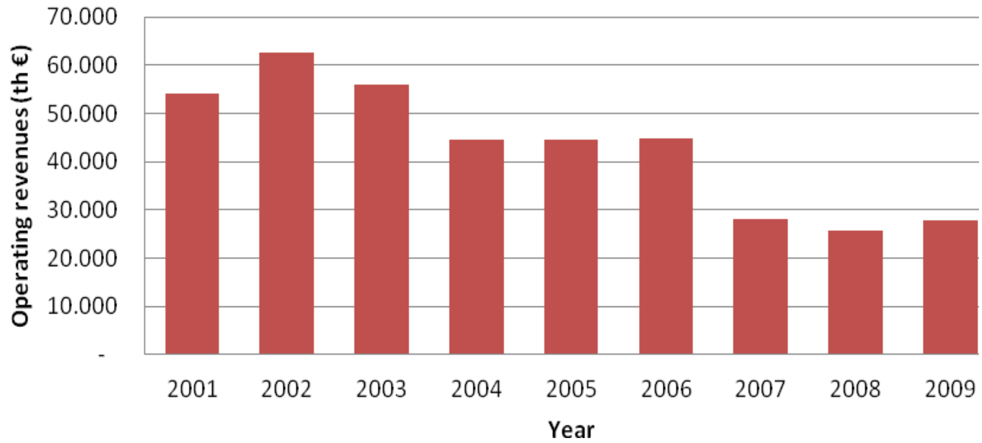
lawsuit agreeing to pay €1,1 billion to all the shareholders and €2,5 million to VEB, the Dutch shareholders' association. In August 2007 Ahold asked to be delisted from the New York Stock Exchange and deregistered from the SEC to not be obliged to report its financial results under U.S. Securities Exchange Act of 1934. The new long term earning targets, 5% sales growth and 5% operating margin, were much lower compared to the ones of the previous period. In 2009 Ahold was listed at the Dow Jones Sustainability Index. Many analysts affirm that Ahold, due to the actual weak position (Table 5), might be a very attractive target for other supermarket chains, like for example Tesco PLC (UK).

Table 4. *Number of Stores owned*



Source: Ahold website

Table 5. *Ahold Operating Revenues*



Source: Orbis

Literature Review

Accounting scandals is a topic that has been widely studied, through different perspectives (Smith, 1996; Cooper, Everett, & Neu, 2005; Gowthorpe & Amat, 2005; Murphy & Dacin, 2011). Jones (2011) presents 58 frauds that have taken place in 12 countries in different continents and several other smaller cases. He often refers to *creative accounting*, which is a difficult term to define, in relation to earnings management and financial statement presentation. He presents a range of *irregular* techniques that have been adopted so far, such as increasing income, decreasing expenses, increasing assets and decreasing liabilities. Moreover he analyzes the stakeholders' roles in the accounting frauds, studying the motivations that drive them to commit irregularities, linking the different psychological traits (Murphy & Dacin, 2011). The growing attention to prevent and detect the accounting irregularities is strictly related to auditors' role to assess and determine the risk of fraud (Gullkvist & Jokipii, 2013). The fraud triangle is often used to understand the elements that incentive the different players to misstate the financial reports (Dorminey, Fleming, Kranacher, & Riley Jr, 2012; Kassem & Higson, 2012). Cooper et al. (2005) ask if we have to consider the ethical nature of the accounting fraud a moralistic concept or an incident that sometimes wrongly happen. The growing importance of the North American universities, in particular the so-called *corporate universities*, has been identified as one of the leading causes of the development of the *creative accounting*, introducing at the same time changes and innovations in the teaching and researching activities.

The Ahold case is among the most discussed and studied together with Enron, WorldCom and Parmalat cases (Healy & Palepu, 2003; Early, 2005; Melis, 2005; De Jong, DeJong, Mertens, & Roosenboom, 2007; Knapp & Knapp, 2007). Knapp & Knapp (2007) analyze the accounting, auditing and control issues. In particular, they discuss the controversial role played by international regulatory agencies and rule-making bodies in the fraud and the following decisions undertaken by the different governments. De Jong et *al*. (2007) study the issues related to investors' relations and corporate governance. The high expectations of the investors and the strong pressure of the top managers over the other managers and subsidiaries have driven the firm's decisions and performance till 2003.

At the same time there is a lack in the analysis of the accounting irregularities linked to the auditors' failure to gather sufficient appropriate evidence with the professional skepticism required by international auditing standards to state an unqualified opinion adopting the professional skepticism required.

Methodology and Scope

This case study will get insights from the examination of the litigation releases of the U.S. Securities and Exchange Commission and of the main journals and newspapers articles. The findings are based on desk research and a review of relevant literature.

The aim of this paper is to discuss the different accounting irregularities that have been disclosed after 2003 by Ahold. The second purpose is to understand the main failures in the auditing activity to prevent and detect misstatements in the financial statements.

Discussion

Ahold has disclosed several accounting irregularities since 2003, mainly planned and carried out by the management that set up a very detailed and sophisticated scheme to misstate the financial reporting. Auditors failed to prevent and detect all the red flags popped up in several occasions. In this analysis I will investigate the accounts that have been involved in this fraud and the role of the different stakeholders.

Promotional Allowance

The misstatement of the financial statements, in this accounting fraud, has been mainly caused by wrongly recording the so-called *promotional allowance* which is an account generally used in the distribution channel. The retailer has to sell a predefined quantity of supplier goods and he receives in return a discount or a rebate. Sometimes food manufactures pay a distributor up front for a promise that only their brands will be promoted. Promotional allowance is the main income of food service firms: margins on the basic business are usually very small (5-10%).

U.S. Foodservice, a company wholly-owned by Ahold, was able to obtain discounts between 8,5% and 46% (Stecklow, Raghawan, & Ball, 2003). USF, in 2001 and 2002, made the majority of the profits from promotional allowances and not from end-sales. Agreements on promotional allowance were supposed to be signed, but most of the time they were just hand-shake deals and often re-negotiated at year-end. The company usually estimated[1] this amount as a percentage of sales and recorded, for interim reporting, periodic accruals based on that rate which was constantly inflated in order to overstate operating incomes. Moreover, these discounts were paid at the purchase time but it was a common practice to *pre-pay* the all multi-year contracts or at least a part of the final amount. In order to cover any shortfall of the budgeted earnings, managers recorded fictitious promotional allowance. According to the SEC,[2] U.S. Foodservice managers used different strategies to cover-up irregularities:

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[1]Check U.S. Securities and Exchange Commission, Litigation release no 19961, 8th January 2007 in which Suzanne Brown, corporate controller at U.S. Foodservice, is accused to do not have done a good-faith estimate of PA rate.

[2]U.S. Securities and Exchange Commission, Litigation release no. 18797, 27th July 2004.

(a) induced vendors to confirm false promotional allowance income, payments and receivable balances;
(b) manipulated the promotional allowance accounts receivable from vendors and manipulated and misapplied cash receipts;
(c) made false and misleading statements, and material omissions, to the company's independent auditors, other company personnel, and/or Ahold personnel in the parent company.

In the end, the total overstated promotional allowance was at least €541 million for fiscal years 2001 and 2002.[1] Ahold has overstated:

(a) net income by approximately 17,6%, 32,6%, and 88,1% for the fiscal years 2000, 2001 and first three quarters of 2002, respectively;
(b) operating income by approximately 28,1%, 29,4%, and 51,3% for the fiscal years 2000, 2001 and first three quarters of 2002, respectively;
(c) net sales by approximately 20,8%, 18,6%, and 13,8% for the fiscal years 2000, 2001 and 2002, respectively.[2]

Auditors

Deloitte Touche Tohmatsu disclosed the fraud on the 24th February 2003 and it '*denied any responsibility for the problems'* and declared that the firm was *'a witness in the investigation and not a target'* (Ball, Zimmerman, & Veen, 2003). The auditing firm was not fined because the SEC recognized that Deloitte detected the fraud and fully collaborated with the Securities and Exchange Commission, with the chief US financial regulator and with the US Department of Justice during the probe.

On the other hand, KPMG, which audited USF until 2001, was fully involved in the fraud because it did not detect any irregularities and it ignored all the possible red flags.[3] Auditors were aware that the valuation, existence and completeness of promotional allowances were hard to determine. The company had a high inherent risk (individual balances were significant) and a high control risk (weakness in the internal control). Internal controls on promotional allowance were nonexistent and the risks related to this account were very high. In order to test management's assertions, the KPMG auditors mainly used three kinds of substantive tests: they vouched cash receipts, they tested subsequent PA payments received and they sent confirmation letters. Using the first method, they found that USF recognized prepayments as PA income. With the intention of avoiding any possible problem, all the asterisks in the working papers were covered up by liquid white-out. Moreover, the letters from vendors were deliberately unclear. It was very hard to understand

[1]U.S. Securities and Exchange Commission, Litigation release no. 18929, 13th October 2004.
[2]U.S. Securities and Exchange Commission, Litigation release no. 19975, 22nd January 2007.
[3]U.S. Securities and Exchange Commission, Administration Proceeding File No. 3-12208, 14th December 2009 and 16th February 2006.

the period on which the PAs were granted. Auditors examined five subsequent PA payments received at the beginning of the 2000 fiscal year. They accepted the company representations without gathering more evidence, also because all the confirmation requests returned. Schedules with the total promotional allowances earned by USF, the amount paid by the vendors and the balances due were prepared by USF managers for every vendor. All these numbers were largely inflated and in some cases fictitious. USF managers have been able to convince suppliers to say that the amounts written in the confirmation letters were only a sort of *'internal number'*[1] and not an actual debt. In fact, USF sent several side letters telling the vendors that they were not debtors for the amounts written on the confirmation letters. Several suppliers were investigated by the SEC and found guilty. Generally Accepted Auditing Standards (GAAS)[2] require that letters have to be sent to people who can provide reliable evidence. At the same time, it was common practice to obtain contact information directly from the client. USF recorded these amounts as reductions of accounts receivable (instead of deferred liabilities) saying that these payments were already earned. According to USF's managers, the company did not receive any kind of prepayments: auditors trusted the managers and they did not go into depth, they did not ask for more evidence and they did not adopt the professional skepticism required. The result was that almost half of all the third party confirmations were sent to brokers who did not have connections with the vendors whom invoices were addressed to. Some letters were even sent to home addresses or to firms that did not have any kind of business with U.S. Foodservice. During the interim review for the second quarter of 2000, the auditors failed to require to USF to record penalties as contingent liability. USF was supposed to incur in these penalties every time that it did not reach the minimum purchase requirements (€12 million during the first two quarters of fiscal year 2000).[3]

Joint Ventures

In order to reach the annual earnings growth rate and the expansion targets, Ahold decided to sign several joint ventures with different companies.

In 1997 Deloitte argued that Ahold could not consolidate the joint ventures in the financial statements because it did not have the requisites reported in the U.S. GAAP.[4] Immediately Ahold replied that it was already its intention to modify all the joint venture agreements to follow U.S. GAAP requirements. The CFO prepared *control letters* that were sent to partner companies. These letters said that in case of disagreement between shareholders, Ahold could take the final decision. These letters were countersigned by the other companies and shown to the auditor at year-end control in order to pursue the

[1]U.S. Securities and Exchange Commission, Litigation release no. 18797, 27th July 2004.
[2]AU §§330.16 and 330.27.
[3]U.S. Securities and Exchange Commission Administration Proceeding File No. 3-12208, 14th December 2009
[4]U.S. Securities and Exchange Commission, Litigation release no. 18929, 13th October 2004, Auditor letter

consolidation of the joint ventures' financial reports. At the same time Ahold received *rescinding letters* from the partners saying that the management disagreed with the contents of the previous letters nullifying the effects of the control letters. Obviously, these side letters were not shown to the auditors, despite the managers knew the implications of the side letters on the financial reports.

In May 2000 another control letter, this time between Ahold and ICA Partners, was signed. This letter allowed Ahold to continue consolidating ICA in accordance with U.S. GAAP. As soon as Ahold's chief internal legal counsel and Ahold's head of the internal audit department discovered the ICA rescinding letter in the fall 2002, they asked the CEO to disclose it to the internal (audit committee) and external (Deloitte Netherlands) auditors. The other side letters were not disclosed until 2003.

In 2003 Ahold had to deconsolidate all the joint ventures under U.S. GAAP. As reported by the SEC,[1] the improper consolidation of joint ventures caused the following discrepancies from 1999 to 2001:

- Net sales were overstated by €4,8 billion in 1999, €10,6 billion in 2000 and €12,2 billion in 2001.
- Operating income was overstated by €222 million in 1999, €448 million in 2000 and €485 million in 2001.

Improper Allocation of ICA purchase Price

In 1999, Ahold acquired 50% of ICA group paying €1,8 billion and it recorded real estate at the existing book value, understating ICA's real estate value. The company, according to accounting standards, was required to use the fair value method to value all the assets and liabilities purchased at the date of acquisition. In the following years, Ahold recorded as gains the difference between the selling price, recognized on the sale of the assets, and the value previously recorded on its books (book value). Three years later, Ahold restated the value of these assets according to the fair market value. Ahold revealed that the sales of ICA's real estate were approximately overstated of €62 million[2].

Other Issues

The joint venture with Disco was part of an agreement signed with Peirano, a Uruguayan family (De Jong, DeJong, Mertens, & Roosenboom, 2007). Grupo Velox, Peirano's family business, failed in 2002. Ahold was immediately forced to buy the remaining shares of Disco according to an agreement signed in 1998 and disclosed only in 2001. To justify this lack of transparency, Ahold said that it was not possible to predict the Argentinean economic crisis and so there were no reasons to disclose this issue earlier. Moreover, in July 2002 Ahold managers discovered that some managers of the

[1]U.S. Securities and Exchange Commission, Litigation release no. 18929, 13th October 2004.
[2]U.S. Securities and Exchange Commission, Litigation release no. 18929, 13th October 2004.

Argentinean subsidiary Disco drew up fictitious invoices to conceal false payments. They capitalized these expenses (approximately €10 million in 2001 and in 2002) as tangible fixed assets.[1]

Ahold's subsidiaries also tried to change the accrual period of some transactions, recording revenues at the wrong time (*Vendor Held Funds*). The scheme of these irregularities was quite simple: Ahold bought goods from a vendor and instead of paying the real prices, they paid slightly more (+ 3-5%). This money was recalled later, sometimes in a different year and was used to increase the income of that period violating the accrual principle. Financial statements failed to reach the level of transparency and reliability required by international standards.

In a similar way, inventory reserves, purchase accounting reserves, or reserves set up for liabilities resulting from potential store closures contained small amount of general reserves that were used to *'improperly smooth earnings.*[2]

Conclusion

Ahold's disclosures shocked the European business community. Before 2003, Europe was considered an area free from accounting scandals and serious company misstatements. Ahold business was characterized by its fragmented markets because it could not enter the main European retail markets (France, UK…) which were completely saturated. Managers played a key role in the expansion strategy but they often failed to understand local cultural norms. Ahold signed agreements all over the world, from South America to Far East even if the main markets were the American and the Dutch ones which generated 80%-90% of Ahold's total revenues. It also decided to enter in the wholesale sector, which was a totally different market from the grocery retail sector. The annual earnings targets were established with no link to reality and the only goals were to put pressure on managers and to meet stock market analysts' forecasts. Without any doubt, this aggressive policy stimulated and encouraged managers to adopt unfair accounting methods. Promotional allowances, joint ventures, but also some of the other practices discussed were rationalized by managers. We have also to say that it was possible for the management to adopt this attitude because controls, especially the internal ones, were weak or absent. In fact, auditors did not recognize several red flags in the company. In order to gather sufficient appropriate evidence to prevent and detect material misstatements, the auditors should have identified the different fraud risk factors. The most relevant were the pressure on management to reach earnings targets, the annual growth rate expected, the number of businesses spread out all over the world and the features of the distribution industry. The auditors were aware of the high control risk, due to

[1]U.S. Securities and Exchange Commission, Litigation release no. 18929, 13th October 2004.
[2]U.S. Securities and Exchange Commission, Litigation release no. 18929, 13th October 2004.

the weak internal controls,[1] and of the high inherent risk of the company. Without considering the risk that management could override controls, they completely relied on management assertions. Significant accounts, like the promotional allowance, joint-ventures consolidation, goodwill and some relevant management assertions (valuation, existence and completeness) were not analyzed with the professional skepticism required by the international auditing standards. Auditors issued unqualified opinions and they never reported the misstatements found to the '*appropriate level of management.*'[2]

The Dutch company planned a very good recovery plan and it was able to attain impressive financial results. On the other hand, authorities and regulatory bodies have not made significant progress to avoid new similar scandals. A transparent market requires harmonized rules and a uniform regulatory system. An old business joke says: '*Investors can take a lot of bad news…but they hate surprises!'*

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[1]The weakness of the internal controls was also caused by the different structure between the retailing industry and the wholesaling one.

[2]AU §722.20.

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