

CASE 1.15

Livent, Inc.

The structure of a play is always the story of how the birds came home to roost.

Arthur Miller

In 1995, Canadian native Maria Messina achieved one of the most sought-after career goals in the public accounting profession when she was promoted to partner with Deloitte & Touche, Chartered Accountants, the Canadian affiliate of the U.S.-based Deloitte & Touche LLP. In an interview she granted to an accounting trade publication shortly after receiving that promotion, Ms. Messina noted that "Becoming a partner is exciting because you are a part of everything."¹ Messina's promotion earned her the respect and admiration of her family, her friends, and her colleagues and catapulted her to a much higher tax bracket and a more comfortable standard of living. But another opportunity soon arose, an opportunity that promised even more intrinsic and extrinsic rewards for Messina.

Throughout the 1990s, Livent, Inc., was the only publicly owned company whose primary line of business was live theatrical productions. Livent's cofounder and the individual recognized as the creative genius responsible for the company's impressive string of Tony Award-winning shows was Garth Drabinsky. Livent's audit firm was Deloitte & Touche, Chartered Accountants. Maria Messina served as the engagement partner for the 1996 audit, after having been the audit manager on several prior audits of the company. Following the completion of the 1996 Livent audit, Drabinsky asked Messina to leave Deloitte & Touche and become Livent's chief financial officer (CFO). After carefully weighing the challenges, opportunities, and potential drawbacks of making the job change, Messina gave up the partnership position with Deloitte & Touche that she had coveted for years in exchange for a "back office" but high-paying and high-profile position in the glitzy and glamorous world of show business.

Within a few weeks of signing on with Livent, Maria Messina was questioning the wisdom of her decision. Time budgets, out-of-town travel, inexperienced subordinates, and an array of other common "stressors" faced by partners of major accounting firms had complicated Messina's professional and personal life when she was at Deloitte. But, at Livent, the pressures she faced were much more intense, much more difficult to manage and control, even physically debilitating at times. Each passing month imposed a heavier emotional burden on Messina. By the late summer of 1998, Messina's life was in complete disarray. A few months later, in January 1999, Messina pleaded guilty to a felony for her role in a massive financial fraud. Following that plea, the single mother of a 10-year-old daughter faced up to 5 years in prison and a \$250,000 fine.

There Is No Business Like Show Business

The entertainment industry had fascinated Garth Drabinsky from an early age. Unlike many of his colleagues in the industry, Drabinsky did not benefit from a network of

1. T. Frank, "Opportunity Knocks," *CA Magazine*, March 1997, 27.

family members and friends in show business. Instead, Drabinsky relied on his own drive, inspiration, and indomitable work ethic to claw his way to the top of the volatile and fickle entertainment industry. Born in Toronto in 1947, Drabinsky was struck down by polio at age three, leaving him with a severe limp for the remainder of his life. The young Canadian refused to allow his physical limitations to prevent him from reaching his goals. In fact, Drabinsky freely admits that his physical problems and his modest upbringing—his father sold air conditioners—were key factors that motivated him to “aim for the stars.”

During his college years, Drabinsky made his first foray into show business by publishing a free magazine that provided critiques of movies appearing in local theaters. After graduating from law school, where he concentrated his studies on the entertainment industry, Drabinsky became involved in real estate development. The young attorney hoped to accumulate a nest egg that he could use to begin producing movies and live plays. A successful condominium project provided him with the funds he needed to begin dabbling in motion pictures and Broadway productions. By age 30, Drabinsky had produced three feature-length movies and one Broadway musical, none of which were particularly well received by critics or the ticket-buying public.

In 1979, Drabinsky and a close friend, Myron Gottlieb, decided to enter the show business world via the “back door.” The two young entrepreneurs persuaded a prominent Toronto businessman to invest nearly \$1 million in a “cinema complex” project they had conceived.² This project involved converting the basement of a large shopping mall into a multiscreen theater. The design for the “cinplex” included plush interiors for each theater, luxurious seats, and cappuccino bars in the lobby. Drabinsky intended to make a trip to the local movie theater the captivating experience that it had been several decades earlier in the halcyon days of Hollywood.

Most industry insiders predicted that Drabinsky’s blueprint for his cineplex concept would fail, principally because the large overhead for his theaters forced his company to charge much higher ticket prices than competitors. But the critics were wrong. Toronto’s moviegoers were more than willing to pay a few extra dollars to watch a film in Drabinsky’s upscale theaters. Over the next several years, Drabinsky and Gottlieb expanded their company with the help of well-heeled investors whom they convinced to pony up large sums to finance the development of multiscreen theater complexes throughout Canada and the United States. By the mid-1980s, their company, Cineplex Odeon, controlled nearly 2,000 theaters, making it the second-largest theater chain in North America.

Several major investors in Cineplex Odeon eventually began complaining of Drabinsky’s unrestrained spending practices. The company’s rapid expansion and the increasingly sumptuous designs Drabinsky developed for new theaters required Cineplex Odeon to borrow enormous amounts from banks and other lenders. An internal investigation in 1989 uncovered irregularities in the company’s accounting records that wiped out a large profit for the year and resulted in Cineplex Odeon reporting a significant loss instead. The controversy sparked by the discovery of the accounting irregularities gave Cineplex Odeon’s major investors the leverage they needed to force Drabinsky and Gottlieb to resign. During the negotiations that led to their departure from the company, Drabinsky and Gottlieb acquired the Pantages Theatre, a large live production theater in Toronto, as well as the Canadian rights to certain Broadway plays.

Within a few weeks after severing their ties with Cineplex Odeon, Drabinsky and Gottlieb had organized Live Entertainment Corporation to produce Broadway-type

2. The key financial amounts reported in this case are expressed in Canadian dollars.

shows in their hometown of Toronto. Drabinsky's concept for this new company, which he coaxed several large investors and lenders to bankroll, was to bring "corporate management" to the notoriously freewheeling and undisciplined show business industry. Following a series of widely acclaimed productions, the company—renamed Livent, Inc.—went public in 1993.³ In May 1995, Livent filed an application with the Securities and Exchange Commission (SEC) to sell its stock in the United States. The SEC approved that application, and Livent's stock began trading on the NASDAQ stock exchange. Within two years, U.S. investors controlled the majority of Livent's outstanding stock.

By early 1998, Livent owned five live production theaters in Canada and the United States, including a major Broadway theater in New York. The company's productions, among them *Fosse*, *Kiss of the Spider Woman*, *Ragtime*, *Show Boat*, and *The Phantom of the Opera*, had garnered a total of more than 20 Tony Awards. Show business insiders attributed Livent's rapid rise to prominence to Garth Drabinsky. After organizing Livent, Drabinsky quickly developed a keen sense of the types of shows that would appeal to the public. Even more important, he was able to identify and recruit talented directors, actors, set designers, and the array of other skilled artisans needed to produce successful Broadway shows. The domineering Drabinsky micro-managed not only the creative realm of Livent's operations but every other major facet of the company's operations as well, although he relied heavily on his friend and confidant, Myron Gottlieb—who had an accounting background—to help him oversee the company's accounting and financial reporting functions.

Despite the artistic success enjoyed by several Livent productions and the company's increasing stature in the entertainment industry, Garth Drabinsky was dogged by critics throughout the 1990s. The enigmatic Drabinsky had a well-deserved reputation as flamboyant and charming with Wall Street analysts, metropolitan bankers, and fellow corporate executives. But critics were prone to point out that Drabinsky also had a darker side to his personality. "He is—by his own admission—complex and difficult, cranky and litigious, breathtakingly ambitious, singled-minded and self-centered."⁴ According to company insiders, Drabinsky could be "tyrannical and abusive"⁵ to his subordinates, berating them when they failed to live up to his perfectionist standards or when they questioned his decisions. Maria Messina subsequently revealed that Livent's accountants were common targets of verbal abuse by Drabinsky and other Livent executives. "They [Livent's accountants] were told on a very regular basis that they are paid to keep their [expletive] mouths shut and do as they are [expletive] told. They are not paid to think."⁶

Critics also charged that Drabinsky failed to live up to his pledge of bringing a disciplined style of corporate management to Broadway. In reality, Drabinsky was anything but disciplined in managing Livent's finances. Because he demanded that the company's live productions be "motion-picture perfect," most of Livent's shows, particularly those that were box-office successes, incurred huge cost overruns. By 1998, Livent was

3. Drabinsky and Gottlieb's company was not affiliated with the California-based Live Entertainment, Inc. Jose Menendez organized the latter company in 1988 but was murdered along with his wife, Kitty, in August 1989. In one of the many "trials of the century," the Menendez's sons, Lyle and Erik, were subsequently convicted of murdering their parents.

4. K. Noble, "The Comeback King: Garth Drabinsky Is Back, and Creating a Lot of Showbiz Buzz," *MacLean's* (online), 4 June 2001.

5. M. Potter and T. Van Alphen, "Livent Charges \$7.5 Million Kickback Scam," *Toronto Star* (online), 19 November 1998.

6. *Profit*, "Backstage at Livent," May 1999, 29.

buckling under the huge load of debt Drabinsky had incurred to finance the company's lavish productions. In early 1998, Roy Furman, a Wall Street investment banker and close friend, persuaded Drabinsky to accept a \$20 million investment from former Disney executive Michael Ovitz to alleviate Livent's financial problems. A condition of Ovitz's investment was that he be granted sufficient common stock voting rights to allow him to control the company's board of directors.

During the 1980s, Ovitz had reigned as Hollywood's top talent agent. When he became chairman of the Creative Artists Agency, show business periodicals tagged him with the title of "Hollywood's most powerful man." In late 1995, Disney chief executive officer (CEO) Michael Eisner chose Ovitz to serve as his top lieutenant and gave him the title of company president. A little more than one year later, repeated personality clashes between the two Hollywood heavyweights resulted in Eisner dismissing Ovitz. No doubt, Ovitz hoped that Livent would provide him with an opportunity to refurbish his reputation in the entertainment industry, a reputation that had been tarnished during his brief and turbulent stint with Disney. Just as important, taking control of Livent would allow Ovitz to compete head-to-head with his former boss. At the time, Disney's *The Lion King* was a colossal hit on Broadway.

Before agreeing to invest in Livent, the cautious Ovitz retained the Big Five accounting firm KPMG to scrutinize the company's accounting records. After KPMG's "due diligence" investigation yielded a clean bill of health for Livent, Ovitz became the company's largest stockholder in early June of 1998 and took over effective control of the company. Ovitz took a seat on the company's board and became chairman of the board's executive committee, while Furman assumed Drabinsky's former titles of chairman of the board and CEO. Drabinsky was given the titles of vice chairman and chief creative director. In the latter role, Drabinsky continued to oversee the all-important creative facets of Livent's operations. To provide a second opinion on artistic matters, Ovitz appointed the noted producer and songwriter Quincy Jones to Livent's board.

Ovitz also demoted Myron Gottlieb to a vice president position. A former Disney executive who left that company along with Ovitz assumed Gottlieb's former position as Livent's president. Among other changes that Ovitz made in Livent's corporate management structure was the hiring of former KPMG audit partner Robert Webster to serve as an executive vice president of the company. Webster, who had supervised KPMG's due diligence investigation of Livent's accounting records, was given a broad range of responsibilities, but his principal role was to monitor Livent's accounting and finance functions for Ovitz's new management team.

Webster's Summer of Discontent

Like Maria Messina, Robert Webster quickly discovered that the work environment within Livent was much less than ideal. After joining Livent in the early summer of 1998, Webster found that the accounting staff, including Messina, who remained Livent's CFO, was reluctant to discuss accounting matters with him. Webster later testified that some of the Livent accountants "told him that Mr. Drabinsky had warned them not to provide certain financial information until [Drabinsky] had reviewed and approved it."⁷ Even more troubling to Webster was Drabinsky's management style. Webster testified that, "I had never before experienced anyone with Drabinsky's

7. M. Petersen, "The Roar of the Accountants: The Strange Last Days of a Theater Impresario's Reign," *New York Times* (online), 10 October 1998.

abusive and profane management style.”⁸ He was shocked to find that Livent’s executives often screamed and swore at the company’s accountants. Webster reported that after meeting with Drabinsky, Livent’s accountants were often in tears or even nauseated. Following one such meeting, Webster recalled Messina “shaking like a leaf.”⁹

When Webster demanded that Livent’s accountants provide him with unrestricted access to the company’s accounting records, the former KPMG partner became the target of Drabinsky’s wrath. Drabinsky accused Webster of attempting to “tear the company” apart with his persistent inquiries and told him that he was there to “service his [Drabinsky’s] requirements.”¹⁰ Webster refused to be deterred by Drabinsky’s bullying tactics. In early August 1998, after Webster began asking questions regarding a suspicious transaction he had uncovered, Messina and four of her subordinates secretly met with him. The five accountants admitted to Webster that Livent’s accounting records had been distorted by a series of fraudulent schemes initiated and coordinated by Drabinsky and other top Livent executives.

Webster relayed the disturbing revelations to Livent’s board. On 11 August 1998, Roy Furman issued a press release announcing that “significant financial irregularities” adversely affecting Livent’s financial statements for the past three years had been discovered. The press release also indicated that Drabinsky and Gottlieb had been indefinitely suspended pending the outcome of a forensic investigation by KPMG. During the fall of 1998, company officials issued successive press releases suggesting that the impact of the accounting irregularities would be more severe than initially thought. Adding to Livent’s problems was the suspension of all trading in the company’s stock and a series of large class-action lawsuits filed against the company and its officers. In August 1998 alone, 12 such lawsuits were filed.

On 18 November 1998, Livent’s board announced that KPMG’s forensic investigation had revealed “massive, systematic, accounting irregularities that permeated the company.”¹¹ The press release issued by Livent’s board also disclosed that Deloitte & Touche had withdrawn its audit opinions on the company’s 1995–1997 financial statements. Finally, the press release reported that Drabinsky and Gottlieb had been dismissed and that Livent had simultaneously filed for bankruptcy in Canada and the United States. A few weeks later, a federal grand jury in New York issued a 16-count fraud indictment against Drabinsky and Gottlieb. When the former Livent executives failed to appear for a preliminary court hearing, a U.S. federal judge issued arrest warrants for the two Canadian citizens and initiated extradition proceedings.

A “Pervasive and Multifaceted” Fraud

Details of the fraud allegedly conceived by Garth Drabinsky and Myron Gottlieb were eventually revealed to the public by the SEC, the Ontario Securities Commission—a Canadian agency comparable to the SEC, and publicly available records of various court proceedings in civil lawsuits. In numerous enforcement and litigation releases, SEC officials repeatedly used the descriptive phrase “pervasive and multifaceted” when referring to the Livent fraud. One of the earliest elements of the fraud was a large kickback scheme.

8. A. Clark, “An Epic from Livent: Executive Accuses Drabinsky of Bullying Tactics,” *MacLean’s* (online), 1 March 1999.

9. *Ibid.*

10. *Ibid.*

11. *In re Livent, Inc. Noteholders Securities Litigation*, 151 F. Supp. 2d 371 (2001).

"As early as 1990, and continuing through 1994, Drabinsky and Gottlieb operated a kickback scheme with two Livent vendors designed to siphon millions of dollars from the company directly into their own pockets."¹² Gottlieb reportedly instructed the two vendors to include in the invoices that they submitted to Livent charges for services that they had not provided to the company. After Livent paid the inflated invoice amounts, Drabinsky and Gottlieb received kickbacks equal to the payments for the bogus services. According to the SEC, over a four-year period in the 1990s, Drabinsky and Gottlieb received approximately \$7 million in kickbacks from the two Livent vendors. The fake charges billed to Livent by the vendors were capitalized in "preproduction" cost accounts for the various shows being developed by the company. Legitimate costs charged to those accounts included expenditures to produce sets and costumes for new shows, costs that were amortized over a maximum period of five years.

By the mid-1990s, the kickback scheme and large losses being registered by several of Livent's plays made it increasingly difficult for the company to achieve quarterly earnings targets that Drabinsky and Gottlieb had relayed to Wall Street analysts. The two conspirators realized that if Livent failed to reach those earnings targets, the company's credit rating and stock price would fall, jeopardizing the company's ability to raise the additional capital needed to sustain its operations. Faced with these circumstances, the SEC reported that beginning in 1994 Drabinsky and Gottlieb directed Livent's accounting staff to engage in an array of "accounting manipulations" to obscure the company's financial problems.

These manipulations included such blatant subterfuges as simply erasing from the accounting records previously recorded expenses and liabilities at the end of each quarter. A particularly popular accounting scam within Livent involved the transfer of preproduction costs from a show that was running to a show still in production. Such transfers allowed the company to defer, sometimes indefinitely, the amortization of those major cost items. To further reduce the periodic amortization charges for preproduction costs, Livent's accountants began charging such costs to various fixed asset accounts. These assets were typically depreciated over 40 years, compared with the five-year amortization period for preproduction costs. Eventually, the company's accountants began debiting salary expenses and other common operating expenses to long-term fixed asset accounts.

The SEC estimated that the accounting manipulations understated Livent's expenses by more than \$30 million in the mid-1990s. Despite the resulting favorable impact on Livent's financial statements, Drabinsky and Gottlieb eventually realized that additional efforts were needed to embellish the company's financial data. So, beginning in 1996, Drabinsky and Gottlieb organized and carried out what the SEC referred to as a "fraudulent revenue-generating" scheme.

This new scam involved several multimillion-dollar transactions arranged by Drabinsky and Gottlieb. The specific details of these transactions varied somewhat, but most of them involved the sale of production rights owned by Livent to third parties. For example, Livent sold the rights to produce *Ragtime* and *Show Boat* in various U.S. theaters to a Texas-based company. The contract for this transaction indicated that the \$11.2 million fee paid to Livent by the Texas company was not refundable under any circumstances. However, a secret side agreement arranged by Livent's executives shielded the Texas company from any loss on this deal and, in fact, guaranteed it a reasonable rate of return on its large investment. Despite the considerable

12. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1095*, 19 May 1999.

uncertainty regarding the actual profit, if any, that would ultimately be earned on this and similar transactions, Livent's accounting staff included at least \$34 million of revenues on those transactions in the company's 1996 and 1997 income statements.

A final Livent scam documented by the SEC involved inflating reported box-office results for key productions. In late 1997, Livent opened *Ragtime* in a Los Angeles theater. The agreement with that theater allowed it to close the show if weekly ticket sales fell below \$500,000. Livent's executives planned to open *Ragtime* on Broadway in January 1998. Those executives realized that if the show fared poorly in Los Angeles, its Broadway opening could be jeopardized. To inflate *Ragtime's* ticket sales during its Los Angeles run, Livent executives arranged to have two of the company's vendors—the same individuals involved in the fraudulent kickback scheme alluded to previously—purchase several hundred thousand dollars of tickets to the show. Livent reimbursed the vendors for these ticket purchases and charged the payments to various fixed asset accounts.

The fraudulent schemes engineered by Livent's executives caused the company's periodic financial statements to be grossly misrepresented. For example, in 1992, the company reported a pretax profit of \$2.9 million when the actual figure was approximately \$100,000. Four years later, Livent reported a pretax profit of \$14.2 million, when it actually incurred a loss of more than \$20 million. By 1997, the company's total fixed assets of \$200.8 million were overstated by nearly \$24 million due to the various accounting schemes.

SEC officials found two features of the Livent fraud particularly disturbing. As the scope of the fraud steadily grew throughout the 1990s, the company's accounting staff found it increasingly difficult to provide meaningful financial data to top management. "Because of the sheer magnitude and dollar amount of the manipulations, it became necessary for senior management to be able to track both the real and the phony numbers."¹³ Gordon Eckstein, the company's senior vice president of finance and administration and Maria Messina's immediate superior, allegedly instructed a subordinate to develop computer software that would solve this problem. This software could be used to filter the bogus data out of the company's accounting records. The secret software also served a second purpose, namely, allowing Livent's accountants to record fraudulent transactions "without leaving a paper trail that Livent's outside auditors might stumble across."¹⁴ The accountants processed in a batch mode the fraudulent changes in the accounting records demanded by Livent's executives. When these so-called "adjustments" were processed, they replaced the initial journal entries for the given transactions, making the adjustments appear as if they were the original transactions, thus duping the company's Deloitte auditors.

The second extremely troubling feature of the Livent fraud, according to the SEC, was the matter-of-fact manner in which the company's management team organized and carried out the fraud. Reportedly, Drabinsky, Gottlieb, and Robert Topol, Livent's chief operating officer (COO), regularly met with Eckstein, Messina, and other members of the company's accounting staff to discuss the details of the fraud. At these meetings, the three top executives reviewed preliminary financial reports prepared by the accounting staff and instructed the accountants on the "adjustments" needed to improve or embellish those reports. As suggested earlier, Livent's top executives relied on coercion and intimidation to browbeat their accountants, including Messina, into accepting these illicit changes. Once the adjustments were processed,

13. *Ibid.*

14. M. A. Hiltzik and J. Bates, "U.S. Indicts Stage Producer Drabinsky," *Los Angeles Times* (online), 14 January 1999.

“the bogus numbers were presented to Livent’s audit committee, the auditors, investors, and eventually filed with the Commission [SEC].”¹⁵

Keeping the Auditors in the Dark

Press reports of a large accounting fraud involving a public company often prompt scathing criticism of the company’s independent audit firm. The disclosure of the Livent fraud in the late summer and fall of 1998 caused Deloitte & Touche to become a target of such criticism. A Canadian financial analyst observed that investors depend on auditors to clamp down on their clients and force them to prepare reliable financial reports. “They [auditors] are the only ones in a position to question the policies, to question the numbers, to make sure they’re right.”¹⁶

Critics could readily point to several red flags or fraud risk factors during Deloitte’s tenure with Livent that should have placed the accounting firm on high alert regarding the possible existence of financial statement misrepresentations. Among those factors were an extremely aggressive, growth-oriented management team; a history of prior financial reporting indiscretions by Drabinsky and Gottlieb; a constant and growing need for additional capital; and the existence of related-party transactions. Regarding the latter factor, several of Livent’s fraudulent “revenue-generating transactions” that were documented by the SEC involved companies or corporate executives affiliated with Livent or its management team.

In Deloitte’s defense, a massive collusive fraud that involves a client’s top executives and the active participation of its accountants is difficult to detect. Making matters worse for Deloitte was the contemptuous attitude that Livent’s executives had toward independent auditors. At one point, a top Livent officer told a subordinate that independent auditors were a “necessary evil and that it was no one’s business how they [Livent’s executives] ran their company.”¹⁷ Also complicating the Livent audits for Deloitte was the fact Maria Messina and Christopher Craib, two former members of the Livent audit engagement team, had accepted key accounting positions with the company. The personal relationships the auditors had with Messina and Craib may have impaired their objectivity during the Livent engagements.

Christopher Craib replaced Maria Messina as the audit manager assigned to the Livent audit engagement team following Messina’s promotion to partner in 1995. After the 1996 audit was completed, Drabinsky hired Craib to serve as Livent’s senior controller for budgeting. Not long after joining Livent, Craib, a chartered accountant, became involved in the ongoing effort to segregate Livent’s “real” accounting data from its bogus data. In subsequent testimony, Craib recalled meeting with Gordon Eckstein to discuss Livent’s schizoid accounting system. Eckstein explained to Craib why it was imperative to track both the real and bogus accounting data: “I have to keep all the lies straight. I have to know what lies I’m telling these people [outside auditors]. I’ve told so many lies to different people I have to make sure they all make sense.”¹⁸

Like Craib, Maria Messina realized that concealing the Livent fraud from the Deloitte auditors was among her primary responsibilities. During a meeting shortly after Messina joined Livent, she became aware of the adversarial attitude that Livent’s top executives had toward the company’s independent auditors. During this meeting,

15. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1095*.

16. J. McCarten, “Auditors Taking the Heat after Financial Scandals,” *Toronto Star* (online), 18 August 1998.

17. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1096*, 19 May 1999.

18. *Ibid.*

Topol became angry when Messina raised an issue involving what documents to turn over to Deloitte. Topol responded with an angry outburst. “[Expletive] you and your auditors.... I don’t care what they see or don’t see.”¹⁹

Despite the efforts of Livent officials to sabotage their independent audits, the company’s Deloitte auditors focused considerable attention on several suspicious transactions that they uncovered. The Deloitte auditors became increasingly skeptical of Livent’s accounting records in 1996 and 1997 when Drabinsky and his colleagues were scrambling to conceal the deteriorating financial condition of their company while, at the same time, attempting to raise much needed debt and equity capital.

Near the end of the 1996 audit, Deloitte & Touche LLP, the U.S.-based branch of the firm, initially refused to allow its Canadian affiliate to issue an unqualified audit opinion on Livent’s financial statements that were to be filed with the SEC. Deloitte’s top technical partners in the United States believed that Livent had been much too aggressive in recognizing revenue on a few large transactions—transactions that, unknown to partners of both the firm’s Canadian and U.S. affiliates, included fraudulent elements. After a series of meetings between Livent officials and representatives of Deloitte & Touche LLP, a compromise was reached. Livent agreed to defer the recognition of revenue on one of the two large transactions in question until 1997. In return, Deloitte allowed the company to record the full amount of the revenue for the other disputed transaction.

During 1997, a major transaction with a real estate firm triggered another conflict between Deloitte and Livent management. In the second quarter of that year, the real estate firm purchased for \$7.4 million the development rights to a valuable parcel of land owned by Livent. The contract between the two companies included a stipulation or “put agreement” allowing the real estate firm to cancel the transaction prior to the date that it began developing the property. When the Deloitte audit engagement partner learned of the put agreement, he insisted that no revenue could be recorded for the transaction. Complicating matters was the fact that the transaction involved a related party since Myron Gottlieb served on the board of directors of the real estate firm’s parent company.

To quell the audit partner’s concern, Gottlieb arranged to have an executive of the real estate firm send the partner a letter indicating that the put agreement had been cancelled—which it had not. After receiving the letter, the Deloitte partner told Gottlieb that the revenue resulting from the transaction could be recorded during Livent’s third quarter when the put agreement had allegedly been cancelled. At this point, a frustrated Gottlieb ignored the partner’s decision and included the disputed revenue in Livent’s earnings press release for the second quarter of 1997.

When Deloitte officials learned of the press release, they demanded a meeting with Livent’s board of directors. At this meeting, Deloitte threatened to resign. After considerable discussion, Livent’s board and the Deloitte representatives reached a compromise. According to a subsequent legal transcript, the board agreed to reverse the journal entry for the \$7.4 million transaction in the second quarter, recording it instead during the third quarter. The board also agreed to issue an amended earnings release for the second quarter. In exchange for these concessions, Deloitte officials purportedly agreed to allow Livent to reverse certain accrued liabilities that had been recorded at the end of the second quarter. The reversal of those accrued liabilities and the corresponding expenses reduced by approximately 20 percent the profit

19. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1097*, 19 May 1999.

“correction” reported by Livent in the amended earnings press release for the second quarter.²⁰

Another serious disagreement arose between Livent executives and Deloitte auditors shortly after the dispute just described was resolved. During the third quarter of 1997, Livent’s management arranged to sell for \$12.5 million the naming rights for one of its existing theaters and a new theater that the company was planning to build. Neither Maria Messina nor the Deloitte auditors assigned to the Livent engagement believed that the \$12.5 million payment should be recorded immediately as revenue since the contract between Livent and the other party, AT&T, was strictly an oral agreement at the time and since one of the theaters was yet to be built. Gottlieb retained Ernst & Young (E&Y) to review the matter.

The report E&Y submitted to Gottlieb did not take a firm position on the revenue recognition issue. Instead, E&Y’s report simply suggested that the \$12.5 million payment for the naming rights could be “considered” for recording during the third quarter. After receiving a copy of E&Y’s report, Deloitte hired Price Waterhouse to review the transaction. When Price Waterhouse reached the same conclusion as E&Y, Deloitte allowed Livent to book the \$12.5 million as revenue during the third quarter.

Don’t Blame Me, Blame...

Resolving the legal implications of a major accounting and financial reporting fraud can require years. However, one Canadian journalist suggested that in the Livent case the legal wrangling could continue even longer, possibly for decades.²¹ From its inception, a key factor complicating the resolution of this case was its “cross-border” nature.

Beginning in late 1998, officials from several federal agencies in Canada and the United States became embroiled in a tedious and often contentious struggle to determine which agency would be the first to prosecute the key parties involved in the Livent fraud. Those agencies included the Royal Canadian Mounted Police, the Ontario Securities Commission, the SEC, and the U.S. Department of Justice, among others. Law enforcement authorities in the United States failed to win the cooperation of their Canadian counterparts in attempting to extradite Garth Drabinsky and Myron Gottlieb to face a series of federal fraud charges filed against them in U.S. courts. Even more frustrating to U.S. authorities was the snail’s pace at which Canadian authorities moved in pursuing legal action against the two alleged fraudsters.

While Canadian and U.S. law enforcement authorities tangled over jurisdictional matters, the leading actors in the final Livent “production” waged a public relations war against each other in major metropolitan newspapers and in the courts. Drabinsky and Gottlieb were the most vocal of these individuals. They repeatedly insisted that they were not responsible for the various fraudulent schemes that had been uncovered within Livent. At a press conference held in early 1999, Drabinsky suggested that he had been too busy overseeing Livent’s creative operations to become involved in any creative bookkeeping.²² In his typical Shakespearean manner, Drabinsky declared: “The final act of this tragedy has yet to be played out

20. *In re Livent, Inc. Noteholders Securities Litigation*. As a point of information, this legal transcript did not include any commentary from Deloitte’s perspective regarding the nature and outcome of these negotiations.

21. Noble, “The Comeback King.”

22. M. Lewycky, “Livent’s Accounting Designed to Deceive,” *Toronto Sun* (online), 15 January 1999.

and, when it is, Myron Gottlieb and I have complete confidence that we will be vindicated."²³

In January 1999, Myron Gottlieb filed a civil lawsuit against Maria Messina, Christopher Craib, Gordon Eckstein, and three other former Livent accountants; the lawsuit charged those six individuals with responsibility for the Livent accounting fraud. In court documents filed with this lawsuit, Gottlieb alleged that he was not "an expert on accounting practices" and that he had relied on Livent's accounting staff to ensure that the company's financial statements were accurate.²⁴ In responding to that lawsuit, the six named defendants, with the exception of Eckstein, claimed that they had been coerced into participating in the fraud by its principal architects.²⁵ These defendants also rejected Gottlieb's assertion that he was unfamiliar with accounting practices. "Gottlieb was and remains an experienced businessman with a sophisticated and comprehensive grasp of accounting and auditing issues and intimate knowledge of the details of Livent's accounting practices."²⁶

When Eckstein eventually responded to Gottlieb's lawsuit, he charged the Livent cofounder with being a key architect of the accounting fraud.²⁷ Eckstein also insisted that Maria Messina had played a key role in the fraudulent scheme. In particular, Eckstein claimed that Messina had used her relationship with the Deloitte auditors to ensure that they approved Livent's fraudulent financial statements.²⁸

Messina answered Eckstein and other critics by maintaining that she had attempted to dissuade Livent's executives from using accounting gimmicks to boost the company's revenues and profits. She insisted that she had "begged" her former colleagues at Deloitte to crack down on the aggressive revenue recognition policies being used by Livent's management.²⁹ To support her claim that she had not been a willing member of the Livent conspiracy, Messina pointed out that she had refused to sign the letters of representations for the 1996 and 1997 audits, each of which indicated that there were no material inaccuracies in Livent's financial statements. In fact, near the end of the 1997 audit, Messina had redrafted Deloitte's preformatted letter of representations to remove her name from it.³⁰

After firing Drabinsky and Gottlieb, Michael Ovitz and the members of the new management team he installed at Livent in June 1998 sued the company's cofounders for \$325 million for their alleged role in the fraudulent accounting schemes. That lawsuit prompted Drabinsky and Gottlieb to file a \$200 million defamation-of-character lawsuit against Ovitz and his colleagues.

In September 1998, Drabinsky sued KPMG, the accounting firm that Ovitz had retained to perform a due diligence investigation earlier in the year and the firm retained by Livent's board of directors in August 1998 to investigate the charges of

23. C. Brodesser and M. Peers, "U.S. Indicts Duo in Liventgate," *Variety*, 18 January 1999, 137.

24. *The Gazette* (online), "Livent Co-Founder Sues 6 Employees," 19 February 1999.

25. V. Menon, "Livent Whistle-Blowers File Defence," *Toronto Star* (online), 1 April 1999.

26. B. Bouw, "Livent Employees Fight Back: 'Gottlieb to Blame,'" *National Post* (online), 1 April 1999.

27. B. Shecter, "Drabinsky's Assertions Refuted," *National Post* (online), 26 June 1999.

28. *Ibid.*

29. *Profit*, "Backstage at Livent." In a deposition filed in one of the many lawsuits triggered by the Livent fraud, Messina described Deloitte's audits of the company as "inadequate." See D. Francis, "Livent: A Bean Counter Scandal," *National Post* (online), 10 May 2001.

30. In a court document, Messina reported that she did not reveal the various Livent fraudulent schemes prior to August 1998 because she feared Drabinsky and Gottlieb and because she believed that she would be "implicated by association." See B. Bouw, "Livent Employees Fight Back: 'Gottlieb to Blame,'" *National Post* (online), 1 April 1999.

accounting irregularities revealed by Maria Messina and her subordinates. That lawsuit, which requested damages of more than \$26 million, was predicated on the fact that Drabinsky had been a client of KPMG over the past two decades. Drabinsky charged that by agreeing to perform the forensic audit requested by Livent's board in August 1998, KPMG had placed itself in a conflict of interest between two clients.³¹

Deloitte & Touche was a primary target of the various plaintiffs attempting to hold someone responsible for the Livent debacle and the resulting financial losses. In December 1999, a U.S. federal judge dismissed Deloitte as a defendant in one of those lawsuits filed by Livent's former stockholders. The judge concluded that the plaintiffs had not made a reasonable argument that Deloitte was at least "reckless" in auditing Livent. For lawsuits filed under the Securities and Exchange Act of 1934, as amended by the Private Securities Litigation Reform Act (PSLRA) of 1995, plaintiffs must allege or "plead" that the given defendant was at least "reckless."

In another class-action lawsuit filed by Livent creditors, a federal judge ruled in June 2001 that the plaintiffs had met the pleading standard of recklessness, meaning that the lawsuit could proceed. This judge observed that Livent's "accounting manipulations" were so flagrant that there was a reasonable likelihood Deloitte was reckless in failing to discover them. "Deloitte & Touche's actions and omissions in connection with Livent's manipulations of its books and records display acquiescence and passivity that, in this Court's reading of the pleadings, cross over the boundary of ordinary breaches of reasonable care into the zone of recklessness."³² Published reports indicate that Deloitte & Touche was dropped as a defendant in this case after it agreed to pay \$5.5 million to a restitution fund established for Livent's former creditors.

EPILOGUE

As predicted, Canadian law enforcement authorities were extremely methodical in pursuing their investigation and prosecution of Garth Drabinsky, Myron Gottlieb, and the other key individuals involved in the Livent scandal. In late 2002, the Royal Mounted Canadian Police finally filed a fraud indictment against Drabinsky and Gottlieb that contained 19 individual charges. Five years later, Gordon Eckstein pleaded guilty to one count of fraud and agreed to testify against Drabinsky and Gottlieb. Eckstein's testimony and the testimony of Maria Messina would prove to be pivotal evidence in the 11-month

long criminal trial of Drabinsky and Gottlieb. That trial ended in late March 2009 with both Drabinsky and Gottlieb being convicted of fraud and forgery.

The Canadian judge who presided over the lengthy trial rejected Drabinsky and Gottlieb's principal argument that they had been unaware of the massive accounting fraud and that it had been orchestrated by their subordinates. In handing down her verdict, the judge concluded that the two executives "had initiated the improper accounting system" that had "systemically manipulated" Livent's reported operating results and financial condition.^{33,34}

31. Drabinsky and KPMG ultimately settled this lawsuit out of court. Although the settlement's financial terms were not disclosed, KPMG acknowledged that it had breached its "fiduciary duty" to Drabinsky by agreeing to perform the forensic audit requested by Livent's board.

32. *In re Livent, Inc. Noteholders Securities Litigation*.

33. *Reuters* (online), "Former Broadway Impresario Drabinsky Found Guilty," 25 March 2009.

34. Robert Topol, Livent's former COO, had faced charges similar to those for which Drabinsky and Gottlieb were prosecuted. However, those charges were dismissed in 2008 when his attorneys convinced the judge that he had been denied his right to a speedy trial.

In August 2009, the judge sentenced Drabinsky and Gottlieb to prison sentences of seven years and six years, respectively.

Drabinsky and Gottlieb lost the appeals of their convictions, but the appellate court reduced their prison sentences to five years and four years, respectively. The two men began serving their sentences in 2011. After serving approximately one-third of his sentence, Gottlieb was paroled in early 2013. After serving 17 months of his sentence, Drabinsky received a "day parole" in February 2013, meaning that he would be free to leave the halfway house where he was serving his sentence during daytime hours but would be required to return to that facility each night. Drabinsky was expected to receive a full parole in early 2014. The double jeopardy provisions in Canada's criminal statutes prevented the two men from being extradited to the United States where they would be subject to prosecution for the same crimes for which they had been convicted in Canada.

In July 1999, SFX Entertainment purchased the remaining assets of Livent, ending the company's dramatic and turbulent existence after only 10 years. In June 2000, the disciplinary committee of the Institute of Chartered Accountants of Ontario (ICAO) sanctioned the former Livent accountants who had publicly admitted some degree of involvement in the Livent fraud. Maria Messina, who pleaded guilty to three charges of professional misconduct, was fined \$7,500 and suspended from practicing as a chartered accountant for two years. Christopher Craib received a six-month suspension and a \$1,000 fine.

In 2007, the ICAO found three of the Deloitte auditors who had been assigned to the 1997 Livent audit engagement team guilty of professional misconduct, publicly reprimanded them, and levied fines against them and Deloitte totaling \$1.55 million. In early 2010, a Canadian appellate court overturned those sanctions. The court ruled that the ICAO had failed to prove that the Deloitte auditors were guilty of a "significant departure" from professional standards during the 1997 Livent audit.

The SEC sanctioned Craib and three other Livent accountants who had confessed to some role in the Livent accounting fraud. Craib received a three-year suspension from practicing before the SEC. During the criminal trial of Drabinsky and Gottlieb, their defense attorneys revealed that Maria Messina was being paid \$325,000 annually by Livent's bankruptcy receiver to testify in the various Livent-related lawsuits. Those attorneys also reported that law enforcement authorities in the United States had privately agreed to drop all charges against Messina if Drabinsky and Gottlieb were ultimately sent to prison. Subsequent to the imprisonment of Drabinsky and Gottlieb, neither the SEC nor the U.S. Justice Department has publicly commented on Messina's status. In 1999, after pleading guilty to violating U.S. federal securities laws, Messina's sentencing had been delayed pending the resolution of the criminal charges filed against Drabinsky and Gottlieb.

The criminal convictions and subsequent imprisonment of Drabinsky and Gottlieb did not end the long-running Livent legal ordeal. As of late 2013, a \$450 million civil lawsuit against Deloitte stemming from the firm's Livent audits was still in process in a Toronto court.

Questions

1. Identify common inherent risk factors that companies involved in the entertainment industry pose for their independent auditors. List and briefly describe specific audit procedures that would not be used on "typical" audit engagements but would be required for audits of companies involved in live theatrical productions, such as Livent.
2. Compare and contrast the responsibilities of an audit partner of a major accounting firm with those of a large public company's CFO. Which work role do you believe is more important? Which is more stressful? Which role would you prefer and why?

3. Explain why some corporate executives may perceive that their independent auditors are a "necessary evil." How can auditors combat or change that attitude?
4. When auditor–client disputes arise during an audit engagement, another accounting firm is sometimes retained by the client and/or the existing auditor to provide an objective report on the issue at the center of the dispute—as happened during Deloitte’s 1997 audit of Livent. Discuss an accounting firm’s responsibilities when it is retained to issue such a report.
5. Do you believe Deloitte & Touche should have approved Livent’s decision to record the \$12.5 million "naming rights" payment as revenue during the third quarter of 1997? Defend your answer. What broad accounting concepts should be considered in determining the proper accounting treatment for such transactions?
6. Maria Messina testified that when she learned of the accounting irregularities at Livent shortly after becoming the company’s CFO she felt "guilty by association," which prevented her from revealing the fraud to regulatory or law enforcement authorities. Explain what you believe she meant by that statement. Place yourself in Messina’s position. What would you have done after discovering the fraudulent schemes affecting Livent’s accounting records?
7. What professional standards apply to "due diligence" investigations performed by accounting firms?