

## CASE 8.1

# Longtop Financial Technologies Limited

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In 1996, two friends and business partners, Jia Xiao Gong and Weizhou Lian, founded Longtop Financial Technologies Limited in Beijing. Gong served as Longtop's chairman of the board, while Lian assumed the title of chief executive officer (CEO). The two men developed a business model intended to make Longtop the leading provider of information technology services to the booming banking industry of the People's Republic of China. China's "Big Four" banks dominate the nation's banking industry. In turn, the powerful Ministry of Finance, the government agency that oversees China's economic and fiscal policies, controls the Big Four banks.

By 2010, Longtop had achieved its goal of becoming the leading provider of information technology services to China's banking industry, including three of the nation's Big Four banks. The company's audited financial statements for fiscal 2010 reported a \$59 million profit, total revenues of \$169 million, and net assets of \$600 million. Although modest by U.S. standards, Longtop's profits, revenues, and net assets were growing rapidly and were expected to continue to do so over the years to come. Similar to the previous five years, Deloitte & Touche Shanghai (D & T Shanghai), the Chinese affiliate of U.S.-based Deloitte Touche Tohmatsu, issued an unqualified audit opinion on Longtop's 2010 financial statements.

### "Faked" Cash and Red-Faced Auditors

The rapidly expanding Chinese economy has captured the attention of investors worldwide over the past two decades. Companies such as Longtop sought to capitalize on the growing interest in the Chinese economy by listing their securities on international stock exchanges, including the leading exchanges in the United States.

In October 2007, Longtop went public with an initial public offering (IPO) managed by Goldman Sachs and Deutsche Bank. The company's common stock, which was listed on the New York Stock Exchange (NYSE), nearly doubled in price during its first day of trading. By late 2010, Longtop's stock had a total market value of \$2.5 billion. Similar to the more than 200 other Chinese companies whose securities have traded on U.S. stock exchanges, Longtop became subject to the regulatory oversight of the Securities and Exchange Commission (SEC) when it listed its common stock on the NYSE.

In the late spring of 2011, Longtop was rocked by allegations that management had recorded bogus revenues to inflate the company's reported operating results and financial condition. Those allegations surfaced just as D & T Shanghai was nearing completion of its Longtop audit for the company's 2011 fiscal year, which ended 31 March 2011.

The source of the claims of fraudulent accounting was a small U.S.-based investment advisory firm that specializes in exposing companies that are "cooking their books." Among other allegations, that firm maintained that much, if not most, of the more than \$400 million of cash reported in Longtop's preaudit 2011 financial statements—which accounted for almost 60 percent of the company's total assets—did not exist.

D & T Shanghai responded to the allegations of the investment advisory firm by extending its audit of Longtop's 2011 financial statements. In particular, the audit firm

decided to revisit the audit procedures that had been applied to the company's cash accounts. In the past, the principal evidence the auditors had collected to corroborate Longtop's cash balances had been confirmations obtained from local branches of the company's banks.

On 17 May 2011, D & T Shanghai attempted to confirm Longtop's 2011 year-end cash balances by contacting the headquarters offices of the company's banks. Those extended cash confirmation tests were abruptly halted by Longtop officials, as reported by the *New York Times*.

*"Within hours" of beginning the new round of confirmations on May 17, the confirmation process was stopped . . . the result of "intervention by the company's officials, including the chief operating officer" . . . Despite the company's efforts, Deloitte learned that Longtop did not have the cash it claimed and that there were "significant bank borrowings" not reflected in the company's books.<sup>1</sup>*

A few days following D & T Shanghai's aborted attempt to reconfirm Longtop's cash balances, Jia Xiao Gong admitted to a partner of that firm that the company had "faked" cash and revenues in its financial statements. That admission prompted D & T Shanghai to resign as Longtop's auditor. Exhibit 1 presents the resignation letter that D & T Shanghai sent to Longtop's audit committee and filed with the SEC on 22 May 2011.

**EXHIBIT 1**  
DELOITTE  
RESIGNATION  
LETTER

22 May 2011

The Audit Committee  
Longtop Financial Technologies Limited  
No. 61 Wanghai Road, Xiamen Software Park  
Xiamen, Fujian Province  
People's Republic of China

Attention: Mr. Thomas Gurnee, Chairman of the Audit Committee

Dear Sirs:

**Longtop Financial Technologies Limited (the "Company") and together with its subsidiaries (the "Group") Audit for the Year Ended 31 March 2011**

We hereby give you formal notice of our resignation as auditor of the Company.

**Background and significant issues encountered by Deloitte Touche Tohmatsu CPA Ltd. (China) ("Deloitte")**

As part of the process for auditing the Company's financial statements for the year ended 31 March 2011, we determined that, in regard to bank confirmations, it was appropriate to perform follow-up visits to certain banks. These audit steps were recently performed and identified a number of very serious defects including: statements by bank staff that their bank had no record of certain transactions; confirmation replies previously received were said to be false; significant differences in deposit balances reported by the bank staff compared with the amounts identified in previously received confirmations (and in the books and records of the Group); and significant bank borrowings reported by bank staff not identified in previously received confirmations (and not recorded in the books and records of the Group).

In light of this, a formal second round of bank confirmations was initiated on 17 May. Within hours, however, as a result of intervention by the Company's officials including the Chief

1. F. Norris, "The Audacity of Chinese Frauds," *New York Times* (online), 26 May 2011.

Operating Officer, the confirmation process was stopped amid serious and troubling new developments including: calls to banks by the Company asserting that Deloitte was not their auditor; seizure by the Company's staff of second round bank confirmation documentation on bank premises; threats to stop our staff leaving the Company premises unless they allowed the Company to retain our audit files then on the premises; and then seizure by the Company of certain of our working papers.

In that connection, we must insist that you promptly return our documents.

Then on 20 May the Chairman of the Company, Mr. Jia Xiao Gong, called our Eastern Region Managing Partner, Mr. Paul Sin, and informed him in the course of their conversation "that there was fake revenue in the past so there was fake cash recorded on the books." Mr. Jia did not answer when questioned as to the extent and duration of the discrepancies. When asked who was involved, Mr. Jia answered: "senior management."

We bring these significant issues to your attention in the context of our responsibilities under Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit" issued by the American Institute of Certified Public Accountants.

### Reasons for our Resignation

The reasons for our resignation include: (1) the recently identified falsity of the Group's financial records in relation to cash at bank and loan balances (and also now seemingly in the sales revenue); (2) the deliberate interference by the management in our audit process; and (3) the unlawful detention of our audit files. These recent developments undermine our ability to rely on the representations of management which is an essential element of the audit process; hence our resignation.

### Prior periods' financial reports and our reports thereon

We have reached the conclusion that we are no longer able to place reliance on management representations in relation to prior financial reports. Accordingly, we request the Company take immediate steps to make the necessary 8-K filing to state that continuing reliance should no longer be placed on our audit reports on the previous financial statements and moreover that we decline to be associated with any of the Company's financial communications during 2010 and 2011.

### Our consent

We hereby consent to a copy of this letter being supplied to the SEC and the succeeding auditor to be appointed.

### Section 10A of the Securities Exchange Act of 1934 (U.S.)

In our view, without providing any legal conclusion, the circumstances mentioned above could constitute illegal acts for purposes of Section 10A of the Securities Exchange Act of 1934. Accordingly, we remind the Board of its obligations under Section 10A of the Securities Exchange Act, including the notice requirements to the U.S. Securities and Exchange Commission. You may consider taking legal advice on this.

Yours faithfully,  
/s/ Deloitte Touche Tohmatsu CPA Ltd.  
c.c.: The Board of Directors

Source: [www.sec.gov/Archives/edgar/data/](http://www.sec.gov/Archives/edgar/data/)

### "The Law on Guarding State Secrets"

Following D & T Shanghai's resignation, published reports from several sources, including the *New York Times*, revealed that employees of Longtop's banks had conspired with company management to conceal the company's fraudulent accounting scheme. For years, those individuals had apparently returned confirmations to D & T Shanghai that vouched for the accuracy of the company's materially overstated cash balances.

In fact, a month before resigning as Longtop's auditor, D & T Shanghai had stepped down as the auditor of China MediaExpress because of concerns regarding the reliability of cash confirmations obtained from that company's banks. A few months earlier, KPMG's Chinese affiliate reported the same concern upon resigning as the auditor of ShengdaTech. Similar to Longtop, both China MediaExpress and ShengdaTech had securities listed on U.S. stock exchanges.

Reports that Chinese banks were complicit in the Longtop accounting fraud stunned the global investment community. An Australian hedge fund official noted that, "Given the centrality of Chinese banks to the global economy ... [this] is a story much bigger than Deloitte or Longtop."<sup>2</sup>

Floyd Norris, a prominent reporter for the *New York Times*, noted that the incidents involving Longtop, China MediaExpress, and ShengdaTech raised the question of whether "defrauding foreign investors is deemed to be a serious crime in China."<sup>3</sup> Norris went on to observe that although accounting frauds and audit failures were a worldwide problem, "the audacity of these frauds, as well as the efforts to intimidate auditors, stand out."<sup>4</sup>

The SEC banned Longtop's securities from U.S. stock exchanges in December 2011. The move was largely symbolic since the company's stock was essentially worthless by that time. *Fraud Magazine* reported that Longtop was among more than two dozen China-based companies whose securities had been banned or suspended from trading on U.S. or European stock markets by late 2011 due to "accounting discrepancies," auditor resignations, or related issues.<sup>5</sup>

In June 2011, the SEC asked D & T Shanghai to turn over the Longtop workpapers that it had in its possession. The SEC believed the workpapers would provide important insights relevant to its ongoing investigation of the Longtop fraud. SEC officials were shocked when D & T Shanghai refused to provide the workpapers. A subsequent subpoena and court order obtained by the SEC failed to persuade D & T Shanghai to comply with the agency's request.

D & T Shanghai reported that it had decided not to give the workpapers to the SEC because doing so would violate an important Chinese law, the Law on Guarding State Secrets, that China's central government had enacted in 1988. According to D & T Shanghai, that law prohibits Chinese citizens and firms from providing documents or other information to foreign entities that relate to "the national economy."<sup>6</sup>

2. *Ibid.*

3. *Ibid.*

4. *Ibid.*

5. R. Hurley and T. Harvey, "Chinese Stock Investment Fraud: Separating Fact from Fiction," *Fraud Magazine*, January/February 2012, 59.

6. F. McKenna, "Deloitte Hides From SEC Behind Chinese Wall Over Longtop," *Forbes* (online), 9 September 2011.

Skeptics believed that it was highly unlikely that any "state secrets" were contained in the Longtop audit workpapers. However, an attorney of a major U.S. law firm explained to a *Wall Street Journal* reporter that the Chinese government invokes a "sufficiently broad" definition of "state secret" to routinely blunt the efforts of foreign regulatory bodies to obtain information from Chinese companies and other entities.<sup>7</sup>

### Chinese Standoff

The controversy spawned by the Longtop fraud focused greater attention on an issue that the Public Company Accounting and Oversight Board (PCAOB) had been wrestling with for years. The Sarbanes-Oxley Act of 2002 requires the PCAOB to inspect all accounting firms that audit companies that have securities traded on U.S. stock exchanges. This requirement extends to foreign accounting firms that audit such companies, including the foreign affiliates of major international accounting firms based in the United States.

Since the inception of the PCAOB in 2004, nearly 2,400 accounting firms that audit companies having securities traded on U.S. markets have registered with the agency, including more than 900 non-U.S. accounting firms from 85 countries. The latter number includes several dozen Chinese accounting firms. By late 2013, the PCAOB had yet to inspect any of those Chinese accounting firms.

Chinese government officials refused to allow the PCAOB to inspect China-based accounting firms because they insisted that their nation's "own regulatory system was adequate."<sup>8</sup> The failure of China to permit PCAOB inspections of Chinese accounting firms when coupled with the growing list of Chinese accounting scandals caused one U.S. accounting professor to question "whether Chinese companies are auditable in the current regulatory environment."<sup>9</sup>

In November 2011, Senator Charles Schumer slammed the PCAOB for allowing Chinese accounting firms to continue auditing companies with securities traded in the United States. "The board's failure to do what it was created to do—particularly in the face of Chinese corporate accounting scandals that have already cost U.S. investors billions—is deeply troubling."<sup>10</sup>

James Doty, the chairman of the PCAOB, deflected much of the criticism of his agency to the Big Four accounting firms. In particular, Chairman Doty maintained that global accounting firms needed "to improve their quality control over far-flung affiliates" such as D & T Shanghai.<sup>11</sup> Doty observed that "many people are unaware that an audit report signed by a large U.S. firm may be based largely on the work of affiliates in other countries that are completely separate legal entities."<sup>12</sup> He went on to note that in many of those instances the U.S. firms fail to review the work of their foreign affiliates.

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7. I. Steger, "How Should Auditors Handle China's State Secrets Law?" *Wall Street Journal* (online), 2 November 2011.

8. D. Aubin, "U.S. Auditor Watchdog Hopeful of Access to China," *Reuters* (online), 5 May 2011.

9. P. Gillis, "China Accounting Blog: State Secrets and Auditing," [www.chinaccountingblog.com/weblog/state-secrets-and-auditing.html](http://www.chinaccountingblog.com/weblog/state-secrets-and-auditing.html), 3 November 2011.

10. M. Rapoport, "Sen. Schumer Urges Audit Watchdog to Act on China," *Wall Street Journal* (online), 22 November 2011.

11. Aubin, "U.S. Auditor Watchdog Hopeful."

12. *Ibid.*

## EPILOGUE

In December 2012, the SEC charged the Chinese affiliates of BDO Seidman, Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers with violating the Securities Exchange Act of 1934 and the Sarbanes-Oxley Act of 2002. These charges stemmed from the refusal of those firms to comply with the SEC's request to turn over audit workpapers for selected clients that were SEC registrants. The director of the SEC's Division of Enforcement observed that "Only with access to workpapers of foreign public accounting firms can the SEC test the quality of the underlying audits and protect investors from the dangers of accounting fraud."<sup>13</sup> As of

December 2013, the charges filed against the five firms were not yet resolved.

In May 2013, the PCAOB signed a "memorandum of understanding" (MOU) with China's Ministry of Finance and another Chinese regulatory agency that established a "cooperative framework between the parties for the production and exchange of audit documents relevant to investigations in both countries' respective jurisdictions."<sup>14, 15</sup> The MOU, however, did not grant the PCAOB the right to inspect Chinese accounting firms that audit companies with securities registered on U.S. stock exchanges.

### Questions

1. What are the key conditions or circumstances that must be present for a company to be "auditable"? What uncommon challenges to "auditability" are posed by Chinese companies?
2. Do the major international accounting firms have a responsibility to ensure that their individual national practice units provide independent audit services that are uniform worldwide? Defend your answer.
3. Acme, Inc., a multinational company based in the United States, has a large subsidiary located in Beijing, China. Acme is audited by an international accounting firm headquartered in the United States; its subsidiary is audited by the Chinese affiliate of that firm. Under U.S. auditing standards, what responsibilities, if any, does Acme's U.S. audit firm have to supervise or oversee the audit of the Chinese subsidiary? Would these responsibilities be different under International Standards of Auditing?
4. What alternative strategies or approaches could U.S. regulatory agencies consider invoking to ensure that the audits of non-U.S. companies with securities traded on U.S. markets are adequate?
5. Since ethical and moral values vary from culture to culture and nation to nation, does this mean that a global profession, such as the accounting profession, cannot have a uniform ethical code? Explain.

13. U.S. Securities and Exchange Commission, "SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents," [www.sec.gov](http://www.sec.gov), 3 December 2012.

14. M. Cohn, "PCAOB Signs Enforcement Cooperation Agreement with Chinese Regulators," [www.accountingtoday.com](http://www.accountingtoday.com), 24 May 2013.

15. Although not publicly confirmed by the SEC, Chinese governmental officials reportedly turned over to the SEC certain Longtop audit workpapers in August 2013.