

Europe's Enron: Royal Ahold, N.V.

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ABSTRACT: Royal Ahold, N.V., is a large multinational company based in The Netherlands. The company's principal lines of business are grocery retailing and food wholesaling. In early 2003, Royal Ahold's independent auditors suspended their fiscal 2002 audit of the company when they discovered irregularities in the company's accounting records. Subsequent investigations documented that the company had improperly included the operating results of foreign joint ventures in its consolidated financial statements, had accounted improperly for initial acquisition costs related to several of those joint ventures, and had materially overstated promotional allowances due from company vendors. The disclosure of the massive accounting fraud resulted in criminal and civil lawsuits being filed against the company and its top executives in both Europe and the United States.

This case examines accounting, auditing, and control issues pertinent to multinational companies. In addition, the case examines recent controversies arising between and among international regulatory agencies and rule-making bodies within the accounting and auditing disciplines. Finally, the case illustrates important risk factors commonly associated with financial statement fraud.

Key Words: Fraud risk factors, Auditing multinationals, Regulatory issues

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In 1887, a young Dutchman, Albert Heijn, entered the business world by purchasing a small grocery store from his father. The store was located in Oostzaan, a village on the Dutch peninsula known as North Holland, which is also one of The Netherlands' twelve provinces. Unlike his father who was content to own and operate a small business, Albert had dreams of becoming an entrepreneur on a much larger scale. Within ten years, the frugal and hard-working Heijn owned two dozen grocery stores scattered throughout the small country.

A key to the early success of Heijn's retail grocery chain was that he designed each of his new stores to meet the specific interests and needs of the community in which it was located. For example, the merchandise stocked by Heijn stores in fishing villages was quite different from the merchandise carried by stores located in farming communities. In metropolitan areas, such as Amsterdam and The Hague, Heijn established large stores that stocked a complete range of food products and household merchandise. In fact, Heijn's company was credited with developing the supermarket concept in The Netherlands; in later years, his company popularized the convenience store format in his home country.

In the early 1900s, Heijn launched his own brand of baked products including cookies and assorted pastries that he sold in his grocery stores. Over the years to come, the company would develop a wide range of its own products that it marketed under the Albert Heijn brand. In 1973, management changed the company's name to Ahold. The following decade, Queen Beatrix awarded the title "Royal" to the company, a designation

reserved for Dutch companies that have operated continuously—and honorably—for one hundred years.¹

By the early 1990s, Royal Ahold ranked among the most prominent and respected corporations in The Netherlands. For several years during that time frame, Royal Ahold was named the most desirable employer in The Netherlands and the company with the best reputation in that nation (Kolk and Pinske 2006). The company was also well known outside of The Netherlands. In 1948, the Heijn family had taken the company public. By 2000, the company's stock was registered on stock exchanges around the world, including the New York Stock Exchange.

A financial scandal shortly after the turn of the century besmirched Royal Ahold's sterling reputation, prompted a consumer boycott of the company in The Netherlands, and resulted in many critics insisting that the Dutch royal family rescind the company's "royal" designation. In March 2003, *The Economist*, one of Europe's most prominent business publications, referred to the Royal Ahold scandal as "Europe's Enron" (*The Economist* 2003). The Royal Ahold scandal, along with the accounting fraud at the giant Italian firm Parmalat, caused the European Union (EU) to impose more extensive and rigorous regulation on the financial reporting system and independent audit function within its member nations. The Royal Ahold debacle also reignited the debate regarding the need for more uniform accounting and auditing standards around the globe.

Going Global

By the mid-1970s, Royal Ahold's management realized that for the company to continue to grow it could not limit its operations to The Netherlands since it dominated

the retail grocery market in that country. At that point, the company's top executives, who had long been known for their conservative operating and financial policies, startled the Dutch business community by announcing that Royal Ahold would expand its operations into other countries.

Royal Ahold's expansion efforts got off to a slow start but then accelerated rapidly in the 1990s after the company hired a new management team. Until the late 1980s, members of the Heijn family had occupied the key management positions within the firm. In 1987, two grandsons of Albert Heijn, Ab Heijn and Gerrit-Jan Heijn, served as Royal Ahold's two top executives. In September 1987, Gerrit-Jan Heijn was kidnapped and murdered; shortly thereafter, his older brother retired from the company.² The professional management team hired to replace the Heijn brothers recognized that the quickest way for Royal Ahold to gain significant market share in the grocery retailing industry outside of The Netherlands was to purchase existing grocery chains in foreign countries. To finance their growth-by-acquisition policy, Royal Ahold's new executives raised large amounts of debt and equity capital during the 1990s.

By 2000, Royal Ahold had purchased retail grocery chains in Asia, Eastern Europe, Latin America, Portugal, Scandinavia, South America, and the United States. This aggressive expansion campaign made Royal Ahold the third largest grocery retailer worldwide by the turn of the century. At the time, only U.S.-based Wal-Mart and the French firm Carrefour SA had larger annual retail grocery sales than Royal Ahold.

Royal Ahold completed its most ambitious acquisition in 2000 when it purchased U.S. Foodservice, a large food wholesaler headquartered in Columbia, Maryland, a suburb of Washington, D.C. Although Royal Ahold had previously purchased several

retail grocery chains along the eastern seaboard of the United States, including New England-based Stop & Shop, U.S. Foodservice was easily the largest U.S. company it had acquired. The U.S. Foodservice acquisition was also important because it signaled the company's commitment to becoming a significant participant in the food wholesaling industry.

In 2003, after purchasing two smaller U.S.-based food distributors, Royal Ahold ranked as the second largest food wholesaler in the United States—Houston-based Sysco Corporation was the largest. In fact, the three U.S. acquisitions caused food wholesaling to be the company's largest source of revenue, accounting for slightly more than one-half of its annual sales. The company's more than 4,000 retail grocery stores located in 27 countries accounted for the remainder of its annual sales.

Royal Ahold's aggressive expansion plan created significant and largely unexpected problems for the company. Among these problems was the impact that key differences in cultural norms and expectations had on the company's ability to manage its worldwide retail grocery operations. As the company entered new markets, particularly markets outside of Western Europe and the United States, it encountered a wide range of laws, regulations, and cultural nuances that had far-reaching implications for the management of retail grocery operations.

Human resource policies regarding hiring, promotion, and employee benefits that had been developed in The Netherlands were not necessarily well received by Royal Ahold's new managers and employees in Asia, Latin America, and South America. Likewise, because grocery shopping is a ritual significantly influenced by longstanding cultural norms across the globe, company officials found that customers in new markets

often did not appreciate and sometimes flatly rejected the “Dutch” way of organizing and managing a grocery store.

Particularly problematic for Royal Ahold was the staunch opposition of consumers in certain markets to the takeover of their local grocery store by an unknown foreign “invader.” Eventually, because of such problems, Royal Ahold’s executives decided that the best strategy to use in managing their foreign grocery chains was to allow most major decisions to be made by the management personnel of those chains that were typically retained when they were acquired by Royal Ahold.

The headaches that Royal Ahold encountered due to rapidly expanding into retail grocery markets around the world were compounded by the company’s decision to become a major player in the wholesaling segment of the huge food industry in the United States. Because company officials were largely unfamiliar with that segment of the industry, they applied their new hands-off mindset to that acquisition and relied almost exclusively on the executives of U.S. Foodservice who were retained following the buyout to oversee the subsidiary’s day-to-day operations.

There was one key exception to the hands-off policy that Royal Ahold adopted with respect to its foreign operations. The company’s top executives in The Netherlands insisted that foreign operating units be held to the same rigorous performance standards that were imposed on the company’s domestic operations. During the 1990s the company’s new management team established a goal of achieving a 15 percent annual growth rate in profits. That overall goal was then used by top management to establish annual earnings targets for each of the company’s operating units in The Netherlands and elsewhere.

Royal Ahold's senior management pressured mid- and lower-level managers throughout the company's worldwide network to reach the earnings goal established for their individual operating units. According to a former Royal Ahold manager, managers who met their unit's earnings target were rewarded with significant year-end bonuses. "Ahold was determined to maintain earnings growth of at least 15% annually. All of the operating units had difficult targets to meet, but the rewards [in the form of bonuses] were good if targets were met" (Raghavan et al. 2003). In retrospect, the earnings targets for many of Royal Ahold's newly-acquired operating units were unrealistic. Intense competition and the historically modest profit margins within the food industry prevented many of those units from achieving the annual earnings goals that had been assigned to them.

Similar to most major large corporations, Royal Ahold had an ethical code that discouraged executives and employees from engaging in dishonest or otherwise unethical conduct. The company's "Code of Professional Conduct" included the following section that dealt specifically with accounting and financial reporting matters.

The integrity and completeness of record keeping is not only Ahold policy, but also law. We properly, accurately, and fairly record our financial transactions. Preventing fraud is an important priority at Ahold, both to protect Ahold's reputation and to prevent loss. Fraud is defined as committing illicit or illegal acts involving money and/or goods to achieve financial benefit, to benefit oneself or others, at a disadvantage to the company or others (Royal Ahold 2002).

Despite such strong statements, the heavy emphasis by Royal Ahold's top management on achieving financial goals prodded many of its employees to engage in self-serving behavior that materially distorted the company's periodic financial statements. When Royal Ahold's independent auditors discovered the misrepresentations in those financial statements, the prominent corporation suffered widespread embarrassment and

condemnation as well as financial problems that threatened its ability to remain a going concern.

Royal Problems

Deloitte Accountants, B.V.,³ had served as Royal Ahold's "group auditor" since the company went public in 1973. The "group auditor" designation means that The Netherlands-based Deloitte Accountants oversaw the audits of the company's annual consolidated financial statements, although accounting firms in other countries, such as the United States, participated in those audits. Deloitte shocked Royal Ahold's top executives when the accounting firm announced in early 2003 that it was suspending its fiscal year 2002 audit of the company. According to Deloitte, auditors assigned to various operating units of Royal Ahold had uncovered questionable accounting and financial reporting practices that had to be thoroughly investigated before the audit could be completed.

Deloitte's announcement sent Royal Ahold's stock price into a nosedive. Over a short period of time in early 2003, the company's stock price plummeted by approximately 70 percent. During this same time frame, Standard & Poor's and Moody's slashed Royal Ahold's credit rating, which drove down the market price of the company's outstanding debt securities and made it extremely difficult for the company to raise additional capital in either the debt or equity markets. The problems facing Royal Ahold caused one London-based financial analyst to suggest that there was a "very real risk" that the large firm would be forced into bankruptcy (de Boer 2003).

Royal Ahold's board of directors responded quickly to the crisis that engulfed the company following Deloitte's decision to suspend its 2002 audit.⁴ The board's first

major decision was to fire Royal Ahold's chief executive officer (CEO) and chief financial officer (CFO), each of whom had been implicated in the company's accounting irregularities. The board also announced plans to raise much needed capital by selling several of its foreign subsidiaries. Finally, and most importantly, Royal Ahold's board pledged that it would fully cooperate with all law enforcement and regulatory agencies investigating the company's financial affairs and take the appropriate measures to ensure that the sources of the accounting problems were identified and eliminated. These measures served to bolster the flagging confidence of investors and lenders in the company.

Accounting and Disclosure Issues at Royal Ahold

The investigative agencies that scrutinized Royal Ahold's accounting records identified three principal sources of the material misrepresentations in the company's financial statements. The largest of those misrepresentations stemmed from Royal Ahold's improper inclusion of the operating results of certain foreign joint ventures in its consolidated financial statements. Related to this matter were aggressive accounting decisions that the company made in recording the initial investments in foreign joint venture companies. Finally, a forensic investigation authorized by Royal Ahold's senior management uncovered extensive fraud in the accounting records of U.S. Foodservice, the company's large United States subsidiary.

Joint Venture Accounting

The growth-oriented policies of the management team hired to replace Ab and Gerrit-Jan Heijn stressed the importance of not only achieving an annual earnings growth rate of 15 percent but also placed a heavy emphasis on rapidly expanding the company's annual revenues. The new management team established a goal of doubling Royal Ahold's total sales every five years. Royal Ahold's growth-through-acquisition strategy allowed the company to increase its total reported sales from approximately 7.7 billion euros in 1990 to 62.7 billion euros in 2002. This dramatic increase in revenues yielded important benefits for the company. Most important, the impressive revenue growth gave Royal Ahold increasing credibility in the global equity and debt markets, which, in turn, allowed the company to raise the capital it needed to finance its expansion program.

During the fiscal 2002 audit of Royal Ahold, Deloitte Accountants uncovered evidence suggesting that the company's consolidated revenues had been overstated. When Royal Ahold invested in a foreign company, it often acquired exactly a 50 percent ownership interest in the given company. Nevertheless, Royal Ahold would fully consolidate the company's financial data in its annual financial statements. Dutch accounting rules at the time permitted a parent company to fully consolidate the financial data of a joint venture company if the parent could control that firm's operations. Such control could be evidenced by a more than 50 percent ownership interest in the joint venture company or by other means.

Since Royal Ahold owned exactly a 50 percent ownership interest in several foreign firms, the company's executives had to persuade their Deloitte auditors that they exercised effective control over those firms' operations to include their financial data in

Royal Ahold's consolidated financial statements. To accomplish this goal, the company's top executives provided the Deloitte auditors with letters signed by key officials of the given joint venture companies. These letters informed the auditors that despite having only a 50 percent ownership interest in the company in question, Royal Ahold exercised effective control over the company's operations. In fact, Royal Ahold's management team had goaded officials of the joint venture companies to provide these letters to the Deloitte auditors. At the same time the "control letters" were forwarded to Deloitte, Royal Ahold's management signed "side letters" addressed to the executives of the joint venture companies that negated the control letters. The side letters indicated that major decisions affecting the joint venture companies would be made mutually by Royal Ahold executives and the other owners or executives of those companies.

Because Royal Ahold did not have effective control over the joint venture companies in which it had only a 50 percent ownership interest, those companies' operating results should not have been fully consolidated in the annual Royal Ahold financial statements. For Dutch accounting purposes, the joint ventures' operating results should have been "proportionately" consolidated in Royal Ahold's annual financial statements. For example, for income statement purposes, 50 percent of the total revenues and expenses of the joint venture companies should have been included in Royal Ahold's annual consolidated income statement.

Since Royal Ahold's common stock was listed on the New York Stock Exchange, the company was required to file audited financial statements with the SEC each year that reconciled its net income determined under Dutch-based GAAP to the net income that would have been produced by the application of U.S. GAAP. U.S. GAAP does not

permit full or proportional consolidation of a joint venture company in which the “parent” owns a 50 percent interest. The equity method must be applied to such investments under U.S. GAAP. As a result, Royal Ahold should have used the equity method of accounting for the joint ventures in which it owned a 50 percent interest when it determined the U.S.-GAAP based net income figure for purposes of the required reconciliation. Instead, the company fully consolidated the financial data of those joint ventures in arriving at the net income figure that allegedly would have been produced by the application of U.S. GAAP.

Besides improperly accounting for its ownership interests in numerous joint venture companies, Royal Ahold failed to disclose that it had an obligation to purchase the ownership interests of certain investors in those companies. For example, Royal Ahold had committed itself to purchasing the residual ownership interest in a joint venture company based in Argentina that was held by a prominent family in Uruguay. The Uruguayan family could only exercise the buyout agreement if the company defaulted on its outstanding debt. Because of poor economic conditions in South America, the Argentine company defaulted on its outstanding debt in 2002 resulting in Royal Ahold being required to buy out the ownership interest of the Uruguayan family.

Initial Accounting for Investments in Foreign Joint Ventures

In the late 1990s, Dutch accounting principles allowed companies to charge off against stockholders’ equity goodwill arising from the acquisition of another company. Under U.S. GAAP at the time, companies were required to report goodwill resulting from

an acquisition as an asset and to amortize that asset to expense over a time period not to exceed forty years.

As Royal Ahold acquired ownership interests in an increasing number of companies during the late 1990s, the company became increasingly aggressive in accounting for the initial purchase transactions. In particular, Royal Ahold inflated the amount of goodwill arising from acquisitions of other companies. The company also improperly charged off various acquisition-related expenses to stockholders' equity at the time of each acquisition. These abusive accounting practices helped Royal Ahold management meet or exceed its goal of achieving 15 percent earnings growth each year.

Again, because Royal Ahold's stock was listed on the New York Stock Exchange, the company had to report U.S. GAAP-based operating results in the financial statements filed with the SEC. Because of the improper application of Dutch accounting principles, the "gap" between Royal Ahold's Dutch GAAP-based net income figure and the corresponding U.S. GAAP-based figure grew larger and larger each year. By 2001, Royal Ahold reported a net income of approximately 1.1 billion euros in The Netherlands but only 119 million euros (on an equivalent basis) in the United States. Although Royal Ahold was required by the SEC to prepare a schedule reconciling those amounts, critics of Royal Ahold maintained that financial statement users were likely confused as to why there was such a large difference between the two net income figures.

Fraudulent Accounting at U.S. Foodservice

Deloitte Accountants' U.S. affiliate, Deloitte & Touche, audited the financial statements of U.S. Foodservice after that company was acquired by Royal Ahold in 2000. Prior to that time, U.S. Foodservice had been audited by KPMG. During the fiscal 2002 audit of U.S. Foodservice, the Deloitte auditors uncovered improper accounting decisions that had a material impact on the company's reported profit for that year. The improper accounting at U.S. Foodservice also materially distorted the consolidated net income of Royal Ahold. Deloitte's subsequent investigation revealed that U.S. Foodservice had been intentionally misrepresenting its financial statements for several years prior to its acquisition by Royal Ahold.

The accounting fraud at U.S. Foodservice involved "promotional allowances." Because the food wholesaling industry is intensely competitive, the companies operating in that industry have very small profit margins on their sales. In fact, the profit margins within the industry result principally from rebates, quantity discounts, "program money," and other promotional allowances paid to food wholesalers by their suppliers or vendors. For example, if U.S. Foodservice purchased \$100 million of merchandise from General Mills during 2002, General Mills may have refunded 5 percent of that amount to U.S. Foodservice. Generally, the more merchandise purchased from a vendor by a food wholesaler, the larger the promotional allowance on a percentage basis.

Accounting for promotional allowances in the retailing and wholesaling industries has long been a controversial topic. In 2002, the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board began studying that issue. Two years later, the EITF decided not to make any explicit changes in the recommended accounting for

promotional allowances, meaning that the historical method of accounting for those allowances would be retained. In a press release, the EITF summarized this method by noting that refunds, rebates, and other promotional allowances should be “recognized as a reduction of the cost of sales based on a systematic and rational allocation of the cash consideration offered to each of the underlying transactions that results in progress by the customer toward earning the rebate or refund, provided the amounts are reasonably estimable” (*The Accountant* 2003).

The EITF effectively ruled that a variation of the “matching” rule or concept should be applied to promotional allowances. That is, promotional allowances should be properly “matched” with the corresponding purchase transactions that generated those allowances. Implicit in the EITF’s policy statement was that food wholesalers and other companies that regularly receive promotional allowances had not been properly accounting for these items if they had not been applying this matching concept. One such company was U.S. Foodservice.

U.S. Foodservice had various contractual agreements with its vendors regarding the volume of promotional allowances to which it was entitled and the timing of the related payments. The most common agreement involved the prepayment of promotional allowances to U.S. Foodservice based upon an expected minimum amount of purchase volume over a multi-year period. Suppose, for example, that U.S. Foodservice expected to purchase \$30 million from a given vendor over the three-year period 2000-2002. The vendor may have agreed to pay U.S. Foodservice \$900,000 or 3 percent of that amount as a promotional allowance. Most likely, the payment would have been made in early 2000,

within the first few weeks of the period covered by the contractual agreement between the two parties.

Despite the material effect that promotional allowances had on U.S. Foodservice's operating results, the company did not have a systematic method of accounting for those allowances. "USF had no comprehensive, automated system for tracking the amounts owed by vendors pursuant to the promotional allowance agreements" (SEC 2004a). The absence of proper internal controls over promotional allowances provided an opportunity for dishonest employees to overstate those allowances for accounting purposes, which is exactly what occurred beginning in the late 1990s. When Royal Ahold acquired U.S. Foodservice in 2000, the improper accounting for promotional allowances escalated. Apparently, many U.S. Foodservice managers began overstating promotional allowances to ensure that their operating units reached the challenging earnings goals assigned to them by Royal Ahold.

Among the most common methods used by U.S. Foodservice managers to overstate their promotional allowances was to simply inflate the promotional allowance percentages allegedly being paid by given vendors. If a vendor had agreed to pay a 5 percent refund on purchases, U.S. Foodservice might record a promotional allowance equal to 7 percent of the purchases made from that vendor. Another common scheme was "front-loading" promotional allowances. For example, suppose that a vendor paid U.S. Foodservice a \$2 million promotional allowance for the three-year period 2000-2002. U.S. Foodservice might record the full amount of that allowance as a reduction in cost of sales for 2000 rather than prorating the allowance over the three-year period. Eventually, some U.S. Foodservice managers resorted to recording totally fictitious

promotional allowances near the end of an accounting period to ensure that their operating unit reached that period's earnings goal. These fictitious promotional allowances were typically recorded as "topside" adjustments to U.S. Foodservice's financial statements after the company's accounting records had been closed at the end of an accounting period.⁵

Pinpointing Responsibility for the Royal Ahold Fiasco

The improper accounting and financial reporting decisions made by Royal Ahold resulted in the company's 2000 through 2002 financial statements being materially misstated. In the fall of 2003, the company issued restated financial statements for 2000, 2001, and the first three quarters of 2002. The net income figures that Royal Ahold originally reported for those three periods had been overstated by 17.6 percent, 32.6 percent, and 88.1 percent, respectively. The corresponding overstatements of the company's reported revenues for those three periods were 20.8 percent, 18.6 percent, and 13.8 percent, respectively.

Similar to other recent accounting and financial reporting scandals, the public disclosure of the Royal Ahold fraud triggered a search by regulatory agencies, law enforcement authorities, the business press, and the investment community for the parties responsible for the fraud. Among the most culpable parties were the top executives of Royal Ahold. The new management team hired by the company's board to replace Ab and Gerrit-Jan Heijn created an environment in which fraud often develops and flourishes. The pressure exerted by that management team on their subordinates to achieve unrealistic earnings and revenue goals when coupled with the significant

incentive compensation that could be earned by reaching those goals almost certainly prompted much of the self-serving behavior within Royal Ahold.

Despite the fact that Royal Ahold's Deloitte auditors were intentionally misled by the company's executives and the fact that those auditors were ultimately responsible for ending the fraud, many parties believed that Deloitte should have discovered and revealed the fraud earlier than it did. In fact, Deloitte was named as a defendant in several large class-action lawsuits filed subsequent to the first published reports of the fraud. In defense of the Deloitte auditors, they faced an onerous task each year in planning and coordinating an annual audit that was, in reality, audits of dozens of individual operating units loosely organized under the Royal Ahold corporate umbrella.

Many parties also held regulatory agencies and oversight bodies within the accounting profession at least partially responsible for the Royal Ahold debacle. The Royal Ahold case clearly confirmed the need for what the London-based *Financial Times* referred to as "cross-border cooperation" between and among the regulatory agencies and rule-making bodies that oversee financial reporting and independent auditing across the globe (Koster 2004). In recent years, a spirit of competition rather than cooperation has often prevailed between such organizations, particularly between those organizations in the United States and those in other developed countries.

The principal source of tension among international rule-making bodies in the accounting profession has been differing philosophies regarding what should be the fundamental nature of professional standards. The Financial Accounting Standards Board in the United States has generally insisted on issuing "prescriptive" or detailed accounting standards. On the other hand, the International Accounting Standards Board,

which is responsible for issuing International Financial Reporting Standards that EU-based companies were required to adopt by 2005, believes that accounting standards should be general guidelines that are principles-based. This philosophical difference often results in financial statements prepared for a company under U.S. and EU accounting rules that are not comparable. That was certainly the case for Royal Ahold. Such lack of comparability can result in confusion on the part of financial statement users and, ultimately, in less than optimal decisions on their part.

Even more tension between international oversight bodies in the accounting and auditing disciplines was spawned by the Royal Ahold case when the U.S.-based Public Companies Accounting Oversight Board (PCAOB) used the case to justify one of its most controversial policies. This policy required non-U.S. accounting firms to register with the PCAOB and be subject to the PCAOB's regulatory oversight. As the Royal Ahold scandal was unfolding, the PCAOB implied that the case demonstrated that non-U.S. regulatory bodies within the accounting and auditing disciplines were not doing an adequate job of carrying out their oversight responsibilities (de Jong et al. 2005). The PCAOB's insinuation prompted indignant responses from professional organizations within several member nations of the EU and other nations as well. For example, the Japanese Institute of Certified Public Accountants (JICPA) sent an open letter to the SEC in which it criticized the PCAOB's policy. "We believe that the oversight system [for independent audits] in Japan should be relied upon without necessitating PCAOB inspection. Japan has an oversight system which is equivalent to the oversight required of professional accountants in the U.S."⁶

Finally, many parties charged that some measure of responsibility for audit failures of multinational corporations, such as those involving Royal Ahold and Parmalat, had to be shouldered by the large international accounting firms that are invariably the lead auditors of such corporations. According to the *Financial Times*, the major accounting firms have “franchised their names like the McDonald’s burger chain, but without its quality control” (Plender 2004). The *Financial Times* went on to note that the major international accounting firms are, in fact, only “loose confederal” organizations. As a result, users of audited financial statements of multinational corporations located across the globe have no basis for judging the quality of those audits even if they are performed by accounting firms within the same organization.

Epilogue

Following the public disclosure of the Royal Ahold fraud in 2003 both Dutch and U.S. law enforcement authorities filed criminal charges against the company and several of its former executives. The *Financial Times* reported that the Royal Ahold case was the “most significant white-collar criminal case” (Bickerton 2006) ever pursued by federal authorities in The Netherlands. Shortly after criminal charges were filed in the case, a Dutch prosecutor asked the SEC not to pursue the charges that it had filed against the company and its former executives since doing so would raise a “double jeopardy” issue under Dutch law. In responding to the request, the SEC noted that, “Because of the importance of the case in The Netherlands and the need for further cooperation between the SEC and regulatory authorities in other countries, the Commission has agreed to the Dutch prosecutor’s request” (SEC 2004b).

In September 2004, the fraud charges filed against Royal Ahold by Dutch law enforcement authorities were settled. The settlement required Royal Ahold to pay a fine of approximately eight million euros. In May 2006, a Dutch federal court found three of Royal Ahold's former executives guilty of fraud charges that had been filed against them. Those executives included the company's former CEO and CFO. The tribunal of judges that presided over the case gave the three former executives suspended prison sentences ranging from four to nine months. In addition, the three men received fines ranging from 120,000 euros to 225,000 euros. One of the judges who presided over the case defended the light sentences imposed on the three individuals by maintaining that although the Royal Ahold fraud was unfortunate and embarrassing to the Dutch business community and Dutch citizens, it was not nearly as serious as either the Enron scandal in the United States or the Parmalat scandal in Italy (Sterling 2006).

A shareholders' activist group in The Netherlands was appalled by the minimal penalties imposed on the three former Royal Ahold executives. A spokesperson for that group noted that, "The judgment sends a signal to managers that no matter what they do, the risk of a heavy punishment is minimal. In the United States, a conviction on the same facts would have led to a prison term of more than ten years. This is Holland at its smallest" (Sterling 2006).

In July 2004, the SEC announced that it had filed fraud charges against four former executives of U.S. Foodservice. These individuals included the company's former CFO, former chief marketing officer, and two former executives in the company's purchasing division. The two former purchasing executives settled the charges by agreeing to permanent injunctions that prohibited them from being officers or directors of

public companies and by forfeiting stock market gains they had earned on the sale of Royal Ahold's common stock during the course of the fraud. The former CFO and chief marketing officer pleaded not guilty to the charges filed against them. The charges against those two individuals are still pending.

In February 2006, the SEC filed charges against two former auditors of U.S. Foodservice, the audit engagement partner and senior audit manager who had been assigned to the company's 1999 audit engagement team. From 1996 through the conclusion of the 1999 audit in April 2000, KPMG served as the independent audit firm of U.S. Foodservice. When the company was acquired by Royal Ahold in 2000, Deloitte Accountants, B.V., chose Deloitte & Touche to audit the U.S. Foodservice financial statements that were to be incorporated in Royal Ahold's consolidated financial statements.

The SEC alleged that the two former KPMG auditors violated numerous GAAS during the performance of the 1999 U.S. Foodservice audit. In particular, the SEC alleged that the two auditors identified several instances in which the company improperly recorded promotional allowances. According to the SEC, the two auditors used liquid white-out to obscure audit exceptions that documented improper promotional allowances booked by the company. Those audit exceptions were allegedly "whited-out" before the U.S. Foodservice workpapers were turned over to the SEC—the federal agency had requested the workpapers during the course of its investigation of the U.S. Foodservice accounting fraud. The SEC also charged that the two auditors failed to inform U.S. Foodservice's audit committee of serious internal control problems related to the accounting for promotional allowances that they discovered during the 1999 audit.

Among other allegations, the SEC charged that the two auditors frequently relied on implausible representations made to them by client officials. By failing to investigate those suspicious statements and other red flags apparent during the 1999 audit, the SEC maintained that the two auditors failed to exercise a proper degree of professional skepticism, failed to propose proper adjustments to U.S. Foodservice's financial statements, and failed to collect sufficient competent evidence to support the audit opinion rendered on those financial statements. In commenting on the case, an SEC spokesperson noted that, "These auditors had evidence in their hands that could have stopped the fraud in its tracks. Instead, because they failed to exercise appropriate professional skepticism, the fraud was allowed to continue" (Walker 2006). The charges filed by the SEC against the two KPMG auditors are still pending.⁷

In November 2005, the SEC announced that it had filed enforcement actions against several individuals who were employees or executives of major U.S. Foodservice vendors. According to the SEC, each of these individuals had signed false confirmations regarding the amount of promotional allowances owed to U.S. Foodservice by their given company. The SEC reported that several of these individuals had been pressured to sign and return the false confirmations to U.S. Foodservice's independent auditors by management personnel of that company. In one case, an executive of a food vendor signed a confirmation indicating that his company owed U.S. Foodservice \$3.2 million when the actual amount was only \$68,000. Each of the individuals agreed to pay a \$25,000 fine to the SEC to settle the charges filed against them. In commenting on the settlement of these charges, an SEC spokesperson noted that, "The use of third-party

confirmations is an important part of the audit process, and the Commission will hold accountable those who work to subvert it” (Taub 2005).

Also in November 2005, Royal Ahold announced that it had reached an agreement to settle a large class-action lawsuit filed against it by the company’s stockholders and former stockholders. Under the terms of the agreement, Royal Ahold contributed approximately 1.1 billion euros to a settlement pool that would be distributed to the class-action plaintiffs. Shortly after the announcement of this settlement, another class-action lawsuit filed by Royal Ahold’s U.S. stockholders against the company’s Deloitte auditors was announced. That pending lawsuit seeks damages of approximately three billion euros.

In responding to the controversy generated by the Royal Ahold debacle, the European Parliament, which is the legislative body of the EU, amended the “8th Directive” that includes the various guidelines and rules to be followed by accounting firms performing independent audits of EU-based companies.⁸ The new 8th Directive includes a requirement that foreign accounting firms involved in the audits of EU-based companies must be registered with regulatory authorities in the EU. A European publication noted that this new requirement was an apparent “tit-for-tat response” to the comparable requirement of the PCAOB (European Information Service 2004).

Among other changes, the revised 8th Directive imposes greater responsibility on group auditors to review and pass judgment on the overall quality of an independent audit and mandates that member nations of the EU establish “effective investigative and disciplinary systems” for accounting firms that perform independent audits. The revised directive also establishes common rules regarding the appointment and resignation of

independent auditors, requires that auditors obtain appropriate training regarding International Financial Reporting Standards and International Auditing Standards, and requires audit clients to disclose the fees paid to their independent auditors for both audit and non-audit services.

In March 2006, the SEC issued a document entitled “SEC Rulemaking and Other Initiatives: Accommodations” (SEC 2006). That document outlines accommodations that the SEC has agreed to make regarding various stipulations of the Sarbanes-Oxley Act of 2002. One of those accommodations involves the SEC’s requirement that foreign accounting firms that “audit or provide substantial services relating to the audit of an SEC-registered entity” must register with, and be periodically inspected by, the PCAOB. According to the SEC document, the PCAOB is permitted to place “varying degrees of reliance on inspections of foreign accounting firms by the home country’s oversight body, based on a sliding scale—the more independent and robust a home country system, the higher the reliance on that system.” Apparently, this accommodation means that if the EU’s 8th Directive is fully implemented by EU member nations, most accounting firms in those nations will be exempt from the PCAOB’s oversight.⁹

Required

1. Identify the factors that complicate an independent audit of a multinational company. Explain how these factors affected the audits of Royal Ahold performed by Deloitte Accountants, B.V., and its affiliated firms.
2. Identify the cultural influences and other variables that account for the significant differences in professional accounting and auditing standards across the globe.
3. In recent years, there has been an apparent need for higher levels of cooperation between international accounting and auditing rule-making bodies. What factors likely account for the seemingly competitive or, at least, non-cooperative attitude displayed recently by those organizations? What measures might be effective in enhancing the degree of cooperation between those organizations?
4. In your opinion, what responsibility, if any, do the major international accounting firms have to facilitate the “harmonization” of professional accounting and auditing standards around the world? Explain.
5. Suppose an accounting firm has a major audit client in a foreign country that routinely engages in business practices considered ethical in that country but that qualify as both illegal and unethical in the accounting firm’s home country. What specific moral or ethical obligations, if any, would these circumstances impose on this accounting firm?
6. Briefly describe the three elements of the “fraud triangle.” Identify the specific fraud risk factors that were present during the audits of Royal Ahold by Deloitte Accountants. How should those risk factors have affected Deloitte’s audits?
7. In your opinion, was the management of Royal Ahold ultimately responsible for U.S. Foodservice’s fraudulent accounting for its promotional allowances? Why or why not?
8. Royal Ahold’s two major business segments were food wholesaling and retail grocery chains. Identify and briefly explain three key differences in the overall design of an audit for those two types of business segments.
9. Identify the factors that you believe courts and regulatory authorities should consider in doling out punishment to individuals involved in accounting and financial reporting frauds. Rank order these factors from most to least important and defend your ranking.

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Footnotes

1. “N.V.” is an abbreviation for “naamloze vennootschap.” This phrase indicates that Royal Ahold is a limited liability company under Dutch federal law whose ownership shares are publicly traded. As a point of information, within The Netherlands, the company is known as Koninklijke Ahold, N.V.; in English-speaking countries, the company is referred to as Royal Ahold, N.V.
2. *The Clearing*, a major motion picture released in 2004 that starred Robert Redford and William DaFoe, was based upon the key facts surrounding the kidnapping and murder of Gerrit-Jan Heijn, although the setting of the film was changed to the United States. Ironically, the perpetrator of the vicious crime was eventually apprehended when he attempted to purchase food in a grocery store with currency from the ransom that he had been paid by the Heijn family. After serving twelve years of a twenty-year sentence, the kidnapper/murderer was released and returned to live with his family in The Netherlands. To protect the individual’s privacy, the Dutch media insists on referring to him by his first name only.
3. “B.V.” is an abbreviation for “besloten vennootschap.” This phrase indicates that Deloitte Accountants is a “limited company” whose ownership shares are privately registered and thus not freely transferable.
4. In fact, major Dutch companies typically have a two-tiered corporate governance structure that consists of a “supervisory board” and a “management board.” For purposes of this case, Royal Ahold’s two boards are simply referred to as the “board of directors.”
5. “Topside” adjustments are made directly to a company’s financial statements without first being recorded in its accounting records.
6. Letter addressed to Jonathan Katz, member of the SEC, dated June 27, 2003, from Akio Okuyama, President and CEO of the Japanese Institute of Certified Public Accountants. (Available at SEC website: <<http://www.sec.gov/>>).
7. As a point of information, the SEC did not file any charges against members of the Deloitte & Touche audit engagement teams assigned to the 2000 and 2001 U.S. Foodservice audits. Recall that the Deloitte & Touche auditors uncovered the fraudulent accounting for the promotional allowances near the completion of the fiscal 2002 audit of U.S. Foodservice. However, Deloitte & Touche reportedly questioned whether Royal Ahold was properly accounting for promotional allowances as early as the 2000 audit.
8. When the European Parliament adopts a “directive,” each member nation of the EU is committed to initiating legislation that, if enacted, would implement the requirements of that directive. However, the relevant legislative body within each EU nation may or may not fully adopt the stipulations of a new directive.

9. As a point of information, by April of 2006, approximately 1,600 accounting firms had registered with the PCAOB, 540 of those firms were non-U.S. accounting firms from more than 70 countries.

Teaching Notes

Historically, cases have not been utilized extensively in accounting curricula, particularly at the undergraduate level. Consequently, accounting instructors may not be familiar with pedagogical issues related to the use of cases. In fact, many accounting instructors may not use cases in their courses because of pedagogical concerns. To mitigate such concerns, instructors may refer to the following excellent source regarding the integration of case materials into accounting courses: J.E. Campbell and W.F. Lewis, "Using Cases in Accounting Courses," **Issues in Accounting Education**, Fall 1991, pp. 276-283. Campbell and Lewis identify several different approaches available to accounting instructors for utilizing cases in their courses.

Among the many methods that may be used to initiate a case discussion is to ask individual students to identify a key fact in a given case and explain the significance of that item. Instructors who choose to use this strategy will likely find that the following listing of key facts for this case is helpful. When using this strategy, many, if not most, of the issues posed by the case questions are adequately addressed by the completion of the in-class discussion of the case's key issues and facts. Any remaining topics raised by the case questions can typically be dealt with in fairly short order. If an instructor has limited time to spend in class discussing this case, he or she may expedite coverage of the case by using the listing of key facts as an overhead template. When this approach is used, instructors can reveal the key facts and ask students to comment briefly on the significance of each item.

Key Facts Template

1. Royal Ahold was controlled by members of the Albert Heijn family until 1989 when a professional management team was hired.
2. The new management team aggressively pursued an international expansion plan that eventually resulted in Royal Ahold owning retail grocery chains in 27 countries and a large food wholesaling operation in the United States.
3. Differences in cultural norms and expectations adversely impacted Royal Ahold's ability to manage its global business operations.
4. The new management team pressured their subordinates to achieve unrealistic earnings goals and rewarded them with large year-end bonuses if they reached those goals.
5. In early 2003, Royal Ahold's Deloitte auditors suspended their fiscal 2002 audit after discovering potential irregularities in the company's accounting records.
6. Deloitte's suspension of its 2002 audit caused significant financial problems for Royal Ahold, including sharp drops in the prices of its outstanding securities and its credit rating.
7. Investigations of Royal Ahold's accounting records revealed that the company's previous financial statements had been materially misstated.
8. The three principal sources of Royal Ahold's financial statement misrepresentations were the improper inclusion of financial data for foreign joint ventures in its consolidated financial statements, improper accounting for purchases of foreign joint ventures, and improper accounting for "promotional allowances" by the company's food wholesaling subsidiary.
9. Among the parties blamed for the Royal Ahold scandal were the company's top executives, the company's Deloitte auditors, and international oversight and rule-making bodies in the accounting and auditing disciplines.
10. The Royal Ahold case refocused attention on the lack of cooperation between international oversight and rule-making bodies in the accounting and auditing disciplines.
11. Three of Royal Ahold's former executives were convicted of fraud charges by a Dutch court; the company settled fraud charges filed against it by paying a fine of approximately eight million euros.
12. Several legal actions stemming from the Royal Ahold case are pending, including charges filed by the SEC against two individuals who supervised the audits of U.S. Foodservice before that company was acquired by Royal Ahold.

Suggested Solutions to Requirements

1. Listed next are key factors that pose challenging problems on audits of multinational companies. Each of these factors was present during the Royal Ahold audits. As a point of information, although the annual Royal Ahold audits were complicated by the fact that they involved operating units of the client in literally dozens of countries, the key factor that undermined the quality of the audits was the lack of candor on the part of executive management, certain of their subordinates, and vendors of the company's U.S. subsidiary.

- a. Auditors will likely encounter different accounting and financial reporting treatments for similar transactions and accounts. If consolidated financial statements are to be prepared for the given entity, auditors must ensure that the home country's accounting and financial reporting standards are properly applied to the client's consolidated financial statement data.
- b. A related problem is the need to audit the conversion of transaction and account balance data from one or more currencies to the currency of the home country.
- c. The audit of a multinational client is also more difficult to administer and control. For example, the audit of a large multinational client may require several teams of auditors assigned to different operating units of the client scattered across several countries. Even with the help of e-mail and other Internet resources, coordinating widely dispersed teams of auditors can be a challenging task.
- d. Quite often, the most challenging feature of multinational audits is the differences in cultural norms across the countries in which a client's operations are located. Cultural and communication barriers between auditors and client personnel can complicate even the simplest audit tasks. Assigning auditors from a local affiliate or a local office of the given audit firm can sometimes eliminate or at least significantly reduce the problems posed by language and cultural differences.

2. The prologues to the various editions of the *European Accounting Guide* published initially by Harcourt Brace Jovanovich in 1991 provide excellent overviews of the cultural influences that impact accounting standards across the world. These same variables almost certainly impact auditing standards as well. The second edition of the *European Accounting Guide* (Alexander and Archer 1995) identified the following four major cultural influences on the promulgation of accounting standards in specific countries:

- "The relative importance of law." Some countries, such as Great Britain, have historically relied on broad principles of fairness and equity in the construction of laws, while legislative bodies in other countries, an example being Germany, have historically passed very detailed laws.
- "Prescriptiveness or flexibility." This item is related to the first one but refers more generally to the degree of discretion that professional groups in individual countries are given in "plying their trade." For example, a country that has very prescriptive or detailed laws nevertheless may permit individual professions to regulate themselves. The example given by the *European Accounting Guide* for this item was to contrast the "true and fair view" of the United Kingdom with

the “fair presentation” concept in the United States. As noted by the *Guide*, these concepts “sound” quite similar, but, in fact, they are very different. The “true and fair view” refers to a general “substance over form” concept, while the “fair presentation” concept is strictly in reference to GAAP. In other words, the British concept is very “flexible,” while the corresponding U.S. concept is “prescriptive.”

- “The providers of finance.” The primary source or sources of capital in a given country have historically had a significant impact on the promulgation of accounting standards. For example, in Switzerland, creditors, meaning banks for the most part, have historically been the primary source of capital for investment ventures. As a result, Swiss accounting standards have typically been “biased” in favor of the information needs of bankers and other creditors.
- “The influence of taxation.” The *Guide* notes that taxation laws or principles have a wide-ranging impact on accounting standards across the world. Some countries’ accounting standards are heavily influence by taxation laws, while others are only modestly influenced by those laws. In the United States, taxation laws have only a minimal impact on accounting standards. One exception is the fact that when LIFO is used for tax purposes, it must also be used for financial reporting purposes.

3. The struggle between the international accounting and auditing rule-making bodies could be characterized as an old-fashioned “turf war.” In a situation in which two parties are struggling for control over a given domain, each party has an incentive to force its competitor to capitulate. Why? Because the “transaction costs” of capitulation are typically high. The party that has to compromise the most will have to expend the most time and effort to make the necessary changes in its rules, system, or whatever. So, in a sense, the lack of cooperation, not surprisingly, could be a simple matter of economics. A less cynical view would be that the various rule-making bodies each believe that their philosophical stance is the most defensible. In truth, the source of the tension in this context is almost certainly some unknown combination of these two factors.

One measure that would likely be effective in bringing about more rapid “harmonization” would be pressure exerted on rule-making bodies by higher authorities, such as, the executive and/or legislative branches of government in given countries. Such authorities could mandate that “summits” be held to resolve the differences of opinion. A similar request or demand could be made by individual leaders within the profession. Arguably, the parties best positioned to arbitrate the differences of opinion between international rule-making bodies are the large international accounting firms—see Question 4.

This is not a “measure” but the occurrence of “disasters” can often precipitate needed changes. For example, the tragic tsunami of December 2005 prompted international authorities to develop more reliable warning systems. Recurring accounting/auditing scandals involving large multinational companies would likely expedite the harmonization process within the accounting and auditing disciplines.

4. Members of a profession have a responsibility to act in that profession's best interest. Consequently, the large international accounting firms certainly have an obligation to work towards eliminating the confusion and dysfunctional outcomes that result from the lack of uniform professional standards across the globe.

5. Many multinational companies or organizations struggle with this issue at some point in time. An important point that instructors and students alike should realize is that no one country has cornered the market on business ethics. That is, there is room for improvement in this regard across the globe. In this same vein, there are honest and often sharp differences of opinion across countries in exactly what practices are considered ethical (and legal). For example, the following article summarizes the results of a study that investigated business practices that are considered ethical or unethical in Russia and the United States: S.M. Puffer and D.J. McCarthy, "Finding the Common Ground in Russian and American Business Ethics," *California Management Review*, Winter 1995. This study found that Russian businesspeople generally have no problem with price-fixing, while American businesspeople believe price-fixing is unethical. "Grease payments" were also considered ethical by the Russian participants in the study but unethical by their U.S. counterparts. On the other hand, whistle-blowing and large differences between executives' and subordinates' salaries were perceived as ethical business practices in the U.S. but unethical practices in Russia.

Seemingly, the best strategy for coping with situations similar to the one posed by this question is to simply rely on the bedrock ethical principles that have been embraced by the public accounting profession in the United States. In auditing classes, we often spend considerable time studying and dissecting the specific rules, rulings, and interpretations included in the AICPA *Code of Professional Conduct*. However, we might better serve our students by spending more time on the six "principles" that underlie those more specific components of the *Code*. The Preamble to the *Code* (ET 51.02) notes that, "The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage." The third principle discussed in the *Code*, "Integrity," has particularly broad implications for CPAs. Here is an excerpt from the *Code* that focuses on the meaning of integrity.

Integrity is measured in terms of what is just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?"

Integrity requires a member to observe both the form and the spirit of technical and ethical standards, circumvention of those standards constitutes subordination of judgment. (ET 54.03)

In the final analysis, the ultimate "moral or ethical obligation" imposed on an accounting firm or individual auditor by the circumstances described in this case question may simply be to respond to the two questions presented in the prior excerpt and then to act accordingly. Individuals and professional organizations all too often make ethical dilemmas too complex, too multidimensional, too "muddy." In many, if not most cases,

the proper decision in such dilemmas is very obvious—as are the costs of making that choice.

6. The fraud triangle was first introduced into the professional auditing literature by *SAS No. 99*, “Consideration of Fraud in a Financial Statement Audit.” Listed next are the three elements of the fraud triangle according to AU 316.07.

Incentives/pressures: “Management or other employees must have an incentive or are under pressure to commit fraud.”

Opportunities: “Circumstances exist—for example, the absence of controls, ineffective controls, or the ability to override controls—that provide an opportunity for a fraud to be perpetrated.”

Attitudes/rationalization: “Those involved are able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.”

The appendix to *SAS No. 99*—which has been codified in AU 316—lists a large number of risk factors related to fraudulent financial reporting. Listed next are several fraud risk factors that were particularly relevant to the Royal Ahold audits.

--“High degree of competition or market saturation, accompanied by declining margins.”

--“Rapid growth or unusual profitability, especially compared to that of other companies in the same industry.

--“Need to obtain additional debt or equity capital . . .”

--“There is excess pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.”

--“Significant operations located or conducted across international borders where differing business environments and cultures exist.”

SAS No. 99 lists the detailed steps that auditors should take in responding to identified risk factors commonly associated with fraudulent financial reporting. In particular, AU 316.48 suggests that auditors should respond in three ways to the risk of material misstatements due to fraud:

1. First, the auditor should consider the “overall effect” that the presence of fraud risk factors should have on how the given audit is performed. For example, the staffing of an engagement may need to be changed if there is an inordinate level of fraud risk present. Likewise, the auditor may need to more rigorously analyze how the client has applied specific accounting principles (to determine whether there is any evidence that they have been intentionally misapplied).
2. Second, the auditor must consider how the presence of given fraud risk factors should affect the application of the audit NET—nature, extent, and timing of specific audit tests—to be applied on the given engagement. For example,

physical observation or inspection of client assets may have to be applied extensively in cases in which numerous fraud risk factors are present.

3. Third, the auditor may have to consider applying additional procedures specifically intended to address the possibility of “risk of material misstatement due to fraud involving management override of controls.” For example, the auditor may find it necessary to closely scrutinize significant accounting estimates made by management. Such estimates are particularly susceptible to misstatement when the risk of fraud is disproportionately high.

7. President Harry S Truman was known for his assertion “that the buck stops here,” referring to the fact that he had the final responsibility for matters of national concern or interest. Although this fact was not necessarily highlighted in the case, there was some degree of “buck-passing” by Royal Ahold’s management when it came to accepting responsibility for the U.S. Foodservice accounting fraud. The point was made that the promotional allowances fraud originated before Royal Ahold acquired U.S. Foodservice, which was true. However, the heavy pressure that Royal Ahold’s management exerted on their subordinates to achieve earnings and revenue goals provided significant “momentum” for that fraud. Top management of an organization has a responsibility to create a culture of responsibility and integrity within an organization. The heavy emphasis by Royal Ahold’s management on reaching earnings and revenue goals that were unrealistic in many, if not most, cases, created an environment in which fraud was likely.

As a sidebar, Royal Ahold’s executives also had a “due diligence” responsibility when they were negotiating to purchase U.S. Foodservice. That is, they had a responsibility to investigate whether U.S. Foodservice’s financial statements were being impacted by aggressive and/or fraudulent accounting practices. Granted, such “comfort” is typically provided by the purchasing entity’s independent auditors, meaning Deloitte in this case. The facts of this case did not indicate whether a pre-purchase due diligence engagement was performed by Deloitte for Royal Ahold.

8. Note: Your students should be at least somewhat familiar with the key differences in the food wholesaling and retail grocery lines of business. If not, you might provide them with a brief overview of those differences before addressing this question.

Audit procedures applied to inventory, receivables, and controls would likely be quite different for a food wholesaler versus a retail grocery chain. The inventory of a food wholesaler is typically congregated in a few locations (warehouses), while a retail grocery chain’s inventory is widely dispersed over its individual retail locations, meaning that the observation of physical inventories can be a more challenging task for a retail grocery chain than for a food wholesaler. On the other hand, a food wholesaler typically has a considerable amount of inventory in-transit at any point in time, which can greatly complicate the taking of an accurate physical inventory and the related audit procedures.

Food wholesalers generally have a large amount of receivables, while retail grocery chains have a modest amount. Plus, the nature of the two types of businesses’ receivables are very different. A large portion of the receivables of food wholesalers are from small retail businesses and thus subject to a moderate to high degree of credit risk.

Alternatively, a retail grocery chain's receivables are usually credit card receivables, which have little credit risk associated with them. Given this difference, confirmation of accounts receivable would generally be a more time consuming and important audit test for a food wholesaler than for a retail grocery chain.

Finally, the very different nature of food wholesaling and retail grocery operations would translate into significant differences in the design and performance of tests of controls. A particular challenge in this respect for a retail grocery chain would be to determine whether controls are being uniformly applied across the large number of individual retail locations.

9. Following is a list of factors that your students are likely to identify in responding to this question. At some point, consider asking your students to relate these factors to the penalties imposed on the parties involved in the Royal Ahold scandal. Students typically agree with the representative of the stockholders' activist group who was disappointed with the minimal sentences given the three Royal Ahold executives convicted of fraud. One or more students are also likely to bring up the fact that the individual convicted of kidnapping and murdering Gerrit-Jan Heijn served only twelve years in a Dutch prison, as pointed out in a footnote in this case.

- Intent: What level of intent was involved in the given fraudulent activity. For example, was the fraud a "spur-of-the-moment" decision or was it premeditated and planned over a long period of time.
- Self-enrichment: To what extent did the given fraudster benefit economically from the fraudulent activity.
- Number of parties impacted: For example, a fraud perpetrated by the CEO of a public company typically has a much more far-reaching effect than a fraud perpetrated by the CEO of a private company.
- Need for a deterrent effect: In some cases, the courts may believe that a severe prison term or other sanction is necessary to serve as a deterrent to the individual involved in the fraudulent activity.
- Need to "set an example": The courts may believe that it is appropriate to impose a severe sanction on the fraudster to serve as a deterrent effect not for that individual but rather for other individuals who may be considering engaging in the same type of fraudulent activity.
- Ability to pay: Courts sometimes consider the economic condition of the fraud perpetrator in deciding whether or not to impose a monetary fine on him or her.

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