Atlas Cold Storage Inc.

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It had been a stressful summer for the executives and board of Atlas Cold Storage; in fact it had not been a summer at all. But Joseph Wiley as Chair of the Audit Committee and representative on the board of Atlas's largest unit holder, TD Capital, felt the pressure most acutely. Although it was August 29th and summer was over, a new phase of the Atlas saga was about to start now that the press announcement was being proofed for the final time. When investors returned from their Labour Day weekend they would know what he had been living with for months -- that Atlas's financial results would need to be significantly restated.

It had all started with the anonymous letter sent to the Ontario Securities Commission (OSC) on April 28, 2003. Had the letter not gone to the OSC perhaps the situation could have been dealt with internally without a need to announce to the public that the financial statements were wrong, very wrong. But with the letter they were forced to tell the auditors, Ernst and Young (E&Y) who insisted on coming in to review the books, again -- no doubt afraid that they might get sued for issuing a clean audit opinion on financial statements that were materially incorrect. To make matters worse, the independent board members insisted that E&Y should not do the investigation, claiming the auditors were not independent enough. Those board members insisted on bringing in Kroll Lindquist Avey to oversee E&Y's investigation.

The news release read as follows:

> TORONTO, Aug. 29 /CNW/ - (TSX: FZR.UN) - Atlas Cold Storage Income Trust announced today that it has received comprehensive reports, prepared in connection with an investigation of certain matters related to its financial statements for its year ended December 31, 2002. This review will result in a restatement of its results for fiscal 2002 and 2001. The in-depth review was precipitated by the receipt of a copy of an anonymous letter that contained certain allegations with respect to the 2002 financial statements of Atlas, its senior management, and certain accounting policies, procedures and controls.
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> Following receipt of the anonymous letter, the board of directors of Atlas Cold Storage Holdings Inc., the Administrator of Atlas, requested that its audit committee undertake a comprehensive review and investigation into the allegations contained in the letter, and report back to the board of directors.
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> The audit committee retained Stikeman Elliott LLP as independent counsel, who engaged Ernst & Young LLP's ("E&Y") Global Investigations and Dispute Advisory Group and Kroll Lindquist Avey, The Risk Consulting Company ("Kroll") to assist in the investigation. E&Y carried out a detailed work plan to review the allegations in the anonymous letter and prepare a report for the audit committee. No members of the E&Y investigation team that prepared the E&Y report had any previous involvement in advising Atlas. Kroll was engaged to assist the audit committee in supervising and reviewing the E&Y engagement, to perform its own investigative procedures to

supplement those performed by E&Y as it considered appropriate and to report to the audit committee thereon as well as with respect to its assessment of the E&Y report.

The audit committee received the Kroll and E&Y reports earlier today.
These reports concluded that expenditures of approximately $3.6 million were inappropriately recorded as additions to capital assets during 2002. In addition to correcting for these items, the audit committee has determined to make approximately $1.2 million of adjustments with respect to items previously identified during the course of the 2002 audit but not made at that time by reason of the fact that they were below Atlas' audit materiality threshold.

As a result, the effects of the adjustments, after reflecting appropriate income tax adjustments, are as set out in the appendix to this press release[1]. A description of the restatement can also be found in note 16 to Atlas' quarterly financial statements for the six months ended June 30, 2003 which were released today and which will be available at www.atlascold.com or www.sedar.com .

After providing copies of these reports to, and consulting with Atlas' auditors, E&Y, Atlas has determined that:

(a) the financial statements for the year ended 2002 will be restated to reflect the conclusions described above;

(b) although the financial statements for the year ended 2001 were not the subject of this investigation, as a result of the conclusions reached in respect of the 2002 financial statements and to ensure the propriety of Atlas' historical financial results, Atlas intends to restate its financial statements for the year ended 2001 by reclassifying $1.6 million of capital assets as expenses as an estimate to address potential overcapitalization of expenses during that year; and

(c) as a result of the restatement by Atlas of its 2002 and 2001 financial statements, it will be necessary for E&Y to reissue its audit opinion for these years; accordingly, such financial statements and the auditors' report therein as originally issued should not be relied upon by investors until such confirmation and corresponding restated financial statements have been provided by Atlas, which is expected to occur once the audit group of E&Y completes certain procedures on the restated numbers provided to it this week. These procedures are expected to be completed as soon as practicable.

The reports concluded that the overstatement of net income by management was consistent with an intent to improve the financial results, including distributable cash, of Atlas. However, the reports concluded that other allegations contained in the anonymous letter were unfounded.

[1] Not included in this case but can be viewed at the September 2, 2003 press release. http://www.sedar.com/DisplayCompanyDocuments.do?lang=EN&issuerNo=00004374

In the reports, each of Kroll and E&Y also made observations regarding certain weaknesses in Atlas' internal controls and procedures, in particular as they relate to the capitalization of project costs. The reports, which were received today, are detailed and the audit committee continues to review them and formulate recommendations with respect to dealing with the findings in the reports.

The audit committee and board of directors have been, and intend to continue to be, proactive and will take steps to implement the changes necessary to address the issues raised by the reports. These steps may include, but will not be limited to, changes as are found to be appropriate to internal controls, systems and personnel. The restatement arising from the reports will not have any impact on distributable cash earned and distributed for Atlas for 2003 other than the costs of the investigation, which is expected to total approximately $1.2 million. These costs are being expensed as incurred. Distributable cash is not a defined term under Canadian generally accepted accounting principles and accordingly, may not be comparable to similar measures presented by other issuers.

The audit committee implemented a policy whereby Atlas' quarterly financial statements, starting with its 2003 first quarter results, are, and will continue to be, reviewed by its auditors on a review engagement basis (including certain substantive procedures with respect to capital assets). Atlas does not contemplate any adjustments with respect to the unaudited financial statements for the three month period ended March 31, 2003 or the six month period ended June 30, 2003.

A copy of each of the Kroll and E&Y reports has been provided to the Ontario Securities Commission.

Joseph P. Wiley, Atlas board member and Chairman of the Atlas audit committee, stated, "As chair of the audit committee and appointee of TD Capital's Canadian Private Equity Partners Fund, Atlas' largest unit holder, I believe that the investigations were carried out rigorously and are complete. Our belief is that the restatement captures all of the adjustments necessary. We are focused on improving Atlas' internal controls and procedures to ensure they are representative of best practices for the size of its operations. The board of directors and the trustees of Atlas are fully supportive of Mr. Gouveia, who has taken a leadership role in resolving these issues."

Patrick A. Gouveia, President and Chief Executive Officer, stated, "It is important to Atlas that its financial statements be beyond reasonable questioning. The process we have just undergone support the actions the board of directors is taking."[2]

[2] Ibid

Background

Atlas Cold Storage is an Income Trust ("Atlas") (formerly Associated Freezers Income Trust) established in February 1997 owned 100% of its operating arm Atlas Cold Storage Holdings ("Atlas Holdings"). The board of Directors of Atlas Holdings administers the Income Trust. As an income trust Atlas also has a Board of Trustees that provides advice to the Board of Directors.

Atlas offers temperature-controlled warehousing and distribution services to chilled-food processors, distributors, and retailers. Atlas is North America's second largest cold storage company with more than 50 warehouse facilities. The company operates throughout Canada and in the eastern, midwestern, and southeastern US. Atlas also offers logistics services, such as transportation management.

From 1997 through mid-2000 Associated Freezers Income Trust grew steadily through acquisitions and internal growth financed through a combination of new unit issues and bank loans. Patrick Gouveia founded Atlas in 1991 and operated a similar but private business to Associated Freezers. Effective August 11, 2000 Associated Freezer Income Trust merged with Atlas Cold Storage. The name after the merger was ACS Freezers Income Trust (later changed to Atlas Cold Storage Income Trust). As consideration for the merger, Atlas shareholders received the equivalent of 4.8 million units and two seats on the board of directors. Atlas's operating subsidiary also entered into long term lease agreements for certain warehouse facilities owned by Gouveia.[3] After the merger Atlas had an asset base of $387 million and annual EBITDA of $38 million.[4] On a pro forma basis total debt was $142 million and total equity, including convertible debentures, of $195 million.[5] Immediately prior to the merger there were approximately 11.5 million Trust Units issued and outstanding[6]. After the merger there were an additional 9.6 million units outstanding with 4.8 million going to each of Atlas and TD Capital.[7] The merger was accounted for as a Business Combination. Patrick Gouveia took over the role of President and CEO of the combined entity.

Subsequent to the merger Atlas continued to grow. During the two years between August 2001 and 2003, Atlas had entered into eight acquisitions at a cost of $590 million,[8] the most significant of which were the:

- July 2001 acquisition of two cold storage facilities in Calgary and Vancouver for $31.3 million known as the Blue Star acquisition;
- March 2002 purchase of some of the assets of TCT logistics, a trucking firm in receivership for $5.2 million - TCT was renamed Atlas Supply Chain Services Limited ("Supply Chain");

[3] See: Material change report August 10, 2000
http://www.sedar.com/DisplayCompanyDocuments.do?lang=EN&issuerNo=00004374
[4] Ibid
[5] See: Material change report May 24, 2000
[6] Management proxy / information circular Form 30 July 17, 2000
http://www.sedar.com/DisplayCompanyDocuments.do?lang=EN&issuerNo=00004374
[7] Concurrently with the closing of the merger, TD Capital Canadian Private Equity Partners received 4.8 million units for its investment of $35 million and one seats on the board of directors.
[8] National Post September 3, 2003

- September 2002 purchase of some of the assets of CoolStor Warehousing Services for US$25 million; and
- October 2002 purchase of the majority of CS Integrated LLC's U.S. distribution network for $218 million (US$137.5 million).

All of these acquisitions and the internal expansions were expensive. To finance them, Atlas entered into 5 successive equity issues in excess of $356 million including:

- 4,250,000 unit issue announced in March 2001 at $8.70 per unit
- 1,935,062 unit issue to Gouveia and TD Bank in March 2001 at $8.70 per unit
- 4,197,500 unit issue announced in July 2001 at $9.60 per unit
- 6,054,750 unit issue announced November 2001 at $10.45 per unit
- 7,460,000 unit issue announced August 2002 at $11.40 per unit
- 9,803,000 unit issue announced October 2002 at $11.55 per unit

Atlas also entered into a credit facility with a syndicate of Canadian and US banks in July 2001 for $191 million and a further facility in October 2002 topping out at $306 million.

Income Trust

An income trust is a special purpose entity that sells equity to the public in the form of units and uses the proceeds to purchase an operating company that holds a set of income-generating assets. Legally, income trusts are a subset of the broader category of 'mutual fund trusts' within the meaning of the Canadian Income tax Act. An income trust is designed to maximize the cash distributions paid to the unit holders by eliminating the corporate income taxes paid by the operating company. An income trust is a 'flow-through' vehicle that allows income to flow through it and be taxes in the hands of the investor only. [9]

Income trusts may be an appropriate investment for individuals and institutions whose focus is on current cash flow rather than long-term growth. This is because an income trust pays out up to 90% of its net income plus non-cash expenses such as depreciation and amortization. An Income trust is an appropriate structure for mature companies in non-cyclical industries that require minimum capital expenditures to maintain the productivity of assets.[10] Due to their structure income trusts' growth prospects through the investment in future growth is limited. This is because profits that might otherwise have been invested in future growth initiatives are used up to achieve the short-term goal of cash distributions.[11] Should an income trust become focused on growth, the cash flow to finance the growth would need to come from either reducing distributions to current unit holders or new debt and/or additional equity financing.

There are a number of issues that an investor should consider an income trust. From a legal perspective, as a consequence of being a unit holder rather than a shareholder, investors do not enjoy limited liability protection offered to those who invest in incorporated companies. Unit holders are potentially on the hook for liabilities related to debt or company actions.[12] The unit

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[9] Income Trust: Understanding the Issues by Michael R. King – Bank of Canada Working Paper 2003 - 25
[10] Ibid
[11] Trusty Trust? By Andy Halloway, for Canadian Business July 19 – August 15, 2004
[12] Ibid

holder's liability is being addressed in some provinces.[13] One of the benefits of trust ownership is that distributions are made to unit holders in a pr-tax basis thus eliminating the possibility of double taxation that can happen under share ownership. Unit holders treat the income as other investment income so the tax rate would be the same as for income such as interest.

The Fall Out

On June 2, 2004 the OSC filed a statement of allegations against Patrick Gouviea, President, Director, President and CEO and second largest unit holder of Atlas at 8.1%, Andrew Peters CMA, Executive vice-president and CEO, Ronald Perryman CA, VP Finance and Paul Vickery CA, Corporate controller and interim VP of Supply Chain.[14] In addition, the Institute of Chartered Accountants of Ontario began an investigation into possible wrongdoing by members.[15]

The Charges

The following allegations have been made by the OSC:

1. Inappropriate capitalizing of expenses from 2001 through the second quarter of 2003 – Atlas's actual quarterly financial results were usually lower than the unreasonably high target presented by Gouveia to the market. Gouveia would instruct accounting staff to find more earnings. With his knowledge, accounting staff reviewed all expenses over $1,000 and reclassified invoices previously classified as expenses as capital expenditures. Many of these capitalizations were not in accordance with GAAP.[16]
2. Timing errors – Atlas recorded expenses of $950,000 in 2002 which related to activities of 2001;
3. Inappropriate recording of refunds – Atlas accounted for a refund of $600,000 related to the purchase of assets of TCT as a reduction of expense rather than a reduction in the purchase price of the assets; and
4. Failed to disclose a breach of covenants - As part of Atlas's lending agreement they were not permitted to invest more that $10 million or lend more than $500,000 to Supply Chain. Although Supply chain only began operation is March 2002, the covenant was breached by May 2002. Atlas did not disclose this fact to their lenders and instead covered it up through two means.
    a. Supply Chain paid funds to Atlas at quarter end to bring them back into compliance. These funds were repaid to Supply Chain the next day.
    b. Atlas entered into a sale leaseback agreement at December 31, 2002, whereby Supply Chain's vehicles were sold to Atlas and leased back. But, Supply Chain's vehicles were already secured under a general security agreement and therefore were not available for sale. This agreement allowed Atlas to infuse cash into

[13] The Ontario government has introduced legislation that would limit the liability of Ontario Based unit holders Under the Trust Beneficiaries' Liability Act 2003. This act was delayed due to the 2004 provincial election.
[14] Statement of allegations http://www.osc.gov.on.ca/Enforcement/Proceedings/2004/soa_20040602_gouveia.jsp
[15] Globe and Mail February 18, 2004. Note: on September 20, 2004 Paul Farley of the ICAO would neither confirm nor deny that in investigation was underway.
[16] Statement of allegations para. 15

> Supply Chain and thereby give the appearance of being in compliance with the debt covenants. In fact, there were no written sale leaseback agreements, no transfer documents for the vehicles and no lease payments were made.

The OSC concluded that the purpose of these activities was to improperly present an improved picture of Atlas's financial performance in order to enhance earnings and conceal the extent of losses at Supply Chain. As a result of the overstated earnings Atlas overpaid the distributed cash to the unit holders and the bonuses paid to management.

The People

Andrew Peters CMA was terminated as executive VP and CFO on September 19, 2003. Ronald Perryman CA, VP of Finance who was responsible for public filings was terminated for cause on November 13, 2003. Patrick Gouveia resigned on November 21, 2003. Effective January 30, 2004 the board of directors were replaced including:

- J. Nicholas Ross CA, Chairman of the board since inception in 1997
- Joseph P. Wiley who had been TD Capital's representative since the merger in 2000
- Jack H. Scott had been involved since inception and had acted as interim President or CEO during the late 1990s
- Jeffrey L. Rosenthal had been involved with Associated Freezers since inception and had been on the board since the merger in 2000
- Patrick Gouveia had joined the board with the merger between Atlas and Associated Freezers, resigned November 21, 2003
- Andrew Peters CMA had joined the had board with the merger between Atlas and Associated Freezers, terminated September 19, 2003

Two of the existing board member would continue until the next annual meeting being Wes Voorheis a new member and Robert Gillespie who is Chairman and CEO of GE Canada and had been on the board since 1998.

Ernst and Young who had audited Atlas since the inception of Associate Freezers Income Trust were replaced with Deloitte and Touche.

The Investors

Prior to the announcement on August 29, 2003 of the need to restate the financial statements, investors in Atlas could expect a steady increase in unit value. At the time of the August 2000 merger the units were valued at $7.55. The market value increased steadily to over $13 in August 2003. Immediately following the announcement of the restatement the units dropped to $8.50. The decline has continued to below $5.00 in the autumn of 2004.

The unit holders could also rely on a steady flow of cash each quarter of approximately $0.24 per unit. These distributions were discontinued subsequent to the second quarterly payment of 2003.

The Beneficiaries

Gouveia and Peters were well compensated for their management of Atlas. In 2002 Gouveia received salary and cash bonus of $1.359 million while Peters received $885,000. They also received 100,000 and 60,000 trust unit options, respectively, in each of 2001 and 2002.

As a unique form of further executive compensation, Gouveia and Peters received “restricted phantom” units (“RPU”). These units entitled the recipient to receive a cash payment equal to the increase in market value of Atlas plus the cash distributions paid over the intervening period. Gouveia’s RPU totalled $602,000 by December 31, 2002 while Peters’ totalled $361,000.

Because of the structure of Gouveia’s and Peters’ employment agreements, their bonuses were guaranteed. In 2003 prior to resigning, Gouveia earned salary and cash bonus of $1.12 million while Peters earned $603,000 prior to termination.

Required

1. What incentives were there for Atlas management to misstate the financial statements? Is there any significance to the fact that Atlas was an income trust? Explain.
2. What “red flags” were present at Atlas? How should an auditor assessing the risk factors of this engagement have handled these red flags?
3. What is the basis for holding directors, management and auditors accountable for misstated financial statements?
4. Comment on the involvement of the auditors in the investigation of the allegations contained in the letter to the OSC. Why might it be appropriate for them to be involved and why would it not be?
5. The OSC detailed some specific accounting wrongdoings as outlined above under the heading *The Charges*. What audit procedures might have detected these problems?