

Livent and the Auditors

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Livent Inc. is a Toronto, Ontario company that produced live theatrical entertainment, generally at one of its own theatres, with touring engagements when warranted. These productions were restorations such as Show Boat, reproductions of established musical productions, such as The Phantom of the Opera and Joseph and the Amazing Technicolor Dreamcoat, or theatrical productions originated by the company such as Ragtime and Kiss of the Spider Woman. Other Livent shows included Sunset Boulevard and Fosse. Livent owned and operated theaters in Toronto, New York and Vancouver.

The company's revenue was derived from performance revenue, the sale of merchandise, corporate sponsorships, gains on sale of rights and exclusivity arrangements, royalties, concession income and other related fees.

Livent became a public company in Canada in May 1993 and its stock was traded on the Toronto Stock Exchange in Canada and on the NASDAQ national stock market in the U.S. On November 18 and 19, 1998, respectively, Livent declared bankruptcy in the United States and Canada.

The attached *Offer of Settlement* between the U.S. Securities and Exchange Commission (SEC) and the company lists the following allegations against the company:

1. During the period 1990-1994 (prior to the time Livent became a SEC registrant) Livent was involved in a fraudulent kickback scheme whereby Drabinsky and Gottlieb received directly or through a company owned by Gottlieb approximately \$7,000,000. Approximately \$4,000,000 was capitalized as pre-production costs. See **section C** of the attached.
2. Livent transferred pre-production costs for shows to fixed assets where the amortization period was significantly longer. See **section D1** of the attached.
3. Livent simply removed certain expenses and corresponding liabilities from the accounting records at the end of each quarter so as to improve quarterly results. See **section D1** of the attached.
4. Livent transferred costs from a currently running show to a show that had not yet opened or which had a longer amortization period. See **section D1** of the attached.

5. The dollar effect of items 2-4 was to understate expenses in 1995 by \$3,500,000, in 1996 by \$18,100,000 and in 1997 by \$8,500,000.
6. Livent during 1996-97 entered into a series of transactions purporting to represent the sale of rights to present certain Livent shows in return for fees from the counter parties which fees were reflected in revenues. Side agreements were signed that obligated Livent to repay the fees. As a result Livent overstated revenues by \$34,000,000 (\$16,400,000 in 1996 and \$17,600,000 in 1997). See **section E** of the attached.

The SEC alleges that misstatements were dealt with in the accounting records in the following ways:

1. The accounting records were fraudulently manipulated. See **section D3** for details.
2. Senior management was involved in the manipulations including Drabinsky, Gottlieb, Topol, Eckstein, Winkfein, Malcolm, Craib, Fiorino and Messina. They were respectively the Chairman of the Board and CEO, the President who was also a director, the Senior Executive Vice President and COO, the Senior Vice President Finance & Administration, the Senior Corporate Controller, the Senior Production Controller, the Senior Controller Budgeting, the Theatre Controller and the Chief Financial Officer (who was also the engagement partner for the 1995 audit). See **section D2** of the attached.
3. Drabinsky, Gottlieb, Topol, Eckstein and others concealed the manipulations by concealing information from the auditors and Drabinsky and Gottlieb signed false and misleading management letters of representation to the auditors. See **section D4** of the attached.

Required:

On the face of it, the auditors were the victims of a massive scheme to fraudulently misrepresent the financial position of the company, a scheme that involved much of the senior management (especially senior financial management).

Assume that you are working on behalf of a plaintiff who is considering a class action suit against the auditors. Were there “red flags” visible which might have/should have alerted the auditors (roused their professional scepticism) that all was not well in the company and were there audit procedures the auditors might have carried out that might have alerted the auditors?

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Glossary of terms – Securities Exchange Acts

1. Securities Act of 1933 (the 1933 Act)- the Act that regulates initial issuances of securities
2. Securities Exchange Act of 1934 (the 1934 Act)- the Act that regulates subsequent trading of securities
3. Section 8A of the 1933 Act- the section which governs the publication of findings and cease and desist orders
4. Section 21C of the 1934 Act- the 1934 Act equivalent of section 8A of the 1933 Act
5. Section 12(g) of the 1934 Act- the section that deals with the use of interstate commerce in the purchase and sale of securities
6. Form 20-F- form used as a registration statement for securities of foreign private issuers under section 12 or as an annual report under sections 13(a) or 15(d) of the 1934 Act
7. Form F-1-basic registration form under the 1933 Act of securities of all foreign private issuers.
8. Form 6K- form used by foreign private issuers who are requested to furnish interim information reports pursuant to Rule 13a-16 of the 1934 Act.
9. Form F-4- registration form used by any foreign private issuer under the 1933 Act of securities to be issued in connection with business combinations and exchange offers.
10. Form 40-F- form used as a registration statement for securities of Canadian private issuers or as an annual report for such issuers
11. Section 17(a) of the 1933 Act- the section which makes it unlawful to engage in fraudulent interstate transactions involving securities

12. Section 10(b) of the 1934 Act- the section which makes it unlawful to use manipulative or deceptive devices or contrivances in connection with the purchase and sale of securities
13. Section 13(a) of the 1934 Act- the section which requires the filing of such documents and annual reports as the SEC considers necessary
14. Section 13(b) of the 1934 Act- the section which prescribes the form of the documents and reports to be filed with the SEC and the need for issuers to keep proper books, records and accounts and a proper system of internal accounting control
15. Rule 10b-5 of the 1934 Act- rule relating to the unlawful use of manipulative and deceptive devices in connection with the purchase and sale of securities
16. Rule 12b-20 of the 1934 Act- addresses the need to add further material information to information already required to be included in a statement or report
17. Rule 13a-1 of the 1934 Act- requires the filing of an annual report by issuers having securities registered pursuant to section 12 of the 1934 Act.
18. Rule 13a-16 of the 1934 Act- requires foreign private issuers to file their annual reports on form 6K.
19. Rule 13b2-1 of the 1934 Act- prohibits the falsification of books, records and accounts
20. Form 10K- annual report pursuant to section 13 or 15(d) of the 1934 Act

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Offer of Settlement *between the U.S. Securities and Exchange Commission (SEC) and the company*