

# Diamond Foods, Inc.: A Comprehensive Case in Financial Auditing

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**ABSTRACT:** Diamond Foods is a comprehensive case that provides an opportunity for students to apply several financial auditing concepts and professional auditing standards to a real-world context. Diamond overstated its earnings of fiscal 2010 and 2011, by 38 percent and 47 percent, respectively, by delaying recognition of the cost of walnuts acquired to later accounting periods. The case requires students to determine whether Diamond's external auditor—Deloitte & Touche, LLP (Deloitte)—fulfilled its responsibility to obtain reasonable assurance that the financial statements were free of material misstatement. Students need to determine whether Deloitte's issuance of an unqualified opinion on Diamond's financial statements and internal controls violated professional auditing standards. In addition, students are required to evaluate whether Deloitte obtained sufficient understanding of Diamond's business and industry, exercised the needed professional skepticism, and used appropriate analytical procedures to discharge its professional responsibilities. The case presents an opportunity to achieve several learning objectives, including the development of research, critical-thinking, communication, and problem-solving skills. The case is appropriate for use in a graduate or undergraduate course in financial auditing. It can also be used in a fraud examination course, or in a capstone course in the accounting curriculum.

**Keywords:** professional skepticism; analytical procedures; auditing standards; auditor liability; Deloitte; fraud detection; Diamond Foods.

## CASE

Auditors must approach their jobs with independence and skepticism. How do we instill those necessary traits in auditors? This may be the most important auditing question of our time.

—James Doty, PCAOB Chairman

Remarks made at SEC Reporting Conference, June 2, 2011

Understanding financial relationships is essential in planning and evaluating the results of analytical procedures, and generally requires knowledge of the client and the industry or industries in which the client operates.

—American Institute of Certified Public Accountants, AU 329

## The Company

**D**iamond Foods, Inc. (hereafter, Diamond or the Company) is an innovative premium snack food and culinary nut company that focused on several brands, including Kettle Brand® Chips, Emerald® snack nuts, Pop Secret® popcorn, and Diamond of California® nuts. The Company's strategy is to build and energize brands as well as identify opportunities to add value by making a relevant connection to the contemporary consumer. Diamond's products are distributed globally in stores where snacks and culinary nuts are sold. The Company has approximately 1,700 employees and its stock trades on the NASDAQ market under the symbol DMND.

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Supplemental material can be accessed by clicking the links in Appendix A.

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Founded in 1912 with a strong heritage under the Diamond of California® brand, Diamond Foods was converted from an agricultural cooperative association to a Delaware corporation when it completed its initial public offering in July 2005. Soon after incorporation, the Company began a series of acquisitions under the leadership of its Chief Executive Officer (CEO) Michael J. Mendes. The annual reports of the Company indicate that in May 2006, Diamond acquired certain assets of Harmony Foods Corporation. In September 2008, it acquired Pop Secret®, a brand of microwave popcorn products, for \$190 million cash from General Mills, Inc. In February 2010, it acquired Kettle Brand® Chips, a premium potato chip company, for \$615 million cash from Lion Capital LLP, U.K.

The acquisitions helped Diamond achieve impressive sales growth and profitability. Every year since its incorporation in 2005, Diamond reported higher revenues, gross profit, and net income than the year before; its reported earnings per share (EPS) has exceeded the consensus analyst estimate in most years.<sup>1</sup> The superior financial performance of Diamond was reflected in the price of Diamond's common stock, which increased from \$17 (IPO price) in July 2005 to \$76.53 in July 2011, earning investors a compound annual return of 28 percent.

### The Stars behind Diamond's Success—CEO Michael Mendes and CFO Steven Neil

Michael Mendes played a pivotal role in Diamond's success. He joined Diamond in 1991 as the Vice President of International Sales and Marketing and was promoted to be Diamond's president and chief executive officer (CEO) in 1997. Mendes was a member of Diamond's Board of Directors beginning in 2005 and was its chairman from January 2011 to February 2012. During his tenure at Diamond, Mendes worked hard to turn Diamond into an entrepreneurial and performance-driven organization. He developed a deep understanding of Diamond's culture and employees.

Steven Neil joined Diamond as Executive Vice President, Chief Financial and Administrative Officer in March 2008 and served in that position until February 2012. He had served as an independent director on Diamond's Board from 2005 until 2008 when he accepted employment with Diamond. In addition to CFO duties, Neil was also responsible for operations, logistics, information technology (IT), treasury, grower relations, and purchasing.

The compensation of Diamond's senior management was tied to the Company's success. In fiscal 2009, 2010, and 2011, \$2.6 million of Mendes' \$4.1 million in annual bonus was paid because Diamond beat its EPS goal, according to regulatory filings (Byrnes, Huffstutter, and Dalal 2012). The compensation paid to Neil, who became the CFO in March 2008, was approximately eight times that of his predecessor CFO at the time of Diamond's conversion from a cooperative. During the fiscal years 2009, 2010, and 2011, Neil received \$1.18 million in bonuses, of which \$687,043 were tied to meeting EPS goals (*SEC v. Steven Neil* 2014).

### Diamond's Growth Ambition Gets Higher: Acquisition of Pringles®

The strategic direction provided by the senior management of Diamond led to an impressive growth in sales and income in every year since its incorporation. The common-size balance sheets, common-size statements of operations, and statements of cash flows of Diamond for each year since 2006 are presented in Exhibit 1, Panels A, B, and C, respectively.

Continuing the trajectory of high growth, Diamond set its sights on an even more ambitious target, Pringles®. Beginning in May 2010, Diamond submitted several offers to Procter & Gamble (P&G) to purchase P&G's Pringles® brand of potato chips. The Pringles® acquisition would make Diamond the second largest snack food company (only behind PepsiCo Inc.'s Frito-Lay®). Although Procter & Gamble initially rejected Diamond's offers, negotiations resumed in February 2011.

On April 5, 2011, Diamond reached an agreement to acquire Pringles® by exchanging \$1.5 billion of Diamond's stock and paying \$850 million in cash toward the total purchase price of \$2.35 billion. As noted in Gujarathi (2015), the transaction had a "cash collar," such that if the price of Diamond's stock dropped, then Diamond would increase the cash component (to as high as \$1.05 billion), and if the stock price rose, then the cash component would be reduced (to as low as \$700 million).

The expected benefits of acquisition were attractive. In the conference call to announce the Pringles® merger, Mendes stated: "In fiscal 2012 we expect net sales for the combined company to be approximately \$1.8 billion and EPS in the range of \$3.00 to \$3.10. This reflects EPS accretion of \$0.12 to \$0.15 per share." In the same conference call, CFO Steven Neil mentioned that although Diamond would incur merger and integration-related costs of approximately \$100 million<sup>2</sup> over the first two years, he agreed with Mendes that "the financial benefits of improved margins, significant EPS accretion, and free cash flow will make Diamond an even stronger company in the future, delivering exceptional value to Diamond and P&G

<sup>1</sup> The consensus estimates of fully diluted EPS for fiscal years 2007, 2008, 2009, 2010, and 2011 were \$0.508, \$0.888, \$1.36, \$1.373, and \$2.319, respectively (Bloomberg). In comparison, the actual fully diluted EPS numbers were \$0.53, \$0.91, \$1.44, \$1.36, and \$2.22, respectively in 2007 through 2011.

<sup>2</sup> On September 16, 2011, Diamond announced in its proxy statement an increase of \$50 million in the estimated transaction and integration costs of the Pringles® acquisition, raising the figure from \$100 million to \$150 million.

**EXHIBIT 1**  
**Common-Size Balance Sheets and Statements**

**Panel A: Balance Sheets, July 31 (amounts in thousand dollars)**

	2006		2007		2008		2009		2010		2011	
<b>ASSETS</b>												
<b>Current assets:</b>												
Cash and cash equivalents	35,614	14.1%	33,755	14.3%	74,279	27.2%	24,802	6.3%	5,642	0.5%	3,112	0.2%
Trade receivables, net	49,536	19.6%	50,662	21.4%	46,256	16.9%	33,492	8.5%	65,553	5.3%	98,218	7.6%
Inventories	99,177	39.2%	90,619	38.3%	88,526	32.4%	85,027	21.5%	143,405	11.7%	145,575	11.3%
Deferred income taxes	4,578	1.8%	4,805	2.0%	7,387	2.7%	13,109	3.3%	10,497	0.9%	13,249	1.0%
Prepaid income taxes	3,147	1.2%	1,854	0.8%	-	0.0%	-	0.0%	9,225	0.8%	2,783	0.2%
Property held for sale	1,728	0.7%	-	0.0%	-	0.0%	-	0.0%	-	0.0%	-	0.0%
Prepaid expenses and other current assets	4,182	1.7%	2,417	1.0%	4,261	1.6%	3,594	0.9%	5,767	0.5%	13,102	1.0%
<b>Total current assets</b>	<b>197,962</b>	<b>78.2%</b>	<b>184,112</b>	<b>77.9%</b>	<b>220,709</b>	<b>80.8%</b>	<b>160,024</b>	<b>40.5%</b>	<b>240,089</b>	<b>19.6%</b>	<b>276,039</b>	<b>21.4%</b>
Restricted cash	-	0.0%	-	0.0%	-	0.0%	-	0.0%	-	0.0%	-	1.2%
Property, plant and equipment, net	34,291	13.6%	33,936	14.4%	34,606	12.7%	51,115	12.9%	117,816	9.6%	127,407	9.9%
Deferred income taxes	4,812	1.9%	4,922	2.1%	5,802	2.1%	6,230	1.6%	13,625	1.1%	3,870	0.3%
Goodwill	5,077	2.0%	5,432	2.3%	5,432	2.0%	76,076	19.3%	396,788	32.4%	407,587	31.6%
Other intangible assets, net	3,941	1.6%	3,707	1.6%	3,473	1.3%	97,883	24.8%	449,018	36.6%	450,855	35.0%
Other long-term assets	6,949	2.7%	4,294	1.8%	3,245	1.2%	3,564	0.9%	8,536	0.7%	6,842	0.5%
<b>Total assets</b>	<b>253,032</b>	<b>100.0%</b>	<b>236,403</b>	<b>100.0%</b>	<b>273,267</b>	<b>100.0%</b>	<b>394,892</b>	<b>100.0%</b>	<b>1,225,872</b>	<b>100.0%</b>	<b>1,288,395</b>	<b>100.0%</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>												
<b>Current liabilities:</b>												
Current portion of long-term debt	-	0.0%	162	0.1%	-	0.0%	15,000	3.8%	40,000	3.3%	41,700	3.2%
Accounts payable and accrued liabilities	28,371	11.2%	26,306	11.1%	42,251	15.5%	64,453	16.3%	92,166	7.5%	144,060	11.2%
Payable to growers (Note 1)	81,902	32.4%	57,117	24.2%	56,942	20.8%	29,149	7.4%	35,755	2.9%	-	0.0%
<b>Total current liabilities</b>	<b>110,273</b>	<b>43.6%</b>	<b>83,585</b>	<b>35.4%</b>	<b>99,193</b>	<b>36.3%</b>	<b>108,602</b>	<b>27.5%</b>	<b>167,921</b>	<b>13.7%</b>	<b>185,760</b>	<b>14.4%</b>
Long-term obligations	20,000	7.9%	20,345	8.6%	20,204	7.4%	100,085	25.3%	516,100	42.1%	490,001	38.0%
Deferred income taxes	-	0.0%	-	0.0%	-	0.0%	1,221	0.3%	144,755	11.8%	131,870	10.2%
Other liabilities	11,933	4.7%	7,132	3.0%	7,647	2.8%	11,643	2.9%	17,153	1.4%	25,969	2.0%
<b>Stockholders equity:</b>												
Common stock, \$0.001 par value	16	0.0%	16	0.0%	16	0.0%	17	0.0%	22	0.0%	22	0.0%
Treasury stock, at cost	-	0.0%	(1,436)	-0.6%	(3,203)	-1.2%	(4,256)	-1.1%	(5,050)	-0.4%	(6,867)	-0.5%
Additional paid-in capital	93,962	37.1%	101,106	42.8%	112,550	41.2%	122,817	31.1%	307,032	25.0%	318,083	24.7%
Accumulated other comprehensive gain/(loss)	(36)	0.0%	2,233	0.9%	1,584	0.6%	(1,296)	-0.3%	(869)	-0.1%	18,500	1.4%
Retained earnings	16,884	6.7%	23,422	9.9%	35,276	12.9%	56,059	14.2%	78,808	6.4%	125,057	9.7%
<b>Total stockholders equity</b>	<b>110,826</b>	<b>43.8%</b>	<b>125,341</b>	<b>53.0%</b>	<b>146,223</b>	<b>53.5%</b>	<b>173,341</b>	<b>43.9%</b>	<b>379,943</b>	<b>31.0%</b>	<b>454,795</b>	<b>35.3%</b>
<b>Total liabilities and stockholders equity</b>	<b>253,032</b>	<b>100.0%</b>	<b>236,403</b>	<b>100.0%</b>	<b>273,267</b>	<b>100.0%</b>	<b>394,892</b>	<b>100.0%</b>	<b>1,225,872</b>	<b>100.0%</b>	<b>1,288,395</b>	<b>100.0%</b>

Note 1: Payable to growers was presented in Diamond's balance sheet as a separate line item until July 31, 2010. In the balance sheet of July 31, 2011, the payable to growers of \$15,186 was combined with accounts payable and accrued liabilities of \$128,874, for a total of \$144,060.  
Source: Numeric Values, Annual Reports of Diamond Foods. Percentages as calculated by the case author.

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shareholders." Prospects of the Pringles® acquisition sent Diamond's share price to \$96.13, the highest in its history, in September 2011.

**Controversy over Accounting of Grower Payments Brings Clouds to Diamond's Horizon**

Everything seemed to be going perfectly well for Diamond until the publication of a report on September 25, 2011 by Mark Roberts, an analyst with the Off Wall Street Consulting Group, a firm specializing in short-sale research (*Off Wall Street 2011*). Roberts noted that Diamond's earnings for 2011 were likely overstated because the Company made payments during that year to pay off growers who were underpaid the prior year. Typically, the Company takes delivery of walnuts during the Fall harvest season (September–November) and pays for the purchases in three installments, per the guidelines issued at the beginning of the season. The price for walnuts is not known at the time of delivery. Therefore, Diamond records the costs of walnuts in its quarterly financial statements using an estimate. The order in *SEC v. Michael Mendes (2014)* noted:

Each quarter, Diamond's finance department would prepare a memorandum justifying the walnut price used to value walnut inventory and the cost of the walnuts sold during the quarter. This memorandum was provided to the company's independent auditors, and the auditors relied on the memorandum as a representation that the walnut price had been determined in accordance with the accounting policy.

## EXHIBIT 1 (continued)

## Panel B: Statements of Operations for the Year Ended July 31 (in thousand dollars, except per share amounts)

	2006		2007		2008		2009		2010		2011	
Net sales	477,205	100.0%	522,585	100.0%	531,492	100.0%	570,940	100.0%	680,162	100.0%	965,922	100.0%
Cost of sales	411,809	86.3%	443,945	85.0%	443,490	83.4%	435,344	76.3%	519,161	76.3%	714,775	74.0%
Gross profit	65,396	13.7%	78,640	15.0%	88,002	16.6%	135,596	23.7%	161,001	23.7%	251,147	26.0%
Operating expenses:												
Selling, general and administrative	37,046	7.8%	42,541	8.1%	43,613	8.2%	60,971	10.7%	64,301	9.5%	96,960	10.0%
Advertising	17,977	3.8%	20,445	3.9%	20,508	3.9%	28,785	5.0%	32,962	4.8%	44,415	4.6%
Restructuring and other costs, net	3,442	0.7%	(15)	0.0%	-	0.0%	-	0.0%	-	0.0%	-	0.0%
Loss on termination of defined benefit plan	-	0.0%	3,054	0.6%	-	0.0%	-	0.0%	-	0.0%	-	0.0%
Acquisition and integration related expenses	-	0.0%	-	0.0%	-	0.0%	-	0.0%	11,508	1.7%	16,792	1.7%
Total operating expenses	58,465	12.3%	66,025	12.6%	64,121	12.1%	89,756	15.7%	108,771	16.0%	158,167	16.4%
Income from operations	6,931	1.5%	12,615	2.4%	23,881	4.5%	45,840	8.0%	52,230	7.7%	92,980	9.6%
Interest expense, net	295	0.1%	1,291	0.2%	1,040	0.2%	6,255	1.1%	10,180	1.5%	23,840	2.5%
Other	310	0.1%	98	0.0%	-	0.0%	898	0.2%	1,849	0.3%	-	0.0%
Income before income taxes	6,326	1.3%	11,226	2.1%	22,841	4.3%	38,687	6.8%	40,201	5.9%	69,140	7.2%
Income taxes (tax benefit)	(1,010)	-0.2%	2,793	0.5%	8,085	1.5%	14,944	2.6%	13,990	2.1%	18,929	2.0%
Net income (loss)	7,336	1.5%	8,433	1.6%	14,756	2.8%	23,743	4.2%	26,211	3.9%	50,211	5.2%
Earnings per share:												
Basic	0.47		0.53		0.92		1.45		1.40		2.28	
Diluted	0.47		0.53		0.91		1.42		1.36		2.22	
Shares used to compute earnings per share:												
Basic	15,634		15,786		16,088		16,073		18,313		21,577	
Diluted	15,653		15,786		16,152		16,391		18,843		22,242	
Total dividends on common stock:	1,407		1,895		2,902		2,960		3,462		3,962	
Annual dividend per share:	0.09		0.12		0.18		0.18		0.18		0.18	

Source: Numeric Values, Annual Reports of Diamond Foods. Percentages as calculated by the case author.

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While the first two installments for the Fall 2009 crop were made in a customary fashion, the third and final payment of \$20 million on August 13, 2010 was unusual. Diamond sent a letter to growers, signed by CEO Mendes, stating that the August 2010 check was intended to “represent both the final payment of the Fall 2009 crop and a ‘continuity payment’ reflecting the value of the multi-year supply arrangement.”

The payment pattern for the Fall 2010 crop was similar to that for the Fall 2009 crop, except that the phrase “momentum payment” was substituted for “continuity payment” and the amount involved was \$60 million. Diamond sent out two checks to each grower toward the final payment, one dated August 31, 2011 and the other dated two days later, September 2, 2011. Neither of these payments used the word “final payment” as Diamond had done in the past.

The market prices of walnuts had been rising for the past several years. The average walnut prices per pound reported by the United States Department of Agriculture (USDA) were 64 cents for the 2008 crop, 85.5 cents for the 2009 crop, 101.9 cents for the 2010 crop, and 143.5 cents for the 2011 crop. The prices received by the walnut growers from Diamond have been generally competitive, except for the 2009 and 2010 crops. A comment from one of the walnut suppliers stated: “Although the 2008 crop price per pound received from Diamond was competitive, for the 2009 crop, even with the continuity payment, Diamond was paying less per pound than the market price paid by other handlers” (Diamond Foods Securities Litigation 2012, 19). The pressure on Diamond to pay higher prices was increasing due to rising walnut prices in the international markets.

Views differed on whether the “continuity” and “momentum” payments made to the walnut growers were for the crop of the preceding or current fiscal year. Diamond argued that since its external auditors (Deloitte) had issued a clean audit report, the Company had no reason to believe that its accounts were not GAAP-compliant. However, several walnut suppliers maintained that the payment was for the crop of the earlier year. Some of the “momentum” payments were puzzling because they were made in August/September 2011 to farmers who terminated their relationship with Diamond in the spring following the 2010 crop season. A grower stated that she “knew of at least two growers who had already cancelled their contracts to sell walnuts to Diamond in Fall 2011, but still received the ‘momentum’ payment” (Diamond Foods Securities Litigation 2012, 26). The order in *SEC v. Michael Mendes* (2014) noted:

Diamond’s independent auditors inquired about the additional payment included with the final payment to growers, and employees in Diamond’s finance department told the auditors that the payment was an advance for the next year’s crop. The auditors required the issue be addressed in the management representation letter prepared by Diamond’s

## EXHIBIT 1 (continued)

## Panel C: Statements of Cash Flows for the Year Ended July 31 (in thousand dollars)

	2006	2007	2008	2009	2010	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>						
Net income	7,336	8,433	14,756	23,743	26,211	50,211
Adjustments:						
Depreciation and amortization	5,532	7,561	6,420	11,362	17,154	29,465
Deferred income taxes	(1,531)	(1,874)	(3,022)	(2,800)	7,072	(7,534)
Loss termination of defined benefit plan	-	2,575	-	-	-	-
Tax benefit related to stock-based compensation plans	-	-	-	(1,067)	(434)	(2,274)
Stock-based compensation	3,992	5,859	6,893	3,901	3,231	6,974
Gain on sale of property held for sale	-	(1,193)	-	-	-	-
Other, net	395	56	4	858	1,109	1,055
Changes in assets and liabilities:						
Trade receivables	(4,805)	(1,048)	4,406	12,764	(2,873)	(32,665)
Inventories	17,278	8,077	2,093	10,316	(45,852)	(2,170)
Prepaid expenses and income taxes and other current assets	(1,957)	1,581	10	1,053	(6,437)	(893)
Other assets	1,764	454	24	-	-	-
Accounts payable and accrued liabilities	(4,419)	(1,871)	15,475	(6,562)	(5,462)	17,577
Other, net	-	-	-	(200)	4,693	5,921
Payable to growers	9,348	(24,785)	(175)	-	-	-
Other liabilities	1,027	(11)	192	-	-	-
Net cash provided by (used in) operating activities	33,960	3,814	47,076	53,368	(1,588)	65,667
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>						
Capital revolve from CoBank	126	419	299	-	-	-
Net proceeds from sales of property, plant and equipment	49	2,941	12	-	-	-
Payment of Harmony acquisition costs	(19,186)	(197)	-	-	-	-
Purchases of property, plant and equipment	(8,354)	(6,790)	(6,583)	(7,994)	(11,790)	(27,703)
Net deposits of restricted cash	-	-	-	-	-	(15,795)
Acquisitions, net of cash acquired	-	-	-	(190,224)	(615,389)	-
Other, net	-	-	-	133	618	262
Net cash used in investing activities	(27,365)	(3,627)	(6,272)	(198,085)	(626,561)	(43,236)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>						
Revolving line of credit borrowings	-	-	-	-	176,000	-
Repayment of revolving line of credit	(2,119)	-	(162)	-	(9,900)	(4,800)
Net proceeds from issuance of long-term debt	-	-	-	123,027	391,148	21,350
Payment to members of membership interest	(17,329)	-	-	-	-	-
Payment of long-term debt and notes payable	-	-	-	(30,141)	(125,119)	(40,884)
Gross proceeds from equity offering	-	-	-	-	179,737	-
Issuance of common stock under stock plans	802	1,204	3,972	-	-	-
Dividends paid	(1,407)	(1,895)	(2,902)	(2,960)	(3,462)	(3,962)
Excess tax benefit from stock option transactions	37	81	579	1,067	434	2,274
Other, net	-	-	-	4,247	24	940
Purchase of treasury stock	-	(1,436)	(1,767)	-	-	-
Net cash (used in) provided by financing activities	(20,016)	(2,046)	(280)	95,240	608,862	(25,082)
Effect of exchange rate changes on cash	-	-	-	-	127	121
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(13,421)</b>	<b>(1,859)</b>	<b>40,524</b>	<b>(49,477)</b>	<b>(19,160)</b>	<b>(2,530)</b>
<b>Cash and cash equivalents:</b>						
Beginning of period	49,035	35,614	33,755	74,279	24,802	5,642
End of period	35,614	33,755	74,279	24,802	5,642	3,112

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**EXHIBIT 1 (continued)**

Source: Annual Reports of Diamond Foods.

Exhibit 1 is available for download as an Excel spreadsheet, see Appendix A.

finance department and signed by Mendes and other senior management, and the letter specifically stated that the continuity payment was for the upcoming crop.

**Audit Committee Investigation, SEC Investigation, and Class Action Suit**

Roberts' report on Diamond's questionable accounting and the media attention it sparked resulted in an audit committee investigation, a SEC investigation, and a class action suit. The plaintiffs in the class action suit alleged that Diamond and its senior managers were motivated to inflate share price of Diamond during a period in which Diamond was seeking to use its stock to acquire Pringles®. Further, they maintained that CEO Mendes and CFO Neil had knowledge of and access to walnut pricing and payment information, and that they were aware of the nature and purpose of the "continuity" and "momentum" payments.

A witness in the class action suit (Diamond Foods Securities Litigation 2012) was a financial accountant at the Company from April 2008 through May 2011. He stated that changing the commodity costs was not a new phenomenon at Diamond. In addition, he mentioned:

Initially I ran profitability and we were losing money or not where we want to be at. They (Donaghy [the assistant controller], Tropp [the controller] and Neil [the CFO]) looked through financials to see any big ticket items they could shuffle into next quarter. Or if we were making too much money they would push more costs in. Whenever we couldn't hit our numbers, (or) if they needed extra money, it was always commodity costs that got changed. It seemed like every quarter it was the same dance. If it seemed like EPS (Earnings Per Share) was going to be a bit higher than expected, then Tropp, Donaghy and or Neil would tell me 'this is a cost, this is a cost' to increase expenses and lower profits to be closer to analysts' expectations and leave more room for profits in the following quarter.

It was "common" for Diamond to change its "commodity costs" without any business justification for doing so. It was common in preparing month end and quarter end financials for Donaghy [the assistant controller] or Tropp [the controller] to ask me what the earnings looked like "if we dropped commodity prices half a penny or one penny" per pound. I would make the change and run the numbers and then report back. If the results did not yield earnings numbers that either met or exceeded analysts' expectations, I was directed to drop the commodity costs by another small increment. When the changes to commodity costs achieved the desired earnings numbers, Tropp [the controller] or Donaghy [the assistant controller] told me "okay, we'll do that." I or a co-worker then entered a journal entry for the commodity cost change.

At the conclusion of each month, the Company prepared an Excel spreadsheet detailing the monthly financial results. Assistant controller Debra Donaghy, Tropp [the controller] and Neil [the CFO] reviewed those results and "scrubbed them." This process was particularly rigorous at quarter end, and Neil [the CFO] was involved in the quarter end review, also sometimes known as the "pre-audit" review. Neil had meetings at quarter end, and instructed employees "to be aggressive." Those meetings were right before Diamond met with its auditors.

The result of changing the financials was significant to the Company's bottom line. In one quarter during Fiscal Year 2010, that took it from not being profitable when I ran roll-ups first, and then all of a sudden we're profitable.

An assistant treasurer who worked for Diamond from March 1999 through May 2011 corroborated the observations of the financial accountant. In the Diamond Foods Securities Litigation (2012, 11), the assistant treasurer stated:

I was involved in several meetings with Neil [the CFO] together with Senior Vice President and Controller Jim Tropp, and Vice President and Treasurer Bob Phillips where accounting decisions were discussed in the context of the impact the decision would have on the Diamond share price. On numerous occasions, they decided to delay recognizing an expense or to accelerate a payment to make their earnings look better and improve their share price.

The assistant treasurer also stated that the information about walnut pricing was not disclosed publicly or internally. In his words:

Information about grower payments and accounting for those payments was maintained within a very small circle of people including Tropp [the controller], Neil [the CFO], Mendes [the CEO], and Senior Vice President of Grower Account, Eric Heidman, Mendes' brother-in-law. (Diamond Foods Securities Litigation 2012, 13).

Similarly, a Diamond employee who worked in the human resources department from May 2011 through June 2012 stated (Diamond Foods Securities Litigation 2012, 18):

Mendes [the CEO] made every decision at Diamond, from what soda to stock in the vending machine to whom to hire.

Information was kept within a tight circle. No one in the Company beneath Mendes, Neil, or Senior Vice President of Supply Chain Steve Zaffarano even obtained access to profit and loss statement.

Another witness in the trial, a financial accountant with the Company from 2005 through November 2010, reported:

Mendes was a master of detail. You could talk to Michael about anything from nut sourcing to the prices being paid by Diamond's international and retailer customers. Mendes' knowledge of what was happening at Diamond was the best of anyone in the Company. He even knew where I went to lunch every day, even though he had no reason to have that information. (Diamond Foods Securities Litigation 2012, 10)

Steven Neil, Diamond's CFO was the co-pilot with CEO Michael Mendes in accounting maneuvers. The complaint in *SEC v. Steven Neil* stated:

Beginning in at least the second quarter of 2010, Neil provided false and misleading information, including written memoranda, regarding the quarterly walnut cost accruals to the auditors. Neil also withheld information from the auditors regarding his efforts to manage the walnut cost to meet EPS targets.

Throughout the audit of Diamond's fiscal year-end 2010 financial statements, the auditors asked Neil for information to substantiate his decision to account for the "continuity" payment as an advance on the 2010 crop and his assertions that the "continuity" payment was unrelated to 2009 crop deliveries. In response to these inquiries, Neil made material misrepresentations and withheld material information from the auditors.

Among other things, Neil [the CFO] omitted information known to him about the competitive prices other handlers had paid for the 2009 crop. Neil also misled Diamond's auditors regarding his conversations with growers, falsely communicating that growers had asked for an advance payment for the next crop and omitting facts about conversations in which he, or others at Diamond, assured growers a competitive price.

Neil [the CFO] misled Diamond's independent auditors with respect to Diamond's recorded walnut cost and concealed the second extraordinary payment (termed the "momentum" payment) from the audit committee during its review of Diamond's financial statements for fiscal year 2011.

#### Auditors of Diamond—Deloitte & Touche, LLP

Until 2005, Diamond used an audit firm, Moss Adams LLP, to check inventory and confirm grower payments (Byrnes et al. 2012). In each year since Diamond was incorporated as a corporation in 2005, Deloitte & Touche, LLP had served as independent auditors. Deloitte had also audited Diamond's prospectus for the IPO and consolidated financial statements for three years prior to going public.

The fees for the audit of financial statements, review of quarterly financial statements, and for evaluation of the internal controls over financial reporting received by Deloitte are presented below. The audit fees for fiscal 2012 include charges for Deloitte's assistance in the Audit Committee investigation relating to certain payments to walnut growers and restatement of prior financial statements.

<u>Fiscal Year</u>	<u>Audit Fees</u>
2006	\$1,197,000
2007	902,000
2008	896,000
2009	976,000
2010	1,259,000
2011	1,630,000
2012	16,504,000

Source: 10-K Reports of Diamond Foods

Deloitte did not raise any red flags for Diamond's accounting treatment of "continuity" or "momentum" payments. It should be noted that Deloitte audited P&G (and received \$29.8 million in fees for audit and audit-related work in 2010) and

was involved in the due diligence on its behalf. Deloitte's report (filed on September 15, 2011, 15 days before the SEC deadline) provided an unqualified audit opinion on Diamond's financial statements and internal controls over financial reporting for fiscal 2011 (see Exhibit 2 for the excerpts of its audit report for fiscal 2011).

The plaintiffs in the class action suit maintained that Deloitte was aware of strategies, methods, and procedures required by the standards of the Public Company Accounting Oversight Board (PCAOB) and Generally Accepted Auditing Standards (GAAS) for conducting proper audits. "It knew," the suit alleged, "or was deliberately reckless in not knowing of the audit risk inherent at Diamond and in the industry in which Diamond operated because of the comprehensive services it provided to Diamond over many years and because of its experience in the packaged and snack foods industry." The class action suit also stated that under GAAS, "the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

The plaintiffs in the class action suit further maintained that Deloitte failed to obtain a sufficient understanding of Diamond's business and operating environment. Deloitte was alleged not to have discharged its responsibility in this respect because it did not exercise professional skepticism, obtain information needed to identify the risks of material misstatement due to fraud, consider the results of analytical procedures performed in planning the audit, consider the fraud risk factors, or consider the possibility that management override of controls could occur.

The suit also alleged that because Deloitte worked on both sides of the Pringles® acquisition, it was aware of Diamond's stock volatility given that the majority of the consideration to be paid by Diamond was in the form of its stock.

### EPILOGUE

Diamond's shares, which traded above \$96 in September 2011, were trading below \$28 by December 2011.

On February 8, 2012, Diamond disclosed the following in its 8-K filing (Report of unscheduled material events or corporate event) to the SEC:

The Audit Committee has substantially completed its investigation of the Company's accounting for certain crop payments to walnut growers. The Committee has identified material weaknesses in the Company's internal control over financial reporting and concluded that a "continuity" payment made to growers in August 2010 of approximately \$20 million and a "momentum" payment made to growers in September 2011 of approximately \$60 million were not accounted for in the correct periods.

Diamond placed CEO Michael Mendes and CFO Steven Neil on administrative leave effective February 8, 2012 for their alleged involvement in the accounting scandal. Subsequently, they both resigned from their positions in November 2012. In a separate agreement, Mendes agreed to pay the Company \$2.74 million in cash clawback, representing the total value of his 2010 and 2011 bonuses, and return 6,665 shares of Diamond stock awarded to him after fiscal 2010 (*San Francisco Business Times* 2012).

In a conference call with the analysts on November 14, 2012, Mike Murphy, Interim CFO of Diamond remarked:

We underwent a new audit of 2010 and 2011 with a much lower materiality threshold across all the Company's accounts. The restatement resulted in a reduction in previously reported income before taxes of \$39.5 million in fiscal 2011 and \$17.0 million in fiscal 2010. These amounts are largely attributable to the restated walnut payments.

On November 14, 2012, Diamond filed with the SEC an amendment to the previously filed 10-K. Deloitte's (amended) report on internal control, and (amended) audit report therein are presented in Exhibit 3, Panels A and B, respectively.

Diamond announced on February 15, 2012 that the Company and P&G had mutually terminated the deal to acquire Pringles® and that it did not have to pay any break-up fees to P&G. Pringles® was acquired by Kellogg Company on February 15, 2012 for \$2.7 billion cash.

On November 30, 2012, the judge in the Diamond Foods Securities Litigation granted Deloitte's motion to dismiss the complaint against Deloitte.

For fiscal year 2012, filed with the SEC on December 7, 2012, Diamond reported a negative EPS of \$3.98 and it suspended dividend payments.

Diamond announced on March 24, 2013 that the Audit Committee of its Board of Directors approved the dismissal of Deloitte & Touche LLP and appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accountants.

On August 21, 2013, Diamond agreed to pay \$11 million in cash and issue 4.45 million common shares to a fund to settle the lawsuit relating to the accounting scandal (*Reuters* 2013). The value of the total payment will depend on the market price of Diamond's shares when they are issued to the fund. At the market price of Diamond's stock on the previous day (August 20) of \$19.13 per share, the total consideration was about \$96 million (\$11 million cash + (\$19.13 × 4.45 million shares)).



On January 9, 2014, the SEC reached a settlement with the Company (*SEC v. Diamond Foods 2014*) in which Diamond agreed to pay a fine of \$5 million. The SEC also reached a settlement with Michael Mendes who agreed to pay a \$125,000 penalty to settle the charges without admitting or denying the allegations (*SEC v. Michael Mendes 2014*).

SEC's litigation against Steven Neil (*SEC v. Steven Neil 2014*) continued well after the settlement with Diamond and Michael Mendes. *CFO.com (2014)* reported:

Neil hasn't settled because he did nothing wrong. He followed longstanding company practices and an accounting treatment that was approved by the company's outside auditors, and he looks forward to prevailing at trial.

On February 2, 2015, without admitting or denying the SEC's allegations, Neil consented to the final judgment that ordered him to pay \$125,000 in civil monetary penalties and barred him from serving as an officer or director of a public company for five years. Neil also agreed to forfeit a legal claim against Diamond related to shares and stock options (worth about \$1 million) that the company awarded him during the time of the fraudulent financial reporting.

## REQUIREMENTS

### Requirement 1

- (a) Explain briefly the technique(s) used by Diamond's senior management to manipulate the Company's earnings in fiscal 2010 and 2011.
- (b) Explain whether Diamond's accounting of the August 2010 "continuity" payments and August/September 2011 "momentum" payments complied with the Generally Accepted Accounting Principles (GAAP) in the U.S. Cite related pronouncement(s).
- (c) Was Diamond's accounting in compliance with the International Financial Reporting Standards (IFRS)? Explain.

### Requirement 2

Diamond's Audit Committee concluded that a "continuity" payment made to growers in August 2010 of \$20 million and a "momentum" payment made to growers in August/September 2011 of \$60 million were not accounted for in the correct periods.

- (a) Assume that a junior auditor of Deloitte's audit team has proposed that given the size of "the total liabilities and stockholders' equity" of Diamond of \$1.226 billion, an adjustment of \$20 million of grower payables is immaterial (1.63 percent) for *fiscal 2010*. Would you agree with the junior auditor? Why? [Note: Assume that Diamond sold all walnuts purchased during the fiscal year in that year.]
- (b) How would you determine whether the effect of recording the \$20 million "continuity" payments and \$60 million "momentum" payments in incorrect accounting periods was material on Diamond's financial statements for *fiscal 2011*? Explain and provide an appropriate explanation and supporting calculations, if any.

### Requirement 3

- (a) Why is it important for an auditor to understand a client's business environment?
- (b) Provide some examples of Diamond's business risks contributing to the financial reporting and audit risks that Deloitte had to consider in performing the audit for fiscal 2011.
- (c) What audit procedures could Deloitte have performed to help it detect the fraud by Diamond's management?

### Requirement 4

Explain how the presence of the three aspects of the fraud triangle enabled fraud to occur at Diamond Foods in *fiscal 2011*.

### Requirement 5

What are the responsibilities of auditors for the *interim* financial statements of public companies? Cite related professional pronouncement(s). Was it relatively easier for Diamond's management to manage earnings in the interim financials compared to the annual financials? Why?

### Requirement 6

Which of the professional auditing standards listed in AU 150 may not have been followed by Deloitte in its audit of Diamond for fiscal 2010 and fiscal 2011? Support your answer with specific examples from the case.

**Requirement 13**

- (a) Based on the data provided in the case, do you think that Diamond’s senior management acted with scienter in fiscal 2010 and 2011? Explain.
- (b) Do you agree with the plaintiffs’ allegation in the Diamond Foods Securities Litigation that Deloitte should have known the “red flags” that accompanied the fraud and thus was responsible for not discovering and reporting the fraud? Why?
- (c) Despite the allegations by the plaintiffs, the court granted Deloitte’s motion to dismiss the complaint against it. What possible reasons explain the court’s verdict?
- (d) What precautions can auditors take to shield themselves from the potential liability arising from fraud committed by client’s management?

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**EXHIBIT 2****Excerpts from Deloitte’s Audit Report for Fiscal 2011**

We have audited the accompanying consolidated balance sheets of Diamond Foods, Inc. and subsidiaries (the “Company”) as of July 31, 2011 and 2010, and the related consolidated statements of operations, stockholders’ equity, and cash flows for each of the three years in the period ended July 31, 2011. We also have audited the Company’s internal control over financial reporting as of July 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway commission. The Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States).

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Diamond Foods, Inc. and subsidiaries as of July 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 2011, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal

control over financial reporting as of July 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ Deloitte & Touche LLP

San Francisco, California

September 15, 2011

### EXHIBIT 3

#### A. Excerpts From Deloitte’s Report on Internal Control over Financial Reporting on Restated Financial Statements of Fiscal 2011

To the Board of Directors and Stockholders of Diamond Foods, Inc.

We have audited Diamond Foods, Inc. and subsidiaries’ (the “Company’s”) internal control over financial reporting as of July 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying “Management’s Report on Internal Control over Financial Reporting.” Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

In our report dated September 15, 2011, we expressed an unqualified opinion on internal control over financial reporting. As described in the following paragraphs, material weaknesses were subsequently identified in connection with the restatement of the previously issued financial statements. Accordingly, management has revised its assessment about the effectiveness of the Company’s internal control over financial reporting and our present opinion on the effectiveness of the Company’s internal control over financial reporting as of July 31, 2011, as expressed herein, is different from that expressed in our previous report.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis. The following material weaknesses have been identified and included in management’s assessment:

- *Control Environment*: The control environment, which includes the Company’s Code of Conduct and Ethics Policy, is the responsibility of senior management, sets the tone of the organization, influences the actions of its employees, and is the foundation for all other components of internal control over financial reporting. The Company did not maintain an effective control environment. Management’s operating style and concentrated decision making increased the risk of management override of certain controls, limited effective communication and flow of information throughout the organization and to those charged with governance and did not provide an environment that consistently encouraged open discussion of alternate views or opinions.
- *Walnut Grower Accounting*: The above material weakness in the control environment contributed to material weaknesses in walnut grower accounting control activities. Management did not effectively or consistently communicate the nature and intent of certain walnut grower payments throughout the organization, to growers, and to those charged with governance. Controls were not designed to ensure that the annual walnut costs and quarterly walnut cost estimates and changes in such estimates were sufficiently supported and based on consideration of all relevant information. Controls over walnut costs and accounting for certain grower payments were improperly designed, were not designed to provide appropriate segregation of duties, and were not operating effectively in ensuring that walnut costs and payments were recorded correctly in the appropriate period.
- *Accounts Payable and Accrued Expenses*: The controls over recording accounts payable and accrued expenses were improperly designed and were not operating effectively to ensure that all expenditures were identified and recorded in the appropriate account and period. Controls were not in place to address the volume and nature of invoice processing.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audits of the consolidated financial statements as of and for the year ended July 31, 2011, of the Company and this report does not affect our report on such financial statements.

In our opinion, because of the effect of the material weaknesses identified above on the achievement of the objectives of the control criteria, the Company has not maintained, in all material respects, effective internal control over financial reporting as of July 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended July 31, 2011, of the Company and our report dated

September 15, 2011, (November 13, 2012 as to the effects of the restatement discussed in Note 15 and subsequent events in Note 17) expressed an unqualified opinion on those financial statements and included an explanatory paragraph relating to the restatement.

/s/ Deloitte & Touche LLP

San Francisco, California

September 15, 2011 (November 13, 2012 as to the effects of the material weaknesses described in Management's Report on Internal Control over Financial Reporting as revised)

#### **B. Excerpts from Deloitte's Audit Report on Restated Financial Statements of Fiscal 2011**

To the Board of Directors and Stockholders of Diamond Foods, Inc.

We have audited the accompanying consolidated balance sheets of Diamond Foods, Inc. and subsidiaries (the "Company") as of July 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended July 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

...

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Diamond Foods, Inc. and subsidiaries as of July 31, 2011 and 2010, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the consolidated financial statements, the accompanying 2011 and 2010 consolidated financial statements have been restated.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of July 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated September 15, 2011 (November 13, 2012 as to the effects of the material weaknesses described in *Management's Report on Internal Control over Financial Reporting*, as revised) expressed an adverse opinion on the Company's internal control over financial reporting because of material weaknesses.

/s/ Deloitte & Touche LLP

San Francisco, California

September 15, 2011 (November 13, 2012 as the effects of the restatement discussed in Note 15 and subsequent events in Note 17)