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CASE 4.4

Creve Couer Pizza, Inc.

Imagine this scenario. A few years after graduating from College of William & Mary, Xavier University, or Youngstown State University with an accounting degree, you find yourself working as an audit senior with an international accounting firm. Your best friend, Rick, whom you have known since kindergarten, is a special agent with the Internal Revenue Service (IRS). Over lunch one day, Rick mentions the IRS's informant program.

"You know, Jess, you could pick up a few hundred dollars here and there working as a controlled informant for us. In fact, if you would feed us information regarding one or two of those large corporate clients of yours, you could make a bundle."

"That's funny, Rick. Real funny. Me, a double agent, spying on my clients for the IRS? Have you ever heard of the confidentiality rule?"

Sound farfetched? Not really. Since 1939, the IRS has operated an informant program. Most individuals who participate in this program provide information on a one-time basis; however, the IRS also retains hundreds of "controlled informants" who work in tandem with one or more IRS special agents on a continuing basis. Controlled informants provide the IRS with incriminating evidence regarding individuals and businesses suspected of cheating on their taxes. In the early 1990s, the IRS revealed that more than 40 of these controlled informants were CPAs.

Now consider this scenario. You, the audit senior, are again having lunch with your friend Rick, the IRS special agent. Rick knows that the IRS is investigating you for large deductions taken in recent years on your federal income tax returns for a questionable tax shelter scheme. The additional tax assessments and fines you face significantly exceed your net worth. Your legal costs alone will be thousands of dollars. To date, you have been successful in concealing the IRS investigation from your spouse, other family members, and your employer, but that will not be possible much longer.

"Jess, I know this investigation is really worrying you. But I can get you out of this whole mess. I talked to my supervisor. She and three other agents are working on a case involving one of your audit clients. I can't tell you which one right now. If you agree to work with them as a controlled informant and provide them with information that you can easily get your hands on, they will close the case on you. You will be off the hook. No questions. No fines or additional taxes. Case closed . . . permanently."

"Rick, come on, I can't do that. What if my firm finds out? I'd lose my job. I would probably lose my certificate."

"Yeah, but face these facts. If the IRS proves its case against you, you are going to lose your job and your certificate . . . and probably a whole lot more. Maybe even your marriage. Think about it, Jess. Realistically, the agency is looking at a maximum recovery of $50,000 from you. But if you cooperate with my supervisor, she can probably squeeze several million out of your client."

"You're sure they would let me off . . . free and clear?"

"Yes. Free and clear. Come on, Jess, we need you. More important, you need us. Plus, think of it this way. You made one mistake by becoming involved in that phony tax shelter scam. But your client has been ripping off the government, big time, for years. You would be doing a public service by turning in those crooks."

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Returning to reality, consider the case of James Checksfield. In 1981, Checksfield, a Missouri CPA, became a controlled informant for the IRS. The IRS special agent who recruited Checksfield had been his close friend for several years and knew that Checksfield was under investigation by the IRS. Reportedly, Checksfield owed back taxes of nearly $30,000 because of his failure to file federal income tax returns from 1974 through 1977.

At the same time the IRS recruited Checksfield, the federal agency was also investigating a Missouri-based company, Creve Couer Pizza, Inc. The IRS believed that the owner of this chain of pizza restaurants was "skimming receipts" from his business–that is, failing to report on his federal income tax returns the total sales revenue of his eight restaurants. Checksfield had served as Creve Couer's CPA for several years, although both the IRS and Checksfield denied that he was recruited specifically to provide information regarding that company.

From 1982 through 1985, Checksfield funneled information to the IRS regarding Creve Couer Pizza. Based upon this information, federal prosecutors filed a six-count criminal indictment against the owner of that business in 1989. This indictment charged the owner with underreporting his taxable income by several hundred thousand dollars. The owner faced fines of nearly $1 million and a prison term of up to 24 years if convicted of the charges. Meanwhile, the IRS dropped its case against Checksfield. Both the IRS and Checksfield maintained that there was no connection between the decision to drop the case against him and his decision to provide the IRS with information regarding Creve Couer Pizza.

Following the indictment filed against the owner of Creve Couer Pizza, the owner's attorneys subpoenaed the information that the IRS had used to build its case against him. As a result, the owner discovered the role played by his longtime friend and accountant in the IRS investigation. Quite naturally, the owner was very upset. "What my accountant did to me was very mean and devious. He sat here in my home with me and my family. He was like a member of the family. On the other hand, he was working against me."[1] In another interview, the owner observed, "A client has the right to feel he's getting undivided loyalty from his accountant."[2] Contributing to the owner's anger was the fact that he had paid Checksfield more than $50,000 in fees for accounting and taxation services during the time the CPA was working undercover for the IRS.

The print and electronic media reported the case of the "singing CPA" nationwide, prompting extensive criticism of the IRS. The case also caused many clients of CPAs to doubt whether they could trust their accountants to protect the confidentiality of sensitive financial information. When questioned concerning the matter, the IRS expressed no remorse for using Checksfield to gather incriminating evidence regarding the owner of Creve Couer Pizza. An IRS representative also rejected the contention that communications between accountants and their clients should be "privileged" under federal law similar to the communications between attorneys and their clients.

> *The IRS says the claim of a privileged [accountant-client] relationship is nonsense. "To the contrary," says Edward Federico of the IRS's criminal-investigation division in St. Louis, "the accountant has a moral and legal obligation to turn over information."*[3]

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1. "Accountant Spies on Client for IRS," *Kansas City Star*, 18 March 1992, 2.
2. "The Case of the Singing CPA," *Newsweek*, 17 July 1989, 41.
3. *Ibid.*

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The accounting profession was appalled by the Checksfield case and tried to minimize the damage it had done to the public's trust in CPAs. In particular, the profession condemned the actions of the IRS.

> *Rarely has there been such a case of prosecutorial zeal that violated rudimentary standards of decency. . . . Turning the client–accountant relationship into a secret tool for government agents is an abominable practice. It demeans the service. It erodes trust in the accounting profession.*[4]

EPILOGUE

In August 1990, the Missouri State Board of Accountancy revoked James Checksfield's CPA license for violating a state law that prohibits CPAs from disclosing confidential client information without the client's permission. In November 1991, the U.S. Department of Justice suddenly announced that it was dropping the tax evasion charges against the owner of Creve Couer Pizza, although pretrial arguments had already been presented for the case. The Justice Department had little to say regarding its decision. Legal experts speculated that federal prosecutors dropped the charges because the judge hearing the case was expected to disallow the evidence that the IRS had collected with the assistance of Checksfield.

Despite the negative publicity produced by the Creve Couer case, the IRS continues to use accountants both in public practice and private industry as informants. In the late 1990s, *Forbes* magazine reported a case in which a disgruntled controller of a retail electronics chain got even with his boss.[5] Shortly before leaving the firm, the controller copied accounting and tax records documenting a large-scale tax fraud perpetrated by the chain's owner. Thanks to this information, the IRS collected a nearly $7 million fine from the owner and sent him to jail for 10 months. The former controller received a significant but undisclosed "finder's fee" from the IRS for his "cooperation."[6]

Questions

1. Do CPAs who provide accounting, taxation, and related services to small businesses have a responsibility to serve as the "moral conscience" of those clients? Explain.
2. In a 1984 opinion handed down by the U.S. Supreme Court, Chief Justice Warren Burger noted that "the independent auditor assumes a public responsibility transcending any employment relationship with the client." If this is true, do auditors have a moral or professional responsibility to turn in clients who are cheating on their taxes or violating other laws?
3. Assume that you were Jess in the second hypothetical scenario presented in this case. How would you respond to your friend's suggestion that you become a controlled informant for the IRS? Identify the parties that would be affected by your decision and the obligations you would have to each.

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4. "IRS Oversteps with CPA Stoolies," *Accounting Today*, 6 January 1992, 22.
5. J. Novack, "Boomerang," *Forbes*, 7 July 1997, 42–43.
6. In 2007, the IRS Whistleblower Office was established. This office administers a provision of a 2006 federal law that guarantees individuals who report significant tax deficiencies owed by other parties a minimum payment equal to 15 percent of the delinquent taxes collected.

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CASE 4.5

F&C International, Inc.

Alex Fries emigrated to the United States from Germany in the early nineteenth century.[1] The excitement and opportunities promised by the western frontier fascinated thousands of new Americans, including the young German who followed his dreams and the Ohio River west to Cincinnati. A chemist by training, Fries soon found a job in the booming distillery industry of southern Ohio and northern Kentucky. His background suited him well for an important need of distilleries, namely, developing flavors to make their products more palatable for the public. Alex Fries eventually established his own flavor company. Thanks largely to Fries, Cincinnati became the home of the small but important flavor industry in the United States. By the end of the twentieth century, the flavor industry's annual revenues approached $5 billion.

Alex Fries' success in the flavor industry became a family affair. Two of his grandsons created their own flavor company, Fries & Fries, in the early 1900s. Several decades later, another descendant of Alex Fries, Jon Fries, served as the president and CEO of F&C International, Inc., a flavor company whose common stock traded on the NASDAQ stock exchange. F&C International, also based in Cincinnati, reigned for a time during the 1980s as Ohio's fastest-growing corporation. Sadly, the legacy of the Fries family in the flavor industry came to a distasteful end in the early 1990s.

The Fraud

Jon Fries orchestrated a large-scale financial fraud that led to the downfall of F&C International. At least 10 other F&C executives actively participated in the scam or allowed it to continue unchecked due to their inaction. The methods used by Fries and his cohorts were not unique or even innovative. Fries realized that the most effective strategy for embellishing his company's periodic operating results was to inflate revenues and overstate period-ending inventories. Throughout the early 1990s, F&C systematically overstated sales revenues by backdating valid sales transactions, shipping customers product they had not ordered, and recording bogus sales transactions. To overstate inventory, F&C personnel filled barrels with water and then labeled those barrels as containing high-concentrate flavor products. The company also neglected to write off defective goods and included waste products from manufacturing processes in inventory. Company officials used F&C's misleading financial statements to sell equity securities and to obtain significant bank financing.

As F&C's fraud progressed, Jon Fries and his top subordinates struggled to develop appropriate sales and inventory management strategies since the company's accounting records were unreliable. To help remedy this problem, F&C created an imaginary warehouse, Warehouse Q.

1. The facts in this case were taken from several SEC enforcement releases and a series of articles that appeared in the *Cincinnati Enquirer.* The key parties in this case neither admitted nor denied the facts reported by the SEC. Those parties include Jon Fries, Catherine Sprauer, Fletcher Anderson, and Craig Schuster.

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> *Warehouse Q became the accounting repository for product returned by customers for being below specification, unusable or nonexistent items, and items that could not be found in the actual warehouses.*[2]

Another baffling problem that faced Fries and his confederates was concealing the company's fraudulent activities from F&C's independent auditors. The executives continually plotted to divert their auditors' attention from suspicious transactions and circumstances uncovered during the annual audits. Subversive measures taken by the executives included creating false documents, mislabeling inventory counted by the auditors, and undercutting subordinates' attempts to expose the fraud.

The size and complexity of F&C's fraud eventually caused the scheme to unravel. Allegations that the company's financial statements contained material irregularities triggered an investigation by the Securities and Exchange Commission (SEC). The investigation revealed that F&C had overstated its cumulative pretax earnings during the early 1990s by approximately $8 million. The company understated its pretax net loss for fiscal 1992 alone by nearly 140 percent or $3.8 million.

The Division Controller

Catherine Sprauer accepted an accounting position with F&C International in July 1992, shortly after the June 30 close of the company's 1992 fiscal year. Sprauer, a CPA, drafted the Management's Discussion and Analysis (MD&A) section of F&C's 1992 Form 10-K registration statement. In October 1992, the 28-year-old Sprauer became the controller of F&C's Flavor Division. Following that promotion, Sprauer continued to help prepare the MD&A sections of F&C's periodic financial reports submitted to the SEC.

In early January 1993, an F&C employee told Sprauer that he saw company employees filling inventory barrels with water in the final few days of June 1992. This individual also advised Sprauer that he had documentation linking two F&C executives to that incident, which was apparently intended to overstate the company's year-end inventory for fiscal 1992. According to the SEC, Sprauer abruptly ended the conversation with this employee and did not discuss his allegations with anyone.

Later that same day, another F&C employee approached Sprauer and confessed that he was involved in the episode recounted to her earlier in the day. This individual told Sprauer that he had acted under the direct instructions of Jon Fries. The employee then attempted to hand Sprauer a listing of inventory items affected by the fraud. Sprauer refused to accept the list. The persistent employee placed the list in Sprauer's correspondence file. The document detailed approximately $350,000 of nonexistent inventory in F&C's accounting records. Sprauer reportedly never showed the list of bogus inventory to her superiors, to other F&C accountants, or to the company's independent auditors. However, she subsequently warned F&C's chief operating officer (COO), Fletcher Anderson, that the company had "significant inventory problems."

The Chief Operating Officer

Fletcher Anderson became the COO of F&C International in September 1992 and joined the company's board of directors a few days later. On March 23, 1993, Anderson succeeded Jon Fries as F&C's president and CEO. During the fall of 1992, Anderson stumbled across several suspicious transactions in F&C's accounting records. In late

2. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 605*, 28 September 1994. All subsequent quotations are taken from this source.

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September 1992, Anderson discovered sales shipments made before the given customers had placed purchase orders with F&C. He also learned that other sales shipments had been delivered to F&C warehouses rather than to customers. Finally, in early October 1992, Anderson uncovered a forged bill of lading for a customer shipment. The bill of lading had been altered to change the reported month of shipment from October to September. Each of these errors inflated F&C's reported earnings for the first quarter of fiscal 1993, which ended September 30, 1992.

More direct evidence that F&C's financial data were being systematically distorted came to Anderson's attention during the second quarter of 1993. In November, a subordinate told Anderson that some of the company's inventory of flavor concentrate was simply water labeled as concentrate. The following month, Anderson learned of Warehouse Q and that at least $1.5 million of the inventory "stored" in that warehouse could not be located or was defective.

Catherine Sprauer submitted her resignation to Fletcher Anderson in late January 1993. Among the reasons Sprauer gave for her resignation were serious doubts regarding the reliability of the company's inventory records. Anderson insisted that Sprauer not tell him why she believed those records were unreliable because he wanted to avoid testifying regarding her concerns in any subsequent litigation.

In February 1993, shortly before Anderson replaced Jon Fries as F&C's top executive, an F&C cost accountant warned him that the company had an inventory problem "in the magnitude of $3-4 million." Anderson later told the SEC that although the cost accountant had access to F&C's inventory records and its actual inventory, he believed the accountant was overstating the severity of the company's inventory problem.

The Chief Financial Officer

Craig Schuster served as the chief financial officer (CFO) of F&C International during the early 1990s. As F&C's CFO, Schuster oversaw the preparation of and signed the company's registration statements filed with the SEC, including the company's Form 10-K reports for fiscal 1991 and 1992. Throughout 1992, Schuster became aware of various problems in F&C's accounting records, most notably the existence of Warehouse Q. In March 1992, Schuster learned that his subordinates could not locate many items listed in F&C's perpetual inventory records. A few months later, Schuster discovered that customer shipments were being backdated in an apparent attempt to recognize sales revenue prematurely. In late 1992, Schuster determined that approximately $1 million of F&C's work-in-process inventory was classified as finished goods.

On December 17, 1992, a frustrated Schuster prepared and forwarded to Fletcher Anderson a 23-page list of $1.5 million of inventory allegedly stored in Warehouse Q. The memo indicated that the inventory could not be located or was defective. The SEC's enforcement releases focusing on the F&C fraud did not reveal how or whether Anderson responded to Schuster's memo.

Because he supervised the preparation of F&C's financial reports filed with the SEC, Schuster knew that those reports did not comment on the company's inventory problems. On January 1, 1993, Craig Schuster resigned as the CFO of F&C International. The final F&C registration statement Schuster signed was the company's Form 10-Q for the first quarter of fiscal 1993, which ended September 30, 1993.

The Rest of the Story

In a September 28, 1994, enforcement release, the SEC criticized Catherine Sprauer, Fletcher Anderson, and Craig Schuster for failing to ensure that F&C's financial reports "filed with the Commission and disseminated to the investing public were accurate."

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The federal agency also chastised the three individuals for not disclosing in F&C's financial reports "significant accounting problems of which they were aware." Finally, the SEC scolded Anderson and Schuster for not establishing adequate internal controls to provide for the proper recognition of revenue and the proper valuation of inventory. In an agreement reached with the SEC to settle the allegations pending against them, the three former F&C executives pledged to "permanently cease and desist" from committing or causing violations of federal securities laws.

A second enforcement release issued by the SEC on September 28, 1994, contained a series of allegations directed at Jon Fries and seven other senior F&C executives. The SEC charged that these executives were primarily responsible for F&C's fraudulent earnings scheme. To settle these charges, each executive pledged not to violate federal securities laws in the future. The settlement agreement permanently banned Jon Fries from serving as an officer or director of a public company. Several of the individuals agreed to forfeit proceeds received from earlier sales of F&C securities. Fries relinquished more than $2 million he had realized from the sale of F&C common stock. Finally, the SEC imposed civil fines on four of the executives that ranged from $11,500 to $20,000.

F&C International filed for bankruptcy in April 1993 shortly after the fraud became public. The following year, a competitor purchased F&C's remaining assets. In March 1995, Jon Fries began serving a 15-month sentence in a federal prison for his role in the F&C fraud.

Questions

1. Jon Fries (CEO), Fletcher Anderson (COO), Craig Schuster (CFO), and Catherine Sprauer (division controller) were the four central figures in this case. Identify the key responsibilities associated with the professional roles these individuals occupied. Briefly describe the type and extent of interaction each of these individuals likely had with F&C's independent auditors.
2. Using the scale shown below, evaluate the conduct of the four key individuals discussed in this case. Be prepared to defend your answers.

   −100 . . . . 0 100
   Highly Unethical — Highly Ethical

3. For a moment, step into the shoes of Catherine Sprauer. What would you have done during and following each of the confrontations she had with the two employees who insisted that F&C executives were involved in a fraudulent scheme to misrepresent the company's financial statements?
4. Craig Schuster resigned as F&C's CFO on January 1, 1993. Apparently, Schuster did not reveal to any third parties the concerns he had regarding F&C's accounting records and previous financial statements. In your opinion, did Schuster have a responsibility to inform someone of those concerns following his resignation? Defend your answer.
5. Assume that you, rather than Fletcher Anderson, were F&C's COO in December 1992. What would you have done upon receiving the list of Warehouse Q inventory from Craig Schuster?

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CASE 4.6

Freescale Semiconductor, Inc.

Who will guard the guardians?

Juvenal

During the summer of 2006, a syndicate of investors led by The Blackstone Group, one of Wall Street's largest private equity investment firms, initiated a secret plan to acquire Freescale Semiconductor. Based in Austin, Texas, Freescale is among the world's largest producers of semiconductors and for decades was a subsidiary of Motorola, Inc., the large electronics company. In July 2004, Motorola spun off Freescale in one of that year's largest initial public offerings.

Blackstone retained Ernst & Young (E&Y) to serve as a consultant for the planned buyout of Freescale. Among other services, Blackstone wanted E&Y to review Freescale's human resource functions and to make recommendations on how to streamline and strengthen those functions following the acquisition. James Gansman, a partner in E&Y's Transaction Advisory Services (TAS) division, was responsible for overseeing that facet of the engagement.

Similar to the other Big Four accounting firms, E&Y became involved in the investment banking industry during the 1990s. In fact, by the late 1990s, the small fraternity of accounting firms could boast of having two of the largest investment banking practices in the world, at least in terms of the annual number of consulting engagements involving merger and acquisition (M&A) deals. In 1998, KPMG consulted on 430 M&A transactions, exactly one more than the number of such engagements that year for PricewaterhouseCoopers (PwC). Despite those impressive numbers, KPMG and PwC had not established themselves as dominant firms in the investment banking industry.

In 1998, the total dollar volume of the M&A engagements on which KPMG and PwC consulted was $1.65 billion and $1.24 billion, respectively. Those numbers paled in comparison to the annual dollar value of M&A transactions for industry giants such as Goldman Sachs, which was involved in M&A deals valued collectively at nearly $400 billion in 1998. At the time, Goldman Sachs, Lehman Brothers, Morgan Stanley, and the other major investment banking firms consulted exclusively on "mega" or multibillion-dollar M&A engagements. By contrast, the "low end" of the M&A market–in which the Big Four firms competed–typically involved transactions measured in a few million dollars.

E&Y's involvement in the huge Freescale M&A deal was a major coup for the Big Four firm. When the transaction was consummated in December 2006, the price paid for the company by the investment syndicate led by The Blackstone Group approached $18 billion. That price tag made it the largest private takeover of a technology company to that point in time as well as one of the ten largest corporate takeovers in U.S. history.

Not surprisingly, Blackstone demanded strict confidentiality from E&Y and the other financial services firms that it retained to be involved in the planned acquisition of Freescale. James Gansman, for example, was told that Blackstone wanted the transaction to be "super confidential" and was instructed in an internal E&Y e-mail to "not breathe the name of the target [Freescale] outside of the [engagement] team."[1]

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1. U.S. Department of Justice, "Former Ernst & Young Partner and Investment Banker Charged in Insider Trading Scheme," 29 May 2008, (http://newyork.fbi.gov).

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During June and July 2006 while he was working on the Freescale engagement, Gansman passed "inside information about the pending transaction"[2] to Donna Murdoch, a close friend who worked in the investment banking industry. An FBI investigation revealed that Gansman and Murdoch "communicated over 400 times via telephone and text messages"[3] in the weeks leading up to the September 11, 2006, announcement that the Blackstone investment syndicate intended to acquire Freescale. In that time span, Murdoch purchased hundreds of Freescale stock options, which she cashed in on September 11–12, 2006, realizing a windfall profit of $158,000.

The FBI also determined that between May 2006 and December 2007 Gansman provided Murdoch with information regarding six other M&A transactions on which E&Y consulted. In total, Murdoch used that inside information to earn nearly $350,000 in the stock market. Murdoch gave that information to three other individuals, including her father, who also used it to produce significant stock market profits.

Published reports indicate that Murdoch became involved in the insider trading scheme to help make the large monthly payments on a $1.45 million subprime mortgage on her home. The funds she initially used to "play the market" were provided to her by one of the individuals to whom she disclosed the inside information given to her by James Gansman. In addition, Gansman at one point loaned her $25,000.

The Securities and Exchange Commission (SEC) uses sophisticated software programs to detect suspicious trading activity in securities listed on stock exchanges. In early 2007, the SEC placed Murdoch on its "watch list" of individuals potentially involved in insider trading and began scrutinizing her stock market transactions. Information collected by the SEC resulted in criminal charges being filed against Murdoch. In December 2008, she pleaded guilty to 15 counts of securities fraud and two related charges.

In May 2009, Murdoch served as one of the prosecution's principal witnesses against Gansman in a criminal trial held in a New York federal court. During the trial, Gansman testified that he had been unaware that Murdoch was acting on the information he had supplied her. Defense counsel also pointed out that Gansman had not personally profited from any of the inside information that he had been privy to during his tenure with E&Y. Nevertheless, the federal jury convicted Gansman of six counts of securities fraud. A federal judge later sentenced him to a prison term of one year and one day.

EPILOGUE

In October 2007, the surging stock market produced an all-time high of 14,164.53 for the Dow Jones Industrial Average. One year later, stock prices began plummeting in the face of an economic crisis triggered by the collapsing housing and subprime mortgage markets in the United States. The frenzied stock market over this time frame produced a record number of insider trading cases as unprincipled investors either attempted to make a "fast buck" when stock prices were trending ever higher or attempted to mitigate their losses when stock prices began nosediving.

Personnel at all levels of the Big Four accounting firms routinely gain access to highly confidential inside information, information that can

2. *Ibid.*
3. *Ibid.*

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