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CASE 5.5

Koger Properties, Inc.

Becoming a partner with one of the large international accounting firms easily ranks among the most common career goals of accounting majors.[1] Michael Goodbread staked out that career goal four decades ago. After graduating from college, Goodbread made the first step toward reaching his objective when he accepted an entry-level position with Touche Ross & Company. In February 1973, Goodbread received his CPA license in the state of Florida after passing the CPA exam. Eight years later, the partners of Touche Ross selected Goodbread to join their ranks.

In December 1989, Goodbread accomplished his career goal a second time by becoming a partner with Deloitte & Touche, the firm created by the merger of Deloitte, Haskins & Sells and Touche Ross. Before the merger, Goodbread served as an audit partner in the Jacksonville, Florida, office of Touche Ross. Goodbread assumed an identical position with the newly formed Jacksonville office of Deloitte & Touche following the merger.

The impressive salaries earned by partners of large international accounting firms provide them ample discretionary funds for investment purposes. Like many investors, Goodbread often considered local companies when making investment decisions. One local firm that caught Goodbread's attention during the late 1980s was Koger Properties, Inc., a real estate development company headquartered in Jacksonville. Koger's claim to fame was originating the concept of an office park. According to a Koger annual report, the company opened the nation's first office park in 1957 in Jacksonville. By the early 1990s, Koger operated nearly 40 office parks in two dozen metropolitan areas scattered across the southern United States.

In December 1988, Goodbread purchased 400 shares of Koger's common stock at a price of $26 per share. At the time, Koger had approximately 25 million shares of common stock outstanding.

Following the December 1989 merger that created Deloitte & Touche, one of Goodbread's first assignments with his new firm was supervising the audit of Koger Properties for its fiscal year ending March 31, 1990. Koger had previously been an audit client of Deloitte, Haskins & Sells. In his role as audit engagement partner, Goodbread oversaw all facets of the Koger audit. On February 21, 1990, Goodbread signed the "audit planning memorandum" that laid out the general strategy Deloitte & Touche intended to follow in completing the Koger audit. Several months later, on June 27, 1990, Goodbread signed the "audit report record" for the Koger engagement. At the time, the signing of that document by the audit engagement partner formally completed a Deloitte & Touche audit.

Goodbread signed Koger's unqualified audit opinion on June 11, 1990. Almost exactly one month earlier, on May 10, 1990, Goodbread had sold the 400 shares of Koger stock that he had owned since December 1988. Goodbread sold the stock at a price of $20.75 per share.

The Securities and Exchange Commission (SEC) eventually learned that Goodbread had held an ownership interest in Koger Properties while he supervised the

1. The events discussed in this case were reconstructed principally from information included in Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 861*, 10 December 1996.

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company's 1990 audit. The SEC charged that Goodbread's ownership interest in Koger violated its independence rules, the *Code of Professional Conduct* of the American Institute of Certified Public Accountants (AICPA), and generally accepted auditing standards. Most important, the SEC charged that Goodbread caused Deloitte & Touche to issue an improper opinion on Koger's 1990 financial statements. Instead of the unqualified opinion Deloitte & Touche issued on those financial statements, the SEC maintained that a disclaimer of opinion had been required given the circumstances. Following its investigation of the matter, the SEC publicly censured Goodbread.

The embarrassing revelation of Michael Goodbread's ownership interest in Koger Properties marked the beginning of a long series of problems that Deloitte & Touche encountered with that audit client. In September 1991, Koger filed for bankruptcy. A short time earlier, Koger's stockholders had filed a class-action lawsuit against Deloitte & Touche. The suit alleged that the 1989 Koger audit performed by Deloitte, Haskins & Sells and the 1990 Koger audit completed by Deloitte & Touche were deficient. Those deficient audits allegedly contributed to the subsequent decline in Koger's stock price.

A federal jury agreed with the Koger stockholders and ordered Deloitte to pay the plaintiffs $81.3 million to compensate them for damages suffered because of the 1989 and 1990 audits. In July 1997, the U.S. Court of Appeals reversed the lower court's ruling and voided the huge judgment awarded to Koger's stockholders. The appellate court ruled that the stockholders failed to prove that any errors made by Deloitte during the 1989 and 1990 Koger audits caused the losses they subsequently incurred.[2]

Another of the megafirms created by a merger of two large international accounting firms encountered an independence problem similar to that experienced by Deloitte & Touche in the Koger Properties case. However, PricewaterhouseCoopers' "problem" was much more severe and embarrassing. In 1999, that firm agreed to be censured by the SEC for dozens of alleged violations of the profession's independence rules.

> *Without admitting or denying wrongdoing, PricewaterhouseCoopers has agreed to be censured by federal regulators over a dispute that ownership of client stock had compromised its independence as an auditor. The Big Five firm agreed to pay $2.5 million to establish education programs for the profession designed to improve auditor compliance. . . . The Securities and Exchange Commission claims it turned up 70 instances from 1996 to 1998 in which some of the partners and managers of the firm purchased client stock.*[3]

The problems experienced by Deloitte & Touche and PricewaterhouseCoopers apparently stemmed from unfamiliarity with the profession's auditor independence rules. In the late 1990s, a top SEC official revealed that personnel from the large international accounting firms frequently contacted the federal agency to inquire about its most basic ethical rules for independent auditors. According to this official, these inquiries commonly included questions regarding "such fundamental issues as the prohibition against owning stock in companies they audit."[4]

In recent years, the major accounting firms have continued to be plagued by embarrassing independence violations by their partners. In October 2008, Deloitte & Touche announced that it was suing its former vice chairman for allegedly using

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2. *Securities Regulation and Law Report*, "Investors' 10b-5 Claims Against Deloitte Fail in CA for Lack of Loss Causation," 18 July 1997, 1018.

3. *Accounting Today*, "PwC Censured for Owning Client Stock," 8–21 February 1999, 3.

4. E. MacDonald, "Levitt Says Wave of Accounting Mergers Could Affect Independence of Auditors," *The Wall Street Journal*, 21 October 1997, A2, A4.

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insider information obtained from at least twelve of the firm's audit clients to trade in the securities of those companies.[5] In May 2009, a federal jury convicted a former Ernst & Young partner of securities fraud for his role in a similar insider trading scheme that involved several of his firm's clients.[6]

Questions

1. The SEC charged that Goodbread violated its independence rules, the AICPA's *Code of Professional Conduct*, and generally accepted auditing standards. Explain the SEC's rationale in making each of those allegations.
2. In your opinion, did Goodbread's equity interest in Koger Properties likely qualify as a "material" investment for him? Was the materiality of that investment a relevant issue in this case? Explain.
3. Given that Goodbread purchased stock of Koger Properties in 1988, under what conditions, if any, could he have later served as the audit engagement partner for that company?
4. During much of the 19th century in Great Britain, independent auditors were not only allowed to have an equity interest in their clients but were required to invest in their clients in certain circumstances. Explain the rationale likely underlying that rule. Would such a rule "make sense" in today's business environment in the United States? Defend your answer.

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5. Reuters.com, "Deloitte Sues Vice Chairman for Client Securities Trades," 7 November 2008.
6. C. Bray, "Ex-Ernst & Young Partner Guilty of Six Fraud Counts," *Wall Street Journal* (online), 15 May 2009.

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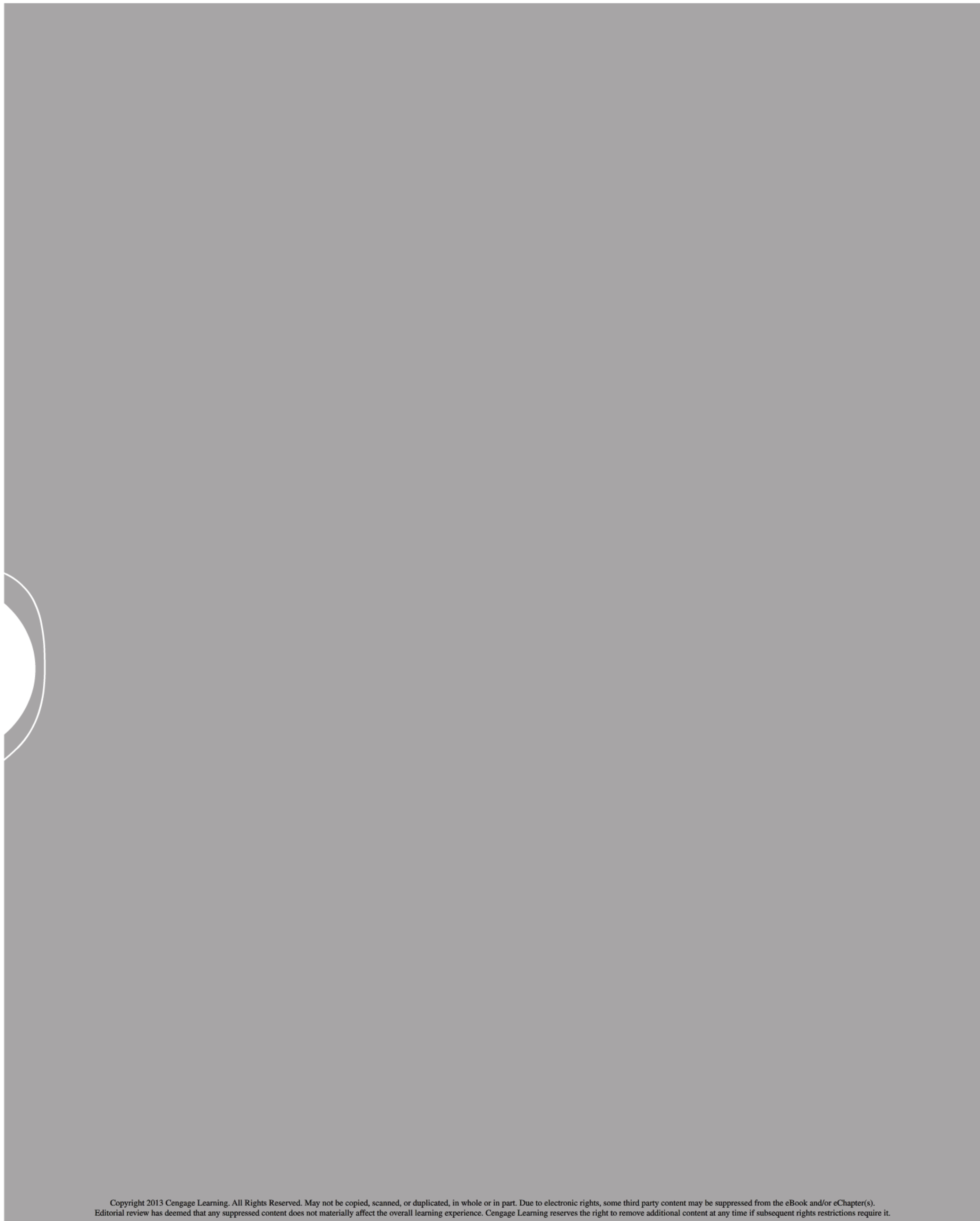

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CASE 5.6

Phillips Petroleum Company

Bill Grant sat in the middle of a large jail cell with 12 other inmates as the long October night dragged on.[1] To pass the time, Grant and several other inmates played cards and talked about their hopes of being reunited with their families. The accommodations of the Tulsa County Jail were not unlike those of most jails: dirty, no lid on the toilet, and 12 beds for 13 inmates. What made this scene unusual was not the less-than-glamorous, overcrowded condition of the jail cell, but rather the presence of Grant, a Big Eight audit partner and graduate of the Harvard Business School. At the time, Grant served as the managing partner of the Tulsa office of Arthur Young & Company, but he was destined to become Arthur Young's co-managing partner in 1988 shortly before that firm merged with Ernst & Whinney to form Ernst & Young.

Earlier that day, Grant had appeared in a Tulsa federal courthouse at a hearing presided over by Judge Allan Barrow. Judge Barrow had ordered Grant to produce certain audit workpapers that had been subpoenaed by a federal grand jury. Those workpapers had been prepared during an audit of the large oil company, Phillips Petroleum Company, a client of Arthur Young's Tulsa office. When Grant respectfully denied the judge's request, he was cited for civil contempt, handcuffed, and led away to jail. Apparently, the judge hoped that an overnight stay in a crowded jail cell would convince Grant to change his mind.

The federal grand jury's interest in the Arthur Young workpapers stemmed from an ongoing investigation of Phillips. That investigation focused on possible tax fraud related to a secret, multimillion-dollar fund that Phillips' executives had established to make political contributions. One contribution made from the secret fund, which was maintained in a Swiss bank account, was an illegal donation of $100,000 to what became known during the Watergate era as CREEP–the Committee to Reelect the President (Richard Nixon). Under the terms of an earlier plea bargain agreement with Watergate, special prosecutor Archibald Cox, Phillips' chairman of the board, had admitted to the $100,000 contribution to Nixon's 1972 reelection campaign and pleaded guilty to one misdemeanor.[2] Following that plea bargain agreement, a seven-count indictment was filed against Phillips that charged the company with filing false federal tax returns for failing to report interest revenue earned on the secret Swiss bank account.

Prior to Bill Grant's appearance before Judge Barrow, Arthur Young had turned over to the federal grand jury approximately 12,000 pages of Phillips's audit workpapers. Arthur Young, however, had refused to give the grand jury several workpapers relating to two key items: (1) certain tax accruals made by Phillips and (2) attorneys'

1. The facts of this case were drawn principally from the following articles: "Arthur Young Aide Cited for Contempt and Jailed in Tulsa," *The Wall Street Journal*, 8 October 1975, 10; F. Andrews, "Arthur Young Faces Test on Protecting Client Audit Secrets," *The Wall Street Journal*, 14 October 1975, 23; "Arthur Young & Co. Gives Grand Jury Data On Phillips Petroleum," *The Wall Street Journal*, 15 October 1975, 28; "Pleas by Phillips Petroleum Filed On U.S. Charges," *The Wall Street Journal*, 23 November 1977, 2.

2. Phillips's chairman also revealed that he had delivered $50,000 to Nixon in a New York City apartment during the 1968 presidential campaign in which Nixon eventually defeated Senator Hubert Humphrey.

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letters that Arthur Young had obtained from Phillips's law firms. Among other topics, these attorneys' letters were known to include discussions of "unasserted claims" by Phillips's attorneys. The federal grand jury believed that both sets of workpapers might provide important insight on the allegations involving Phillips.

Arthur Young had refused to provide the contested workpapers to the grand jury on the grounds that they contained confidential information that, if disclosed, would be potentially damaging to Phillips. Tax accrual audit workpapers, for example, typically contain an audit firm's analysis of tax-related decisions made by their clients. Access to such workpapers would make it much easier for the Internal Revenue Service (IRS) to "build a case" against a given company.

Bill Grant was released from the Tulsa County Jail on October 7, 1975, but was ordered to make an appearance the following week before Judge Barrow. If Grant again refused to produce the workpapers subpoenaed by the grand jury, he faced the risk of being cited for criminal contempt and receiving a 17-month jail term. During the week between Grant's two court appearances, Arthur Young's attorneys worked out a compromise with Judge Barrow. Under the terms of the agreement, Arthur Young turned over copies of the requested tax accrual workpapers. All matters other than those specifically identified by the subpoena were masked in the copies of the workpapers given to the grand jury. Judge Barrow also granted Arthur Young the right to contest any subsequent court order to provide the original "unmasked" tax accrual workpapers to the grand jury.

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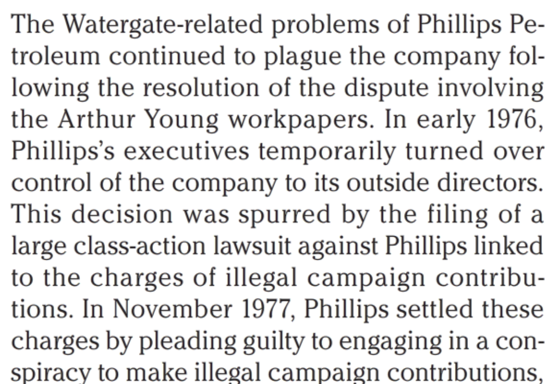
Judge Barrow did not relent with respect to the contested attorneys' letters. He ordered Arthur Young to provide copies of those letters to the grand jury. Phillips filed a motion to appeal this order, but that appeal was denied.



EPILOGUE

The Watergate-related problems of Phillips Petroleum continued to plague the company following the resolution of the dispute involving the Arthur Young workpapers. In early 1976, Phillips's executives temporarily turned over control of the company to its outside directors. This decision was spurred by the filing of a large class-action lawsuit against Phillips linked to the charges of illegal campaign contributions. In November 1977, Phillips settled these charges by pleading guilty to engaging in a conspiracy to make illegal campaign contributions, pleading no contest to four related tax evasion charges, and paying a fine of $30,000.

Ironically, Arthur Young's tax accrual workpapers for another audit client, the large oil company Amerada Hess, became the focal point of another major litigation case. The issue in this case was whether the IRS had the right to review copies of auditors' tax accrual workpapers. In 1984, the Supreme Court decided the case by unanimously ruling that the IRS has the right to review tax accrual workpapers prepared during an independent audit.

Questions

1. Do you believe that Bill Grant was justified in refusing to provide the requested workpapers to the grand jury? Explain.
2. What responsibility, if any, does a public accounting firm have to its partners and employees when they are subpoenaed to testify regarding a client?

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3. What is the purpose of "attorneys' letters" obtained during the course of an audit? If attorneys are aware that these letters can be routinely subpoenaed, how does this fact likely affect the quality of the audit evidence yielded by these letters?
4. Do you believe the documentation included in tax accrual audit workpapers is likely affected by auditors' knowledge that those workpapers can be obtained by the IRS? Explain.

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