Case 1.6

The Fund of Funds: A Focus on Independence

Synopsis

As total assets reached $617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF's bankruptcy trustee sued Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. Arthur Andersen was ultimately found liable and forced to pay around $70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

National Resources Fund Account

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by its investment advisors. Each of FOF Prop's investment advisors had a duty to act in FOF's best interests and to avoid conflicts of interest. Each was compensated based on the realized and unrealized (paper) appreciation of their portfolios.[67]

One of FOF's specialized investment accounts was the National Resources Fund Account (NRFA), which was dedicated to investments in oil, gas, and mineral assets. Although no formal written agreement established the King Resources Corporation (KRC) as the investment advisor for the NRFA, FOF's intent was to use KRC's expertise, as it did that of other investment advisors, to locate and purchase speculative natural resource investments. FOF also

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[67] The Fund Of Funds, Limited, et al. v. Arthur Andersen & Co., et al. No. 75 Civ. 540 (CES), United States District Court For The Southern District Of New York, 545 F. Supp. 1314; 1982 U.S. Dist. Lexis 9570; Fed. Sec. L. Rep. (Cch) P98,751, July 16, 1982. Available from LexisNexis Academic.

had no means of valuing the assets proposed for investment and no means of participating in any of the work requirements.[68] Importantly, King's own corporate documents clearly represented that KRC was an investment advisor to FOF.

Andersen's Relationships with FOF and KRC[69]

Both KRC and FOF, including its NRFA, were audited by Arthur Andersen. Andersen also audited John King's personal accounts. The partner-in-charge and the manager of the KRC audit held the same respective positions on the NRFA audit, and other Andersen staffers sometimes worked contemporaneously on the KRC and the NRFA audits. In addition, Andersen used records from KRC to perform its audit of the NRFA. Andersen's auditors possessed minutes of an FOF Board of Directors meeting describing the NRFA as "essentially a discretionary account managed by King Resources Corporation." Andersen's auditors themselves noted KRC's "carte blanche authority to buy oil and gas properties for [NRC]" and its "quasi-fiduciary" duty to FOF.

Prior to the year-end 1968 KRC audit, and as early as 1966, Andersen viewed John King and his companies as a difficult client, one that posed risks to the firm itself. In fact, Andersen personnel had repeated, serious difficulties with John King as a client since at least 1961. For example, Mr. King often spoke directly with the highest echelon of the Andersen partnership in Chicago when he was displeased with the Denver office's resolution of certain issues. Andersen also viewed FOF as presenting its own set of problems and risks.

In addition to performing a substantial amount of work on the audit of NRFA for FOF, Andersen's Denver office had primary responsibility for the KRC audits. Therefore, Andersen's Denver office was well aware of the advisory relationship between KRC and FOF because the relationship was described in KRC filings with the SEC. The Denver office was also aware of the lack of a written contract evidencing the terms of the relationship between

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KRC and FOF. In addition, it sought confirmation of the nature of any KRC-FOF agreement from KRC for the KRC audit, although it surprisingly did not seek such a confirmation from FOF with respect to the NRFA audit.

As part of its primary responsibility for the audits of the NRFA occurring after year end 1968, the Denver office of Andersen determined the cost value of NRFA purchases by examining the books of KRC as evidential matter. Andersen only reviewed the valuations set by KRC to assess whether they were presented in accordance with FOF's guidelines, and it did not determine the market value of the NRFA interests as part of the FOF audit scope.

Andersen's Relationship with Key Third Parties[70]

FOF was required to value its investment portfolio on a daily basis because it redeemed shares on the basis of its daily share value. The daily share value was determined by dividing the net asset value of FOF's entire portfolio by the number of outstanding shares.

FOF relied exclusively on the advice of KRC for the initial valuations and subsequent revaluations of its natural resource assets. Natural resource asset valuations were challenging due to their speculative nature and the lack of an active trading market for determining current realizable value. Thus, in some cases, KRC arranged for sales of percentages of certain assets to third parties to help determine valuations of those assets or to justify revaluations. In some instances, Andersen was also the independent auditor for the third parties.

For example, in late 1969, King arranged for a sale of 9.375 percent of his group's Arctic interest to John Mecom and Consolidated Oil & Gas (COG) to help justify a revaluation for FOF. In fact, this sale was the basis for the $119 million upward revaluation of the remainder of FOF's Arctic interest. Mecom, a wealthy Texan who owned U.S. Oil of Louisiana, Inc., had lost $11,458,000 for the year ending September 30, 1969, and reported debts of over $132,000,000. As a result of Mecom's cash problems, King agreed to provide the $266,000 down payment for the Arctic transaction, with the subsequent $10 million in payments provided by KRC's use of Mecom-owned oil and

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drilling equipment. Andersen audited Mecom from its Houston office.[71]

Case Questions

1 What is auditor independence and what is its significance to the audit profession? What is the difference between independence in appearance and independence in fact?

2. Consider that both KRC and FOF, including its NRFA, were audited by Arthur Andersen. In addition, Arthur Andersen audited King's personal accounts. Do you believe these relationships impair the independence of Arthur Andersen? Why or why not?

3. Would your answer be any different if the fact pattern changed so that different partners were assigned to both the KRC audit and the NRFA audit? Please assume that both audit teams were completely different. Why or why not would your answer be different?

4. Consult Paragraphs #32–35 of PCAOB Auditing Standard No. 2. Based on the case information, do you believe that Arthur Andersen violated any of the four basic principles of auditor independence described? Why or why not?

5. Refer to Sections 201, 203, and 206 of SOX. Based on your understanding of the FOF audit, do you believe these sections were needed? Why or why not? Be specific.

[71] In February 1968, Leonard Spacek, Andersen's managing partner, met with King and Mecom to discuss integration of the King and Mecom organizations. Spacek also discussed a role for KRC in refinancing Mecom's debts in May 1968 and, in December 1968, Spacek discussed the possibility of a King-Mecom joint venture with the Houston office of AA.