Case **4.12**

The Fund of Funds: A Focus on Evidence—Asset Valuation

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.

Background

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for its specialized investment accounts that were managed by outside investment advisors. Each investment advisor had a duty to act in FOF's best interests and to avoid conflict of interests. Each adisor was compensated based on the realized and unrealized (paper) appreciation of their investment portfolios.[294]

In a presentation at a meeting of the FOF Board of Directors in Acapulco, Mexico, on April 5, 1968, John King suggested that FOF establish a proprietary account with an initial allocation of $10 million that would be invested in

---

[294] The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And Arthur Andersen & Co., S.A., Defendants, 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.

a minimum of 40 properties. King described the role of King Resources as follows: "that of a vendor of properties to the proprietary account, with such properties to be sold on an arms-length basis at prices no less favorable to the proprietary account than the prices charged by King to its 200-odd industrial and other purchasers." The Board approved the idea, and the National Resources Fund Account was established.

Although no formal written agreement established the King Resources Corporation (KRC) as the investment advisor for the NRFA, FOF's clear intent was to use KRC's expertise to locate and purchase speculative natural resource investments. FOF had no means of valuing the assets proposed for investment by NRFA and did not possess the industry expertise to do so.

Independent Audit Relationships

KRC, NRFA, and FOF were all audited by the same independent auditor, Arthur Andersen. Andersen's Denver office performed the KRC audits, as well as performed substantial work on the NRFA. The partner-in-charge and the manager of the KRC audit held the same respective positions on the NRFA audit. Many aspects of the NRFA audit were completed by using the records of KRC and, sometimes, Andersen staffers would even work on both the KRC and NRFA audits contemporaneously. Finally, Arthur Andersen also audited various third parties that KRC sold assets to in order to ultimately determine the valuations of those assets.

FOF's Natural Interest Purchases[295]

Beginning immediately after the Board of Directors' meeting where NRFA was established, on April 5, 1968, it began to purchase oil, gas, and mineral interests from KRC. King reported to the FOF Board of Directors on August 2, 1968, that $3 million of the initial authorization of $10 million was committed. For the year-end 1968 audit of FOF by Andersen, the Denver office prepared a series of comparisons of prices charged by the King group to FOF, other King affiliates, and other knowledgeable industry purchasers. The "Summary of 1968 Sales" shows the

[295] The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And Arthur Andersen & Co., S.A., Defendants, 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.

following with respect to sales to the King affiliates:

	Current Sales	Current Cost [to KRC]	Current Profit	Profit as a % of Sales
Sales to IAMC	$9,876,271	$8,220,324	$1,655,947	16.8%
Sales to Royal	6,566,491	4,085,544	2,480,947	37.8%
Sales to IOS	11,325,386	4,307,583	7,017,803	62.0%

In the same document, Andersen also computed the comparative profits for KRC, excluding interests sold to Royal and to IOS (which was essentially FOF). After subtracting those sales with higher markups, KRC's profits as percentages of sales on its sales to its affiliates, Royal and IAMC, were substantially smaller than the profits on its sales to FOF.

In fact, KRC's "Consolidated Sales to Industry," dated September 30, 1969, illustrated that KRC's profits on sales to FOF were 68.2 percent, as compared with average profits on all sales of nearly 36 percent. In comparing only the seven industry customers that purchased over $1 million of interests from KRC, FOF had the highest profit/sales ratio, at 68.2 percent. After FOF, the next highest profit/sales ratio, earned by KRC on sales to such customers was 24.4 percent; the lowest profit/sales ratio was 5 percent.

Andersen's Knowledge of the Purchases[296]

By Andersen's account, "the earliest date when anyone employed by Andersen would have become aware of KRC's 1968 sales to FOF was in early 1969." At the same time, evidence exists that some FOF-KRC transactions were reviewed for the 1968 year-end audit in Andersen's Denver office before January 28, 1969. Andersen auditors from its Denver office also testified that they did some "information gathering" on the NRFA for the FOF Prop audit as of December 31, 1968. They also testified that they obtained documents related to the FOF audit from KRC. Andersen's auditors contend that their duty of confidentiality to KRC would prohibit it from having disclosed to FOF

[296] The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And Arthur Andersen & Co., S.A., Defendants, 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.

any relevant knowledge it may have had related to KRC's costs.

Case Questions

1. Based on your understanding of audit evidence, did Arthur Andersen rely on competent and sufficient audit evidence in auditing the valuation assertion related to FOF's natural resources assets? Why or why not?
2. Consider the series of comparisons prepared by the Denver office of Arthur Andersen of prices charged by the King group to FOF, King affiliates, and other knowledgeable industry purchasers. Can you think of any additional evidence that would have strengthened the "Summary of 1968 Sales"?
3. Please explain the primary purpose of substantive analytical procedures (i.e., the type of procedures that are completed during the testing stages of an audit). If you completed such procedures on FOF, do you think you could use KRC's "Consolidated Sales to Industry," which illustrated that KRC's profits on sales to FOF were 68.2 percent, as compared to 36 percent on all other sales, to help execute the procedures? How?
4. Do you believe Andersen's contention that they had a duty of client confidentiality to KRC that would, indeed, prohibit the firm from disclosing to FOF any relevant knowledge it may have had related to KRC's costs? Why or why not?