

Case 3.5

The Fund of Funds: A Focus on Company Level Controls

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 specialized investment accounts that were managed by its investment advisors. One of these 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 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 independently valuing the assets proposed by KRC for investment.¹⁶⁰

¹⁶⁰ 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.

Revaluations

FOF was required to value its investment portfolio on a daily basis because the company 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 on the advice of KRC for the revaluations of its natural resource assets contained in the NRFA. Because of its speculative nature and the lack of an active trading market, determining the value of its natural resource interests was very difficult.¹⁶¹

Fox-Raff

In late 1968, KRC's founder and owner John King arranged a deal with Robert Raff, president of a Seattle brokerage firm, whereby Raff would purchase 10 percent of a specific natural resource interest that was owned by FOF. The sale was designed to provide a basis for the revaluation of FOF's remaining 90 percent interest in the natural resource interest. The purchase price for Raff's 10 percent interest totaled \$440,000, with an \$88,000 down payment required. The transaction provided a basis for FOF to write-up the valuation of its 90 percent interest in the specific natural resource interest by \$820,000.

To execute the deal, King actually advanced Raff all of the money that was needed to make the down payment, and assured Raff that no further financial commitment was necessary. Raff intended to sell the investment within six months, so that he would never have to meet the remaining financial obligations to FOF. When FOF pressed for payment, KRC would provide Raff with the means to pay.

Andersen's auditors questioned whether the 10 percent sale was sufficient enough to establish the value of the whole parcel. They also questioned the basis for the write-up due to the short holding period for the natural resource interest, as well as the lack of any oil strikes or any new geological information that would justify the revaluation of the parcel. Arthur Andersen resolved to express these concerns in a letter to the Board of Directors of FOF, but, ultimately, never sent such a letter. The Arthur Andersen partner working on the year-end 1968 FOF audit, John Robinson, told Edward Cowett, the COO of FOF, that Andersen could accept the Fox-Raff transaction as a basis for

¹⁶¹ The Fund Of Funds, Limited, et al. v. Arthur Andersen & Co., et al. 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.

revaluation only because it was immaterial to the financial statements as a whole.

Development of Guidelines for Revaluation¹⁶²

In the fall of 1969, Andersen sought to establish guidelines for unrealized appreciation or revaluations to allow for “substantive independent evidence for reviewing the reasonableness of the client’s valuations.” A November 7, 1969 memorandum set out Arthur Andersen’s proposal:

Any *significant increase* in the value of natural resource properties over original cost to FOF must, for audit purposes, be supported by either:

- (1) An appraisal report rendered by a competent, independent expert, or
- (2) an arms-length [sic] sale of a sufficiently large enough portion of a property to establish a proportionate value for the portion retained ...

On the question of what constitutes adequate sales data for valuation purposes (i.e., the 10% question), we have proposed the following to King Resources Company:

(1) *No* unrealized appreciation would be allowed on sales of relatively small percentages of properties to *private investors or others who do not have the necessary expertise* to determine a realistic fair market value. By “relatively small,” we envision approximately 50% as being a minimum level in this type of sale to establish proportionate values for the remaining interests. This would preclude any unrealized appreciation on sales such as the December, 1968, sales to Fox-Roff, [sic] Inc. since it could not be reasonably sustained that a brokerage firm has the expertise necessary to evaluate primarily undeveloped resource interests.

(2) Appreciation *would be allowed* if supported by arms-length [sic] sales to *knowledgeable outside parties*. For example, if King Resources Company sold a 25% interest in the Arctic permits to Texaco or another major oil company, we believe it would be appropriate to ascribe proportionate value to the 75% retained. Just where to draw the line on the percentage has not been clearly established. We feel 10% would be a bare minimum and would like to see a higher number....

¹⁶² The Fund Of Funds, Limited, et al. v. Arthur Andersen & Co., et al. 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.

The senior Andersen partner responsible for audit practices, John March, suggested a sale of a “25–30 percent minimum,” as a more conservative figure, and stated that it “must be a cash deal with no take-out option.” Yet, the guideline finally adopted by FOF for inclusion in the 1969 Annual Report did not specify a fixed percentage that must be sold and also did not refer to the identity or attributes of a buyer. (See Exhibit 3.5.1.)

Arctic Revaluation¹⁶³

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 justify a revaluation for FOF. Essentially, this sale was the basis for a \$119 million increase in the valuation of FOF’s interest in the Arctic interest. Details of the transaction were provided in the 1970 FOF Annual Report. (See Exhibit 3.5.2.)

John Mecom, who also owned U.S. Oil of Louisiana, Inc., which had lost \$11,458,000 for the year ending September 30, 1969, faced debts of over \$132,000,000 at this time. As a result of Mecom’s overall cash problems at that time, King agreed to provide the entire \$266,000 down payment for the Arctic transaction, with the subsequent \$10 million in payments being provided by KRC’s projected usage of Mecom’s oil and drilling equipment. Exhibit 3.5.3 shows the written side agreement which enabled Mecom to make the Arctic purchase. Interestingly, Arthur Andersen also audited Mecom from its Houston office and, therefore, knew of his financial difficulties.¹⁶⁴

In addition, COG was a Denver-based oil and gas concern headed by John King’s personal friend. King Resources had joined together with COG in several previous business transactions, a fact that Arthur Andersen was well aware of. To facilitate the Arctic transaction, King arranged for COG to get a \$600,000 loan from a Tulsa, Oklahoma bank, without which COG would not have entered into the Arctic transaction.

Andersen obtained representation letters from KRC that the Arctic sale was bona fide. Although Andersen

¹⁶³ The Fund Of Funds, Limited, et al. v. Arthur Andersen & Co., et al. 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.

¹⁶⁴ 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.

obtained representation letters from Mecom and COG confirming the terms of the Arctic purchase agreement, no inquiry was made of Mecom or COG as to the existence of possible side agreements. Andersen also obtained a Dun & Bradstreet report on Mecom, which likely would have showed his cash flow problems. In May 1970, prior to issuing FOF's report, Andersen learned of a *Wall Street Journal* article that cast doubt on COG's obligation related to the sale. Andersen obtained a reconfirmation from KRC, discussed the matter with COG's principal, and obtained a reconfirmation specifically excluding side deals, but no further inquiry about side deals was made to Mecom. In late May 1970, Andersen decided that a "subject to" qualification was necessary in issuing its report concerning FOF as of year-end 1969. (See Exhibit 3.5.4.)

Exhibit 3.5.1

Revaluation Guideline Adopted by FOF for Inclusion in the 1969 Annual Report

Natural resources

The following sets forth the present guidelines established by the Boards of Directors of the fund and Proprietary with respect to the valuation of natural resource properties. Such guidelines have been consistently followed.

- a. Such properties are carried at cost, until an event of such obvious and compelling significance occurs as to require a change in that value. Discovery of a mineral interest, determination of the property being unproductive through testing or other geological evaluation, or a sale of all or a portion of the property held would be among the factors which would constitute such an event.
- b. A partial sale may be used as a basis for evaluation of unrealized appreciation on the remaining holdings when such sale is at arm's length, and when a sufficient percentage of Proprietary's holding is sold.
- c. Outside appraisals are used only in those cases where the Boards of Directors are satisfied that there is appropriate substance to recognition of unrealized appreciation on the basis of appraisal. However, where significant unrealized appreciation is involved, independent appraisals may not be considered sufficient and demonstration of the current realizability of such appreciation through a consummated sale may be required.

Source: 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.

Exhibit 3.5.2

Arctic Revaluation Transaction Description in 1970 FOF Annual Report

In January 1970, Proprietary concluded a sale for its subsidiaries of 10 percent of their interests in the Arctic permits. This sale was made to the operator of the permit interests on the same bases and terms as a December, 1969, sale by such operator of a 9.375% interest to outside third parties. Sales proceeds consisted of \$779,300 cash down payment and \$7,570,000 payable in six semi-annual installments beginning in 1973 and bearing interest at 6% per annum. The sales agreement also relieves the sellers of 80% of the first \$10,436,500 of their commitment for exploration costs. The purchasers have thereby assumed an obligation for exploration costs which is \$7,305,500 in excess of such costs applicable to their interests in the permits.

Based on the terms of the sale outlined above, and as approved by the Boards of Directors of the Fund and Proprietary, Proprietary has valued its subsidiary's interest in the Arctic permits at \$119,000,000. Such value represents a gross valuation of \$156,000,000 less, (a) discounting to provide an effective 8-1/2% interest rate on permit payments and an effective 10% interest rate on excess work obligation payments (\$20,000,000) and, (b) the 12-1/2% net operating profits interest (\$17,000,000). The portion of that valuation applicable to Proprietary is \$114,240,000, equal to \$10.60 per net acre. After deduction of management fees and income taxes, the Fund's value per net acre is \$8.01.

Source: 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.

Exhibit 3.5.3

Side Agreement with Mecom to Make the Arctic Purchase

Dear Mr. Mecom:

This is to confirm my agreement with you in connection with your purchase from King Resources Company of approximately 347,883 net acres of oil and gas exploration permits in the Canadian Arctic Islands for \$7.50 per acre plus \$7.50 per acre in work obligations under the terms of an agreement with King Resources Company dated December 24, 1969.

I have agreed to provide sufficient net cash receipts to be paid to you to enable you to make all payments on your said contract with King Resources Company through payments due in October, 1971.

At any time after October 1971 up to December 31, 1971, I have also agreed that if you so request and assign to me your interest to said permits, I will assume and pay and hold you harmless from all obligation to pay all amounts due King Resources under said contract subsequent to October, 1971. Provided that if, prior to October 1971, you are afforded an opportunity to sell your interests at a price in excess of your costs, my further obligations hereunder shall cease.

This letter will be held for our mutual account by Timothy G. Lowery [sic] of Peterson, Lowry, Rall Barger & Ross of Chicago, Illinois.

Source: 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.

Exhibit 3.5.4

1969 Auditor Opinion

To the Shareholders and Board of Directors,

The Fund of Funds, Limited:

We have examined the consolidated statements of net assets and investments of The Fund of Funds, Limited (an Ontario, Canada, corporation) and subsidiary as of December 31, 1969, and the related consolidated statements of fund operations and changes in net assets for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other

auditing procedures as we considered necessary in the circumstances. Investments owned by the Fund at December 31, 1969, were confirmed directly to us by the custodian or brokers. The position of investments sold short was confirmed directly to us by the custodian or brokers. Consistent with past practice, certain investments, in the absence of quoted market prices, have been valued by the Board of Directors as indicated in Note 9. These valuations have been reviewed by us to ascertain that they have been determined on the bases described, but since we are not competent to appraise these investments we do not express an opinion as to such valuations.

In our opinion, subject to the effect of certain investment valuations referred to in the preceding paragraph, the above-mentioned financial statements present fairly the financial position of The Fund of Funds, Limited and subsidiary as of December 31, 1969, and the results of their operations and the changes in their net assets for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Source: 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.

Case Questions

1. Consult Paragraph #7 of PCAOB Auditing Standard No. 2. Do you believe that FOF has established an effective system of internal control over financial reporting related to the valuation of its natural resource assets? Why or why not?
2. Please consider the valuation assertion related to the natural resources assets. Do you think it is reasonable for an auditor to rely on a recent sale of a 10 percent interest as evidence to justify a revaluation of FOF's remaining 90 percent interest in the natural resource assets? Why or why not?
3. What other evidence could an auditor seek to justify the valuation of an asset where there is no active trading market? Please comment on whether Arthur Andersen's guidelines for the appreciation of national resource properties were appropriate under the circumstances. Why or why not?
4. Based on your understanding of fraud risk assessment, what three conditions are likely to be present when a

fraud occurs? Based on your understanding of the FOF audit, which of these three conditions appears to be most prevalent, and why?