

Case A.7

The Fund of Funds

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 FOF's independent auditor Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. As a result, 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

The Investors Overseas Services, Limited (IOS) was a Canadian company headquartered in Switzerland that offered diversified financial services, which included the management of mutual funds. IOS was founded in 1956 by Bernie Cornfield, a former Philadelphia social worker. One of IOS's most successful mutual funds was its Fund of Funds (FOF). The FOF was also a Canadian company that had operations directed from Switzerland; however, its corporate records were maintained in Ferney-Voltaire, France. FOF's total assets reached \$617 million by the end of 1967.⁵³⁶

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by investment advisors. FOF Prop's investments were heavily concentrated in American securities. Each investment advisor had a duty to act in FOF's best interests and to avoid a conflict of interest. In

⁵³⁶ "I.O.S. Lists Records Sales of Investments Programs," Special to the New York Times, *New York Times*, February 23, 1968. Accessed from ProQuest Historical Newspapers, The New York Times, 52.

addition, each was compensated based on the realized and unrealized (paper) appreciation of their portfolios.⁵³⁷

Challenges Faced by IOS and Its Affiliates

During the mid- to late 1960s, IOS and its affiliates began to face several difficult conditions. The industry had become increasingly competitive as new competitors entered the field. In addition, the entire industry was negatively impacted by a decline in stock market prices. The industry was also impacted by significant regulatory changes; that is, a number of national authorities had put more regulatory controls on fund selling.⁵³⁸

In 1966, the SEC brought charges that IOS had violated U.S. law by selling unregistered securities. As part of its settlement with the SEC, IOS and its affiliates, agreed to the following restrictions:⁵³⁹

- Will not engage in any activities subject to SEC jurisdiction.
- Will cease substantially all sales of securities to U.S. citizens or nationals, wherever located.
- Will not buy more than 3 percent of the stock of any registered investment company.
- Will dispose of its interests in Investors Planning Corp. of America, a registered broker-dealer, and Investors Continental Services, Ltd., a wholly owned Investors Overseas subsidiary and also a registered broker-dealer.
- Will withdraw the SEC broker-dealer registration of five investment companies owned by FOF.
- Will not acquire a controlling interest in any financial organization doing business in the U.S.

⁵³⁷ 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.

⁵³⁸ Clyde H. Farnsworth, "Beleaguered Empire," *New York Times*, April 27, 1970. Accessed from ProQuest Historical Newspapers, The New York Times, 53.

⁵³⁹ "Investors Overseas Ltd. Agrees with SEC to Leave U.S. Securities Field," *Wall Street Journal*, May 25, 1967. Accessed from ProQuest Historical Newspapers, The Wall Street Journal, 8.

FOF Expands into Natural Resource Assets⁵⁴⁰

FOF's strategy for dealing with the SEC's sanctions and the prospect of a potential stock market downturn in the late 1960s was to diversify its holdings into assets less affected by the stock market, such as natural resource assets. To set up an investment account that specialized in natural resource assets, the officers of FOF contacted John King, a Denver oil, gas, and mineral investor and developer. In February 1968, a formal contract designating a subsidiary of King's company, King Resources Corporation (KRC), as an investment advisor to FOF Prop was circulated between Edward Cowett, the chief operating officer (COO) of FOF, and Timothy Lowry, counsel for KRC. The agreement was not finalized and, ultimately, no written investment advisory agreement was ever entered into by the parties.

However, in a presentation at a meeting of the FOF Board of Directors in Acapulco, Mexico, on April 5, 1968, Mr. King suggested to the Board of FOF that they establish a proprietary account with an initial allocation of \$10 million that should be invested in a minimum of 40 natural resource properties. In the presentation, King described the role of KRC 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 KRC to its 200-odd industrial and other purchasers." The Board approved the idea, and the National Resources Fund Account (NRFA) was established.

The clear intent of FOF was to use King's expertise, as it did that of other account advisors, to locate and purchase speculative investments in oil, gas, and mineral assets. FOF had no means of valuing the assets proposed for investment and no means of participating in any work requirements. FOF's dependence was encouraged by King in two ways: King's own corporate documents represented that KRC was an investment advisor to FOF, and its prospect summaries barely outlined the geologic and financial information that would be necessary for an informed, independent investment decision.

⁵⁴⁰ 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.

Yet, investments in natural resource interests were different from other FOF Prop investments in one important aspect: the interest purchased in every natural resource transaction was a portion of an interest that was owned or had previously been owned by a member of the King group.

KRC's Pricing Policy

As FOF's COO, Cowett's general understanding of the pricing policy was stated in a memorandum written on **April 19, 1968**: KRC would offer properties to FOF "from time to time and on a more or less continuous basis," the terms of sale are to be "no less favorable than those offered by [KRC] to other non-affiliated purchasers [and] all transactions will be arms-length in nature." Cowett also stated his understanding of the relationship and pricing policy in a letter dated **November 11, 1970**.⁵⁴¹

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 natural resource interests was very difficult.^{541a}

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

⁵⁴¹ 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.

^{541a} 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.

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 provided Raff with the means to pay.

Independent auditor Arthur Andersen 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 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 revaluation only because it was immaterial to the financial statements as a whole.

Development of Guidelines for Revaluation⁵⁴²

In the fall of 1969, independent auditor Andersen sought to help FOF 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),

⁵⁴² 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.

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....

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 in Section 3, on page 85.)

Arctic Revaluation⁵⁴³

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 the FOF’s interest in the Arctic interest. Details of the transaction were provided in the 1970 FOF Annual Report. (See Exhibit 3.5.2 on page 86.)

John Mecom, who also owned U.S. Oil of Louisiana, Inc., which had lost \$11,458,000 for the year ending

⁵⁴³ 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.

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, on page 87, 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.⁵⁴⁴

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 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 in Section 3, on page 88.)

⁵⁴⁴ 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.

Andersen's Relationships with FOF and KRC⁵⁴⁵

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. Andersen used records from KRC to perform many aspects of its audit of 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 Andersen itself. In fact, Andersen personnel had repeated, serious difficulties with John King as a client at least since 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 substantial 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 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 well aware of the lack of a written contract evidencing the terms of the relationship between KRC and FOF. In addition, it sought confirmation of the nature of any KRC-FOF agreement from KRC for a KRC audit, although it surprisingly did not seek any such information from FOF with respect to the NRFA audit.

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

⁵⁴⁵ 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.

FOF's Natural Interest Purchases^{546, 547, 548}

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, the Denver office of Andersen 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 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%

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In the same document, Andersen's auditors 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 Purchases⁵⁴⁹

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

Comprehensive List of 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

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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. If so, why 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.
6. Based on your understanding of inherent risk assessment, identify three specific factors about IOS and/or FOF that would be likely to impact your audit procedures if you were conducting an audit of IOS and/or FOF.
7. Consider the charges brought against IOS/FOF in 1966 that ultimately led to a settlement with the SEC. As part of its standard audit procedures, do you believe that Andersen should be responsible to insure that IOS/FOF complies with the settlement? Why or why not?
8. Please define what is meant by an “arm’s length” transaction. Given that all of FOF Prop’s investments in natural resources had also been owned (or were currently owned) by a member of the King group, do you believe that inherent risk related to these transactions should be elevated? Why or why not?
9. Consider the memo illustrated in Exhibit 2.7.1. If you were auditing FOF, would this memo impact your planned audit procedures? If so, what is the financial statement assertion that would cause you the greatest concern? Why?
10. If you were auditing one of the transactions between King Resources and FOF, what type of evidence would you seek to examine to determine whether the transaction was consummated on an “arm’s length” basis?
11. 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?
12. 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?

13. What other evidence could an auditor seek to justify the valuation of an asset where there is no active trading market for the asset? Please comment on whether Arthur Andersen's guidelines for the appreciation of natural resource properties were appropriate under the circumstances. Why or why not?
14. 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?
15. 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?
16. 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"?
17. 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?
18. Please consult your primary audit text. 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?