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Audit Firm: Victim or Accomplice?

By ALISON LEIGH COWAN

In their view, they were unwitting victims of a client's desperate scheme to doctor the books and keep the business afloat. But to the Securities and Exchange Commission, they were willing accomplices who valued their six-figure fees more than their duty to keep the client's shareholders and potential investors informed.

In this instance, they are the three Price Waterhouse auditors who certified the books of AM International, a maker of duplicating equipment and other office products, several years before the company went bankrupt in 1982.

The Government wrapped up its case against Price and the three auditors yesterday in Federal District Court in Manhattan, but Judge John E. Sprizzo, who has appeared unsympathetic to the S.E.C.'s case, is not likely to hear the closing arguments in the case until this fall.

What Auditors Can Do

The case has been watched closely by the accounting profession because it involves one of the six largest accounting firms in the country and because the Government is seeking one of the harshest punishments ever against an accounting firm. It also captures in a nutshell the differences between accountants and the investors who rely upon them about what independent auditors can reasonably accomplish.

The Government's complaint, which was filed in 1985 and accuses the three auditors, two of them partners, of allowing AM to resort to nearly every type of accounting gimmick imaginable to inflate income — such as booking revenue on merchandise that customers had no obligation to buy.

It also contends that the auditors engaged in a cover-up by falsifying their work papers after a new management team took over at AM in 1981 and began questioning Price's work. Ultimately, the new team at AM, on the advice of another accounting firm, Arthur Andersen, took a $203 million charge against earnings for accounting adjustments, much of which Andersen believed would have been more appropriately recorded in the years before.

Reluctant Judges

Judges are often reluctant to second-guess accounting firms on complex issues, especially in situations where expert witnesses themselves disagree.

Yet just two weeks ago, an administrative law judge for the S.E.C., in a case brought in 1985, imposed sanctions on another firm, Ernst & Whinney, for failing to uncover wrongdoing at the U.S. Surgical Corporation. The judge temporarily suspended the firm, now part of Ernst & Young, from accepting any new audits in the New York region and censured the partner in charge of the office that did the audit.

In the Price case, the Government is seeking a harsher punishment: a wide-ranging court order against the firm and the three individuals that could subject them to harsh criminal penalties if they were found guilty of future violations of Federal securities laws.

More cases like this can be expected, as the S.E.C. has toughened its stance on accounting and auditing issues this year. In recent months, the commission has set up a special unit with five lawyers to sue advisers to public companies, mostly lawyers and accountants, whom it views as guilty of "unethical or improper professional conduct." Proceedings brought on these charges are being made available to the public for the first time, too.

The commission hopes to curb what it contends is a growing temptation by accountants to bend professional standards in a highly competitive time in which audits have become a commodity. The number of customers have been whittled by the mergers of the late 1980's, and accounting firms feel they cannot afford to lose clients.

The S.E.C. says Price Waterhouse valued its fee more than its duty.

For its part, Price Waterhouse has fought the Government's allegations for half a decade — long after AM and five of seven members of its former managers settled related charges with the S.E.C. (AM International, whose stock trades on the Big Board, emerged from bankruptcy in 1984.)

'No Better Group'

Joseph E. Connor, the former chairman of Price Waterhouse, has testified that "there is no better group of auditors that this firm has ever had" than the three on trial, Daniel Jerbasi, Benjamin Perks and Michael LeRoy, who all saw their responsibilities increase after the AM bankruptcy.

To prove its case, the Government has marshaled evidence that the defendants knew of certain accounting irregularities in the client's fiscal year 1980 books and ignored them even though their colleagues at Price and some AM executives had questioned the practices.

For instance, the company adopted a policy in 1979 of booking revenue on merchandise that had been shipped to customers on a no-obligation, 90-day trial basis. Price Waterhouse maintains that a reserve set up by the company for returned merchandise was a sufficient response.

Sales Were Switched

The company was also accused of doctoring its performance on one occasion by switching $1.9 million in sales from the third quarter of the fiscal year 1980 to the fourth quarter, presumably to improve the quarterly comparisons. Price's Chicago office had identified the bookkeeping entry as a problem in a memo it sent to Mr. Jerbasi, who had final say over the audit. Chicago was ultimately one of seven Price offices that expressed reservations in internal reports about AM units that they had been asked to audit.

The company in 1980 altered its fiscal year for AM's foreign subsidiaries from June 30 to July 31, creating a one-time, phantom month. The Government contends that because the month's results were not supposed to show up on the company's income statement, AM managers dumped expenses into the phantom month and diverted revenues into the adjoining fiscal years, ringing up a $10.9 million loss for the month. Mr. Jerbasi acknowledged in a memo to AM's management that "the large loss may raise questions" about fiscal year 1980 results, but he did not reopen the 1980 audit, as the Government contends would have been proper.

Unreported Changes

The Government also charges that the company adopted, with its auditors' blessing, three undisclosed accounting changes that affected reported income favorably. Price Waterhouse has argued that the two of them were immaterial and that the third was a "refinement of current policy" not a change and thus did not have to be disclosed.

Arthur Andersen, which eventually replaced Price Waterhouse as AM's auditor, concluded in a special investigation conducted in 1981 that the company had understated its expenses in prior years by at least $41 million.

Internal Price Waterhouse memos, which the Government has introduced into evidence, suggest why the firm might have signed off on practices that in hindsight masked the company's troubles. In memos to other partners, Mr. Jerbasi complained that the firm had negotiated a very competitive three-year contract with AM and thus was not making as much money as it had expected on the audit. He said he would seek to have the firm reappointed the following year to recoup the firm's lost fees.