

The New York Times

When an Auditor's Hats Clash

KPMG Case Shows Varied Duties Can Create Conflicts

By MELODY PETERSEN

Accused of being too cavalier about conflicts that might impair their ability to get tough with clients, the nation's auditors argue that they should be allowed to police themselves, just as they always have.

Now comes a case, headed for trial this month in California, that puts that way of thinking to the test. In it, auditors from KPMG Peat Marwick are under attack for repeatedly ignoring signs of their waning independence from a real estate company whose financial reversal cost 20,000 teachers about \$100 million in losses. And so far, the accounting industry's trade group has sided with KPMG in arguing that the public expects too much from auditors.

Lawyers for the teachers accuse the accounting firm of failing to step down as auditors despite several conflicts of interest its Orange County office had with the Teachers Management and Investment Corporation. The company managed dozens of real estate ventures that the teachers' money had bankrolled. KPMG audited both Teachers Management and many of its limited partnerships.

The teachers, who filed a class-action lawsuit against the firm in October 1995 as part of a broader legal strategy to recover the lost money, say that auditors for Peat Marwick, as it was known before a 1987 merger, had a duty to tell them that the company had been nearly insolvent for years but did not do so until it was too late, perhaps because of numerous entanglements with its client.

Too Many Roles?

Teachers in California are suing KPMG Peat Marwick, the accounting firm, over losses they suffered as limited partners in real-estate deals run by the Teachers Management and Investment Corporation and audited by KPMG. The firm says it did nothing wrong and obeyed all professional standards. But the teachers contend that KPMG's multiple roles created conflicts:

CLIENT

The tax partner who shared responsibility for the account for years bought control of Teachers Management soon after his retirement and remained close to his successor at the firm.

SELF-REGULATOR

With some oversight from the Government, accountants, by and large, police themselves on questions concerning their independence from clients.



Business Day

The New York Times

"I always got the impression that everything was fine," said Louise Carmichael, a retired fourth-grade teacher from Fullerton, Calif., who says she lost \$183,000. "Peat Marwick had not said anything was wrong. And they were the watchdogs."

According to court records, through the years, KPMG became much more than just the company's watchdog. In 1987, a retired KPMG partner who had long shared responsibility for the account bought a majority stake in the company. The former partner thus became the client. Besides serving as the company's auditor, KPMG did consulting work for the company and hoped to do more. And when the company could not pay about \$400,000 it owed in fees to the accounting firm, KPMG essentially became a reluctant lender.

Under prevailing industry rules, the unpaid fees alone could constitute enough of an independence problem to require an auditor to step down.

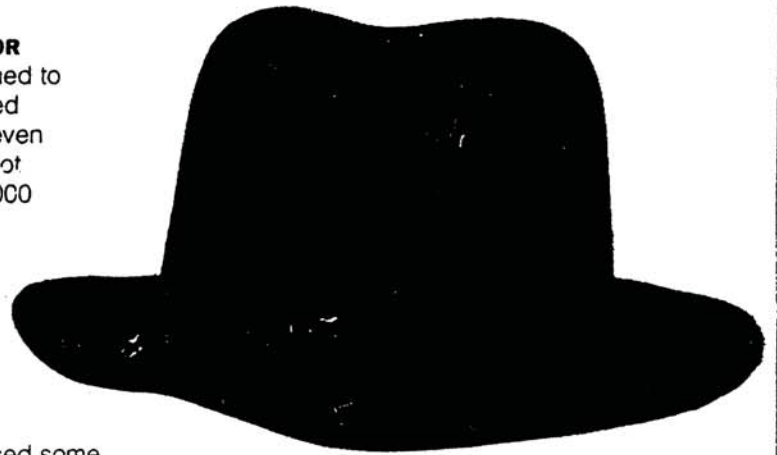
"This was a breakdown of ethics in the pursuit of money," said Ronald Rus, a lawyer at Rus, Miliband, Williams & Smith in Irvine, Calif., who is representing the teachers. "It was greed. That is what this is all about."

In a written statement, KPMG called the allegations made by the teachers' lawyers "irresponsible." The firm is defending itself vigorously. KPMG has already persuaded the

Continued on Page 21

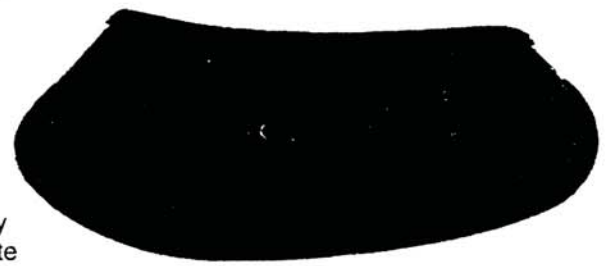
BILL COLLECTOR

KPMG continued to audit the limited partnerships even after it could not collect \$400,000 that Teachers Management owed the firm.



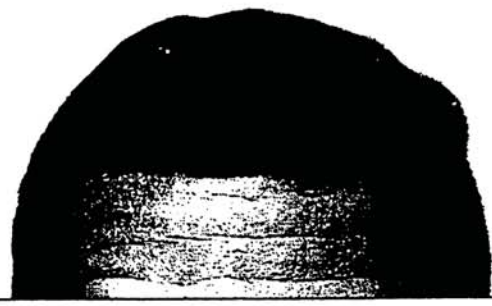
AUDITOR

KPMG expressed some reservations about the company's financial condition as early as 1989. But the teachers say that KPMG should have done a better job of alerting the limited partners whose money went into the real estate projects.



CONSULTANT

On top of its audit work, KPMG was consulting for Teachers Management and had hopes of selling it more services.



KPMG Case Shows Clash of Roles

Continued From First Business Page

court to dismiss allegations that it was negligent and said it "is confident that the only remaining claims will be rejected when all of the facts are presented to the court."

The accounting firm's court papers argue that its auditors obeyed all accounting and auditing standards and that the firm cannot be blamed for having caused the teachers' losses when not one of the teachers could demonstrate having read or relied on the audited financial statements when they were issued. The firm disputes the teachers' assertion that it was anything but independent.

The case, scheduled to go to trial on Jan. 20 in Orange County Superior Court, comes at a time when securities regulators have already expressed concern that the major accounting firms, known as the Big Six, are poorly monitoring their independence from the companies they audit.

Pending mergers between four of the Big Six are only likely to raise the number of conflicts as firms that now consult for companies also turn up as their auditors. Indeed, KPMG is merging with Ernst & Young, a deal that will bring together two powerful auditing and consulting practices.

Officials at the Securities and Exchange Commission, whose rules for auditors of public companies provide guidance to all accountants reviewing corporate matters, said that they could not comment on the case. But according to other accounting experts, the dispute underscores how outmoded the current independence standards are.

"This case raises issues, whether you agree with the lawyers or not, that need to be addressed," said Paul R. Brown, an accounting professor at New York University. "When does the auditor reach that point when decisions are clouded?"

Rules regarding independence are essentially written by the S.E.C., the American Institute for Certified Public Accountants and the accounting firms. Of all the conflicts of interest raised by the teachers' case, pro-

ceeding with an audit in the face of unpaid fees would be considered the most serious, akin to extending a loan to a client.

Under professional standards set by the institute, independence "may be impaired if more than one year's fees due from a client for professional services remain unpaid for an extended period of time." What rule makers wanted to avoid was giving auditors the temptation to prop up a client long enough to get paid. KPMG argues that most of the unpaid fees were owed by limited partnerships that had gone bankrupt and that the firm had ceased auditing.

But the teachers dispute that and say that it would not make a differ-

A lawsuit says an accounting firm became too close to its client.

ence anyway. "They struck a deal," Mr. Rus said. "They got to do the audits in the future if they agreed to write the fees off."

Other potential conflicts raised by the case — accountants taking jobs with a client, the pursuit of consulting work and an accounting firm's high dependence on a single client — have been mentioned by regulators and experts as troubling but are not explicitly prohibited. A new panel known as the Independence Standards Board is reviewing the rules at the urging of the S.E.C. The board draws half its members from the accounting profession and has yet to take action.

For years, KPMG had good reason to want to keep Teachers Management happy. A 1989 internal KPMG memo describes the company, based in Newport Beach, Calif., as the biggest client of the Orange County office.

Started in the 1960's, Teachers Management grew out of an informal effort by a group of teachers to

benefit from the boom in California real estate. They put up money that dozens of limited partnerships used to buy land, with Teachers Management, as the general partner, managing the partnerships. Many teachers moonlighted as sales representatives. For years, profits far surpassed expectations, and the company brandished its slogan, "Teachers Helping Teachers," with pride.

That all changed once the 1986 tax act eliminated many breaks for real estate investors. In 1987, James R. Martin, a Peat Marwick tax partner who had key responsibility for the account for more than a decade until he retired the previous year, bought a majority stake in Teachers Management with his longtime business partner, Maurice B. Shuman. By 1988, existing management had left, and the two men began running the company. Through the years, other accountants from the firm also quit and took key roles at the company, though KPMG insists that in Mr. Martin's case, two years passed between the time he worked on the account and the time he began managing the company's affairs.

Nonetheless, the teachers' lawyers say, the accountants and the client were too close for comfort. For instance, Mr. Martin, who assumed active management of the company in early 1988, still golfed and socialized with William M. Gilbow, the partner who succeeded Mr. Martin on the account.

In reviewing the 1988 financial statements for Teachers Management, its last completed audit of the company, Peat Marwick felt obliged to insert a "going concern" paragraph in its annual opinion, an auditor's way of signaling that a company might not last long without outside help. KPMG's court papers assert that its warning was "widely disseminated" to the teachers.

The teachers disagree, arguing in the lawsuit that nowhere in the materials sent to them, as limited partners, was there a glimmer of their general partner's ailing condition.

The teachers' lawyers trace one of the most glaring conflicts to 1989, when Teachers Management and its affiliates said they could not pay \$400,000 out of more than \$800,000



Bart Bartholomew for The New York Times

Ronald Rus, standing, represents 200,000 teachers in a lawsuit against KPMG Peat Marwick including, from left, Louise Carmichael, Elmer Carmichael, Stan Clough, Jean Sweeney and Kay Seibert.

owed to the firm. KPMG agreed to write off the fees over three years as long as the company continued to hire the firm for more work, internal memos show. According to one such memo, the unpaid bills had created "a constant strain" between the auditors and the company. But the partners saw opportunities to wring more fees and consulting work from the client if they could keep the business.

Lawyers for the teachers say that KPMG's auditors also knew that the company's management was commingling the teachers' money with its own money in a central cash account to cover checks that would have otherwise bounced. At least \$300,000 of the limited partners' money funneled through the account has never been repaid, they say.

In one memo dated Dec. 2, 1987, Georgeann Elliott, a financial executive at Teachers Management, complained about the arrangement to a colleague, stating that the only reason the company had avoided having this "house of cards fall down is because we keep the funds churning in and out of the account." She also objected to having had to cover one payment in a way that was in "direct

conflict" with California regulation.

"The general partner stole money from the teachers, and Peat Marwick knew it," said Mr. Rus, the teachers' lawyer. "They should have disclosed what they knew."

In its defense, KPMG acknowledges that its auditors knew generally how the cash account was being used and noted that in at least one case in 1992 it notified limited partners whose money was being "advanced" to other partnerships that such advances were prohibited under their partnership agreement. Still, the firm argues that Teachers Management's use of a central cash account to handle multiple entities is a common real estate technique.

David C. Grant, a lawyer for Mr. Martin and Mr. Shuman, who ran Teachers Management, said the company had paid the teachers, without admitting fault, \$3.8 million about two years ago to settle a similar lawsuit. "They're quite upset by the allegations," Mr. Grant said of his clients. "They did not do anything without consultation and advice, and they still got nailed."

Besides any effect the dispute may have on existing independence rules, the lawsuit against KPMG has also

raised concerns throughout the accounting profession because of the unusual decision by Judge John C. Woolley to make all 250 of KPMG's California partners defendants. The judge made that move after KPMG could not prove that it had enough liability insurance to cover a judgment.

The teachers' lawyers had questioned the adequacy of KPMG's insurance because it faces two other big lawsuits in Orange County. One of those, filed by the county government after its investment pool collapsed, seeks \$3 billion in damages. "Who pays for this if there is no insurance?" Mr. Rus asked. A spokeswoman for KPMG said last week that the firm did not wish to comment further on its insurance.

In yet another twist on the kinds of conflicts that accountants must grapple with, Kenneth Leventhal, an accounting firm in Los Angeles that specializes in real estate, has provided expert help to the teachers' case against KPMG. In 1995, Leventhal merged with Ernst & Young, which is merging with KPMG. "It looks to me like you just got in bed with yourself," the judge noted wryly in November to the opposing camps.