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CASE 5.3

The PTL Club

Jim and Tammy Faye Bakker founded the PTL (Praise the Lord) Club, a religious broadcasting organization, in 1974. A little more than one decade later, the PTL Club claimed more than 500,000 members and boasted annual revenues of almost $130 million. Bakker and his close associates came under intense scrutiny in 1987 following a revelation that they used PTL funds to pay a former church secretary to remain silent concerning a brief liaison between herself and Bakker. That disclosure triggered a series of investigations of PTL's finances. Key agencies involved in those investigations included the Internal Revenue Service, the Federal Bureau of Investigation, and the U.S. Postal Service. In March 1987, Bakker resigned as PTL's chairman. Two years later, a federal jury convicted him of fraud and conspiracy charges. A federal judge then fined Bakker $500,000 and sentenced him to forty-five years in prison.[1]

The Bakker scandal spurred a nationwide debate focusing on the issue of whether the financial affairs of religious broadcasting companies should be subject to regulatory oversight. The investigations of PTL revealed that Bakker and his associates received huge salaries and bonuses from funds raised via the organization's televised appeals. In 1986, PTL paid the Bakkers almost $2 million. During the first three months of 1987, while PTL struggled to cope with severe cash flow problems, the couple received $640,000. Critics also chastised the Bakkers for their flamboyant lifestyle. Tammy Faye Bakker decorated PTL's executive suites in Fort Mill, South Carolina, in opulent style, including gold-plated bathroom fixtures and extravagant chandeliers. The Bakkers enjoyed a rambling Palm Springs ranch house on their many trips to the West Coast, a $600,000 condominium in Highland Beach, Florida, and a fleet of luxury automobiles, including Rolls-Royces.

Before 1987, Jim Bakker's critics persistently called for more extensive financial disclosures by PTL. Bakker resisted these demands. He repeatedly insisted that such disclosures were not necessary since PTL maintained strong financial controls. In addition, Bakker often reminded his critics that PTL "had excellent accountants and that it had external audits by reputable [CPA] firms."[2] The subsequent investigations of PTL failed to support Bakker's claims. Those investigations revealed that the organization's internal controls were extremely weak, and nonexistent in many cases. Investigators found that Bakker's subordinates issued paychecks to individuals not employed by PTL and paid large sums to consultants who never provided any services to the organization. Additionally, investigators could not locate documentation for millions of dollars of construction costs recorded in PTL's accounting records.

1. In early 1991, a federal appeals court upheld Bakker's conviction on the fraud and conspiracy charges but voided Bakker's 45-year sentence, as well as the $500,000 fine, and ordered that a new sentencing hearing be held. According to the appeals court, the trial judge who imposed the lengthy sentence on Bakker may have allowed his personal religious predispositions to influence his sentencing decision. Following the re-sentencing hearing in August 1991, Bakker received an 18-year sentence. In 1994, Bakker was paroled after serving nearly five years in federal prison.

2. L. Berton, "Laventhol & Horwath Beset by Litigation, Runs into Hard Times," *The Wall Street Journal*, 17 May 1990, A1, A10.

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One of the most troubling weaknesses uncovered in PTL's accounting system involved a secret payroll account used to disburse funds to Bakker and his closest aides. This account was so secretive that the organization's chief financial officer was not informed of the expenses funneled through it, while PTL's board of directors was totally unaware of its existence. Surprisingly, during the mid-1980s a partner of Laventhol & Horwath, PTL's independent audit firm, maintained the secret payroll account, including overseeing the preparation of the checks issued on that account.[3] Even more surprisingly, that same partner also supervised PTL's annual audits.

Laventhol was widely criticized for its role in the PTL scandal and eventually named as a co-defendant in a $757 million class action lawsuit filed by PTL contributors. The suit alleged that Laventhol assisted Bakker in misrepresenting PTL's financial condition and facilitated Bakker's efforts to embezzle millions of dollars from PTL through the secret payroll account. Among several other parties named as co-defendants in the lawsuit were Bakker and PTL's former audit firm, Deloitte, Haskins & Sells. PTL had dismissed Deloitte as its audit firm in 1985 for undisclosed reasons and retained Laventhol as its new audit firm.

Laventhol's decision to accept PTL as a client was apparently linked to an aggressive marketing strategy adopted by the firm in the late 1970s. From 1980 to 1986 alone, Laventhol's nationwide revenues increased 300 percent. This phenomenal growth resulted in part from Laventhol's acceptance of high-risk audit clients that other audit firms hesitated or refused to consider as clients. A former Laventhol employee bluntly observed that the firm "took too many risky clients like PTL--a strategy that, ironically, accountants often advise their clients to avoid."[4] Critics charged that the large fees Laventhol received from PTL influenced the accounting firm's decisions regarding that client. In the civil lawsuit that named Laventhol as a co-defendant, the plaintiffs maintained that the CPA firm permitted the questionable payments from the secret payroll account "because PTL was the largest client for its [Laventhol's] Charlotte office."[5]

In the fall of 1990, Laventhol, the seventh-largest CPA firm in the United States at the time, filed for bankruptcy. Attorneys for PTL's contributors subsequently dropped the accounting firm as a co-defendant in the $757 million class action lawsuit.[6] Two months later, the jury hearing that case rendered a $130 million judgment against Jim Bakker to be paid to the plaintiffs. The jury ruled that Deloitte & Touche, the successor firm of Deloitte, Haskins & Sells, was not guilty of any malfeasance in the case. In commenting on the jury's verdict, a Deloitte official noted that the suit was "a well-financed and well-executed attempt to recover enormous damages from an innocent accounting firm for the alleged wrongdoing of others."[7,8]

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3. Although Laventhol prepared the checks written on this account, the accounting firm forwarded the checks to a PTL executive to be signed.

4. Berton, "Laventhol & Horwath Beset by Litigation," A1.

5. M. Isikoff and A. Harris, "PTL Contributors Sue Ministry's Accounting Firms," *Washington Post*, 19 November 1987, C10, C16.

6. Laventhol's partners and former partners did not escape financial responsibility for the firm's role in the PTL scandal. In a subsequent bankruptcy plan approved in 1992 by the U.S. Bankruptcy Court of New York, Laventhol's partners and former partners contributed approximately $47 million to a settlement pool to liquidate outstanding claims against Laventhol. This pool was to be divided among Laventhol's creditors and several parties that had sued the firm, including PTL's contributors. Individual payments made by Laventhol partners to this settlement pool reportedly ranged as high as $700,000.

7. "Deloitte Victorious in PTL Case," *Public Accounting Report*, 31 January 1991, 5.

8. An excellent and comprehensive summary of the accounting and auditing issues involved in the PTL scandal can be found in *Anatomy of A Fraud* (New York: Wiley, 1993), by Gary Tidwell.

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Questions

1. Identify the ethical questions raised by the maintenance of PTL's secret payroll account by the Laventhol partner. Does the fact that PTL was a private organization not registered with the Securities and Exchange Commission affect the propriety of the partner's actions? Explain.
2. What procedures should an audit firm perform before accepting an audit client, particularly a high-risk client such as PTL?
3. Briefly define the so-called "deep pockets theory" as it relates to the litigation problems of large public accounting firms in recent years. What measures can these firms take to protect themselves from large class action lawsuits predicated upon false or largely unfounded allegations?

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CASE 5.4

Cardillo Travel Systems, Inc.

If virtue is not its own reward,
I don't know any other stipend attached to it.

Lord Byron

Act 1

Russell Smith knew why he had been summoned to the office of A. Walter Rognlien, the 74-year-old chairman of the board and chief executive officer (CEO) of Smith's employer, Cardillo Travel Systems, Inc.[1] Just two days earlier, Cardillo's in-house attorney, Raymond Riley, had requested that Smith, the company's controller, sign an affidavit regarding the nature of a transaction Rognlien had negotiated with United Airlines. The affidavit stated that the transaction involved a $203,000 payment by United Airlines to Cardillo but failed to disclose why the payment was being made or for what specific purpose the funds would be used. The affidavit included a statement indicating that Cardillo's stockholders' equity exceeded $3 million, a statement that Smith knew to be incorrect. Smith also knew that Cardillo was involved in a lawsuit and that a court injunction issued in the case required the company to maintain stockholders' equity of at least $3 million. Because of the blatant misrepresentation in the affidavit concerning Cardillo's stockholders' equity and a sense of uneasiness regarding United Airlines' payment to Cardillo, Smith had refused to sign the affidavit.

When Smith stepped into Rognlien's office on that day in May 1985, he found not only Rognlien but also Riley and two other Cardillo executives. One of the other executives was Esther Lawrence, the firm's energetic 44-year-old president and chief operating officer (COO) and Rognlien's wife and confidante. Lawrence, a long-time employee, had assumed control of Cardillo's day-to-day operations in 1984. Rognlien's two sons by a previous marriage had left the company in the early 1980s following a power struggle with Lawrence and their father.

As Smith sat waiting for the meeting to begin, his apprehension mounted. Although Cardillo had a long and proud history, in recent years the company had begun experiencing serious financial problems. Founded in 1935 and purchased in 1956 by Rognlien, Cardillo ranked as the fourth-largest company in the travel agency industry and was the first to be listed on a national stock exchange. Cardillo's annual revenues had steadily increased after Rognlien acquired the company, approaching $100 million by 1984. Unfortunately, the company's operating expenses had increased more rapidly. Between 1982 and 1984, Cardillo posted collective losses of nearly $1.5 million. These poor operating results were largely due to an aggressive franchising strategy implemented by Rognlien. In 1984 alone that strategy more than doubled the number of travel agency franchises operated by Cardillo.

Shortly after the meeting began, the overbearing and volatile Rognlien demanded that Smith sign the affidavit. When Smith steadfastly refused, Rognlien showed

1. The events discussed in this case were reconstructed principally from information included in Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 143*, 4 August 1987. All quotations appearing in this case were taken from that document.

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him the first page of an unsigned agreement between United Airlines and Cardillo. Rognlien then explained that the $203,000 payment was intended to cover expenses incurred by Cardillo in changing from American Airlines' Sabre computer reservation system to United Airlines' Apollo system. Although the payment was intended to reimburse Cardillo for those expenses and was refundable to United Airlines if not spent, Rognlien wanted Smith to record the payment immediately as revenue.

Not surprisingly, Rognlien's suggested treatment of the United Airlines payment would allow Cardillo to meet the $3 million minimum stockholders' equity threshold established by the court order outstanding against the company. Without hesitation, Smith informed Rognlien that recognizing the United Airlines payment as revenue would be improper. At that point, "Rognlien told Smith that he was incompetent and unprofessional because he refused to book the United payment as income. Rognlien further told Smith that Cardillo did not need a controller like Smith who would not do what was expected of him."

Act 2

In November 1985, Helen Shepherd, the audit partner supervising the 1985 audit of Cardillo by Touche Ross, stumbled across information in the client's files regarding the agreement Rognlien had negotiated with United Airlines earlier that year. When Shepherd asked her subordinates about this agreement, one of them told her of a $203,000 adjusting entry Cardillo had recorded in late June. That entry, which follows, had been approved by Lawrence and was apparently linked to the United Airlines–Cardillo transaction:

Dr Receivables–United Airlines	$203,210	
Cr Travel Commissions and Fees		$203,210

Shepherd's subordinates had discovered the adjusting entry during their second-quarter review of Cardillo's Form 10-Q statement. When asked, Lawrence had told the auditors that the entry involved commissions earned by Cardillo from United Airlines during the second quarter. The auditors had accepted Lawrence's explanation without attempting to corroborate it with other audit evidence.

After discussing the adjusting entry with her subordinates, Shepherd questioned Lawrence. Lawrence insisted that the adjusting entry had been properly recorded. Shepherd then requested that Lawrence ask United Airlines to provide Touche Ross with a confirmation verifying the key stipulations of the agreement with Cardillo. Shepherd's concern regarding the adjusting entry stemmed from information she had reviewed in the client's files that pertained to the United Airlines agreement. That information suggested that the United Airlines payment to Cardillo was refundable under certain conditions and thus not recognizable immediately as revenue.

Shortly after the meeting between Shepherd and Lawrence, Walter Rognlien contacted the audit partner. Like Lawrence, Rognlien maintained that the $203,000 amount had been properly recorded as commission revenue during the second quarter. Rognlien also told Shepherd that the disputed amount, which United Airlines paid to Cardillo during the third quarter of 1985, was not refundable to United Airlines under any circumstances. After some prodding by Shepherd, Rognlien agreed to allow her to request a confirmation from United Airlines concerning certain features of the agreement.

Shepherd received the requested confirmation from United Airlines on December 17, 1986. The confirmation stated that the disputed amount was refundable through 1990 if certain stipulations of the contractual agreement between the two parties

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were not fulfilled.[2] After receiving the confirmation, Shepherd called Rognlien and asked him to explain the obvious difference of opinion between United Airlines and Cardillo regarding the terms of their agreement. Rognlien told Shepherd that he had a secret arrangement with the chairman of the board of United Airlines. "Rognlien claimed that pursuant to this confidential business arrangement, the $203,210 would never have to be repaid to United. Shepherd asked Rognlien for permission to contact United's chairman to confirm the confidential business arrangement. Rognlien refused. In fact, as Rognlien knew, no such agreement existed."

A few days following Shepherd's conversation with Rognlien, she advised William Kaye, Cardillo's vice president of finance, that the $203,000 amount could not be recognized as revenue until the contractual agreement with United Airlines expired in 1990. Kaye refused to make the appropriate adjusting entry, explaining that Lawrence had insisted that the payment from United Airlines be credited to a revenue account. On December 30, 1985, Rognlien called Shepherd and told her that he was terminating Cardillo's relationship with Touche Ross.

In early February 1986, Cardillo filed a Form 8-K statement with the Securities and Exchange Commission (SEC) notifying that agency of the company's change in auditors. SEC regulations required Cardillo to disclose in the 8-K statement any disagreements involving accounting, auditing, or financial reporting issues with its former auditor. The 8-K, signed by Lawrence, indicated that no such disagreements preceded Cardillo's decision to dismiss Touche Ross. SEC regulations also required Touche Ross to draft a letter commenting on the existence of any disagreements with Cardillo. This letter had to be filed as an exhibit to the 8-K statement. In Touche Ross's exhibit letter, Shepherd discussed the dispute involving the United Airlines payment to Cardillo. Shepherd disclosed that the improper accounting treatment given that transaction resulted in misrepresented financial statements for Cardillo for the six months ended June 30, 1985, and the nine months ended September 30, 1985.

In late February 1986, Raymond Riley, Cardillo's legal counsel, wrote Shepherd and insisted that she had misinterpreted the United Airlines-Cardillo transaction in the Touche Ross exhibit letter filed with the company's 8-K. Riley also informed Shepherd that Cardillo would not pay the $17,500 invoice that Touche Ross had submitted to his company. This invoice was for professional services Touche Ross had rendered prior to being dismissed by Rognlien.

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Act 3

On January 21, 1986, Cardillo retained KMG Main Hurdman (KMG) to replace Touche Ross as its independent audit firm. KMG soon addressed the accounting treatment Cardillo had applied to the United Airlines payment. When KMG personnel discussed the payment with Rognlien, he informed them of the alleged secret arrangement with United Airlines that superseded the written contractual agreement. According to Rognlien, the secret arrangement precluded United Airlines from demanding a refund of the $203,000 payment under any circumstances. KMG refused to accept this explanation. Roger Shlonsky, the KMG audit partner responsible for the Cardillo

2. Shepherd apparently never learned that the $203,000 payment was intended to reimburse Cardillo for expenses incurred in switching to United Airlines' reservation system. As a result, she focused almost exclusively on the question of when Cardillo should recognize the United Airlines payment as revenue. If she had been aware of the true nature of the payment, she almost certainly would have been even more adamant regarding the impropriety of the $203,000 adjusting entry.

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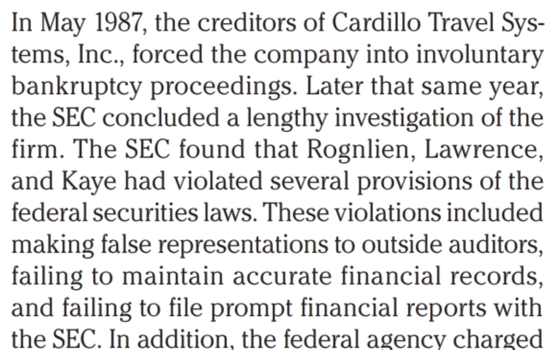
engagement, told Rognlien that the payment would have to be recognized as revenue on a pro rata basis over the five-year period of the written contractual agreement with United Airlines.[3]

Cardillo began experiencing severe liquidity problems in early 1986. These problems worsened a few months later when a judge imposed a $685,000 judgment on Cardillo to resolve a civil suit filed against the company. Following the judge's ruling, Raymond Riley alerted Rognlien and Lawrence that the adverse judgment qualified as a "material event" and thus had to be reported to the SEC in a Form 8-K filing. In the memorandum he sent to his superiors, Riley discussed the serious implications of not disclosing the settlement to the SEC: "My primary concern by not releasing such report and information is that the officers and directors of Cardillo may be subject to violation of rule 10b-5 of the SEC rules by failing to disclose information that may be material to a potential investor."

Within ten days of receiving Riley's memorandum, Rognlien sold 100,000 shares of Cardillo stock in the open market. Two weeks later, Lawrence issued a press release disclosing for the first time the adverse legal settlement. However, Lawrence failed to disclose the amount of the settlement or that Cardillo remained viable only because Rognlien had invested in the company the proceeds from the sale of the 100,000 shares of stock. Additionally, Lawrence's press release underestimated the firm's expected loss for 1985 by approximately 300 percent.

Following Lawrence's press release, Roger Shlonsky met with Rognlien and Lawrence. Shlonsky informed them that the press release grossly understated Cardillo's estimated loss for fiscal 1985. Shortly after that meeting, KMG resigned as Cardillo's independent audit firm.

EPILOGUE



In May 1987, the creditors of Cardillo Travel Systems, Inc., forced the company into involuntary bankruptcy proceedings. Later that same year, the SEC concluded a lengthy investigation of the firm. The SEC found that Rognlien, Lawrence, and Kaye had violated several provisions of the federal securities laws. These violations included making false representations to outside auditors, failing to maintain accurate financial records, and failing to file prompt financial reports with the SEC. In addition, the federal agency charged Rognlien with violating the insider trading provisions of the federal securities laws. As a result of these findings, the SEC imposed permanent injunctions on each of the three individuals that prohibited them from engaging in future violations of federal securities laws. The SEC also attempted to recover from Rognlien the $237,000 he received from selling the 100,000 shares of Cardillo stock in April 1986. In January 1989, the two parties resolved this matter when Rognlien agreed to pay the SEC $60,000.

3. Cardillo executives also successfully concealed from the KMG auditors the fact that the United Airlines payment was simply an advance payment to cover installation expenses for the new reservation system.

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Questions

1. Identify the accountants in this case who faced ethical dilemmas. Also identify the parties who would be potentially affected by the outcome of each of these dilemmas. What responsibility did the accountant in each case owe to these parties? Did the accountants fulfill these responsibilities?
2. Describe the procedures an auditor should perform during a review of a client's quarterly financial statements. In your opinion, did the Touche Ross auditors who discovered the $203,000 adjusting entry during their 1985 second-quarter review take all appropriate steps to corroborate that entry? Should the auditors have immediately informed the audit partner, Helen Shepherd, of the entry?
3. In reviewing the United Airlines–Cardillo agreement, Shepherd collected evidence that supported the $203,000 adjusting entry as booked and evidence that suggested the entry was recorded improperly. Identify each of these items of evidence. What characteristics of audit evidence do the profession's technical standards suggest auditors should consider? Analyze the audit evidence that Shepherd collected regarding the disputed entry in terms of those characteristics.
4. What are the principal objectives of the SEC's rules that require Form 8-K statements to be filed when public companies change auditors? Did Shepherd violate the client confidentiality rule when she discussed the United Airlines–Cardillo transaction in the exhibit letter she filed with Cardillo's 8-K auditor change statement? In your opinion, did Shepherd have a responsibility to disclose to Cardillo executives the information she intended to include in the exhibit letter?
5. Do the profession's technical standards explicitly require auditors to evaluate the integrity of a prospective client's key executives? Identify the specific measures auditors can use to assess the integrity of a prospective client's executives.

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