CASE 5.5

Phillips Petroleum Company

Bill Grant sat in the middle of a large jail cell with 12 other inmates as the long October night dragged on.[1] To pass the time, Grant and several other inmates played cards and talked about their hopes of being reunited with their families. The accommodations of the Tulsa County Jail were not unlike those of most jails: dirty, no lid on the toilet, and 12 beds for 13 inmates. What made this scene unusual was not the less-than-glamorous, overcrowded condition of the jail cell, but rather the presence of Grant, a Big Eight audit partner and graduate of the Harvard Business School. At the time, Grant served as the managing partner of the Tulsa office of Arthur Young & Company, but he was destined to become Arthur Young's co-managing partner in 1988 shortly before that firm merged with Ernst & Whinney to form Ernst & Young.

Earlier that day, Grant had appeared in a Tulsa federal courthouse at a hearing presided over by Judge Allan Barrow. Judge Barrow had ordered Grant to produce certain audit workpapers that had been subpoenaed by a federal grand jury. Those workpapers had been prepared during an audit of the large oil company, Phillips Petroleum Company, a client of Arthur Young's Tulsa office. When Grant respectfully denied the judge's request, he was cited for civil contempt, handcuffed, and led away to jail. Apparently, the judge hoped that an overnight stay in a crowded jail cell would convince Grant to change his mind.

The federal grand jury's interest in the Arthur Young workpapers stemmed from an ongoing investigation of Phillips. That investigation focused on possible tax fraud related to a secret, multimillion-dollar fund that Phillips' executives had established to make political contributions. One contribution made from the secret fund, which was maintained in a Swiss bank account, was an illegal donation of $100,000 to what became known during the Watergate era as CREEP–the Committee to Reelect the President (Richard Nixon). Under the terms of an earlier plea bargain agreement with Watergate special prosecutor Archibald Cox, Phillips' chairman of the board, had admitted to the $100,000 contribution to Nixon's 1972 reelection campaign and pleaded guilty to one misdemeanor.[2] Following that plea bargain agreement, a seven-count indictment was filed against Phillips that charged the company with filing false federal tax returns for failing to report interest revenue earned on the secret Swiss bank account.

Prior to Bill Grant's appearance before Judge Barrow, Arthur Young had turned over to the federal grand jury approximately 12,000 pages of Phillips's audit workpapers. Arthur Young, however, had refused to give the grand jury several workpapers relating to two key items: (1) certain tax accruals made by Phillips and (2) attorneys'

1. The facts of this case were drawn principally from the following articles: "Arthur Young Aide Cited for Contempt and Jailed in Tulsa," *The Wall Street Journal*, 8 October 1975, 10; F. Andrews, "Arthur Young Faces Test on Protecting Client Audit Secrets," *The Wall Street Journal*, 14 October 1975, 23; "Arthur Young & Co. Gives Grand Jury Data On Phillips Petroleum," *The Wall Street Journal*, 15 October 1975, 28; "Pleas by Phillips Petroleum Filed On U.S. Charges," *The Wall Street Journal*, 23 November 1977, 2.

2. Phillips's chairman also revealed that he had delivered $50,000 to Nixon in a New York City apartment during the 1968 presidential campaign in which Nixon eventually defeated Senator Hubert Humphrey.

letters that Arthur Young had obtained from Phillips's law firms. Among other topics, these attorneys' letters were known to include discussions of "unasserted claims" by Phillips's attorneys. The federal grand jury believed that both sets of workpapers might provide important insight on the allegations involving Phillips.

Arthur Young had refused to provide the contested workpapers to the grand jury on the grounds that they contained confidential information that, if disclosed, would be potentially damaging to Phillips. Tax accrual audit workpapers, for example, typically contain an audit firm's analysis of tax-related decisions made by their clients. Access to such workpapers would make it much easier for the Internal Revenue Service (IRS) to "build a case" against a given company.

Bill Grant was released from the Tulsa County Jail on October 7, 1975, but was ordered to make an appearance the following week before Judge Barrow. If Grant again refused to produce the workpapers subpoenaed by the grand jury, he faced the risk of being cited for criminal contempt and receiving a 17-month jail term. During the week between Grant's two court appearances, Arthur Young's attorneys worked out a compromise with Judge Barrow. Under the terms of the agreement, Arthur Young turned over copies of the requested tax accrual workpapers. All matters other than those specifically identified by the subpoena were masked in the copies of the workpapers given to the grand jury. Judge Barrow also granted Arthur Young the right to contest any subsequent court order to provide the original "unmasked" tax accrual workpapers to the grand jury.

Judge Barrow did not relent with respect to the contested attorneys' letters. He ordered Arthur Young to provide copies of those letters to the grand jury. Phillips filed a motion to appeal this order, but that appeal was denied.

EPILOGUE

The Watergate-related problems of Phillips Petroleum continued to plague the company following the resolution of the dispute involving the Arthur Young workpapers. In early 1976, Phillips's executives temporarily turned over control of the company to its outside directors. This decision was spurred by the filing of a large class-action lawsuit against Phillips linked to the charges of illegal campaign contributions. In November 1977, Phillips settled these charges by pleading guilty to engaging in a conspiracy to make illegal campaign contributions, pleading no contest to four related tax evasion charges, and paying a fine of $30,000.

Ironically, Arthur Young's tax accrual workpapers for another audit client, the large oil company Amerada Hess, became the focal point of another major litigation case. The issue in this case was whether the IRS had the right to review copies of auditors' tax accrual workpapers. In 1984, the Supreme Court decided the case by unanimously ruling that the IRS has the right to review tax accrual workpapers prepared during an independent audit.

Questions

1. Do you believe that Bill Grant was justified in refusing to provide the requested workpapers to the grand jury? Explain.
2. What responsibility, if any, does a public accounting firm have to its partners and employees when they are subpoenaed to testify regarding a client?

3. What is the purpose of "attorneys' letters" obtained during the course of an audit? If attorneys are aware that these letters can be routinely subpoenaed, how does this fact likely affect the quality of the audit evidence yielded by these letters?
4. Do you believe the documentation included in tax accrual audit workpapers is likely affected by auditors' knowledge that those workpapers can be obtained by the IRS? Explain.