Michael Hamersley at the Big Firm: Auditor or Tax Advocate?

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ABSTRACT

This real-world, disguised case provides auditing students with an opportunity to apply recent professional standards to an ethical dilemma involving the audit of a client's income tax provision.

INTRODUCTION

When Michael Hamersley left a meeting with Burk Mitchell, the Area Managing Partner of Big Firm's Tax Practice in the Western United States, he knew that he faced a decision that could end his career.[1]

CASE BACKGROUND

All had been going so very well for Michael ("Mike") Hamersley. Following graduation from Georgetown University, where he received his law degree, MBA and BBA degrees, Mike joined Big Firm's National Tax office in Washington D.C. as a member of the Mergers and Acquisitions Group. In March of 2000 he relocated to Los Angles with the expectation that he would replace Brian Timmons as the partner in charge of the Los Angeles Merger and Acquisition Practice. In fact, the national leader of Big Firm's Merger and Acquisition practice agreed that Mike would be admitted to the partnership no later than two complete fiscal years after his arrival in Los Angeles if his performance was as expected.

Prior to his move to LA, most of Mike's work had been in the Merger and Acquisition (M&A) area, where his focus was on structuring transactions for favorable tax treatment. The law surrounding M&A transactions is fairly well-established, which allowed Mike to get comfortable with this specialty and to progress quickly within the firm. This level of success continued after his relocation, as his performance was rated "exceptional" in the years 2000 through 2002. In fact, Brian Timmons had informed Mike that his candidacy for partner was progressing well. In Mike's performance review, Timmons referred to Mike as "our 'A' player." Now, however, a run-in with the Area Managing Partner could change everything.

CASE OVERVIEW

Mike's problems began when he was assigned to the financial statement audit of XYZ Corporation.[2] XYZ Corporation is a public company that had historically been audited by Arthur Andersen. Following Arthur Andersen's criminal indictment in the Enron matter, XYZ Corporation

[1] Big Firm's true identity is not disclosed. Names of the professionals with whom Michael Hamersley deals are also disguised.

[2] XYZ Corporation is a pseudonym.

announced that it had engaged Big Firm as its new independent auditor. The first task for the new auditors was a re-audit of the previous three years in order to assure the financial market that XYZ's financial statements were fairly stated. What was not announced, however, was that Big Firm had hired the Andersen audit partner in charge of the XYZ account, and Big Firm had put this audit partner in charge of the XYZ re-audit.

The re-audit engagement was scheduled for early 2002, and Big Firm's audit opinion was expected to be issued prior to the Sarbanes-Oxley Act implementation date. This timing was important so that Big Firm and XYZ Corporation would not yet be required to comply with the additional audit requirements of the Sarbanes-Oxley Act.

During the course of the re-audit, Mike was asked to review a number of transactions including the proposed disposition of XYZ's Special Purpose Entity, ABC Partnership. The issue at hand was whether XYZ Corporation could recognize a federal income tax loss of $450 million upon the disposition of that partnership. Specifically, Mike was asked to validate the tax loss in order for Big Firm to permit XYZ Corporation to recognize a financial statement benefit for this loss.

The ABC Partnership appeared to Mike to fit the characteristics of a tax shelter. Mike had been successful in staying away from corporate tax shelters during his tenure in Washington D.C. He knew that corporate tax shelters had been a high priority for the Internal Revenue Service (IRS) in recent years. However, the national accounting firms, major banks, and the largest law firms had continued to recommend tax shelter transactions to their clients. Although Mike was willing to agree that reasonable minds will differ regarding who, what, and how much should be taxed under existing law, he felt that, all too often, tax shelters involved twisting the law beyond reasonable bounds (Written Testimony). Moreover, because this new client engagement had presented a new focus on innovative tax strategy and conflicting priorities among the business parties associated with XYZ Corporation, Mike soon found himself working outside his comfort zone.

At the time of this transaction, corporate tax shelters had become a focus of congressional review. The Treasury Department had also issued a series of rulings aimed at limiting tax shelters; however, as rulings were issued, transactions were changed and new, slightly different, shelters were created. It should be noted that although the Treasury Department was largely successful in litigating tax shelter cases, not all courts supported the Treasury Department rulings and taxpayers occasionally prevailed in court.

Generally speaking, in order for a publicly traded corporation to include in its financial statement benefits derived from a tax shelter, it must be "probable" that the shelter will succeed on its merits. This probable standard generally requires that the tax benefits have a greater than 50 percent chance (i.e. more likely than not) of successfully surviving the taxing authorities' scrutiny. When the probable standard is not met, substantial tax penalties are asserted. These penalties may be avoided by disclosing in the tax return that the taxpayer has taken a reporting position that is contrary to existing Treasury Department authority. Such disclosures result in certain IRS challenge.

The ABC partnership that Mike was reviewing was structurally identical to a partnership in private letter ruling No 9644003. A private letter ruling may be used by a taxpayer who wants to know the IRS's view on the applicability of the law and regulations to a proposed transaction. Private letter rulings are requested for prospective transactions. The IRS views private letter rulings as "substantial authority" for the probable standard; however, the IRS is not required to follow the guidance of a private letter ruling for a taxpayer who did not obtain the ruling.

In the ABC transaction, through a series of distributions, transfers, mergers and the formation of new subsidiaries and a partnership, the cost basis of the investment in a subsidiary company's stock was increased substantially. The viability of that increase in cost basis was crucial in order to generate the $450 million loss. If the cost basis was not valid, XYZ would have to increase the provision for income taxes and restate earnings. The IRS, in PLR 9644003, disagreed with the asserted increase in the cost basis because it had no economic substance. The IRS conclusion was based on the fact that the series of underlying transactions had no business purpose other than tax avoidance. After reviewing the ABC Partnership stock basis issue and based on the facts provided by XYZ and PLR 9644003, it was Mike's opinion that the "probable" standard could not be met. He wrote a memorandum for the audit files outlining his findings and rationale.

Soon thereafter, Mike was asked to join a conference call involving Mark Richards, Big Firm's tax partner on the XYZ engagement, and David Hanks, XYZ's Vice President of Tax. When Richards indicated that the prospects did not look good with respect to Big Firm's ability to support the "probable" standard, Hanks became quite upset. He realized that it would be necessary for the company to restate earnings if Big Firm did not approve the partnership transaction.

The following day, Mike received an e-mail message informing him that another meeting had taken place between representatives of Big Firm and XYZ Corporation to discuss the tax treatment of the ABC Partnership transaction. In that meeting, Big Firm's directing partners had agreed that the firm would support the "probable" conclusion that was necessary to avoid a financial statement restatement. Mike was unable to locate any documentation that attempted to analyze the situation, justify the conclusion, or explain how this position squared with Mike's memorandum.

When Mike inquired about the inconsistencies, he was told that the decision had been made by a tax partner who indicated that "the client would fire us if we did not get comfortable with this." Mike protested that the problems he had found had not been resolved.

That e-mail brought about a meeting with Burk Mitchell. Mike had little prior contact with Burk Mitchell, as Burk was a level above Mike's boss (Brian Timmons). Burk wanted to know what had occurred on the ABC Partnership transaction at XYZ Corporation. Mike stated that he had grave concerns about the re-audit environment and auditor independence issues, including the treatment of the tax-motivated transactions consummated by XYZ.

Burk chastised Mike for being naïve about these types of transactions. Burk said that Mike was now "playing with the big boys" and that he better learn how to "play in the big leagues". Burke told Mike that Big Firm's role was not to ferret out problems but, rather to be partners with its audit clients. He accused Mike of unnecessarily alarming the client. Burk also chastised Mike for breaching protocol by discussing the issue with Burk's boss, Mark Richards.

Burk said that Mike must recognize how business is done. He then attempted to persuade Mike to revise his memorandum to support the recording of the tax losses for XYZ. When Mike tried to express his disagreement, Burk asked, "Are you telling me that you cannot write a persuasive brief like you did in law school"?

UNDERLYING AUDIT ISSUES

1. What ethical issues is Mike facing? Refer to specific principles and rules of the AICPA Code of Professional Conduct and support your answer with details from the case.
2. Is Mike too risk averse, or should he advocate his client's position? What differences exist between the roles of an auditor and advocate? Comment on these competing forces among the members of Big Firm.
3. If this case had taken place *after* the implementation of the Sarbanes-Oxley Act, what *differences* must have occurred regarding:
    - Big Firm's assignment of its engagement team members?
    - Big Firm's responsibilities on this audit engagement?
    - XYZ's responsibility for the audited financial statements?
4. If this case had taken place after the implementation of FIN 48, what differences must have occurred regarding Big Firm's handling of XYZ's tax reporting issue?

REFERENCES

Michael Hamersley vs. (Big Firm), LLP et al, Case no. BC 297905 Superior Court of the State of California for the County of Los Angeles, June 23, 2003.

Written Testimony of Michael Hamersley, United States Senate Finance Committee, October 21, 2003.

Teaching Note/Instructor Manual available from the Journal of Business Cases and Applications.