How a Ballpark Tip Evolved Into a Burden for One Auditor

By Elizabeth MacDonald
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Like many young companies seeking credibility with potential investors, Emcore Corp. hired a big-name auditor.

And, for more than a decade, the Somerset, N.J., semiconductor maker remained a satisfied Coopers & Lybrand client. Emcore's business expanded, its financial statements passed muster, and the strong stock-price run-up that followed its March 1997 initial public offering encouraged the company to begin planning for a second stock issue.

Then, in January 1998, as its auditor was preparing to merge with Price Waterhouse, Thomas Werthan, Emcore's chief financial officer, got a call that marked the beginning of the end of the longtime relationship. The breach culminated nearly two years later with Emcore filing a closely watched lawsuit against one of the nation's biggest accounting firms.

What Mr. Werthan says he learned from the call was that several partners of the soon-to-be PricewaterhouseCoopers LLP owned Emcore stock, in violation of federal rules requiring accounting firms to be strictly independent of their audit clients. He says the auditing partner on the other end of the line gave him two options: That Emcore either get a new auditor so the partners wouldn't have to sell their shares, or that it cover their costs of selling the stock.

Mr. Werthan says that after further discussion, the partner agreed that his firm's executives would sell their Emcore shares, at their own expense, and assured Emcore that its coming audit would be free of conflicts.

Executive Holdings

PricewaterhouseCoopers disputes certain elements of Mr. Werthan's account, including his assertion that it wanted Emcore to cover the expense of selling the shares. But it concedes that some of its executives continued to own a total of as many as 140,000 Emcore shares -- or 1.5% of the total then outstanding -- at the same time its auditors were crunching the company's numbers for the fiscal year ended Sept. 30, 1998. That was despite the fact that the accounting firm had ordered its employees to unload any investments in the merged firm's audit clients by the end of July 1998, the month its merger took effect. When securities regulators later got wind of the Emcore holdings, they ordered Emcore to hire another firm to re-audit its fiscal 1998 results, at a cost of about $400,000. Emcore says the upshot was an expensive delay in its planned offering.

This past November, Emcore sued PricewaterhouseCoopers and 10 of its executives in federal court in Newark, N.J., under the Racketeer Influenced and Corrupt Organizations law, accusing the firm of a pattern of fraud that
caused the company millions of dollars in damages, and which Emcore says amounted to racketeering. The accounting firm denies the allegations.

On Tuesday, in an internal e-mail sent to all U.S. partners and staff, PricewaterhouseCoopers advised employees that The Wall Street Journal was preparing an article about the Emcore lawsuit.

The case has alarmed the accounting industry not only because the suit seeks treble damages, but because it exposes a problem that has plagued the industry in recent years. As mergers have whittled the Big Eight accounting firms down to the Big Five, many of which have expanded into consulting and other professional services, those firms are frequently bumping up against strict rules that prevent employees and their immediate families from holding stock in audit clients -- no matter how distant those individuals may be from the actual audit.

In general, the industry regards the independence rules as outdated and too complex and confining, and it blames them for driving away some employees and putting off potential recruits. A partner at the big accounting firm Ernst & Young says conflicts like the one involved in the Emcore case are "endemic" in the industry. But he plays down their significance, adding, "The real conflict is that we get paid by the companies we're auditing."

'A Bedrock Principle'

Traditionalists, however, say that if the independence rules are tough, that's because they need to be. Not owning stock in an audit client is "a bedrock principle. It's not some technical thing that can be overlooked," says Richard C. Breeden, a former chairman of the Securities and Exchange Commission and a former partner at Coopers & Lybrand.

Until recently, at least, accountants at some top firms haven't taken the rules as seriously as regulators might have hoped. Last month, for example, the SEC released a report detailing conflicts involving investments in 2,159 of 3,170 audit clients by partners and other employees at PricewaterhouseCoopers. In response, the firm fired 10 people, including five partners.

PricewaterhouseCoopers says most of the problems stemmed from its 1998 merger. It says it has worked to get rid of these kinds of conflicts, and so far, the SEC hasn't found any problems with those audits or ordered any re-audits. It adds that Emcore, which wasn't included in the SEC report, is overreacting to a problem the firm offered to fix.

"We offered to pay for Emcore's re-audit, but they turned us down," says Frank Barron, the firm's outside counsel from Cravath, Swaine & Moore, New York. "They have a claim to be reimbursed for what it cost for the re-audit, and that's it," he says. "This is just a stickup, and we intend to fight the suit."

A Strong Rally

In 4 p.m. Nasdaq Stock Market trading Thursday, Emcore's shares were up a strong $51.75, or 59%, at $140.125 on volume of 1.2 million shares. The company attributed the rally to news that it plans to enter a manufacturing alliance with telecommunications-gear maker JDS Uniphase Corp., San Jose, Calif.

The Emcore case traces back to 1984 in Warren Township, N.J. There, Edward Cameron, a partner of the old Price Waterhouse, struck up an acquaintance with Norm Shumaker, an Emcore co-founder. During a Little League game in which both of their sons were playing, Mr. Shumaker told Mr. Cameron that he was looking for
investors. Mr. Cameron relayed the tip to co-workers, and he and eight colleagues, including James Schiro, now the accounting giant's chief executive, plunked down a total of about $550,000; six other executives of the firm invested about $400,000. Ultimately, the nine that included Mr. Cameron held a total of 140,000 shares. The 10th defendant is a staff lawyer accused of aiding the alleged fraud.

After Emcore's incorporation in 1986, Coopers & Lybrand began auditing the company's books. But in December 1997, several months after Emcore went public at $9 a share, Mr. Werthan, the CFO, and Brendan Dougher, the Coopers & Lybrand partner overseeing the company's audits, had a phone conversation about the Price Waterhouse partners' Emcore holdings. Mr. Werthan had read about Coopers & Lybrand's merger plans and wanted to make sure the Price Waterhouse executives would get rid of their Emcore shares ahead of the company's fiscal 1998 audit. Mr. Dougher told him that, yes, the partners "would have to comply with the independence rules."

That's one reason the CFO was so troubled to learn in January 1998 that those holdings still hadn't been sold. But Emcore says that following the accounting firm's assurances after the audit began that the stock had been unloaded, the audit was wrapped up that autumn, and Emcore proceeded with its stock-offering plans, aiming for a February 1999 deal.

By that time, PricewaterhouseCoopers had other worries. In January 1999, the SEC slapped it with an embarrassing censure for violating the auditor-independence rules in connection with investments in audit clients by 11 employees in its Tampa, Fla., office, as well as the firm's retirement plan; it was that case that led the SEC to review the firm's other potential conflicts. In settling the Tampa matter, PricewaterhouseCoopers agreed to tell audit clients of any similar violations.

So, on Feb. 2, 1999, two days before Emcore planned to file for an offering it hoped would raise $97.5 million, Mr. Dougher, its lead auditor, phoned Mr. Werthan about some partners' continued ownership of Emcore shares. And, there was a new wrinkle: Until the partners sold their shares, the firm couldn't let Emcore use any past audits as part of its offering documents. The accounting firm says Mr. Schiro, its CEO, had legally transferred his shares to his adult daughter before the fiscal 1998 audit. A person close to the matter says PricewaterhouseCoopers had assumed all "the partners had done the right thing and gotten rid of the stock."

Disclosure Statement

Still, the setback seemed short-lived. A day later, PricewaterhouseCoopers phoned Emcore with the news that the partners had sold their Emcore shares, so the company could now use the firm's audit opinions in connection with its offering. Emcore immediately registered the shares with the SEC, attaching the audit opinions and disclosing the past conflict of interest. "Certain Price Waterhouse LLP partners" owned Emcore shares when Price Waterhouse merged with Coopers & Lybrand on July 1, 1998, the statement read, adding that they had disposed of them "on or before" Feb. 3, 1999. (In its suit, Emcore maintains three partners continued to own shares, an allegation the firm denies.)

Now, another issue loomed: Would the SEC require a re-audit? Over the next week, PricewaterhouseCoopers officials reassured Emcore's anxious executives. On Feb. 8, Mr. Dougher, the auditor, wrote a letter to the Emcore board's audit committee stating the firm's past experience with the SEC indicated that Emcore would be able to conduct "business as usual" because the conflict was essentially technical in nature. A few days later, the committee received a similar opinion from a PricewaterhouseCoopers staff attorney, says Reuben Richards, Emcore's CEO.

PricewaterhouseCoopers officials close to the matter say, however, that the firm's representatives made clear as
early as Feb. 4 that the SEC might order a re-audit. They say that Emcore's chairman, Thomas Russell, threatened to take the matter to the media if the firm didn't make amends and use its extensive network to help boost Emcore's stock. Emcore's general counsel, Howard Brodie, speaking for Mr. Russell, calls that assertion "outrageous" and says the chairman "never made any such threats."

Seeking Answers

On March 9, the SEC weighed in. In a letter to Emcore, it demanded the names of the accounting firm's partners who owned Emcore stock during the audit. It also asked "why the shares were not disposed of immediately after July 1, 1998," the effective date of the accounting merger.

Over the next few days, Emcore and its auditors worked on a joint response. At a printer's office in Manhattan where he was dealing with offering documents, Mr. Brodie took a call from two attorneys representing PricewaterhouseCoopers, and shouting ensued. The hot-button issue: whether Emcore should attend a meeting that the auditors had scheduled with the SEC the following day.

"We insist on attending because this could involve issues concerning Emcore," Mr. Brodie remembers saying.

"This is an unprofessional request," responded one of the firm's attorneys, who added that if Mr. Brodie continued "insisting on attending, we're going to resign as auditors, and you'll have to get another audit," say Mr. Brodie and Emcore's outside counsel, who was also on the line. Walter Ricciardi, the accounting firm's in-house counsel, says no such threat was made.

In the end, Emcore didn't attend the meeting, which didn't go well. The SEC appeared poised to require a re-audit of the company's 1998 results.

Emcore immediately scheduled a meeting with Lynn Turner, the SEC's chief accountant. On March 19, Mr. Richards, the Emcore CEO, along with Mr. Werthan and two attorneys, filed into Mr. Turner's Washington office. About a dozen regulators sat around a conference table.

'We Shouldn't Be Punished'

Mr. Werthan recounted the company's efforts to ensure that the shares had been sold, summing up: "We shouldn't be punished for what the auditors did." When he finished, silence fell, and Mr. Turner rested his head in his hands. Then, raising his head, he emphasized the importance of compliance with the rules and said the SEC would get back to the company.

Two months later, the SEC told Emcore to re-audit its 1998 books.

The bad feelings didn't end there. On June 8, Mr. Dougher told Mr. Werthan PricewaterhouseCoopers wouldn't endorse Emcore's 1996 and 1997 audits unless the company released the firm from any legal liability related to the 1998 mess, a stance from which it later retreated. For its part, the accounting firm calls the incident a short-lived "misunderstanding."

On June 11, Emcore completed its second stock offering, issuing 3.9 million shares at $19 apiece. That was about $5 a share less than its common stock fetched in February, the original target date of the offering; a stock's price often falls when new shares are issued, but Emcore says it doesn't know if this was a factor. Still, the company figures the delay cost it millions of dollars.
PricewaterhouseCoopers counters that the delay was due partly to the SEC's questioning of a 1998 write-off. But Emcore says the SEC didn't raise questions about that write-off, which the auditor had valued and approved, until April 1999, well after the offering's original target date, and it says it resolved that issue quickly.

In December, Emcore asked PricewaterhouseCoopers to re-endorse the company's 1997 audit -- as it had on 10 prior occasions when the company had made regulatory filings -- as part of a registration for yet another stock offering. In a Jan. 4 letter to Marc E. Kasowitz, the attorney handling the suit for Emcore, a PricewaterhouseCoopers staff attorney said such an endorsement amounted to a "new engagement," which the firm was declining in part because of the pending lawsuit. Emcore's 1997 books have since been re-audited by Deloitte & Touche, revealing no problems.

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