CASE 1.6

Nextcard, Inc.

In the late 1990s, the investing public's fascination with Internet-based companies prompted the cyberspace equivalent of the Oklahoma Land Rush, according to one prominent Wall Street analyst. "In a land rush, you suspend rules because your perception is that time is of the essence."[1] That perception caused many anxious investors who feared missing out on a once-in-a-lifetime investment opportunity to bid the prices of Internet stocks to ever-higher levels. Those investors readily discounted the fact that most Internet companies were reporting minimal revenues and sizable, if not staggering, operating losses. Over a 15-month stretch between late 1998 and March 2000, the dot-com-laced NASDAQ stock exchange rose by more than 150 percent. By comparison, over the same time frame, the largely "Old Economy" Dow Jones Industrial Average managed a much less impressive 15 percent gain.

Dot-com fever caused many investment services and publications to create new stock indices dedicated strictly to Internet companies. On June 30, 1999, *USA Today* launched the *Internet 100* to track the stock prices of 100 high-profile companies whose primary lines of business were directly or exclusively related to the Internet. Within a few months, the collective value of that index had risen by more than 60 percent. Other Internet stock indices realized similar increases. By early March 2000, the 300 companies included in the *Forbes Internet Index* had a collective market value of $1.2 trillion, which was approximately equal to the total value of all publicly traded U.S. stocks a little more than one decade earlier.

The public's feeding frenzy on Internet stocks produced numerous paper billionaires among dot-com bigwigs. Dot-com billionaires making appearances in the *Forbes 400*, a list of the 400 "richest people in America," included, among several others, Jeff Bezos (Amazon), Stephen Case (AOL), Mark Cuban (Broadcast.com), Andrew McKelvey (Monster.com), Pierre Omidyar (eBay), Jay Walker (Priceline), David Wetherell (CMGI), and Jerry Yang and David Filo (Yahoo!). As you might expect, the surging prices of Internet stocks added an even larger number of new members to the millionaires' club. By early 2000, one publication reported that in northern California's Silicon Valley alone, the Internet revolution was creating 64 new millionaires each day.[2] Among these millionaires were Jeremy and Molly Lent, a husband-and-wife team that founded the Internet-based NextCard, Inc., in 1997.

Credit on the Fly

Jeremy Lent served as the chief financial officer (CFO) of Providian Financial Corporation during the early 1990s. At the time, Providian ranked among the largest financial services companies in the United States. Experts in the financial services industry attributed Providian's success to the direct-mail marketing methods the company used to identify and then recruit as customers, individuals who made extensive use of credit cards. In the late 1990s, Lent decided that the marketing tactics used by

1. G. Ip, S. Pulliam, S. Thurm, and R. Simon, "How the Internet Bubble Broke Records, Rules, Bank Accounts," *The Wall Street Journal* (online), 14 July 2000.

2. *The Economist* (online), "The Country-Club Vote," 20 May 2000.

Providian could be easily adapted to the Internet, which prompted him and his wife to create NextCard, an online company that would offer Internet users the opportunity to obtain a credit card in a matter of moments.

Because of his tenure at Providian, Lent realized that a key metric in the credit card industry is the acquisition cost of a new customer. Lent was convinced that he could use the Internet to undercut the average acquisition cost of a new customer incurred by brick-and-mortar credit card companies, such as Providian. Likewise, Lent believed that his company would have significantly lower bad debt losses than conventional credit card issuers. Marketing research had found that Internet users were generally more affluent, and thus better credit risks, than individuals drawn from the general population of consumers.

One of Lent's first major strategic initiatives was hiring dozens of marketing researchers to analyze a large database of "clickstream data" that documented the "surfing" habits of Internet users. After analyzing these data, the company's marketing team developed Internet-based advertising campaigns targeting Internet users who made frequent use of, and maintained large balances on, their credit cards. NextCard's online ads encouraged such individuals to apply for a credit card with NextBank, a virtual bank that was NextCard's largest operating unit, and to transfer their existing credit card balances to this new card. The key inducement used by Lent to convince potential customers to apply for a NextBank credit card was a lower interest rate than that charged by conventional credit card issuers. Lent also promised those potential customers that a decision regarding their online credit card application would be made within 30 seconds of their submitting that application.

Initially, Lent's business model for NextCard appeared to be a huge success as the company quickly became recognized as one of the leaders of the Internet Revolution that made the term *e-commerce* the hottest buzzword among Wall Street analysts and individual investors. The company's website was regularly named one of the top 50 financial websites by *Money* magazine and by 2000 had more daily "hits" or visits than any other website in the financial services industry. More importantly, for several consecutive years, NextCard issued more credit cards online than any other credit card issuer, including such large and well-established firms as American Express, Bank of America, Citibank, and MBNA. Lent used NextCard's prominent position in the Internet industry to create a network of 60,000 online "affiliates" that referred potential credit card customers to NextCard. Several of these affiliates, including Amazon.com, purchased significant ownership interests in NextCard.

By early 2000, NextCard was well on its way to achieving one of Lent's primary goals for the company: obtaining one million credit card customers. During that year, NextCard extended more than $1 billion of credit to its customers. Those impressive operating statistics did not translate into immediate profits for NextCard, a fact that Lent and other company executives frequently downplayed or simply ignored in press releases and other public disclosures. In February 2000, a NextCard executive boasted that "we continue to beat our aggressive growth targets while maintaining very strong parameters in the other core elements of our business model. Our average balance per account, which is one of the major drivers of success in the credit card business, remains approximately $2,000. Our acquisition cost, credit quality, and yield—all major drivers of profitability—continue to be strong and stable, leading to continued very strong revenue results."[3] This statement conveniently overlooked the

3. Business Wire (online), "NextCard Announces Significant Growth Milestones Ahead of Plan," 22 February 2000.

fact that NextCard's New Age business model had produced a large loss during the company's just completed 1999 fiscal year, $77.2 million to be exact.

Despite the fact that NextCard was posting large losses each reporting period, Lent had taken the company public in 1999. On the first day NextCard's stock was traded, the stock's price rose from an initial selling price of $20 per share to more than $40, making Lent and several other NextCard executives instant multimillionaires. A few months later, the stock surged past $50 per share. When the "lock-up" period mandated by the Securities and Exchange Commission (SEC) following an initial public offering expired, Lent and his colleagues sold large chunks of their ownership interests in the company.

When NextCard reported an unexpectedly large loss of $81.9 million for fiscal 2000, company executives could no longer sidestep the recurring question posed by persistent Wall Street analysts, namely, "When would NextCard earn its first quarterly profit?" NextCard's management team insisted that the company had "turned the corner" and pledged that NextCard would report its first-ever quarterly profit by the fourth-quarter of fiscal 2001. At the same time, company officials predicted that NextCard would report a net income of $150 million by fiscal 2003.

In March 2000, the NASDAQ stock index crested at an all-time high of more than 5,000. Over the following 18 months, the Internet "bubble" in the stock market burst, causing the stock prices of most Internet companies, including NextCard, to spiral downward. Many of these New Age companies survived, including such firms as Amazon.com, eBay, Monster.com, and Yahoo!. NextCard would not be among those survivors.

Loose Credit = Bad Debts

The bursting of the Internet bubble in the stock market quickly cut off NextCard's access to the debt and equity markets. Without the ability to raise additional debt or equity capital, NextCard suddenly faced the need to raise capital the "old-fashioned way," namely, via profitable operations.

Despite the promises and predictions of NextCard's executives, the company never reported a profit, principally because two of the key premises on which Jeremy Lent had predicated NextCard's business model proved to be invalid. First, the average acquisition cost NextCard incurred to obtain new customers proved to be much higher than the figure Lent had originally projected. NextCard spent huge amounts on Internet advertising campaigns to recruit customers only to find that Internet users routinely ignored, if not treated with contempt, most efforts of online advertisers to attract their attention. In fact, the "click-through" rate for most Internet advertisements hovered at a fraction of 1 percent, considerably lower than the response rate to direct or "junk" mail advertisements used by conventional credit card issuers.

Lent's other major miscalculation had even more serious consequences for NextCard. Internet users, at least the subpopulation of Internet users who signed up for a NextBank credit card, proved to be much higher credit risks than Lent had expected. A large proportion of the Internet users who took advantage of NextCard's liberal credit policies were individuals who could not obtain credit from any other source. For these desperate and shallow-pocketed consumers, NextCard effectively served as the "lender of last resort." These individuals eventually produced the large balances that Lent had expected Internet users to carry on their credit cards but they often allowed those balances to go unpaid, resulting in large credit losses for NextCard.

In sum, instead of incurring minimal marketing expenditures to acquire "good" credit card customers, NextCard spent large amounts to acquire "bad" credit card customers. Making matters worse, many of NextCard's competitors, including American Express, "went to school" on NextCard's mistakes. These competitors learned from those mistakes and developed more cost-effective—and ultimately profitable—Internet marketing strategies to expand their market shares in the intensely competitive credit card industry.

Early in NextCard's history, the company's executives apparently realized that their business model contained serious flaws. Despite that realization, those executives continued to pursue Jeremy Lent's dream of creating one of the dominant companies in the credit card industry. To shore up the company's stock price and to maintain credibility on Wall Street and among private investors, NextCard's executives chose to conceal the extent and source of the company's financial problems. The principal means used to accomplish this goal was understating NextCard's massive credit losses by refusing to provide sufficient allowances each period for expected bad debts.

Because NextBank was subject to federal banking regulations, the Office of the Comptroller of the Currency (OCC) regularly reviewed the company's accounting records and operating policies and procedures. During 2001, OCC auditors forced NextCard to significantly increase its allowance for bad debts. When NextCard publicly reported the OCC's decision, company management denied that the larger allowance for bad debts was due to unexpectedly high credit losses. Instead, NextCard officials insisted that the increase in the allowance for bad debts was necessary because the company had suffered large losses as a result of fraudulent schemes perpetrated by hackers and other Internet miscreants. In November 2001, a skeptical Wall Street analyst questioned how such a massive problem could "pop up" so unexpectedly and without any previous warning from company officials.[4] In fact, subsequent investigations would reveal that NextCard officials had routinely and materially understated the company's allowance for credit losses.

In late 2001, angry NextCard investors filed a large class-action lawsuit against the company and its executives. Among other charges, that lawsuit alleged that NextCard's management team had intentionally concealed the extent and nature of the company's financial problems. In addition, the plaintiffs charged that the NextCard executives had engaged in insider trading by selling off large portions of their ownership interests in the company before NextCard's true financial condition became apparent. This large class-action lawsuit and widespread concerns regarding the integrity of NextCard's publicly reported financial data caused federal regulatory authorities, including the SEC, to launch investigations of the company's financial affairs.

Suspicious Audit Trails

Discovering that your largest client is the subject of a series of federal investigations for tampering with its accounting records and issuing materially misleading financial statements is, no doubt, among the life events feared most by audit partners of major accounting firms. Thirty-six-year-old Thomas Trauger found himself facing that disturbing scenario in the fall of 2001. Trauger, a partner in the San Francisco office of Ernst & Young (E&Y), had served for several years as the audit engagement partner for NextCard. In March 2001, Trauger had authorized the unqualified opinion issued on NextCard's 2000 financial statements.

After considering his options, including doing nothing and simply awaiting the outcome of the federal investigations of NextCard, Trauger decided to take matters

4. J. Graham, "What's the Next Move for Troubled NextCard?" *Investor's Business Daily*, 1 November 2001, 6.

into his own hands. His first decision was to contact his top subordinate on the 2000 NextCard audit, Oliver Flanagan.

Like most accounting professionals, Oliver Flanagan enjoyed challenging assignments. A native of Ireland, Flanagan accepted an entry-level position on the auditing staff of the London, England, office of E&Y in the mid-1990s. Flanagan left E&Y in late 1999 to accept a position in the banking industry but quickly discovered that he missed working as an independent auditor. So, Flanagan asked E&Y for his job back. In the late 1990s, the Internet bubble had created a huge demand for the services of public accounting firms, which caused E&Y to be more than happy to rehire Flanagan. Among the locations having the greatest need for auditors at the time was the booming Silicon Valley region near San Francisco. Given his interest in the banking industry and the "adventure" of going stateside, Flanagan quickly accepted the opportunity to move to San Francisco and become a member of the NextCard audit engagement team.

Despite the fact that he had only a few years of auditing experience, Flanagan was assigned to serve as the senior audit manager on the NextCard engagement, a position in which he would report directly to Thomas Trauger. Flanagan realized that Trauger was a "fast track" partner in the San Francisco office of E&Y since he was in charge of the prestigious NextCard engagement. The young Irishman hoped that Trauger would serve as his mentor and help him advance quickly within E&Y.

In early November 2001, more than six months after the 2000 NextCard audit was completed, Thomas Trauger left a message instructing Oliver Flanagan to meet him in the E&Y office the following Saturday morning. Flanagan was probably not surprised by the request since weekend work was nothing unusual with a major accounting firm. Plus, the planning phase for the 2001 audit of the financially troubled NextCard was nearing completion. If Flanagan expected Trauger to discuss the 2001 audit during the weekend meeting, he was wrong. Instead, when Flanagan contacted Trauger, the audit partner told him to gather all of the workpapers for the 2000 NextCard audit and "have them ready for revisions"[5] during that meeting. Flanagan knew that it was not common to revise prior-year audit workpapers once they had been archived. Almost certainly, NextCard's well-documented financial problems and the insinuations of an accounting scandal within the company caused Flanagan to wonder what types of "revisions" Trauger intended to make to the NextCard workpapers.

Before meeting with Flanagan, Trauger contacted the other audit manager on the NextCard engagement team, Michael Mullen—Mullen had not been involved in the 2000 NextCard audit as he had only been assigned to the engagement team since June 2001. Trauger instructed Mullen to determine whether it was possible to "manipulate E&Y's computer system so that he [Trauger] could alter electronically archived working papers without being discovered."[6] Trauger wanted to revise the original NextCard workpapers without leaving any evidence that they had been altered. For the conventional "hard copy" workpapers, this goal did not pose any particular challenge. But accomplishing that same goal for the electronic workpapers meant that Trauger had to change the electronic "time stamps" on those files.

Mullen complied with Trauger's request and eventually learned from another E&Y employee that it was possible to "de-archive" previously completed electronic audit workpapers and thereby change the time stamps posted on those workpapers.

5. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1871*, 25 September 2003.

6. *Ibid.*

Mullen sent this information to both Trauger and Flanagan. During their weekend meeting, Trauger and Flanagan reviewed the 2000 NextCard audit workpapers and made numerous additions and deletions to those workpaper files. The principal items changed were the "Summary Review Memorandum" and the receivables workpapers. In a subsequent enforcement release that focused on the conduct of Oliver Flanagan, the SEC described the process used by Trauger and Flanagan to alter the NextCard workpapers. (Note: In this enforcement release, the SEC referred to Trauger as simply the "audit partner.")

> *The audit partner marked up printed versions of the documents and gave them to Flanagan for Flanagan to input using Flanagan's laptop computer. In order to ensure that the revised documents appeared to have been created as part of the original working papers, the audit partner instructed Flanagan to reset the date on his computer so that any documents bearing computer-generated dates would reflect a date in early 2001. Some documents went through more than one edit, as Flanagan input the audit partner's changes and then printed out the revised version for the audit partner's further review.*[7]

NextCard's deteriorating financial condition in late 2001 and the increasing scrutiny of the company by federal regulatory authorities apparently prompted Trauger to ask Flanagan to meet with him once more to make additional alterations to the 2000 NextCard workpapers. Trauger also asked Michael Mullen to attend this second meeting, which took place in late November 2001. The SEC provided the following overview of what transpired during this second meeting.

> *The audit partner marked up printed versions of the memoranda he was revising and then the other audit manager [Mullen] input the changes. At the audit partner's direction, the other audit manager deleted charts, portions of tables, and discussion sections that indicated problems with NextCard's charge-off numbers and trends. The audit partner also added information and altered the tone of certain sections. One of the documents altered during this meeting was a memorandum entitled "Analysis for Loan Losses." Flanagan remained involved in the process by proofreading the other audit manager's work to ensure that all of the audit partner's changes were made.*[8]

The SEC issued multiple enforcement releases that documented the improper professional conduct of Thomas Trauger, Oliver Flanagan, and Michael Mullen. In those enforcement releases, the SEC noted on several occasions that Trauger's intent in revising the 2000 NextCard audit workpapers was to "make it appear that there was a more satisfactory basis" for the key E&Y conclusions reached during that engagement. The *New York Times* reported that "Mr. Trauger told Mr. Flanagan that he wanted to 'beef up' the workpapers to make it appear as if the auditing team had been 'right on the mark' all along."[9] During the course of the federal investigations of NextCard, the FBI retrieved e-mails that Trauger had sent to his subordinates. One of those e-mails provided a more pointed statement of Trauger's intent in modifying the NextCard workpapers. According to an FBI affidavit, in one of those e-mails Trauger stated that he did not want "some smart-ass lawyer"[10] second-guessing the decisions that he had made during the 2000 NextCard audit.

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7. *Ibid.*

8. *Ibid.*

9. K. Eichenwald, "U.S. Charges Ernst & Young Ex-Partner in Audit Case," *The New York Times*, 26 September 2003, 1.

10. J. Hoppin, "Snared by SOX," *Corporate Counsel*, December 2003, 24.

Following the two meetings in which the E&Y auditors had altered the NextCard workpapers, Trauger had instructed Flanagan "to scour his hard drive and delete documents or e-mails inconsistent with the altered versions of the working papers."[11] Once more, Flanagan followed his mentor's instructions. Approximately three months later, E&Y received a subpoena from the OCC that instructed the firm to give the federal agency certain NextCard workpapers. At that time, Trauger discovered that Michael Mullen had kept a computer diskette containing some of the original NextCard workpapers that had been altered in November 2001. Trauger ordered Flanagan to obtain that diskette and destroy it. Flanagan obtained the diskette and told Trauger that he had destroyed it. In fact, Flanagan kept the diskette and subsequently gave it to federal authorities.

EPILOGUE

The computer diskette that Oliver Flanagan turned over to federal authorities investigating NextCard ultimately resulted in the FBI arresting Thomas Trauger in September 2003. The U.S. Department of Justice filed criminal charges against Trauger for obstructing the federal investigations of NextCard. Trauger was the first partner of a major accounting firm to be prosecuted for destroying audit-related documents under the criminal provisions of the Sarbanes-Oxley Act of 2002. Those provisions were included in the Sarbanes-Oxley Act as a direct consequence of the widely publicized scandal involving Enron Corporation. During an SEC investigation of Enron, Andersen, the company's audit firm, had shredded certain Enron workpapers. The subsequent felony conviction handed down against Andersen by a federal court effectively put the prominent accounting firm out of business.[12] Ironically, Trauger and his subordinates were altering the NextCard workpapers in November 2001, the same time frame during which Andersen personnel were shredding the Enron work papers.

Shortly after being arrested in September 2003, Thomas Trauger insisted that he was innocent of the charges filed against him. When Trauger was released after posting a $1 million bail, his attorney issued the following public statement defending his client: "He's a good man, a well-respected accountant, and I'm confident he will be exonerated."[13] Despite those assertions, a little more than one year later on October 28, 2004, Thomas Trauger pled guilty to one count of impeding a federal investigation. As a result of that plea, Trauger faced a prison sentence of up to 25 years and a fine of $500,000. On January 27, 2005, a federal judge sentenced Trauger to one year in prison and two years of "supervised release." The judge also ordered Trauger to pay a $5,000 fine. In his plea agreement, Trauger admitted he had failed to inform federal authorities that he and his subordinates had altered certain of the NextCard audit workpapers subpoenaed by those authorities.

Ernst & Young disavowed responsibility for the actions of Trauger, Flanagan, and Mullen. In a press release, an E&Y spokesperson pointed out that the actions of the three individuals were in clear violation of the firm's professional standards and internal policies. That spokesperson also noted that when E&Y discovered the nature of the individuals' conduct, firm officials cooperated fully with federal law enforcement authorities.

Not surprisingly, federal authorities were elated with the outcome of the Trauger case. In commenting on the case, a spokesperson for the U.S. Department of Justice observed that the proper functioning of the nation's capital

11. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 1871.*

12. The U.S. Supreme Court overturned Andersen's felony conviction in May 2005; however, by that time, the firm was in the process of being disbanded.

13. E. Iwata, "Accountant Arrested under Sarbanes-Oxley," *USA Today*, 26 September 2003, 2B.

markets depends, in large part, on the integrity of auditors and other professionals involved in the financial reporting process:

> *This is one of the first cases in the country in which an auditor has been accused of destroying key documents in an effort to obstruct an investigation. Our financial markets depend on the integrity of auditors, lawyers and other professionals to do their jobs ethically and fairly. Where they fail to do so because of negligence, markets are compromised. Where they fail to do so because of criminal intent, all of us are at risk. The U.S. Attorney's Office will bring those professionals to justice who join in criminal acts they are supposed to uncover and expose.*[14]

Stephen Cutler, the SEC's Director of Enforcement, echoed these sentiments and stressed the importance of auditors' maintaining the integrity of the audit process:

> *Complete and accurate workpapers are critical to the integrity of the audit process and the efficacy of our investigative work. We will aggressively pursue auditors who alter or destroy workpapers or otherwise undermine the financial reporting process, and will work closely with criminal authorities to ensure that those who engage in such conduct are held accountable.*[15]

Finally, an FBI spokesperson observed: "We look to certified public accountants to maintain the integrity of publicly traded companies. The criminal acts of auditors who abuse their authority, act in their own self-interest, and violate the sacred trust of shareholders will not be tolerated."[16]

In October 2004, Michael Mullen pled guilty to lying to an FBI agent involved in the NextCard investigation. Mullen was sentenced to one year of probation and ordered to pay a $100 fine. As a result of his guilty plea, Mullen's right to practice before the SEC was suspended. In August 2003, Oliver Flanagan pled guilty to one count of criminal obstruction of justice. After cooperating with federal authorities in the prosecution of Thomas Trauger, Flanagan was allowed to return to his native Ireland. Flanagan's attorney noted that "Oliver has made peace with our [U.S.] government."[17] The attorney then added that Flanagan's only wish is that Thomas Trauger had been a "better mentor."[18]

NextCard's financial problems steadily worsened following the announcement in late 2001 that federal law enforcement authorities were investigating the company's financial affairs. In February 2002, the OCC ruled that NextBank was operating in an "unsafe and unsound" manner and placed the bank under the control of the Federal Deposit Insurance Corporation (FDIC). At the time, NextCard's stock was trading for $0.14 per share, down from its all-time high of $53.12. In the summer of 2003, a federal bankruptcy court liquidated the company. NextCard had total liabilities of nearly $470 million, which far exceeded its realizable assets of approximately $20 million.

In November 2006, the SEC announced that it had reached an agreement to settle fraud charges filed in 2004 against five former NextCard executives, including Jeremy Lent. In total, the SEC required the executives to pay $1.4 million of fines and other monetary damages. Approximately $900,000 of that amount was paid by Lent. The SEC allowed the five executives to consent to the settlement "without admitting or denying" the charges that had been filed against them.[19] One year earlier, in December 2005, the class-action lawsuit filed against NextCard and its former executives had been settled out of court. Ernst & Young contributed $23.5 million to the settlement pool, while Jeremy Lent contributed $635,000.

14. Securities and Exchange Commission, "Former Ernst & Young Audit Partner Arrested for Obstruction Charges and Criminal Violations of the Sarbanes-Oxley Act," *Release No. 2003-123*, 25 September 2003.

15. *Ibid.*

16. *Ibid.*

17. V. Colliver, "FBI Arrests Suspect in Fraud," *San Francisco Chronicle*, 26 September 2003, B1.

18. *Ibid.*

19. Securities and Exchange Commission, *Litigation Release No. 19903*, November 2006.

Questions

1. Should auditors evaluate the soundness of a client's business model? Defend your answer.
2. Identify and briefly describe the specific fraud risk factors present during the 2000 NextCard audit. How should these factors have affected the planning and execution of that engagement?
3. What are the primary objectives an audit team hopes to accomplish by preparing a proper set of audit workpapers?
4. Identify the generally accepted auditing standards violated by the E&Y auditors in this case. Briefly explain how each standard was violated.
5. When he became a member of the NextCard audit engagement team, Oliver Flanagan hoped that Thomas Trauger would serve as his mentor. What responsibility, if any, do senior audit personnel have to serve as mentors for their subordinates?
6. Assume the role of Oliver Flanagan in this case. What would you have done when Thomas Trauger asked you to help him alter the 2000 NextCard audit workpapers? In answering this question, identify the alternative courses of action available to you. Also identify the individuals who may be affected by your decision, and briefly describe how they may be affected.