Application Opened

Just for FEET, Inc.

*Life is so fragile. A single bad choice in a single moment can cause a life to turn irrevocably 180 degrees.*

***U.S. District Judge C.Lynwood Smith, Jr.***

In 1971, 25-year-old Thomas Shine founded a small sporting goods company, Logo 7, that would eventually become known as Logo Athletic. Shine’s company manufactured and marketed a wide range of shirts, hats, jackets, and other apparel items that boldly displayed the logos of the Miami Dolphins, Minnesota Twins, Montreal Canadiens, and dozens of other professional sports teams. In 2001, Shine sold Logo to Reebok and became that company’s senior vice president of sports and entertainment marketing. In that position, Shine wined and dined major sports stars with the intent of persuading them to sign exclusive endorsement contracts with Reebok.

During his long career, Thomas Shine became one of the most well-known and respected leaders of the sporting goods industry. Shine’s prominence and credibility in that industry took a severe blow in February 2004 when he pleaded guilty to a criminal indictment filed against him by the U.S. Department of Justice. The Justice Department charged that Shine had signed a false audit confirmation sent to him in early 1999 by one of Logo’s largest customers. The confirmation indicated that Logo owed that customer approximately $700,000. Although Shine knew that no such debt existed, he signed the confirmation and returned it to the customer’s independent audit firm, Deloitte &Touche, after being pressured to do so by an executive of the customer. As a result of his guilty plea, Shine faced a possible sentence of five years in federal prison and a fine of up to $250,000.

**Out of South Africa**

At approximately the same time that Thomas Shine was launching his business career in the retail industry in the United States, Harold Ruttenberg was doing the same in South Africa. Ruttenberg, a native of Johannesburg, paid for his college education by working nights and weekends as a sales clerk in an upscale men’s clothing store. After graduation, he began importing Levi’s jeans from the United States and selling them from his car, his eventual goal being to accumulate sufficient capital to open a retail store. Ruttenberg quickly accomplished that goal. In fact, by the time he was 30, he owned a small chain of men’s apparel stores.

Mounting political and economic troubles in his home country during the early and mid-1970s convinced Ruttenberg to move his family to the United States. South Africa’s strict emigration laws forced Ruttenberg to leave practically all of his net worth behind. When he arrived in California in 1976 with his spouse and three small children, Ruttenberg had less than $30,000. Despite his limited financial resources and unfamiliarity with U.S. business practices, the strong-willed South African was committed to once again establishing himself as a successful entrepreneur in the retailing industry.

Ruttenberg soon realized that the exorbitant rents for commercial retail properties in the major metropolitan areas of California were far beyond his reach. So, he moved his family once more, this time to the more affordable business environment of Birmingham, Alabama. Ruttenberg leased a vacant storefront in a Birmingham mall and a few months later opened Hang Ten Sports World, a retail store that marketed children’s sportswear products. Thanks largely to his work ethic and intense desire to succeed, Ruttenberg’s business prospered over the next decade.

In 1988, Ruttenberg decided to take a gamble on a new business venture. Ruttenberg had come to believe that there was an opportunity to make large profits in the retail shoe business. At the time, the market for high-priced athletic shoes—basketball shoes, in particular—was growing dramatically and becoming an ever-larger segment of the retail shoe industry. The principal retail outlets for the shoes produced by Adidas, Nike, Reebok, and other major athletic shoe manufacturers were relatively small stores located in thousands of suburban malls scattered across the country, meaning that the retail athletic shoe “subindustry” was highly fragmented. The five largest retailers in this market niche accounted for less than 10 percent of the annual sales of athletic shoes.

Ruttenberg realized that the relatively small floor space of retail shoe stores in suburban malls limited a retailer’s ability to display the wide and growing array of products being produced by the major shoe manufacturers. Likewise, the high cost of floor space in malls with heavy traffic served to limit the profitability of shoe retailers. To overcome these problems, Ruttenberg decided that he would build freestanding “Just for FEET” superstores located near malls. To lure consumers away from mall-based shoe stores, Ruttenberg developed a three-pronged business strategy focusing on “selection,” “service,” and “entertainment.”

Ruttenberg’s business plan for his superstores involved a stores-within-a-store concept; that is, he intended to create several mini-stores within his large retail outlets, each of which would be devoted exclusively to the products of individual shoe manufacturers. He believed this store design would appeal to both consumers and vendors. Consumers who were committed to one particular brand would not have to search through store displays that included a wide assortment of branded products. Likewise, his proposed floor design would provide major vendors an opportunity to participate in marketing their products. Ruttenberg hoped that his planned floor design would spur the major vendors to compete with each other in providing so-called vendor allowances to his superstores to make their individual displays more appealing than those of competitors.

Customer service was the second major element of Ruttenberg’s business plan for his shoe superstores. Ruttenberg planned to staff his stores so that there would be an unusually large ratio of sales associates to customers. Sales associates would be required to complete an extensive training course in “footwear technology” so that they would be well equipped to answer any questions posed by customers. When a customer chose to try on a particular shoe product, he or she would have to ask a sales associate to retrieve that item from the “back shop.” Sales associates were trained to interact with customers in such a way that they would earn their trust and thus create a stronger bond with them.

Just for Feet’s 1998 Form 10-K described the third feature of Harold Ruttenberg’s business plan as creating an “Entertainment Shopping Experience.” Rock-and-roll music and brightly colored displays greeted customers when they entered the superstores. When they tired of shopping, customers could play a game of “horse” on an enclosed basketball half-court located near the store’s entrance or sit back and enjoy a multiscreen video bank in the store’s customer lounge. Frequent promotional events included autograph sessions with major sports celebrities such as Bart Starr, the former Green Bay Packers quarterback who was also on the company’s board of directors.

Ruttenberg would eventually include two other key features in the floor plans of his superstores. Although Just for Feet did not target price-conscious customers, Ruttenberg added a “Combat Zone” to each superstore where such customers could rummage through piles of discontinued shoe lines, “seconds,” and other discounted items. For those customers who simply wanted a pair of shoes and did not have a strong preference for a given brand, Ruttenberg incorporated a “Great Wall” into his superstores that contained a wide array of shoes sorted not by brand but rather by function. In this large display, customers could quickly compare and contrast the key features of dozens of different types of running shoes, walking shoes, basketball shoes, and cross-trainers.

**Quite a FEET**

Just for Feet’s initial superstore in Birmingham proved to be a huge financial success. That success convinced Harold Ruttenberg to open similar retail outlets in several major metropolitan areas in the southern United States and to develop a showcase superstore within the glitzy Caesar’s Forum shopping mall on the Las Vegas Strip. By 1992, Just for Feet owned and operated five superstores and had sold franchise rights for several additional stores. The company’s annual sales were approaching $20 million, but that total accounted for a small fraction of the retail shoe industry’s estimated $15 billion of annual sales.

To become a major force in the shoe industry, Ruttenberg knew that he would have to expand his retail chain nationwide, which would require large amounts of additional capital. To acquire that capital, Ruttenberg decided to take his company public. On March 9, 1994, Just for Feet’s common stock began trading on the NASDAQ exchange under the ticker symbol FEET. The stock, which sold initially for $6.22 per share, would quickly rise over the next two years to more than $37 per share.

Ruttenberg used the funds produced by Just for Feet’s initial public offering (IPO) to pursue an aggressive expansion program. The company opened dozens of new superstores during the mid-1990s and acquired several smaller competitors, including Athletic Attic in March 1997 and Sneaker Stadium in July 1998. For fiscal 1996, which ended January 31, 1997, the company reported a profit of $13.9 million on sales of $250 million. Two years later, the company earned a profit of $26.7 million on sales of nearly $775 million. By the end of 1998, Just for Feet was the second largest athletic shoe retailer in the United States with 300 retail outlets.

During the mid-1990s, Just for Feet’s common stock was among the most closely monitored and hyped securities on Wall Street. Analysts and investors tracking the stock marveled at the company’s ability to consistently outperform its major competitors. By the late 1990s, market saturation and declining profit margins were becoming major concerns within the athletic shoe segment of the shoe industry. Despite the lackluster profits and faltering revenues of other athletic shoe retailers, Harold Ruttenberg continued to issue press releases touting his company’s record profits and steadily growing sales. Most impressive was the company’s 21 straight quarterly increases in same-store sales through the fourth quarter of fiscal 1998.

In November 1997, Delphi Investments released a lengthy analytical report focusing on Just for Feet’s future prospects. In that report, which included a strong “buy” recommendation for the company’s common stock, Delphi commented on the “Harold Ruttenberg factor.” The report largely attributed the company’s financial success and rosy future to “the larger-than-life founder and inventor of the Just for Feet concept.”

In frequent interviews with business journalists, Harold Ruttenberg was not modest in discussing the huge challenges that he had personally overcome to establish himself as one of the leading corporate executives in the retail apparel industry. Nor was Ruttenberg reluctant to point out that he had sketched out the general frame-work of Just for Feet’s successful business plan over a three-day vacation in the late 1980s. After being named one of 1996’s Retail Entrepreneurs of the Year, Ruttenberg noted that Just for Feet had succeeded principally because of the unique marketing strategies he had developed for the company. “Customers love our stores because they are so unique. We are not a copycat retailer. Nobody does what we do, the way we do it. The proof is in our performance.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://) In this same interview, Ruttenberg reported that he had never been tempted to check out a competitor’s stores. “I have nothing to learn from them. I’m certainly not going to copy anything they are doing.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://) Finally, Ruttenberg did not dispute, or apologize for, his reputation as a domineering, if not imposing, superior. “I can be a very demanding, difficult boss. But I know how to build teams. And I have made a lot of people very rich.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)

Ruttenberg realized that one of his primary responsibilities was training a new management team to assume the leadership of the company following his retirement. “As the founder, my job is to put the right people in place for the future. I’m preparing this company for 25 years down the road when I won’t be here.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://) One of the individuals who Ruttenberg handpicked to lead the company into its future was his son, Don-Allen Ruttenberg, who shared his father’s single-minded determination and tenacious business temperament. In 1997, at the age of 29, Don-Allen Ruttenberg was named Just for Feet’s vice president of new store development. Two years later, the younger Ruttenberg was promoted to the position of executive vice president.

Similar to most successful companies, Just for Feet’s path to success was not without occasional pitfalls. In 1995, Wall Street’s zeal for Just for Feet’s common stock was tempered somewhat by an accounting controversy involving “store opening” costs. Throughout its existence, Just for Feet had accumulated such costs for each new store in an asset account and then amortized the costs over the 12-month period following the store’s grand opening. A more common practice within the retail industry was to expense such costs in the month that a new store opened. Criticism of Just for Feet’s accounting for store opening costs goaded company management to adopt the industry convention, which resulted in the company recording a $2.1 million cumulative effect of a change in accounting principle during fiscal 1996.

In the summer of 1996, Wall Street took notice when Harold Ruttenberg; his wife, Pamela; and their son, Don-Allen, sold large blocks of their Just for Feet common stock in a secondary offering to the general public. Collectively, the three members of the Ruttenberg family received nearly $49.5 million from the sale of those securities. Major investors and financial analysts questioned why the Ruttenbergs would dispose of much of their Just for Feet stock while, at the same time, the senior Ruttenberg was issuing glowing projections regarding the company’s future prospects.

**Clay Feet**

No one could deny the impressive revenue and profit trends that Just for Feet established during the mid- and late 1990s. [Exhibit 1](javascript://) and [Exhibit 2](javascript://), which present the company’s primary financial statements for the three-year period fiscal 1996 through fiscal 1998, document those trends. However, hidden within the company’s financial data for that three-year period was a red flag. Notice in the statements of cash flows shown in [Exhibit 2](javascript://) that despite the rising profits Just for Feet reported in the late 1990s, the company’s operating cash flows during that period were negative. By early 1999, these negative operating cash flows posed a huge liquidity problem for the company. To address this problem, Just for Feet sold $200 million of high-yield “junk” bonds in April 1999.

**Exhibit 1Just for FEET, Inc., 1996–1998 Balance Sheets**

Enlarge Image

**Exhibit 2Just for FEET, Inc., 1996–1998 Income Statements and Statements of Cash Flows**

Enlarge Image

A few weeks after selling the junk bonds, Just for Feet issued an earnings warning. This press release alerted investors that the company would likely post its first-ever quarterly loss during the second quarter of fiscal 1999. One month later, Just for Feet shocked its investors and creditors when it announced that it might default on its first interest payment on the $200 million of junk bonds. Investors received more disturbing news in July 1999 when Harold Ruttenberg unexpectedly resigned as Just for Feet’s CEO. The company replaced Ruttenberg with a corporate turnaround specialist, Helen Rockey. Upon resigning, Ruttenberg insisted that Just for Feet’s financial problems were only temporary and that the company would likely post a profit during the third quarter of fiscal 1999.

Harold Ruttenberg’s statement did not reassure investors. The company’s stock price went into a freefall during the spring and summer of 1999, slipping to near $4 per share by the end of July. In September, the company announced that it had lost $25.9 million during the second quarter of fiscal 1999, a much larger loss than had been expected by Wall Street. Less than two months later, on November 2, 1999, the company shocked its investors and creditors once more when it filed for [Chapter 11](javascript://)bankruptcy protection in the federal courts.

Just for Feet’s startling collapse over a period of a few months sparked a flurry of lawsuits against the company and its executives. Allegations of financial mismanagement and accounting irregularities triggered investigations of the company’s financial affairs by state and federal law enforcement authorities, including the Alabama Securities Commission, the FBI, the Securities and Exchange Commission (SEC), and the U.S. Department of Justice. In May 2003, the Justice Department announced that a former Just for Feet executive, Adam Gilburne, had pleaded guilty to conspiracy to commit wire and securities fraud. Gilburne, who had served in various executive positions with Just for Feet, revealed that he and other members of the company’s top management had conspired to inflate the company’s reported earnings from 1996 through 1999.

*The information [testimony provided by Gilburne] alleges that beginning in about 1996, Just for Feet’s CEO [Harold Ruttenberg] would conduct meetings at the end of every quarter in which he would lay out analysts’ expectations of the company’s earnings, and then draw up a list of “goods”—items which produced or added income— and “bads”—those which reduced income. The information alleges that the CEO directed Just for Feet’s employees to increase the “goods” and decrease the “bads” in order to meet his own earnings expectations and those of Wall Street analysts.[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)*

Approximately two years following Gilburne’s guilty plea, the SEC issued a series of enforcement releases that documented the three key facets of the fraudulent scheme perpetrated by Just for Feet’s management team. “Just for Feet falsified its financial statements by

* (1)

improperly recognizing unearned and fictitious receivables from its vendors,

* (2)

failing to properly account for excess inventory, and

* (3)

improperly recording as income the value of display booths provided by its vendors.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)

The stores-within-a-store floor plan developed by Harold Ruttenberg provided an opportunity for Just for Feet’s vendors to become directly involved in the marketing of their products within the company’s superstores. Each year, Just for Feet received millions of dollars of “vendor allowances” or “advertising co-op” from its major suppliers. These allowances were intended to subsidize Just for Feet’s advertising expenditures for its superstores.

Despite the large size of the vendor allowances, in most cases there was not a written agreement that documented the conditions under which Just for Feet was entitled to an allowance or the size of a given allowance. After Just for Feet had run a series of advertisements or other promotional announcements for a vendor’s product, copies of the advertising materials would be submitted to the vendor. An account manager for the vendor would then approve an allowance for Just for Feet based upon the amount of the advertised products that the company had purchased.

Generally accepted accounting principles (GAAP) dictate that vendor allowances not be offset against advertising expense until the given advertisements have been run or other promotional efforts have been completed. However, Just for Feet began routinely recording *anticipated* vendor allowances as receivables and advertising expense offsets well before the related advertising or promotional programs had been completed. Just for Feet’s management team was particularly aggressive in “front-loading” vendor allowances during fiscal 1998. At the end of fiscal 1997, Just for Feet had slightly more than $400,000 of outstanding vendor allowance receivables; 12 months later, at the end of fiscal 1998, that total had soared to almost $29 million.[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)

During fiscal 1998, Just for Feet’s merchandise inventory nearly doubled, rising from $206 million on January 31, 1998, to almost $400 million on January 31, 1999. Although Just for Feet had a large amount of slow-moving inventory, the company’s management team refused to properly apply the lower of cost or market rule in arriving at a year-end valuation reserve for that important asset. As a result, at the end of both fiscal 1997 and fiscal 1998, the company’s allowance for inventory obsolescence stood at a nominal $150,000.

The major athletic shoe vendors erected promotional displays or booths in the Just for Feet superstores. These booths were maintained by sales representatives of the vendors and were the property of those vendors. In early 1998, Don-Allen Ruttenberg concocted a fraudulent scheme to produce millions of dollars of “booth income” for Just for Feet. Without the knowledge of its vendors, Just for Feet began recording in its accounting records monthly booth income amounts allegedly earned from those vendors. The offsets to these revenue amounts for accounting purposes were booked (debited) to a booth assets account.[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://) By the end of fiscal 1998, Just for Feet had recorded $9 million of bogus assets and related revenues as a result of this scheme. More than 80 percent of these bogus transactions were recorded during the final two quarters of fiscal 1998, ostensibly to allow Just for Feet to reach its previously announced earnings targets for those two periods.

An important feature of the Just for Feet accounting fraud was Don-Allen Ruttenberg’s close relationship with key executives of the major athletic shoe vendors. Since Just for Feet was among the largest customers of each of those vendors, the company had a significant amount of economic leverage on their executives. The younger Ruttenberg used this leverage to persuade those executives to return false confirmations to Just for Feet’s independent audit firm, Deloitte &Touche. Those confirmations were sent to Just for Feet’s vendors to confirm bogus receivables that were a product of the company’s fraudulent accounting scheme. In most cases, the bogus receivables resulted from inflated or otherwise improper vendor allowances booked by Just for Feet. One of the five vendor executives who capitulated to Don-Allen Ruttenberg’s demands was Thomas Shine, the senior executive of Logo Athletic. Executives of four Just for Feet vendors steadfastly refused to provide false confirmations to Deloitte. Those executives were employed by Asics-Tiger, New Balance, Reebok, and Timberland. Ironically, in 2001, Thomas Shine became an executive of Reebok when that company purchased Logo Athletic.

**Footing & Cross-Footing**

Deloitte &Touche served as Just for Feet’s independent audit firm from 1992 through early December 1999, one month after the company filed for [Chapter 11](javascript://) bankruptcy. Deloitte issued unqualified audit opinions each year on Just for Feet’s financial statements, including the financial statements in the S-1 registration statement the company filed with the SEC when it went public in 1994.

Steven Barry served as Just for Feet’s engagement partner for the fiscal 1998 audit. Barry was initially an employee of Touche Ross & Co. and was promoted to partner with that firm in 1988. The next year, Barry became a Deloitte &Touche partner following the merger of Touche Ross with Deloitte, Haskins, & Sells. In 1996, Barry was promoted to managing partner of Deloitte’s Birmingham, Alabama, office. Barry’s principal subordinate on the 1998 Just for Feet audit was Karen Baker, who had been assigned to the company’s audit engagement team since 1993. Initially the audit senior on that engagement team, she became the engagement audit manager after being promoted to that rank in 1995.

Deloitte assigned a “greater than normal” level of audit risk to the fiscal 1998 Just for Feet audit during the planning phase of that engagement. To help monitor high-risk audit engagements, Deloitte had established a “National Risk Management Program.” In both 1997 and 1998, Just for Feet was included in that program. Each client involved in this program was assigned a “National Review Partner.” This partner’s duties included “discussing specific risk areas and plans to respond to them … reviewing the audit workpapers concerning risk areas of the engagement, and reviewing the financial statements and Deloitte’s audit reports with an emphasis on the identification of specific risk areas as well as the adequacy of the audit report and disclosures regarding these risk areas.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)

The audit workpapers for the fiscal 1997 audit identified several specific audit risk factors. These factors included “management accepts high levels of risk,” “places significant emphasis on earnings,” and “has historically interpreted accounting standards aggressively.” Another 1997 workpaper noted that the company’s management team placed a heavy emphasis on achieving previously released earnings targets, expressed an “excessive” interest in maintaining the company’s stock price at a high level, and engaged in “unique and highly complex” transactions near fiscal year-end. A summary 1997 workpaper entitled “Risk Factors Worksheet” also noted that Harold Ruttenberg exercised “one-man rule (autocrat)” over Just for Feet and that the company practiced “creative accounting.”

For both the 1997 and 1998 audit engagements, Deloitte personnel prepared a “Client Risk Profile.” This workpaper for those two audits identified vendor allowances and inventory valuation as key audit risk areas. In 1996, Deloitte’s headquarters office had issued a firm-wide “Risk Alert” informing practice offices that vendor allowances should be considered a “high-risk area” for retail clients.

During the 1998 audit, the Deloitte engagement team identified several factors that, according to the SEC, should have caused both Barry and Baker to have “height-ened professional skepticism” regarding Just for Feet’s vendor allowances. The most important of these factors was the huge increase in the vendor allowance receivables between the end of fiscal 1997 and fiscal 1998. In the final few weeks of fiscal 1998, Just for Feet recorded $14.4 million of vendor allowances, accounting for almost one-half of the year-end balance of that account. Deloitte was never provided with supporting documentation for $11.3 million of those vendor allowances, although a Just for Feet executive had promised to provide that documentation. Deloitte completed its fieldwork for the fiscal 1998 audit on April 23, 1999, almost three months following the fiscal year-end. As of that date, Just for Feet had not received any payments from its suppliers for the $11.3 million of undocumented vendor allowances.

In March 1999, Deloitte mailed receivables confirmations to 13 of Just for Feet’s suppliers. Collectively, those vendors accounted for $22 million of the $28.9 million of year-end vendor allowances. Again, Don-Allen Ruttenberg persuaded executives of five Just for Feet vendors to sign and return confirmations to Deloitte even though the vendor allowance receivables listed on those confirmations did not exist or were grossly inflated. The confirmations returned by the other eight vendors were generally “nonstandard,” according to the SEC. That is, these confirmations included caveats, disclaimers, or other statements that should have alerted Deloitte to the possibility that the given receivable balances were unreliable. “Five vendors returned nonstandard letters that, instead of unambiguously confirming amounts owed to Just for Feet at the end of the fiscal 1998 year, as requested by the auditors, provided ambiguous information on amounts of co-op [vendor allowances] that the Company had earned, accrued, or had available during the year” [emphasis added by SEC]. Another of the returned confirmations explicitly noted that “no additional funds” were due to Just for Feet.

The eight nonstandard confirmations accounted for approximately $16 million of the $22 million of vendor allowance receivables that Deloitte attempted to confirm at year-end. “Despite these and other flaws, the Respondents [Deloitte, Barry, and Baker] nonetheless accepted these letters as confirming approximately $16 million in receivables claimed by Just for Feet.” The SEC’s investigation of Deloitte’s Just for Feet audits revealed that although Barry and Baker accepted these flawed confirmations, two subordinates assigned to the 1998 engagement team continued to investigate the obvious discrepancies in those confirmations well after the completion of that audit. These two individuals, who were audit seniors, twice contacted a Just for Feet executive in the months following the completion of the 1998 audit in an attempt to obtain plausible explanations for the eight nonstandard and suspicious confirmations. That executive did not respond to the audit seniors and neither Barry, nor Baker, apparently, insisted that he provide appropriate documentation and/or explanations regarding the amounts in question.

Just for Feet’s large increase in inventory during fiscal 1998 raised several important issues that the Deloitte auditors had to address during the 1998 audit, the most important being whether the client’s reserve for inventory obsolescence was sufficient. The primary audit procedure used by Deloitte during the 1998 audit to assess the reasonableness of the client’s inventory valuation reserve was to obtain and test an inventory “reserve analysis” prepared by a company vice president. This latter document was supposed to include the following three classes of inventory items for which company policy required application of the lower of cost or market rule:

* (1)

shoe styles for which the company had four or fewer pairs,

* (2)

shoes and other apparel that were selling for less than cost, and

* (3)

any inventory styles for which no items had been sold during the previous 12 months.

The reserve analysis for 1998, however, excluded those inventory styles for which no sales had been made during the previous 12 months, an oversight that the Deloitte auditors never questioned or investigated. The Deloitte auditors also discovered that a large amount of inventory included in a Just for Feet warehouse had been excluded from the reserve analysis prepared by the company vice president. Again, the auditors chose not to question client personnel regarding this oversight.

After completing their inventory audit procedures, the Deloitte auditors concluded that Just for Feet’s year-end reserve for inventory obsolescence was significantly understated. The SEC noted that this conclusion was reached by the Deloitte auditors despite the obvious deficiencies in audit procedures applied to Just for Feet’s reserve for inventory obsolescence:

*Even using the flawed inventory analysis provided by the Vice President and the deficient inventory information that excluded the goods from the New Jersey warehouse, the Respondents concluded that Just for Feet’s obsolescence reserve should have been in the range of $441,000 to over $1 million.*

The Deloitte audit team proposed an audit adjustment to increase the reserve for inventory obsolescence by more than $400,000; however, the client rejected that audit adjustment, meaning that the year-end balance of that account remained at a meager $150,000.

Although not specifically identified as a “key audit risk area” during the 1998 audit, the Deloitte auditors focused considerable attention on Just for Feet’s accounting decisions for the approximately $9 million of “booth income” the company recorded during that year. The Deloitte auditors discovered the monthly booth income journal entries recorded by Just for Feet during fiscal 1998 and prepared a workpaper documenting those entries. “An analysis at the end of the workpaper, which Baker reviewed, showed that the net effect of Just for Feet’s booth-related journal entries was to increase assets with a corresponding increase in income. The Respondents [Deloitte, Barry, and Baker] performed no further analysis to determine the basis and propriety of these journal entries.”

Instead of independently investigating these entries, the Deloitte auditors accepted the representation of a Just for Feet executive that the entries had no effect on the company’s net income. According to this executive, the monthly booth income amounts were offset by preexisting “co-op” or advertising credits that had been granted to Just for Feet by its major vendors. In other words, instead of using those advertising credits to reduce reported advertising expenses, Just for Feet was allegedly converting those credits into booth income or revenue amounts.

By the end of 1998, the bogus booth income journal entries had produced $9 million of nonexistent “booth assets” in Just for Feet’s accounting records. Since “neither the Company nor the auditors had internal evidence supporting the recording of $9 million of booth assets,” the Deloitte engagement team decided to corroborate the existence and ownership assertions for those assets by obtaining confirmations from the relevant Just for Feet vendors. These confirmations were prepared with the assistance of certain Just for Feet executives who were aware of the fraudulent nature of the booth income/booth assets amounts. Apparently, these executives contacted the vendor representatives to whom the confirmations were mailed and told them how to respond to the confirmations. The booth assets confirmations returned by the vendors to Deloitte were replete with errors and ambiguous statements. A frustrated audit senior who reviewed the confirmations brought this matter to the attention of both Barry and Baker.

*An audit senior reviewed these confirmations and informed Barry and Baker that she was in some cases sending multiple confirmation requests to the vendors because many of their initial requests came back in forms different from that requested. The Respondents failed to discover from these indications that Just for Feet might not actually … [own]the booths as claimed.*

**Epilogue**

In February 2000, after realizing that Just for Feet was no longer salvageable, Helen Rockey began the process of liquidating the company under [Chapter 7](javascript://) of the federal bankruptcy code. Over the next few years, settlements were announced to a number of large lawsuits linked to the Just for Feet accounting fraud and the company’s subsequent bankruptcy. Just for Feet’s former executives and Deloitte were among the principal defendants in those lawsuits. One of those cases, a class-action lawsuit filed by Just for Feet’s former stockholders, was settled for a reported $32.4 million in 2002.

Several of Just for Feet’s former executives pleaded guilty to criminal charges for their roles in the company’s massive accounting fraud. Among these individuals was Don-Allen Ruttenberg. In April 2005, a federal judge sentenced Ruttenberg to 20 months in federal prison and fined him $50,000. At the same time that the younger Ruttenberg’s sentence was announced, a Justice Department official reported that Harold Ruttenberg, who was gravely ill with brain cancer, would not be charged in the case. In January 2006, Harold Ruttenberg died at the age of 63.

Five executives of Just for Feet’s former vendors also pleaded guilty to various criminal charges for providing false confirmations to the company’s auditors. Most of these individuals, including Thomas Shine, received probationary sentences. An exception was Timothy McCool, the former director of apparel sales for Adidas, who received a four-month “noncustodial” sentence. While sentencing McCool, U.S. District Judge C. Lynwood Smith, Jr., noted, “ Life is so fragile. A single bad choice in a single moment can cause a life to turn irrevocably 180 degrees. I think that is where you find yourself.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)

Arguably, the party to the Just for Feet scandal that received the most condemnation from the courts and the business press was Deloitte. In April 2005, the SEC berated the prominent accounting firm for the poor quality of its Just for Feet audits in *Accounting and Auditing Enforcement Release No. 2238*. In that same enforcement release, the SEC fined Deloitte $375,000 and suspended Steven Barry from serving on audit engagements involving SEC registrants for two years; Karen Baker received a one-year suspension.

On the same date that the SEC announced the sanctions that it had imposed on Deloitte for its Just for Feet audits, the federal agency also revealed the sanctions that Deloitte received for its allegedly deficient audits of a large telecommunications company, Adelphia Communications. Similar to Just for Feet, the once high-flying Adelphia had suddenly collapsed in 2002 following revelations that its previously issued financial statements that had been audited by Deloitte were riddled with errors. The SEC stunned the public accounting profession by fining Deloitte $50 million for its role in the huge Adelphia scandal, which was easily the largest fine ever imposed on an accounting firm by the federal agency.

Shortly after the SEC announced the sanctions that it had levied on Deloitte for its Just for Feet and Adelphia Communications audits, James Quigley, Deloitte’s CEO, issued a press release responding to those sanctions. Quigley noted in his press release that, “Among our most significant challenges is the early detection of fraud, particularly when the client, its management and others collude specifically to deceive a company’s auditors.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://) This statement infuriated SEC officials. An SEC spokesperson responded to Quigley’s press release by stating that, “Deloitte was not deceived in this case. The findings in the order show that the relevant information was right in front of their eyes. Deloitte just didn’t do its job, plain and simple. They didn’t miss red flags. They pulled the flag over their head and claimed they couldn’t see.”[https://ng.cengage.com/static/nbapps/glossary/images/footstar.png](javascript://)

The SEC also suggested that Quigley’s press release violated the terms of the agreement that the agency had reached with Deloitte in settling the Just for Feet and Adelphia cases. Under the terms of that agreement, Deloitte was not required to “admit” to the SEC’s findings, nor was it allowed to “deny” those findings. Deloitte subsequently rescinded Quigley’s press release and issued another that eliminated some, but not all, of the statements that had offended the SEC.

**Questions**

1. Prepare common-sized balance sheets and income statements for Just for Feet for the period 1996–1998. Also compute key liquidity, solvency, activity, and profitability ratios for 1997 and 1998. Given these data, comment on what you believe were the high-risk financial statement items for the 1998 Just for Feet audit.
2. Just for Feet operated large, high-volume retail stores. Identify internal control risks common to such businesses. How should these risks affect the audit planning decisions for such a client?
3. Just for Feet operated in an extremely competitive industry, or subindustry. Identify inherent risk factors common to businesses facing such competitive conditions. How should these risks affect the audit planning decisions for such a client?
4. Prepare a comprehensive list, in a bullet format, of the audit risk factors present for the 1998 Just for Feet audit. Identify the five audit risk factors that you believe were most critical to the successful completion of that audit. Rank these risk factors from least to most important and be prepared to defend your rankings. Briefly explain whether or not you believe that the Deloitte auditors responded appropriately to the five critical audit risk factors that you identified.
5. Put yourself in the position of Thomas Shine in this case. How would you have responded when Don-Allen Ruttenberg asked you to send a false confirmation to Deloitte &Touche? Before responding, identify the parties who will be affected by your decision.