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How to audit a known fraud

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HOW TO AUDIT A KNOWN FRAUD

by NORMAN C. GROSMAN

The magnitude of the Equity Funding fraud had not been seen in the American economy since the days of McKesson and Robbins in the mid-30's. Actually, to begin the reorganization of a company with a fraud as pervasive as this one is beyond the experience of most professionals in today's business world—be they accountants, attorneys, trustees, or anyone else.

The fraud continued for at least nine years. All of the mechanisms of regulation and scrutiny, including annual audits, did not uncover what was going on. It came to light because a disgruntled former employee talked to a securities analyst. How much longer the fraud might have continued is very problematical. It seemed that it could not have lasted very much longer, but I suspect that anyone looking at the situation two to three years before would have said the same thing.

The case was originally billed as a sophisticated computer and insurance fraud. Really, it was neither of these. It would be more accurately characterized as an ordinary securities fraud. Ordinary in the sense that the motivation was one of inflation of earnings to provide the basis for increased stock prices. The purpose of the fraud was to create artificial values for the stock. The other aspects of it developed during the later years of its existence.

In talking about Equity Funding as a securities fraud, it is necessary to understand that the illegal acts started before the company ever went public in 1964. The wrongdoing, as best as can be determined, was premeditated. In other words, it was planned to inflate earnings, to increase the price of the stock. It is unique of course in the length of time during which it continued. It is also probably unique in its pervasiveness. Most other cases seem to have been limited to a few major transactions, usually involving a limited number of people. In Equity Funding's case, however, there was direct involvement of at least 15 people. And the misrepresentation was not limited to a few transactions but involved the basic operating accounts of Equity Funding.

From the initiation of the fraud through at least 1969, the procedure was highly simple, took very little time, and involved little effort to cover-up. The basic fraud during this period was achieved through regular accounting entries—increasing both accounts receivable and commission income. It was one accounting entry a month, or one accounting entry a quarter. There was no computer involvement at all.

As the fraud developed, it was expanded into the Equity Funding's insurance operations, through the creation and reinsurance of fictitious insurance policies. Since this required significant detailed support, the use of the computer became important.

But the use of the computer in the Equity Funding operations was still not extensive compared to its use in today's business. While certain fictitious information was maintained on the computer, none of it was inputed on a regular basis. The information that was added to the records was done off-line. It did not involve any special technology, or any unusual programming. It did, however, require a lower level of controls and less systems integration than one would ordinarily expect.

Part of the nature of the fraud was that it had to increase in magnitude in order that the company could show increased earnings. Thus, increasing amounts of fictitious income had to be created. The company was in an extremely tight cash position at the time of the discovery of the illegal acts, and it undoubtedly had similar problems in the past as well. This required the continual raising of additional capital and additional borrowings. How much longer all this could have continued is unclear.

The fraud got its first major publicity at the end of March, 1973, when an extensive article appeared in the *Wall Street Journal*. A day or two after this disclosure, the Touche Ross office in Los Angeles received a phone call from a law firm in our city asking us if we would be interested in becoming the auditors for Equity Funding. We met with the law firm and with the judge and were appointed as auditors on April 2. The company went into Chapter X reorganization on April 5, 1973 and we were reappointed as auditors to the company under the Chapter X proceedings. We were actually appointed before the trustee. This was an unusual situation, but it was necessary because of the extent of the fraud, the publicity that was given to it, and the need for some work to be done immediately.

When we started our work, senior audit personnel from the California and Illinois insurance departments were already at Equity Funding and had begun their investigation. The SEC was also present, as well as the FBI and the U.S. Post Office.

The major thrust of the investigation as we joined it was in the insurance area. Very little was known about the fraud in other parts of the company. Thus, our initial concept was much the same as the public concept, namely that it was a large sophisticated computer fraud—and an insurance fraud. As our work developed it became apparent that not only were the illegal acts more pervasive, but that the insurance aspects were a later development, not the initial thrust. It also became clear that the computer aspects were not nearly so important as originally portrayed.

From the start, we really had two basic objectives in our work as auditors. The first was to help establish the current financial condition of the company; the second was to assist in the fraud investigation.

To ascertain the financial condition of the company, we needed to locate the principal fictitious items and identify what adjustments to the accounts were necessary. This information did not have to be highly accurate, but it was necessary to arrive as quickly as possible at a reasonable picture of the company's financial condition. At the same time, we started on a more complete determination of the financial condition of the company as of the date of the filing of the Chapter X proceedings. In other words, we commenced an audit of the company's books as of April 5th, the same day as the reorganization filing, and these two phases were done simultaneously.

The Equity Funding operation covered a wide geographical area. The firm was headquartered in Century City, Los Angeles, and a part of the insurance operation and most of the insurance sales operation were based there. There were other freestanding insurance companies in the states of New Jersey and Washington. There was a cattle operation headquartered in Colorado. There was also a savings and loan association in Los Angeles. These freestanding subsidiaries and a number of others were not extensively involved in the fraud, if at all. Of course we didn't know this when we started our work, and so we had to approach our audits of these companies as though fraud might exist. But we adjusted our procedures as it became apparent that their records and their balances were reliable.

Practical Problems of a Fraud Audit

In performing this work, we started out with probably 10 to 15 people, and soon had as many as 70 people working on the engagement. The work in connection with the fraud investigation, the other part of our work, was done over a period of two years. The major effort in the investigatory area was done after the completion of our audit, since it was much more important to determine the current status of the company than what went on in the past.

There are, of course, significant problems in auditing a company following an extensive fraud. Most of the senior financial and management people were no longer with Equity Funding, for example; many of them had been involved in the deceit and were immediately dismissed upon discovery. But because of the pervasiveness of the illegal acts, we were not able to determine immediately which of the people who remained were not involved. In other words, who could be trusted.

Obviously, too, the records were in very poor condition. Many of them were not complete. We were also not sure if any records had been destroyed or altered in the last days in an attempt to conceal the fraud—particularly computer files. And still other records contained significant errors.

Because the senior financial and management people had been discharged, we had no one to discuss most of the transactions with. Normally you have people who can tell you the background of a transaction—the nature of it, the details. In this case, there was no one to ask. Many unusual receivables existed on the books that we could get little information on. In other areas of fraud, we were able to reconstruct balances, but we had no one to corroborate the information that we developed.

The trustworthiness of those in the computer department was one of our critical problems. The regulatory people were very much concerned that computer files might be destroyed, which is obviously very easy to do. Because of this, we had to control from the start all computer files that had existed on April 5, the date of the Chapter X proceeding.

Our first step was to duplicate the files as they were requested, so that we could maintain control of the computer files at all times. While the company's data processing people were permitted to continue their operation, they had to request files from us whenever they were needed for processing.

However, I think the most significant problem related to our uncertainty whether we had complete records. As an example, the receivables arising through the insurance funding operation had a balance of approximately $108 million on April 5, 1973, whereas the detailed computer file totalled only $43 million. We knew there was extensive fraud in this area, although we still had no idea of the magnitude. That is, we didn't know whether the data processing files which totalled $43 million were the complete files or not, and it took a significant amount of additional work to establish that. We learned eventually that these were the only valid funding receivables of the company. There were no others.

Another major problem was related to a significant number of large and unusual receivables. The company files and records contained little information on the background of these receivables—how they arose and, more particularly, if they were collectible. As it developed, a number of these receivables were fictitious or resulted from transactions that did not have economic substance. But because we had no one to discuss these receivables with, it took a significant effort to determine their nature and particularly their recoverability.

Still another problem was that there were early indications that certain documents in the company's files—such as bank advices, security advices, and bank statements—were counterfeit or fraudulent. We had no idea of their extent, however, and therefore had to perform extensive verification of internal documents with outside sources. Finally, because we didn't know the extent of the fictitious entries, we had to perform almost 100 per cent verification and analysis of the accounts for long periods of time, usually for the full year of 1972.

Another complication, not really a problem, was the need to coordinate our work with a large number of interested parties, including the insurance departments of Illinois and California, the SEC, the FBI, the US Post Office, and the US Attorney, as well as the trustee and his counsel. Certain of the work was divided up, and it was clear that it should not be duplicated. As an example, Equity Funding showed a receivable from a Liechtenstein company of some $9 million. There was no real information about this transaction in the company's files. The investigation of the status of the company was done by members of the SEC staff. It was not necessary for us to redo this work.

The Question of Testing

In performing a normal audit, we need to evaluate internal control to determine the extent to which we can limit our auditing tests. Where there is extensive fraud, it is obviously logical to assume that the internal control is too weak to rely on. Otherwise, the fraud could not have taken place. Therefore, we have to do 100 per cent verification in order to support the proper balances.

While that is a logical approach, I still do not really think it's the practical or correct approach. First of all, 100 per cent verification assumes that all entities and operations of the company are involved in the fraud more or less equally. At Equity Funding, however, and probably in other situations, that was not true. There were many subsidiaries that were not tainted. Even within operations where the illegal

Author Norm Grosman, left, keeps appointment at Century City in Los Angeles with Robert Loeffler, trustee of Equity Funding Corporation of America.

acts were extensive, not all operations were involved. In some segments, records were properly maintained.

My conclusion, therefore, is that the way to approach an audit of this nature is first of all to determine the precise extent of the fraud. Until then, do not attempt 100 per cent verification of the transactions or balances. Second, determine the true need for accuracy of information. Need it be 100 per cent accurate for operating purposes? Must it be so for reporting purposes, or for the purpose of issuing a report? There is really no practical way to issue an unqualified audit report in an extensive fraud situation. Conditions are not clear. For operating purposes, however, it may be adequate to have reasonably accurate information.

In other words, the only way to fully establish a balance may be 100 per cent verification. But, reasonable accuracy may well be obtained by significantly reduced testing, and this would be more than sufficient for the company's continued operation. The audit uncertainty that would arise could appropriately be covered in the auditor's report.

Therefore, I think the proper approach is to take an initial sampling of transactions. In other words, start out with less than 100 per cent testing in a certain area. But structure the testing so that it can be increased in an organized way after the initial sample is evaluated.

It is also extremely important to maintain communications with all of the investigatory and operating personnel. Unfortunately, people tend to be concerned only with their own responsibility. They do not communicate automatically to others, even though we all could benefit from what is learned by other parties.

For example, at the insurance subsidiary headquartered in Century City, approximately two-thirds of the purported insurance in-force did not exist. The company had created large numbers of fictitious insurance policies, and then reinsured them with other insurance companies. In this situation, the insurance in-force file contained details on the fictitious policies as well as the valid ones. When we started our work we knew that a large percentage of the policies purportedly in-force were not valid, but we did not know which ones they were.

To identify which of the policies in the files were valid, so that regular operations could proceed, the fictitious policies were labeled with special department numbers or billing codes. The state insurance department personnel and company computer people split the in-force file

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Donald Ingberg, vice president and controller of Equity Funding of America confers with Los Angeles aud t manager Janice Buswell.

between valid policies and policies based on information provided by former employees who had been involved in the fraud.

The accuracy of the split was not clear, however. The credibility of the people providing the information was suspect. The accuracy with which the computer files were regularly maintained was not clear. Also, there was some indication that in the last days of the fraud, when discovery was imminent, the billing codes and department numbers might have been changed in an attempt to conceal the full extent of the fraud. Because of these reasons, the split needed verification. We concluded that the only valid way to do this would be a 100 per cent confirmation of the in-force file.

This involved extensive computer programming to update the files. It took probably a month's planning to program the confirmation procedure and to prepare the confirmations. The follow-up and other work took two or three months. We used a STRATA developed computer program, but even so we used about eight people in this confirmation process.

A 100 per cent verification was necessary because the company needed to know which policies to bill premiums to, and which policies were valid if a death claim were filed. The results of the confirmation indicated that the preliminary split was substantially accurate. In retrospect, it might seem 100 per cent verification was unnecessary, but we didn't know when we started just how accurate was that preliminary split based upon department numbers and billing codes. Our decision for the 100 per cent verification was based as much upon the company's operating need for an accurate listing of policies in-force as it was for our audit purposes.

There was another related area in which we did not perform 100 per cent verification. The in-force file contains information about the policy holder necessary to calculate reserves: such as the extent of coverage, the age of the insured, sex, any physical impairment which would require additional reserves. We felt that this file would not require 100 per cent confirmation because, while the in-force file contained a significant number of fictitious policies, we had no indication that other information which would be used to calculate the reserve was inaccurate. Of course, if the sample tests indicated that the information was inaccurate, we could always expand our confirmation.

In normal audits, we confirm relatively limited numbers of balances and transactions. Problems of non-response, although significant, don't present important problems. In the Equity Funding situation, however, problems arose in areas that do not exist in regular audits. For example, in regular audits you don't have to obtain information from outsiders in order to *determine* a balance. You go to the outsider in order to verify a balance which you presume to be correct. In Equity Funding, we had to go to outsiders for the basic information needed to reconstruct the balance.

One surprise to me was that we did not get a significantly higher level of response than we would have received in a normal audit. This became immediately clear in the confirmation of the insurance in-force. Despite all the publicity attendant to the Equity Funding fraud, many people who held valid policies did not answer our confirmation requests. I thought they would be concerned that their policy was properly maintained in the company's records, but that presumption was not correct. We did get a higher level of response than normal, but nowhere near the 100 per cent level. Many people with valid policies simply did not answer our request for confirmation.

As I previously mentioned, we had to support the authenticity of a substantial number of external documents that were maintained in the company's files—because we didn't know whether they were authentic or not. The first impulse was to say that no document in the company's files could be relied upon. Therefore to the extent that the document was an important document, its authenticity would have to be verified with third parties.

Nelson Gibbs, Los Angeles partner, left, checks audit figures with senior Jim Johnson at Equity Funding offices.

But that, we soon learned, was not practical. Most third parties are not willing to cooperate in any extensive confirmation process. When this became evident, we carefully screened those documents we wanted authenticated. Even so, it took a number of months for banks to answer us, and other parties were less cooperative.

Many of the third parties had become adversaries during the proceeding. Others were afraid of being sued. And some just did not want to be implicated in any way with Equity Funding.

Of course we had no way to force cooperation. We could have gone to one of the regulatory groups and requested subpoenas, but that would not have provided the timely cooperation we really needed.

There was also a need to discuss the substance of transactions with third parties. Indeed, the best source of information on the nature of a transaction would be the other side. But, our ability to obtain meaningful information was almost nonexistent.

In normal audits, we are used to dealing with a final set of balances. Uncertainties, if any, are limited and clearly defined. In Equity Funding, however, if we chose to wait until that point was reached, we still would not have issued our report. As a result, we balanced the number of unresolved items with the need for getting out a public document that had basically accurate information.

That is why we completed our audit and issued our report with a substantial number of uncertainties left unresolved—far more than one would clearly expect in normal audits. One of the principal areas of uncertainty was in creditor claims. The attorneys and company personnel had started to screen and evaluate such claims only a month or so before our report had to be issued. When we issued the report, we indicated that the claims had not yet been evaluated, nor had their effect been determined. Our conclusion was that while this was an important area, even if the claims had been fully analyzed, there would be no way of knowing the ultimate allowance of claims for as long as a year and a half. So we completed our work and issued our audit in early February, 1974.

The Fraud Investigation

Concerning the fraud investigation, there are some obvious points to make. Probably we all realize them. First of all, we didn't do this investigation alone. I have already referred to the FBI, SEC, the US Attorney, the trustee's attorneys, and the state insurance departments. We were all really part of the team and we each had our strengths and weaknesses.

I think it's also obvious that the training and experience of a CPA doesn't help him very much when doing work of an investigative nature. We have limited experience in questioning people and recording the results of that interrogation. Lawyers are trained to do this all the time.

Much of the fraud investigation goes beyond the mere analysis of numbers and records. It involves taking statements—actually testimony—from a large number of people who were involved or had dealings with the company. This really is not our strong point. What we do best is to understand the financial import of what we see, relating information to the total framework of the company's financial position. We can evaluate the known areas of the fraud and its effects on the company's operation much better than can any of the other parties. We can also provide analyses and summaries of transactions in a much better way than they can. We are always doing these things. Concentrating our efforts where we have such experience is the best way, I think, to coordinate our work with that being done by the other members of the investigatory team.

Another important point is that documentation in this area is different from what we normally consider adequate documentation. Our long experience in documenting audit work is not necessarily adequate in a legal or evidentiary sense. So when we start to develop information, it is very important that we spend time with the lawyers to make sure that we will obtain sufficient detail and sufficient support for it to be used as evidence later.

Roundup and Conclusions

Touche Ross issued a report on the audit of Equity Funding's balance sheet in February, 1974. This ended our major man-hour effort. Since then, we have frequently assisted in the investigatory aspects. The trustee issued a report on the fraud at the end of October, 1974. We participated in the preparation of the report and provided much of the basic financial information in the report. Since then we have assisted the trustee in developing the accounting basis for the reorganized entity, and in developing information and preparing the documents filed during the reorganization process. We have also worked with a large number of lawyers who are handling criminal and civil litigation arising out of the fraud. In fact, the civil litigation will continue after the reorganization. Frankly, the work done after the issuance of our audit report in February, 1974, has been far more varied, far more interesting than was the basic audit work done during 1973.

Probably the most difficult part of the audit work in 1973 was pulling together quickly the number of people necessary to do the work, and then managing a group of that size. In retrospect, the auditing and reporting problems seem less than the management problems of the audit.

Recent work has seemed more interesting because the people-management problem has disappeared and because knowledge of the situation and the facts has become clearer. The passage of time alone has firmed up many of the things that we were uncertain about. Also, the viability of the reorganization plan has become clear. And certainly satisfaction with the work we are doing is greater when it is evident that the company will survive.

What were the major auditing lessons learned as a result of this experience at Equity Funding? Three stand out: One, establish the auditor's role and the role of others as early as possible, so that each can benefit from the other's information and not duplicate each other's work. Two, top priority must be given to the continued operation of the business. Traditional auditing and preparation of reports is not nearly so important as is obtaining valid and accurate information that will enable the business to operate. If all the auditor does is to provide an audit of a financial statement, he hasn't best served the reorganization of the company. And three, do not be limited by traditional audit approaches, which depend on an evaluation of the reliability of records and controls. In a fraud, such controls and validity do not exist in all the company's operations.

What is the status of Equity Funding today?

A plan of reorganization has been approved by all major stockholder credit groups, by the SEC, and by the court. The plan provides for continuing the operations of the insurance companies in New Jersey and Washington which were not involved in the fraud. The reorganization of Equity Funding was completed this spring. The operations will be transferred to the new reorganized entity, which will have an estimated net worth of \$80-\$90 million. The companies are viable and are presently profitable. △

About the authors...

How to Define the Limits of Responsibility—In addition to being chairman of the firm's US Board of Directors, Carleton H. Griffin is Director, Litigation Management.

How to Detect Illegal Activity—Robert S. Kay, a partner on the National Accounting and Auditing staff, is Director, Accounting and Professional Standards.

How to Audit a Known Fraud—Norman C. Grosman was the partner responsible for the audit of Equity Funding. Based in Los Angeles, he is now assisting Griffin in the area of litigation management.