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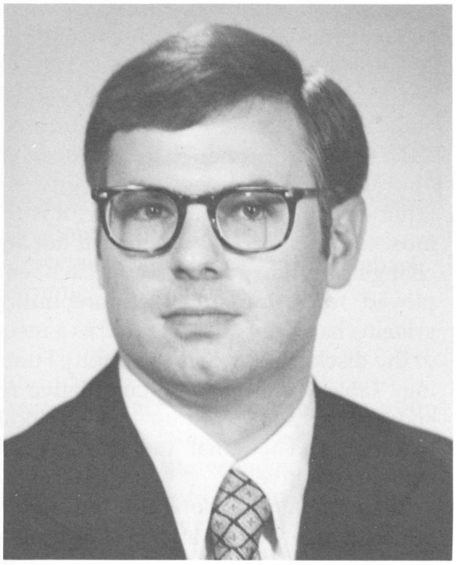

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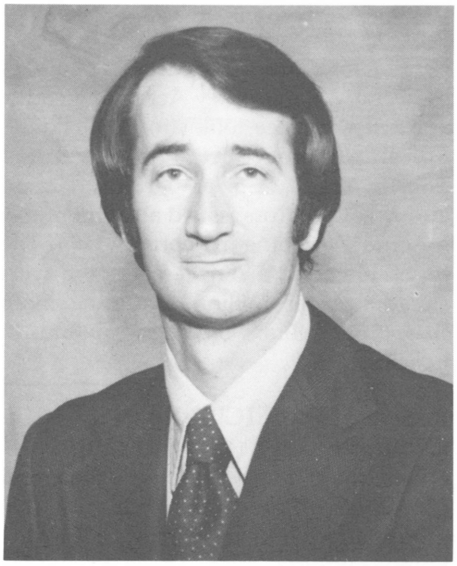
The authors report on the results of a survey they conducted to discover the profession's reaction to the Equity Funding case.



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More than three years have passed since the American business community was rocked by the revelations of massive, management-perpetrated fraud in the Equity Funding Corporation. As soon as the dimensions of the fraud became known, it was apparent that its repercussions would be widespread and dramatic, especially for the accounting profession. This article assesses the reaction of the accounting profession to the fraud over the past three years. An analysis of the official AICPA response (the report of the Special Committee on Equity Funding) and the results of a survey of accounting firms is included. Initially, however, it is perhaps helpful to offer a brief description of the fraud at Equity Funding.

The Equity Funding Case

The Equity Funding Corporation of America was formed in the early 1960s. Its operations focused on a marketing program involving life insurance policies and mutual fund shares in a rather unique investment package. This plan involved the sale by Equity Funding of mutual fund shares which were then pledged as collateral by the buyer for loans to buy term life insurance. The major selling point was that it permitted individuals to invest in mutual funds and receive life insurance as an added benefit. The firm grew rapidly, acquiring mutual funds, insurance companies, and a reputation for shrewd, aggressive management. From a price of $6 a share in 1964, the company's stock soared to a 1969 high of $80 a share.

The apparent profitability of the firm's operations was, however, a sham almost from the beginning. The installment nature of the mutual fund share sales caused Equity Funding to be perennially starved for cash. This pressing need for cash obliged the company to heavily reinsure new business — a practice which involves the sale of a life insurance policy to another company. Under a reinsuring arrangement, the issuing company continues to service the policy and to collect the customer's premium payment, of which about 90% is remitted to the reinsurer.

The practice of reinsuring was not unusual in the life insurance industry. Equity Funding, however, gave a new twist to the practice. It sold phony policies (which were altered versions of real ones) in order to obtain needed cash. On Equity's records, the sham policies were scattered throughout its magnetic tape files but were linked together by secret code numbers. The latter feature permitted these policies to be excluded from selected printouts by the use of computer programs designed specifically for this purpose — a useful measure for deceiving auditors.

The sale of bogus life insurance policies and the corresponding manipulation of the books were the predominant features of the fraud. Other fraudulent activities were carried out, however, including the borrowing of cash without recording the liability, the booking of nonexistent securities investments, and the inflation of the existent asset values.

The fraud was exposed in early 1973 as the result of telephone calls from a former Equity Funding employee to the New York State Department of Insurance and to Raymond Dirks, a financial analyst in New York. The Department of Insurance referred the matter to the insurance regulatory authorities in Illinois and California where Equity Funding Life Insurance and the parent company, respectively, were chartered. The official investigation launched by these agencies and the unofficial one launched by Dirks triggered rumors that something was amiss with Equity Funding. Trading volume in Equity shares rose from a normal 14,000 shares a day to 768,000 shares on March 26, the last day of trading before the SEC suspended trading in all Equity Funding securities in all markets. The price per share dropped from 27¼ on March 15 to 14⅜ on March 26.

The SEC filed suit in federal district court against Equity Funding, charging fraud and violation of federal securities laws. Under court order, the firm filed a petition for protection under Chapter 10 of the Federal Bankruptcy Act, and a court-appointed trustee took control of Equity Funding. The court also appointed Touche Ross & Co. to perform a fraud audit. Touche Ross issued an audit report for Equity Funding in February 1974. The report indicated that net assets were overstated by $185 million, including more than $62 million of bogus insurance policies.

Report of the AICPA Special Committee on Equity Funding

Other than company employees and executives, there were primarily five groups affected in varying degrees by the Equity Funding fraud. These groups included the life insurance policyholders, the insurance industry, financial analysts, investors in Equity Funding, and independent certified public accountants. The ultimate impact on the last group is perhaps the most difficult to project.

The fact that Equity's auditors had failed to discover the fraud became an immediate object of media attention and raised questions regarding the effectiveness of current audit standards and procedures and auditor responsibility for the detection of management fraud. In May 1973 the AICPA appointed a special committee to study whether or not the Equity Funding case indicated a need for change in auditing standards.

The special committee's report was released to the public in June, 1975.[1] The committee concluded that the proper application of customary audit procedures would probably have resulted in the detection of the existence of fraud at Equity Funding. The committee recommended only minor changes in auditing procedures (relating to confirmation of insurance policies and treatment of related-party transactions) and no changes in auditing standards.

The committee carefully attempted to draw these conclusions without attributing fault to the Equity Funding auditors. (This was not merely a matter of professional courtesy. Although the criminal cases involving Equity's auditors were complete and the guilty verdicts rendered at the time of the release of the committee report, a great deal of civil litigation was still pending.) The committee argued against the enlargement of auditor responsibility for fraud detection on the grounds that the benefits were not commensurate with the costs.

Reaction to Equity Funding Case: Survey Results

While the report on the Special Committee on Equity Funding constitutes an official response to this fraud case, it is also of interest to assess the reactions of individual CPAs. In an attempt to gain some insight regarding such reaction, a survey of 500 public accounting firms and individual practitioners was conducted. The mailing list for the questionnaire was randomly selected from *Accounting Firms and Practitioners* which contains member firms by state and city.[2] The survey resulted in 105 usable responses. Represented among the respondents were 77 local, 13 regional, and 15 national and international firms.

The firms were queried in regard to only one aspect of possible reaction to the Equity Funding fraud. However, it is the most crucial aspect — whether or not any changes in the auditing approach employed for computer-based accounting systems had been implemented as a result of the disclosures regarding Equity Funding. Table 1 indicates the cumulative responses of all the firms and of local, regional, and national and international firms, respectively.

Respondent reactions to the Equity Funding case were analyzed according to the size of geographical area served by each firm. It is likely that these reactions represent somewhat tentative attitudes about a situation that most certainly will be subjected to additional scrutiny and action by certified public accounting firms. However, from the analysis of these initial responses, it appears that the national and international firms took a more formal approach while the local and regional

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Table 1
REACTION TO THE EQUITY FUNDING CASE

Has your firm made any changes in its policy toward auditing financial statements produced in a computer-based accounting system as a result of the alleged insurance fraud case involving the Equity Funding Corporation of America?

	Local Firms (n=77)	Regional Firms (n=13)	International Firms (n=15)	All Firms (n=105)
Have not heard of case	6%	8%	7%	7%
No, we are awaiting final outcome of pending litigation before further action is taken	21	30	27	23
Yes, to the extent of informal suggestions and comments exchanged by firm personnel	42	54	27	42
Yes, a committee has been established to study the audit implications but no recommendations have been made	1	0	20	4
Yes, formal changes have been made and implemented	3	0	7	3
Do not know firm reaction	9	8	6	8
No response	18	0	6	13
	100%	100%	100%	100%

the user, is the technique of data encryption. Cryptography represents a transformation of data which makes it unreadable to a person who does not have access to the cryptographic key. This technique deals with the problem of limiting access by unauthorized users. It also deals with the problem of electromagnetic eavesdropping.

Additional provisions for data security represent potentially a significant increase in the cost of information systems. One estimate suggested that the additional data which would have to be collected to provide a complete history of all accesses to data files and additions for unambiguous identification of individuals would increase the size of existing files by 10% a year. The increase in file sizes for these identification records and the additional checking procedures implemented in software and hardware features represent a price which will have to be paid in increased processing time for each file access. The costs of increasing individual privacy should be considered as carefully as the conditions to be imposed in insuring that privacy.

Social Security Numbers as Universal Identifiers

Adoption of a single standard identification system for all individuals would make data-gathering, data storage, and data retrieval more efficient. It would also facilitate the exchange of information between computer systems and data files. For that reason there have been several proposals to establish standard universal identifying numbering system. Further, the suggestion has frequently been made that this universal identification numbering system should be the social security numbers.

One objection to the adoption of such a universal identifier rests with the concept of a common identification scheme. Many object to the potential for abuse and excessive control which such a standard identification number could have. Apart from such a consideration, however, use of the social security number itself has several weaknesses as a universal identifier should that concept find acceptance.

Social security numbers as they currently exist incorporate no self-checking features which would make it possible to distinguish any randomly chosen nine-digit number from a valid social security number. Further as early as 1973, the Social Security Administration estimated that more than 4.2 million people had two or more social security numbers.

The Privacy Act of 1974, in section 7, provides:

(a)(1) It shall be unlawful for any Federal, State, or local government agency to deny to any individual any right, benefit, or privilege provided by law because of such individual's refusal to disclose his social security account number.

(2) the provisions of paragraph (1) of this subsection shall not apply with respect to —

(A) any disclosure which is required by Federal statute, or

(B) the disclosure of a social security number to any Federal, state, or local agency maintaining a system of records in existence and operating before January 1, 1975, if such disclosure was required under statute or regulation adopted prior to such date to verify the identity of an individual.

(b) Any Federal, state, or local government agency which requests an individual to disclose his social security account number shall inform that individual whether that disclosure is mandatory or voluntary, by what statutory or other authority such number is solicited, and what uses will be made of it.

Implications for the Future

With the continued expansion of computerized information systems, the concern with individual privacy and the related requirements for data accuracy, confidentiality, and security are likely to increase. The Privacy Act of 1974 will not be the final legislation in that area. Additional federal action (HR 1984) dealing with privacy and data security concerns within individual states and in the private sector is already under consideration.

Soon the privacy regulations will extend to the many thousands of installations operated by business and other sectors of society besides Federal agencies. In addition, many states are also actively studying legislation dealing with protection of individual privacy implications in computer data banks.

This heightened concern at both the Federal and state level gives promise that adequate attention will be focused on the potential abuses of such data systems. At the same time, it is essential that we manage to develop some consensus between the federal and state agencies and the private sector services on the appropriate levels of regulation and the standard security procedures to be implemented. Without this consensus we could be faced with the development of numerous and conflicting regulations by the many legal jurisdictions currently involved. Such duplication and conflict would severely limit the usefulness of these data systems and dramatically raise their cost.

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firms reacted to the case in a more informal manner. About half of the local and regional firms stated that their firm's reactions to Equity Funding disclosures were limited to informal comments among firm personnel. About one-fourth of the national and international firms, on the other hand, had a much larger frequency of instances in which they established a committee of firm personnel in order to study the audit implications of the Equity Funding fraud. One-fifth of the national and international firms, compared to almost none of the local or regional firms, stated that they had formed such committees.

Few of the respondents indicated any formal changes in audit policies and procedures for computer-based accounting systems as a result of the Equity Funding case disclosures, regardless of the size of the firm surveyed. Only three percent of the local firms and seven percent of the national and international firms indicated any formal changes.

Summary and Conclusions

The Equity Funding fraud raised serious questions about the role of the auditor in the American business system. The attest function is intended to provide assurance to investors that financial information concerning firms offering investment securities is a fair representation (in accordance with generally accepted accounting principles) of economic realities. Such massive fraud cases clearly place this presumed assurance in jeopardy.

The accounting profession, up to this point in time at least, has reacted cautiously and deliberately, but positively, to the Equity scandal. Only time will tell if the profession's reaction has been an appropriate response.

Notes

[1]Special Committee on Equity Funding, Report of the Committee, *The Adequacy of Auditing Standards of Procedures Currently Applied in the Examination of Financial Statements* (New York: American Institute of Certified Public Accountants, 1975).

[2]American Institute of Certified Public Accountants, *Accounting Firms and Practitioners: 1971* (New York: American Institute of Certified Public Accountants, 1972). This survey was conducted in November, 1973, approximately eight months after the Equity Funding fraud was disclosed to the public.