Report of the Special Committee on Equity Funding

The Adequacy of Auditing Standards and Procedures Currently Applied in the Examination Of Financial Statements

American Institute of Certified Public Accountants

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Chapter 1

Introduction

The Equity Funding debacle, like all disasters caused by human actions, offers the promise of useful lessons for the future. Of particular concern to the accounting profession is what may be learned from this debacle about the adequacy of standards governing the work of independent auditors.

The dimensions of the Equity Funding disaster and the general nature of its causes were revealed within a period of a few weeks in the spring of 1973. In March of that year, press reports questioned the integrity of the consolidated financial statements and other records and reports of the apparently successful Equity Funding Corporation of America (EFCA) and its subsidiaries, including Equity Funding Life Insurance Company (EFLIC). Within a month, on April 4, the parent company filed a petition in bankruptcy. It appeared by then that a fraud of substantial proportion had been carried out over several years by certain officers and employees of the Equity Funding companies. The result of the fraud was to present to investors, creditors and regulators a picture of ever-increasing earnings and assets and to stimulate an active market in the securities of the parent corporation. It is now apparent that much of the reported earnings and assets were false. EFCA's publicly held securities, with a previous market value in the hundreds of millions of dollars, are now virtually worthless.

The Equity Funding collapse brought on a host of legal proceedings, many of which are likely to go on for years. In addition to the bankruptcy proceedings, there have been investigations by insurance regulatory agencies of several states, as well as by the Securities and Exchange Commission and other federal agencies, grand jury investi-

gations which have resulted in the indictment and in some cases conviction of corporate officers and employees; the indictment of certain of the auditors;* disciplinary proceedings by the New York Stock Exchange; and scores of civil lawsuits.

A number of questions are raised by this disaster. In addition to criminal culpability and civil liability, the questions involve the sufficiency of regulatory procedures affecting publicly owned companies, including life insurance companies, and the adequacy of prevailing assumptions about the responsibilities of various kinds of professions and occupations—including accountants, lawyers, actuaries, investment bankers and securities analysts—in relation to enterprises like Equity Funding.

Some of these questions concern standards governing the work of the public accounting profession, for EFCA had published annual consolidated financial statements through December 31, 1971 giving a false and misleading picture of its operations and financial position. These financial statements had carried reports by independent auditors which indicated that the financial statements had been examined in accordance with generally accepted auditing standards and were presented fairly in conformity with generally accepted accounting principles. The examination of the consolidated financial statements which were to be included in the 1972 annual report was substantially complete and printer's proofs were prepared. However, the consolidated financial statements and the auditors' report thereon were never issued.

On May 5, 1973, the Board of Directors of the American Institute of Certified Public Accountants, recognizing the importance of the questions raised with respect to the adequacy of prevailing professional standards, resolved that the president of the Institute should appoint a special committee to study whether auditing standards applicable to the examination of financial statements should be changed in the light of Equity Funding. The Board's resolution was as follows:

> WHEREAS, the Institute shares the general public concern about the Equity Funding disaster, which caused enormous losses to investors and creditors apparently by reason of massive and collusive fraud; and
>
> WHEREAS, developments in the Equity Funding matter may suggest that changes in generally accepted auditing standards are called for; and
>
> WHEREAS, identification and implementation of any such changes in

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* On May 20, 1975 a federal district court jury returned a verdict of guilty in a trial of three of the accountants involved with Equity Funding.

> generally accepted auditing standards should not await the eventual resolution of litigation or other proceedings concerned with assigning responsibility in respect of Equity Funding.
>
> NOW THEREFORE BE IT RESOLVED, that a special committee be appointed by the president of the Institute to study whether the auditing standards which are currently considered appropriate and sufficient in the examination of financial statements should be changed in the light of Equity Funding, and report its conclusions to the Board of Directors and the auditing standards executive committee.
>
> The appointment of the special committee to consider the possible larger implications of Equity Funding should not be understood as involving any deviation from the Institute's customary procedure for dealing with possible departures from the requirements of the Code of Professional Ethics. Accordingly, any questions raised by the Equity Funding matter as to adherence to professional standards by members of the Institute will be handled by the division of professional ethics.

This is the report of the special committee appointed pursuant to that resolution.

The Committee's Charge

As the resolution of the Institute's Board makes clear, the committee was not charged with attempting to assess fault or legal responsibility of the accountants or firms involved. Its charge was to consider whether the Equity Funding matter suggested a need for changes in generally accepted auditing standards.

The phrase "generally accepted auditing standards" refers to the ten standards which were formally adopted by the membership of the Institute in 1948 and 1949. These standards—three "General Standards," three "Standards of Field Work," and four "Standards of Reporting"—are explained and interpreted in a substantial body of professional literature of which the most authoritative is a series of pronouncements of the Institute set forth in its Statements on Auditing Standards.

The committee has understood its charge to require appraisal not only of the ten standards, but more particularly of the auditing procedures by means of which auditing standards are implemented. The Institute's Board of Directors has confirmed this understanding.

There were two aspects of this appraisal—one particular and the other general. The first focused on the auditing procedures that would customarily have been applied in the circumstances; the other involved

consideration of the general question of the auditor's responsibility to detect fraud.

The specific questions that the committee sought to answer were these:

1. What was the nature of the fraud in Equity Funding and how was it accomplished?
2. Would customary auditing procedures provide a reasonable expectation of detecting such a fraud?
3. Are any changes in customary auditing procedures called for in order to provide such a reasonable expectation?
4. Finally, and more generally, is there a need for change in scope of an auditor's responsibility for the detection of fraud, or for clarification of the auditor's responsibility, for the benefit of the accounting profession and the public at large?

The Conduct of the Committee's Study

To answer these questions, the committee did not consider it necessary to conduct an audit of the financial statements of any of the Equity Funding entities. In any event, to perform an audit for the years in which the fraud occurred would probably have been impractical if not impossible. The auditors appointed by the bankruptcy court completed an audit as of the date of bankruptcy. Their audit report appears in the *Report of the Trustee of Equity Funding Corporation of America* dated February 22, 1974.

The committee also did not determine what procedures actually were followed by the auditors of the Equity Funding entities since determination of fault, if any, was not part of its charge. To fulfill its purposes, the committee needed to gather information only with respect to the nature of the fraud and to relate this information to its understanding of the auditing procedures that would customarily have been applied in the examination of the financial statements of the Equity Funding entities.

The information needed for the study was obtained from the February 22 and October 31, 1974 reports of the Trustee of Equity Funding Corporation of America and through interviews with his executive staff, representatives of the auditing firm engaged by the Trustee, representatives of the California and Illinois Insurance Departments, the conservator for the life insurance subsidiary (EFLIC) and certain

of his staff, and some of the Equity Funding personnel who had been retained by the Trustee and the conservator.

The committee's representatives also looked at some of the records of the Equity Funding entities for the purpose of understanding the manner in which certain transactions were recorded on the books of the companies. Access to these records was granted by the Trustee and the conservator.

The committee's conclusions in this report necessarily rest upon the information in the reports of the Trustee and the information gathered in interviews and other investigations. If that information subsequently turns out to be inaccurate, the conclusions could be affected.

The committee generally limited its study to the pertinent Equity Funding entities for the years 1971 and 1972. Although it appears that the fraud began as early as 1964, the committee concluded that for its purposes it would be neither practicable nor necessary to extend its study to years before 1971 or into 1973, for the committee understands that the general pattern of the fraud which had appeared in earlier years or in 1973, could be identified without extending the review beyond these two years.

Chapter 2

Overview of Equity Funding

To provide background for the detailed discussion which follows, it will be useful to describe briefly the Equity Funding operation and the committee's understanding of the pattern and magnitude of the fraud.

Description of the Operation

The initial EFCA operation, which began in 1959 with the combination of two small securities and insurance marketing organizations, was that of an independent sales company which marketed mutual fund shares, life insurance policies and funded programs combining the two. During the early period of the company's history, substantially all of its income was derived from commissions earned. EFCA's expenses in connection with the sales of mutual fund shares and life insurance consisted principally of commissions paid to agents, the cost of maintaining a marketing organization, the cost of administering funded programs and interest on borrowed money. In the ensuing years the sale of funded programs became the most important part of the Equity Funding operation. The acquisition of Equity Funding Life Insurance Company (EFLIC) late in 1967 made it possible for EFCA subsequently to project a corporate image not simply of a marketing organization but rather of a life insurance-based conglomerate.

The following paragraphs describe the accounting procedures followed to record legitimate transactions.

As previously noted the most significant part of the operation was the "Equity Funding Program," which involved the combined sale of mutual fund shares and life insurance. Under the "program" an investor would, for example, purchase mutual fund shares for $1,000, pledge these shares as collateral for a loan of $400, and use the $400 to pay the first annual premium on a life insurance policy. Subsequently purchased mutual fund shares could be similarly pledged to obtain new loans to finance renewal premiums. Customers were required to maintain a prescribed ratio of collateral to their loans. This arrangement offered investors the opportunity to purchase mutual fund shares in anticipation that dividends and appreciation would exceed the interest cost of the loan used to pay insurance premiums. Investors sometimes purchased more mutual fund shares than were required under the "program," expecting to use the excess investment to collateralize future loans to pay insurance premiums for subsequent years.

EFCA and three of its subsidiaries, a broker-dealer organization, a marketing organization and an insurance underwriter, were principally involved in this operation. The mutual fund shares were sold through Equity Funding Securities Corporation (EFSC) and insurance was marketed by Equity Funding Corporation–California (EFC-Cal). After 1967 the insurance was issued in most instances by Equity Funding Life Insurance Company (EFLIC), although EFC-Cal also marketed insurance of unrelated companies, both separately and under the "program."

The Trustee determined that loans receivable from "program" sales (funded loans receivable) were legally assets of EFCA. However, since EFC-Cal maintained all funded loan records and dealt directly with policyholder/borrowers, funded loan transactions for purposes of simplicity are treated throughout this report as transactions of EFC-Cal rather than of EFCA.

EFSC's income was derived from commissions on sales of mutual fund shares while EFC-Cal's income was derived from commissions on sales of insurance. On mutual fund sales, EFSC generally received a 7% dealer's commission, 50% of which went to the selling agent. Thus, EFSC's books showed commission income from transactions equal to 7% of the offering price, commission expense equal to 3.5% and an increase in cash of 3.5%. The difference between the offering price and the 7% commission retained by EFSC was paid to the mutual fund distributor to purchase the participants' shares.

On "program" insurance written by EFLIC, EFC-Cal's commissions were substantially equal to the first year's premium and were payable in the first year. Therefore, in a policy's first year no cash was

actually transferred between EFC-Cal and EFLIC in payment of the premium and commission, respectively, since the amount of the premium payable to EFLIC was offset by the amount of the commission due to EFC-Cal for sale of the policy. In subsequent policy years, EFLIC was entitled to receive the gross insurance premiums because no commissions were payable on renewal premiums. Since on "program" sales EFC-Cal received promissory notes rather than cash from policyholders, cash was raised by bank borrowings. The bank loans were secured by the policyholder notes and the mutual fund shares with which those notes were collateralized.

Thus "program" sales by EFC-Cal of EFLIC policies would be reflected on EFC-Cal's books in the first year by an intercompany payable to EFLIC for the premium and an offsetting receivable from EFLIC for the commissions; and on EFLIC's books by intercompany receivables and payables for the same items. EFC-Cal would in the first year record income in the amount of the commission and a corresponding increase in funded loans receivable. Correspondingly, EFLIC would reflect premium income and commissions paid and its inventory of insurance in force would be increased for the policies written.

In subsequent years, premiums received by EFC-Cal, again in the form of promissory notes, would be similarly recorded as an intercompany payable to EFLIC. At the time a policyholder's loan was increased for the renewal premium, an entry would be made on EFC-Cal's books increasing funded loans receivable, with an offsetting increase in the amount payable to EFLIC. EFLIC, on the other hand, would record the amount of the gross premium as an intercompany receivable from EFC-Cal, and as renewal premium income.

The intercompany accounts were settled through the parent, EFCA, and not directly between the subsidiary entities. Settlements were made before year-end because in the case of EFLIC intercompany receivables are "non-admitted" assets for regulatory purposes. Such receivables are not treated as assets in determining whether minimum statutory capital requirements applicable to life insurance companies have been met.

It was the practice of EFLIC to reinsure with other insurance companies all or a portion of the risks on insurance policies it had issued. These reinsurers paid EFLIC approximately 180% of the first year's premium on reinsured policies. Since EFLIC retained the first year premiums, reinsurers actually paid cash equal to approximately 80% of the first year's premium on reinsured policies. The reinsurers then assumed responsibility for future benefits and claims on these policies. This enabled EFLIC to reduce its liability for future benefits and claims

to policyholders. Under the reinsurance agreements, EFLIC remained responsible for collecting subsequent years' premiums, for which it received a service charge. In many instances, EFLIC guaranteed a "persistency rate"—that is, the proportion of the policies on which premiums would continue to be paid—as high as 85% in the policies' second year.

Cash receipts from reinsurers, approximately 80% of the first year's premium on reinsured policies, provided EFLIC with substantial cash flow and increased earnings.

General Description of the Fraud

Prior to 1971 Equity Funding personnel began falsifying records to improve reported income and increase assets—presumably for the purpose of maintaining and encouraging the market for EFCA's securities. The falsification consisted of a number of elements; the two most significant involved the recording of fictitious funded loans receivable, which appears to have begun as early as 1964, and the recording of fictitious insurance policies, which began in 1969.

During the years 1964 through 1969 EFC-Cal's books were falsified to show increases in funded loans receivable and commission income accounts which purported to represent the company's participation in commissions earned by brokerage houses from various "program" securities transactions. Supposedly because it was improper for the company to receive such reciprocal commissions, they were disguised as funded loans receivable in EFCA's financial statements.

After 1969, a different approach to falsifying funded loans and commission income was adopted. This involved the recording of false receivables purporting to reflect loans made to pay policy premiums and recording a corresponding amount of fictitious commission income.

EFC-Cal was generally not entitled to receive commissions on renewal premiums; however, it appears that such premiums on fictitious policies were improperly recorded as commissions earned. EFC-Cal's commission income account was further falsified to reflect commissions on fictitious sales of mutual fund shares. Since EFSC sold most of the mutual fund shares used to secure the funded loans receivable, commissions on such sales would normally be recorded on its books and not on EFC-Cal's books.

As of the date of bankruptcy, April 5, 1973, fictitious funded loans receivable amounted to approximately $62.3 million.

Other fictitious or fraudulently inflated assets, principally in the form of receivables and investments approximating $37.7 million, were recorded on the books of EFCA and EFC-Cal. The recording of sub-

stantially all of these fictitious assets resulted in direct or indirect reduction of other fictitious asset accounts, especially funded loans receivable.

Beginning in 1969 EFLIC's records were falsified to reflect an increase in the insurance in force. This falsification did not by itself result in the recording of net income to EFLIC in the first year of the fictitious policies. However, when EFLIC reinsured the fictitious policies, the cash received (approximately 80% of the purported first year's premiums) was recognized as gross income. Reinsurance of fictitious policies made it necessary for EFLIC to make payment of subsequent years' premiums on those policies to the reinsurers. The need for cash to make these payments led to the creation of still more fictitious policies which were also reinsured, with much of the cash generated from the reinsurance being applied to payment of premiums attributable to fictitious policies reinsured in prior years.

Thus, in the absence of other sources of cash flow, each year's fraud required an even larger fraud the following year, with the magnitude of the falsification pyramiding from year to year.

The falsifications on EFLIC and EFC-Cal records represented two separate efforts to inflate assets and income. Fictitious transactions which would normally have required corresponding entries on the records of the two entities were not correlated either as to their nature or as to the amounts involved, and documentation supporting the falsifications apparently was not prepared except when requested by the auditors.

EFLIC's intercompany accounts would generally show a substantial net receivable balance, created by transfers of cash to EFCA and by the excess of premiums owed it by EFC-Cal over commissions EFLIC owed to EFC-Cal. In 1971, EFCA settled such accounts by a cash transfer of $16 million to EFLIC. This transfer was falsely recorded by EFCA as a purchase of commercial paper. In 1972, the books of EFLIC reflected an intercompany account receivable of $24 million. This balance was supposedly paid by the transfer of marketable securities from EFCA to EFLIC. These securities, like the insurance policies, funded loans and commercial paper, were fictitious. In 1972, EFCA also recorded fictitious purchases of commercial paper totaling $8 million in order to bring its intercompany accounts into balance with those of its subsidiaries.

The Magnitude of the Fraud

The magnitude of the fraud is indicated by the following summary of fictitious or fraudulently inflated assets based on the February 22,

1974, report of the Trustee. (When these items are discussed hereafter, some of the dollar amounts vary slightly because they represent the balances as of December 31, 1972, while the Trustee's report reflects amounts as of April 5, 1973.)

		(millions)
Inflated funded loans receivable		$ 62.3
Other fictitious or fraudulently inflated assets:		
Receivable from Compania de Estudios y Asuntos (Estudios)	$12.7	
Receivable from Establissement Grandson (Grandson)	9.1	
Investment in commercial paper—Apatinska Tekstilna Industrijia (Apatex)	2.0	
Capitalized mineral exploration costs	1.8	
Receivable from insurance companies and agents	5.9	
Receivable originating from the sale of casualty insurance agency operation	2.9	
Investment in Bishops Bank	2.7	
Receivables from mutual funds	.6	37.7
Write off by EFCA of carrying value of investment in EFLIC (see discussion of fictitious securities recorded on books of EFCA and EFLIC in 1971 and 1972 in connection with the elimination of intercompany accounts)		35.4
Non-existent investments in commercial paper		8.0
Total		$143.4

The Trustee also adjusted other accounts by $42.1 million representing write-downs of assets and other adjustments not necessarily related to fictitious or fraudulently inflated assets; thus, net assets were reduced by a total of $185.5 million.

Chapter 3

The Nature of the Fraud And How It Was Accomplished

As stated in Chapter 1, the fraud at Equity Funding began as early as 1964. However, the committee generally limited its study to the pertinent entities for the years 1971 and 1972 since the general pattern of the fraud which had appeared in earlier years or in 1973 could be identified without extending the review beyond these two years.

Funded Loans Receivable

The falsification of funded loans receivable accounts and corresponding commission accounts was accomplished in a simple manner. The general ledger control accounts were falsified by recording fictitious journal entries and there was virtually no attempt to create supporting documentation. For example, the subsidiary loan accounts were not falsified to correlate with the general ledger control account; neither were memoranda collateral records prepared to support the required ratio of collateral to funded loans receivable.

At the end of 1971 and 1972, funded loans receivable accounted for about 14% of Equity Funding's total consolidated assets. In 1971, approximately $34 million of the loans—49%—were fictitious; and in 1972, $61 million—61%. A related amount of collateral in each year was also non-existent.

The sale by EFC-Cal of insurance policies involving funded loans receivable generated commission income and expense. False sales of

funding programs were recorded by fictitiously increasing the funded loans receivable account with corresponding increases in the commission income accounts. Although commission income from sales of insurance and mutual fund shares normally would have resulted in incurring commission expense, the commission expense accounts do not appear to have been falsified so as to maintain their expected relationship to commission income. However, other expenses were apparently reclassified as commission expense when data for the various entities were consolidated, so that the consolidated financial statements reflected the expected relationship.

Interest income on funded loans was recorded monthly by EFC-Cal on the aggregate loan balance and was therefore overstated to the extent it was computed on fictitious loans.

During the examination of EFCA's 1972 financial statements, EFC-Cal personnel used the computer to prepare, for the auditor's use, a detailed trial balance listing all the individual loans supposedly included in the total of the funded loans receivable general ledger control account. This false trial balance was created by listing the legitimate loans a sufficient number of times until the desired total was reached. To avoid detection of this duplication, the listing omitted borrowers' names and the first two digits of each five-digit loan number. Although the trial balance contained numerous duplications, each line item could be supported by genuine documents (principally the power of attorney and promissory notes signed by the borrower) contained in a legitimate individual loan file. There was, however, the risk that the auditors, in selecting individual loans for testing from the trial balance, would select the same loan more than once. The committee was informed that when this occurred company personnel presented either genuine documentation for other loans having the same balance and a loan number with the same last three digits, or counterfeit documentation.

A deceptive measure was also apparently taken by company personnel in connection with the auditors' direct confirmation of selected loans with the borrowers. The committee was informed that when the loan selected by the auditors was fictitious (that is, a repetitive listing of a genuine loan also selected for confirmation), a confirmation request would be prepared and addressed to company personnel or their friends who were instructed to make appropriate response. Thus, through collusion, the risk of exceptions to confirmation requests was minimized.

Such preventive measures to avoid detection of the fraud were not, however, systematically carried out in the books of EFC-Cal.

Journal entries recording fictitious commission income on EFC-Cal's books were not consistent with EFC-Cal's method of operation in at least two ways. First, large amounts of commission on supposed sales of mutual fund shares were recorded by journal entries which inexplicably increased funded loans receivable. Commissions on mutual fund sales would normally be received in cash, not by an increase in notes receivable from customers. Furthermore as previously noted, commissions from the sales of mutual fund shares would be expected to be recorded on the books of EFSC, not EFC-Cal. Secondly, EFC-Cal recorded additions to funded loans receivable representing gross renewal premiums on program policies as insurance commission income. Since EFC-Cal was not entitled to receive commissions on the renewal of EFLIC policies, all such additions to funded loans receivable should have been recorded as payable to EFLIC instead of as commission income.

Other Fictitious Assets
Related to Funded Loans Receivable

At the date of bankruptcy the accounts of EFC-Cal reflected the following fictitious assets which were created by journal entries that directly or indirectly reduced fictitious funded loans receivable by a corresponding amount:

- a receivable of $12.7 million from a Panamanian company, Estudios,
- a note receivable of $9.1 million from a Liechtenstein company, Grandson,
- an investment of $2 million in commercial paper of a Yugoslavian company, Apatex,
- capitalized mineral exploration costs of $1.8 million.

The manner in which the receivables from Estudios and Grandson were recorded raises questions about their validity. The bookkeeping entries relating to these receivables are summarized in the following paragraphs.

During 1969 and 1970 EFC-Cal's purported right to receive commissions on "programs" established in prior years was recorded as "contractuals receivable" and commission income was increased by approximately the same amount. During 1970, the "contractuals receivable" were ostensibly sold for $18 million to Estudios, a company

which the Trustee has determined was secretly controlled by EFCA. It appears that the purpose of these entries was merely to present a picture of ever-increasing earnings and assets.

The original Estudios receivable of $18 million was reduced to approximately $12.7 million by the end of 1972 apparently by treating an unrelated $2 million cash transfer from Bishops Bank, another EFCA subsidiary, as though it were a payment on this receivable and by applying actual commissions received on sales made in prior periods.

In 1969, EFCA borrowed approximately $9.1 million through an international brokerage firm. The proceeds of the loan were not recorded as a liability but were recorded instead as a reduction of funded loans receivable. The committee was informed that the liability was not recorded until the lender subsequently asked why the obligation did not appear on the borrowers' financial statements. The liability was then recorded in 1970 with an offsetting charge to a new asset account purporting to represent a loan receivable from Grandson. The net effect of these entries was to reduce funded loans receivable and create a new fictitious asset of a corresponding amount. The Trustee has determined that, like Estudios, Grandson was secretly controlled by EFCA. The purpose of these entries appears to have been concealment of the fraud and manipulation of earnings.

The committee has been informed that there are agreements in EFCA's files to document these non-interest bearing receivables from Estudios and Grandson. Attempts by the Trustee to locate the corporate officers, obtain financial statements or identify any operations by either company have been unsuccessful. The committee understands that the receivables due from Estudios and Grandson are worthless and that the companies are corporate shells without assets.

The creation of the investment in the commercial paper of Apatex appears to be related to the $2 million transfer from Bishops Bank to EFC-Cal, which was recorded as a down payment on the sale of the "contractuals receivable" to Estudios. Subsequent to this transfer, the $2 million was repaid to Bishops Bank and the disbursement improperly recorded as a purchase of Apatex commercial paper. Bishops normally traded in the commercial paper of Apatex and apparently supplied a false purchase advice indicating that the securities were being held by Bishops for safekeeping. These transactions resulted in the substitution of what the Trustee has determined to be a fictitious investment in Apatex for a fictitious receivable due from Estudios in the amount of $2 million and were apparently designed to make it appear that the Estudios note was collectible.

In November 1970, journal entries further reduced EFC-Cal's funded loans receivable by $1.8 million and in effect created another fictitious asset in the form of capitalized mineral exploration costs. As with most of the other journal entries discussed above, supporting documentation for these entries cannot be found. Again, the purpose of these entries appears to have been concealment of the fraud and manipulation of earnings.

Fictitious Insurance Policies

The key element of this aspect of the fraud, which began in 1969, was the falsification of EFLIC's records to indicate that policies had been issued and continued in existence. The extent of the falsification can be best appreciated when viewed in terms of statistics regarding life insurance in force. Of the $2.2 billion in life insurance policies shown to be in force by EFLIC at December 31, 1971, approximately $1.3 billion were fictitious. Of the $3.2 billion in life insurance policies shown to be in force a year later, approximately $2.1 billion were fictitious. Substantially all of the fictitious policies were reinsured with other life insurance companies.

Although the use of the computer to produce fictitious records is discussed later in this report, the following brief description of its use at EFLIC will be helpful. In 1972 (and perhaps in earlier years as well), the computer was used to reconstruct EFLIC's journals, insurance in force files, and the general ledger for the entire year, so as to spread the fictitious entries in an apparently normal fashion. This seems to have been done to avoid the suspicion which might have been aroused by recording all of the fictitious business in a single month or quarter. This reconstruction could have been achieved even if the records were maintained manually. However, an enormous amount of clerical work would have been involved. The use of the computer made the reconstruction much easier.

To further conceal the fictitious insurance policies:

- The liability for future policyholder benefits was duly calculated on the basis of the supposed total insurance in force which had not been reinsured.
- Deferred acquisition costs for the fictitious policies which had not been reinsured were recorded as though the policies had been genuine.
- State insurance premium taxes were paid to the appropriate taxing authorities on fictitious as well as genuine policies.

- Expenses were falsified to give the appearance that a normal relationship existed between premium income and such expense accounts as commissions, credit reports and medical fees.
- Records were further falsified to manifest a pattern of termination and death claims on the fictitious policies. Since substantially all of these policies were reinsured, a major object was to deceive the reinsurers.

Other measures were also taken to conceal the falsification. When, in the course of audit, fictitious transactions (including legitimate policies which had been terminated but were maintained as though they were still in force) were selected for audit testing, EFLIC personnel either created bogus documentation—including copies of policies, applications and medical reports—or produced documents relating to legitimate policies which had been terminated.

EFLIC's premium income and commission expense accounts were inflated to correspond with the volume of fictitious policies. This operation was rendered easier than would normally have been the case for an insurance underwriter by the fact that virtually all the transactions passed through an affiliated entity—EFC-Cal. That is, most premiums were receivable from EFC-Cal, and commission expenses were payable to EFC-Cal. In most instances there were no direct dealings by the underwriter, EFLIC, either with its policyholders (with respect to premium payments) or with the salesmen who sold its policies; rather, these transactions were conducted through its marketing affiliate, EFC-Cal. Nor was there a direct flow of cash with respect to either premiums or commissions on "program" business; rather these were accumulated and reflected in offsetting intercompany accounts which were purportedly settled by lump-sum payments to EFLIC.

While the recording of fictitious life insurance sales by EFLIC and of fictitious funded loans receivable by EFC-Cal might superficially appear to be a single, integrated fraud, they were really two separate schemes to inflate assets and income. In fact, EFC-Cal's inflation of funded loans receivable apparently commenced well before EFLIC was acquired by EFCA.

Fictitious Securities Transactions and Their Relation to Intercompany Account Balances

As has been explained, intercompany receivables and payables between EFC-Cal and EFLIC, arising from their complementary roles in sales of the "Equity Funding Program," were cleared through their

common parent, EFCA. Clearance was desirable before year-end for EFLIC because, for life insurance regulatory purposes, receivables from affiliated companies are "non-admitted assets" which are deducted from equity in determining statutory capital.

As discussed earlier, the transactions recorded in the intercompany accounts between EFLIC and EFCA were not correlated, and as a result the balances in the accounts were not equal and offsetting. To bring the accounts into balance, a series of fictitious purchases and sales of commercial paper and bonds was recorded at the end of both 1971 and 1972. The net result of these entries was as follows:

EFCA Books	*1971*	*1972*
Investments inflated	$19 million	$ 8 million
Balance due from EFLIC decreased		(8 million)
EFLIC Books		
Investments inflated		24 million
Balance due from EFCA decreased	(16 million)	(24 million)
Books of Other Subsidiaries		
Balance due from EFCA decreased	(3 million)	

To document fictitious investments, company personnel prepared fictitious brokerage advices reflecting purported purchases and indicating that securities were being held in safekeeping at a commercial bank.

EFCA also advised EFLIC on regular interest payment dates that interest was received on the investments. EFLIC's records duly reflected this interest income with a corresponding increase in its intercompany account receivable from EFCA.

At the end of 1972 the auditors' request for confirmation of certain securities represented as being held in safekeeping by the bank was addressed by company personnel to a mail drop set up under a name similar to the bank so company personnel would receive the request, sign the confirmation and return it to the auditors.

Other Fictitious or Fraudulently Inflated Assets

At the date of bankruptcy the accounts of EFCA reflected the following additional fictitious or fraudulently inflated assets:

- a $5.9 million receivable from insurance companies and agents,
- a $2.9 million note receivable from the sale of future profits on casualty insurance agency operations,

- a $2.7 million investment in Bishops Bank, and
- a $600,000 receivable from mutual funds.

The creation of the $5.9 million receivable from insurance companies and agents was accomplished piecemeal. Prior to 1970, journal entries, for which no supporting documentation can be found, were recorded on the books of EFC-Cal creating a receivable due from insurance companies approximating $4 million and effectively increasing income by a like amount. This portion of the receivable balance apparently remained unchanged after it was recorded. The $1.9 million remainder represents unreconciled differences between the control account and detail records supporting amounts due from agents. Although these differences existed for some time, the discrepancy was never charged off.

The $2.9 million notes receivable originated from the sale of future profits on casualty insurance agency operations of an EFCA subsidiary. Although there are documents in the files relating to this transaction, they provide, with minor exceptions, that payments are to be made only to the extent that the agency operation generated profits. The transaction appears not to have been a completed sale (although it was so recorded) giving rise to income at the time of the transaction. In addition, one of the journal entries recording the receivable for a significant portion of the sale reduced asset accounts unrelated to the casualty agency operation.

Bishops Bank was acquired by EFCA in May 1969. During 1970, a $2.1 million fictitious cash account with Bishops Bank and fictitious investments in subsidiaries amounting to $600,000 were created by means of journal entries which effectively increased EFCA's income by $2.7 million. In December 1970 journal entries were made substituting a $2.7 million intangible asset in the nature of goodwill (i.e., cost of the investment in Bishops Bank in excess of net assets acquired) for the non-existent cash account and fictitious investment accounts.

During 1972, a $600,000 receivable from mutual funds was recorded on EFCA's books with an offsetting credit to commission income. The committee was informed that documentation supporting the receivable does not exist.

Use of the Computer to Produce Fictitious Records

During the later years bookkeeping and accounting records, including general ledgers, of EFCA and its subsidiaries were prepared

almost entirely by use of a computer. Nonetheless, the fraud was not based on a sophisticated application of data processing technology. The principal falsifications were achieved by manually preparing fictitious journal entries and recording them on the books of certain Equity Funding companies. However, the computer was used to prepare records in support of some of the fictitious account balances. An enormous amount of clerical effort would have been required to create the supporting detail manually.

Much of the publicity about Equity Funding has characterized it as a "computer fraud." It would be more accurate to call it a "computer-assisted fraud." The computer was used, to a large extent, to manipulate files and create detail designed to conceal the fraud. Much of this processing was performed by personnel from outside the EDP department who were allowed access to computer hardware, software and files.

The computer was an important factor in carrying out measures to conceal the fraud, but was not essential to the commission of the basic fraudulent acts.

Chapter 4

Conclusions and Recommendations Regarding The Adequacy of Auditing Standards and Procedures Currently Applied in the Examination of Financial Statements

General Conclusion

From its review, the committee has concluded that, except for certain observations relating to confirmation of insurance in force and auditing related party transactions, generally accepted auditing standards are adequate and that no changes are called for in the procedures commonly used by auditors. In reaching this conclusion, the committee is aware that it is possible to hypothesize ways in which virtually any audit procedure may be thwarted. Nevertheless, the committee believes that customary audit procedures properly applied would have provided a reasonable degree of assurance that the existence of fraud at Equity Funding would be detected.

The nature, extent and timing of audit procedures are normally based on a study and evaluation of the system of internal control in existence in the area under examination. While such procedures would not necessarily reveal a fraud, it appears that internal accounting and administrative controls at Equity Funding were so weak as to raise concern about the reliability of the accounting records. The committee believes that in such circumstances customary procedures would be extended because of the internal control weakness, thereby enhancing the likelihood of detecting fraud.

The remainder of this chapter sets forth some of the audit procedures which the committee believes would customarily be applied in the circumstances in testing the validity of certain accounts in which fraudulent entries were made at Equity Funding. Each section heading indicates the areas toward which the selected audit procedures would be primarily directed. However, these audit procedures might have

uncovered misstatements in related areas as well. For example, discovery of overstatements in the funded loan account might have led to the discovery of overstatements in the insurance in force, in commission income and in other related accounts. Similarly, discovery of an illogical relationship between commission income and commission expense might have led to discovery of the overstatement of funded loans.

Fictitious Funded Loans Receivable

The committee believes that the following customary audit procedures taken together would provide a reasonable degree of assurance that fictitious funded loans receivable would be detected:

- Prepare under the auditor's control a trial balance of funded loans receivable showing borrowers' names, full account numbers and balances.
- Reconcile the trial balance total with the general ledger control account balance and ascertain the propriety of any reconciling items.
- Review on a test basis the entries recording additions and deductions in the funded loans receivable account and examine documentation supporting the changes.
- Request on a test basis confirmation from borrowers of loan balances and amount of collateral pledged.
- On a test basis, inspect, or request confirmation from custodians of, mutual fund shares pledged as collateral by individual borrowers.

The auditor could carry out the above audit procedures relating to the trial balance and confirmation of funded loans receivable manually or through the use of computer programs designed for that purpose. If a client's computer programs were utilized the auditor would review and test such programs to the extent necessary to satisfy himself that they would produce valid data. To conduct such a review an auditor should have adequate technical training and proficiency in EDP techniques.

Fictitious Commission Income and Expense

The committee believes that the following customary auditing procedures taken together would provide a reasonable degree of assurance that fictitious EFC-Cal commission income and expense would be detected:

- Select a sample from the additions to the commission income account and trace the origin of such additions to supporting detail. Recalculate commissions earned on a test basis.
- Select a sample from the additions to the commission expense account and trace the origin of such additions to supporting detail. Recalculate commission expense on a test basis.
- Determine whether a logical relationship exists between insurance commission income and insurance commission expense.
- Test other major sources of commission income by examining supporting documentation or by confirming with the sources of such income.
- Review propriety of consolidation elimination and reclassification entries affecting insurance commission income and expense.
- Test overall reasonableness of insurance commission income by comparing it with first year and renewal premium data.

In the audit of commission income and expense the auditor would be cognizant of the relationship between premium volume and insurance commissions. An awareness of this relationship and more particularly, an awareness of that portion of premium volume attributable to first year sales as distinguished from renewals would permit the auditor to determine the overall reasonableness of recorded insurance commission revenue. Similarly, the overall propriety of recorded insurance commission expense would be established in light of gross premium or commission income and the provisions of agents' commission contracts.

Fictitious Life Insurance Policies

The committee believes that the following customary auditing procedures taken together would provide a reasonable degree of assurance that fictitious life insurance policies included in the inventory of insurance in force would be detected:

- On a test basis trace policies included in the inventory of insurance in force to the related premium collection.
- On a test basis trace premium income to premium collections and the related policies to the inventory of insurance in force.

Since EFLIC received no cash when it wrote new "program" policies, premiums could not be traced to specifically identifiable cash collections within its own records. Premiums on such policies were merely recorded as a charge to EFLIC's intercompany receivable due

from EFC-Cal and immediately offset by a credit in the same amount representing the first year commission. Thus, the only independent evidence to support premiums on new "program" business was the note receivable representing a loan made by EFC-Cal to finance the assured's premium.

Similar tests tracing evidence of billing and collection would be applied to renewal premiums. Again, in the case of "program" sales, such premiums were added to income and charged by EFLIC to its intercompany account receivable due from EFC-Cal. While the intercompany account balances were settled periodically, settlements were made on a lump sum basis making it impossible to trace specific premiums to specific cash collections as would customarily be the case.

To perform these audit tests it would be necessary to work with the records of both EFLIC and EFC-Cal, since EFC-Cal maintained the related loan account and billing and commission records in connection with its sales of EFLIC policies. Entries recording premium income and commission expense on EFLIC's books for policies sold by EFC-Cal were based solely on intercompany advices from EFC-Cal. Thus, an auditor could not trace premiums on "program" policies to evidence of billing and collection without gaining access to EFC-Cal's records. Under these circumstances, the auditor of EFLIC would either test the records of EFC-Cal himself or, if the two companies engaged separate auditors, EFLIC's auditor might request and rely upon EFC-Cal's auditor to carry out tests using data supplied by him from EFLIC's inventory of policies in force. In addition, EFC-Cal's commission income and premiums remitted would be compared on a test basis with premium income and commission expense on EFLIC's books to see if they corresponded.

Another auditing procedure, which heretofore has not been considered particularly useful, is verification of the authenticity of a selected number of policies included in the in force inventory by direct confirmation with the policyholders. Such a procedure has not generally been considered necessary because it would be unusual for companies to overstate liabilities. Inflation of the inventory of life insurance in force by a company that follows statutory accounting would result in an overstatement of the liability for future policyholder benefits and a reduction in current earnings. However, when companies report on the basis of generally accepted accounting principles (GAAP) there could be motivation for overstating insurance in force because it could result in an addition to current earnings.

There could be an additional motivation for overstating insurance in force when reinsurance of policies has the effect of materially increasing current earnings, which can occur when a company reports on the

basis of either GAAP or statutory accounting. Reinsurance of life insurance policies permits the elimination of the related liability for future policyholder benefits. Under certain circumstances, reinsurance may also result in increasing current earnings to the extent that the proceeds received from reinsurance exceed expenses incurred in connection with the sale and servicing of the reinsured policies.

EFLIC reinsured substantial numbers of both bona fide and fictitious policies. Thus, fictitiously inflating the in force inventory, coupled with the manner in which reinsurance commissions were accounted for, resulted in substantially increasing EFLIC's reported earnings.

The committee believes that when current earnings of a company could be materially increased as a result of either the reinsurance of policies or reporting on the basis of GAAP, there may be occasions when policies should be confirmed with policyholders on a test basis. Nevertheless, the committee cautions against placing too much reliance on such confirmation procedures as a sole means of determining the reasonableness of the in force inventory since such procedures cannot be expected to disclose unrecorded policies.

The committee recommends, therefore, that the Institute's auditing standards executive committee consider whether the Life Insurance Audit Guide requires clarification with regard to the confirmation of policies with policyholders.

Fictitious Securities Transactions

As discussed in Chapter 3, fictitious purchases of investments were recorded in 1971 and 1972 by EFCA and EFLIC to substitute for intercompany account balances between EFCA and EFLIC. The committee believes that the customary audit procedures of inspection of the securities held by the company or confirmation of the securities in safekeeping directly with an independent custodian would provide a reasonable degree of assurance that the non-existence of securities would be revealed.

In connection with the fictitious investments recorded on the books of EFLIC at December 31, 1972, the *Report of the Trustee of Equity Funding Corporation of America* dated October 31, 1974, states that Equity Funding established an office in Chicago using a name very close to that of American National Bank and Trust Co. by leasing space at a different address under the name of "American National Trust." The report states:

> From time to time thereafter, fraud participants sent letters addressed to "American National Bank" at the mail drop address to ac-

> custom post office employees to delivering mail so addressed to the bogus location.
>
> A print-out of the bogus bond portfolio was prepared on EFCA's System/3 computer, and was given to ... (the auditors) during the 1972 audit to support purchases of $24 million of the bonds at American National Bank. When the auditors also requested a direct bank confirmation for the bogus bonds, a request for confirmation was prepared, addressed to the fictitious branch office and given to them for mailing. . . . (An officer of EFCA) went to Chicago to receive it at the phony American National Bank branch. Nothing was received for a period of several days, causing great consternation among the conspirators who feared that the post office had delivered the request to the real American National Bank and Trust Co. However, they later learned that ... (the auditors) simply forgot to mail the confirmation request. . . . When the auditors' confirmation finally arrived at the mail drop . . . (an officer of EFCA) apparently signed and returned it to them in Los Angeles. In this manner, the conspirators concealed the $24 million imbalance in the intercompany account on EFLIC's books at year-end 1972.

While this points up the need for auditors to ascertain that valid addresses are used, such a step is already a customary and integral part of confirmation procedures.

An auditor customarily compares recorded security transactions with supporting broker or bank advices. However, this procedure probably would have been ineffective because certain advices had been forged.

Other Fictitious Receivables and Fraudulently Inflated Assets

With respect to the receivables resulting from the sale of the casualty insurance agency operation, the committee believes that the following customary audit procedures taken together would raise serious questions as to whether the receivables were valid:

- Analyze the accounts and review supporting data including contracts or agreements.
- Examine recent financial statements and credit ratings of the debtors to establish the financial standing of debtors.
- Confirm unpaid balances directly with the debtors.

Although the above auditing procedures would customarily be applied to the Estudios and Grandson receivables, the committee is of

the opinion that these procedures might have been ineffective in detecting the fraudulent nature of these accounts since the Trustee has determined that both companies were secretly controlled by EFCA. These audit procedures could have been circumvented through management collusion.

As to the investment in the commercial paper of Apatex, the committee is of the opinion that customary auditing procedures (described in the section Fictitious Securities Transactions) might not have disclosed that the asset was fictitious. This opinion is based on the following:

1. Forged purchase advices were available for inspection.
2. The commercial paper was supposedly held by Bishops Bank, an EFCA subsidiary. Confirmation from the bank that it was holding the paper would not have furnished adequate audit evidence because the bank was not an independent custodian.
3. The bank made a market in this commercial paper and may have had such securities on hand for sale. Accordingly, inspection of $2 million of Apatex commercial paper would have given no assurance that the paper inspected was the property of EFC-Cal.

Circumstances such as those which were present regarding the Estudios, Grandson and Apatex accounts highlight the fact that transactions between related parties pose serious auditing problems. The committee did not attempt to reach any conclusions regarding the problems inherent in auditing such transactions since the auditing standards executive committee of the AICPA is currently studying the need for additional auditing procedures in connection with related party transactions.

With respect to the $5.9 million receivable from insurance companies and from agents, the committee believes that the following customary auditing procedures taken together would provide a reasonable degree of assurance that the highly questionable nature of the accounts would be disclosed.

As to the approximately $4 million receivable from insurance companies:

- Analyze the account balance (which would have shown that it had remained unchanged for several years).
- Review commission collections early in the subsequent year which were applicable to the year-end balance under audit.

As to the approximately $1.9 million receivable from agents representing unreconciled differences between the control account total and total of the subsidiary records:

- Review the company's method of clearing unreconciled differences.
- Inquire as to why the difference had not been written off.

With respect to the inflated investment in Bishop's Bank, the committee is of the opinion that customary auditing procedures would have included a review of the net change in the "goodwill" account which was recorded on the books of EFCA. Such a review would provide a reasonable degree of assurance that the inflated account would be discovered.

In regard to the capitalized mineral exploration costs, the committee believes that an attempt to review data supporting the journal entries which gave rise to deferral of such costs would provide reasonable assurance that the impropriety of the asset would be discovered.

Use of the Computer

In the opinion of the committee, a knowledge of computer audit techniques was not essential to the detection of the Equity Funding fraud. Manual application of customary auditing procedures would have provided a reasonable degree of assurance that the fraud would be uncovered.

The committee also believes that the fraud did not contain any elements that involved new or unique computer applications. Thus, no recommendations are made for any new auditing standards or procedures in regard to computer maintained financial records.

Chapter 5

Responsibility of Auditors for Detection of Fraud

The extensive fraud at Equity Funding raises fundamental conceptual and practical questions about the responsibility of auditors for detection of fraud, and about the understanding of that responsibility by both the accounting profession and the public. The committee believes it should address these questions even though it has concluded that no significant changes in generally accepted auditing standards and procedures are necessary in the light of Equity Funding.

The understanding of the public accounting profession as to its responsibility for detection of fraud is set forth in Statement on Auditing Standards No. 1, in sections 110.05, .06, .07 and .08, which are reproduced in the Appendix. The propositions contained in that Statement relate to the ten generally accepted auditing standards, which govern the auditor's work in examining financial statements. One of these standards requires that the auditor make a proper study and evaluation of internal control as a basis for reliance thereon and for the determination of the extent of the tests to which auditing procedures are to be restricted. Thus, in the presence of weakness in internal control, the auditor recognizes the possibility that fraud could go undetected; and, correspondingly, modification of the nature, extent and timing of audit tests may be considered necessary.

The ten standards also require adequate technical training and proficiency as an auditor, independence in mental attitude, exercise of due professional care, adequate planning and supervision, and sufficient competent evidential matter to support the auditor's opinion on the

financial statements being examined. The auditor's report explicity states whether his examination has met these standards.

In meeting these standards, the auditor's attitude is one of awareness of the possibility of fraud. Many customary auditing procedures, though not specifically aimed at fraud detection, are nonetheless designed to test the reliability of the books and records and may raise questions as to the possibility of fraud. If the auditor suspects that there is a lack of honesty affecting the records or financial statements, he should modify the nature, extent and timing of his tests so as to either confirm or dispel his suspicion.

Although an auditor's unqualified opinion provides a degree of assurance that there is no material fraud, the committee believes that there is a risk that the opinion may be misunderstood as providing a higher degree of assurance as to the absence of fraud than can reasonably be expected. If such misunderstanding is to be avoided, it is important that the inescapable limitations on an audit be understood.

SAS No. 1, section 110.06, states that the auditor cannot give assurance that all types of fraud have been detected even when the most extensive audit has been conducted. Three examples are given: forgery, collusion and unrecorded transactions.

Forgery may be employed as to signatures and other signs of authenticity, or to entire documents. Throughout history skillful forgers have eluded detection even by experts; and auditors cannot reasonably be expected to be handwriting or documentary experts.

Collusion—as between client personnel and outsiders, or among management or employees of the client—may result in the presentation to the auditor of falsified confirmations or other documents that appear genuine. If the auditor has no reason to suspect the genuineness of the documents, it would be reasonable for him to rely on them. In a scheme to conceal fraud, of course, there is likely to be a combination of forgery and collusion.

Finally, auditing techniques cannot provide assurance that there are no unrecorded transactions. For example, a payable may be concealed, and little short of requesting confirmation from every possible creditor would provide assurance of its discovery.

In addition to the foregoing limitations which are largely insurmountable, there are practical and economic limitations on the degree of assurance that auditors can reasonably be expected to provide. An ordinary audit is not an examination of every transaction and of every document relating to every transaction; rather, an audit involves a testing of transactions and of the related underlying records and other documents. The nature, extent and timing of the testing depend upon a

number of factors, including the auditor's study and evaluation of the client's internal control, the results of particular tests, the importance of particular items being tested, and whether grounds for suspicion of fraud are discovered in the course of the audit. In the usual case, to substitute for such an examination one covering every transaction and record of the client would multiply the amount of work involved to an impracticable degree.

"Detailed" audits, which may be undertaken for special purposes, offer a greater likelihood of detecting fraud because they ordinarily involve examination of larger numbers of individual items and transactions than the ordinary audit. Even in detailed audits, however, some types of fraud may escape detection (e.g., unrecorded transactions, forgery, or collusion) because there is necessarily a point where the auditor's inquiry stops.

In every audit, the auditor is expected to be aware of the possibility of fraud. Nonetheless, there must come a point where, unless he has reason for suspicion, the auditor accepts the truth of representations made to him and the genuineness of documents which he inspects. Examples of representations which would normally be accepted (in the absence of specific reasons for suspicion) even though they might be deliberately false would be representations by management as to the completeness of a set of board or executive committee minutes; or by the client's counsel as to the absence of pending material litigation; or by a debtor of the client as to the correctness of an account receivable; or by a bank or depository as to the status of the client's accounts with it.

Yet there will almost always be some further step that could be taken to corroborate the accuracy of the representation made to the auditor. For example, a debtor's response to a request for confirmation of an account receivable could be checked by inspection of the debtor's records reflecting the corresponding account payable, or by a certificate from the debtor's auditor. If the representation is one of counsel, the auditor could ask to inspect the pleadings in the case, he could examine the court records, or he could require an opinion of his own counsel with respect to the opinion of the client's counsel, and so on. Each such incremental step would add a degree of confidence, and yet in few cases would it produce absolute certainty.

Similarly, there is a point where, again assuming that he has no reason for suspicion, the auditor accepts the genuineness of documents: as, for example, the genuineness of securities held by the client and inspected by the auditor, even though these might be skillfully counterfeited; or of contracts or signatures on confirmations, although these

might be forged; or of underlying internal documents, although the availability of the client's own forms often makes these relatively easy to falsify. As to any such matter, there is ordinarily some further step that could be taken to test the authenticity of a document on which reliance is placed: the authority of a debtor's officer or employee to sign a confirmation could be authenticated; the genuineness of that person's signature could be verified; the authority of the authenticating officer could itself be authenticated, and the genuineness of that signature checked, and so on. Again each additional step would produce another degree of confidence, still without achieving complete certainty.

Absolute certainty is no more an attainable goal of auditing than it is of any other professional endeavor. What is sought is a reasonable degree of assurance; and what is applied to achieve such reasonable assurance is and must be a professional judgment as to how far inquiry should go. The necessity for such a judgment reflects the fact that there is no ultimate stopping place: each new level of test offers yet another choice between reliance or still a further test. It reflects the fact that each incremental step would increase the work involved and therefore the cost and duration of the audit, without promising ultimate certainty.

The question may be raised whether, even if in ordinary circumstances audits cannot reasonably be expected to detect all material fraud, the expectation should not be different when, as in Equity Funding, the fraud is a "massive" one. In other words, it might be suggested that, assuming the term "massive" could be given a concrete definition, auditing standards should be such that an auditor's opinion would invariably constitute a reasonable assurance that no "massive" fraud existed such as in Equity Funding. The committee does not believe that such a suggestion is sound.

On analysis, three fairly distinct meanings might be assigned to the term "massive": referring to size—the numerical magnitude of the falsified figures or of the losses incurred by investors and others as a result of the fraud; referring to the extent of the collusion—the number of persons involved in the fraudulent scheme and the elaborateness of that scheme; and referring to the number of accounts affected. There is, of course, some connection between these several dimensions of the term, since it is often the case that the larger dollar amounts of falsification, the more accounts will be tainted and the more elaborate will be the precautions necessary to avoid detection of the falsification.

In any of these senses, the more massive a fraud, the greater will be the likelihood of its detection by customary audit tests. The larger the number of accounts and records affected by the falsification, the larger will be the number of potential audit trails leading to its discovery. The

larger the dollar amount of falsification resulting from the fraud, the more likely it will be that the fraud will continue and enlarge from year to year; and the longer the fraud continues, the greater will be the chances of its coming to light in one way or another. Moreover, the more extensive the collusion, the more numerous will be the persons who may intentionally or inadvertently betray their guilty knowledge or behave in a manner that will arouse suspicion.

On the other hand, the more skillful the collusion, the less likely will be the discovery of the fraud—regardless of its massiveness in the sense of size or numbers of accounts affected. Fraudulent devices such as forgery and the failure to record transactions are virtually impossible to detect by ordinary auditing, and as to any given auditing procedure, techniques can be devised that will offer reasonable promise of circumventing the procedure in question. Thus, there remains the possibility that even a massive fraud can escape detection by an audit conducted in accordance with generally accepted auditing standards.

It may fairly be said that the more massive the fraud the more likely it is to be detected in a conventional audit; nonetheless there is no definable degree of massiveness as to which such an audit can invariably be relied upon for such detection. Nor, in the committee's view, is there any practicable means of altering auditing standards or procedures so as to provide such an absolute assurance with respect to any set degree of massiveness.

In sum, the committee reaffirms the soundness of the accounting profession's understanding with respect to the role of audits in the detection of fraud. A change in this basic understanding to make the auditor's opinion into more of a guarantee of the absence of fraud would represent a major change in the conception and performance of audits and would vastly increase their expense—yet still not furnish a complete guarantee. To ask that a professional opinion be made into an absolute assurance would, moreover, be to seek a degree of certainty which is seldom to be found in any other area of commercial life—or, for that matter, in any area of our lives, private or public. However, even though such absolute assurance is not feasible, the application of generally accepted auditing standards will often result in the discovery of material frauds. Audits also can be expected to deter frauds which might otherwise occur.

Having said all this, the committee is still concerned that there may be a divergence in the understanding of the public and of the accounting profession with respect to the auditor's responsibility for detection of fraud. Although the committee believes that all of the propositions contained in SAS No. 1, sections 110.05, .06, .07 and .08, are

sound, it also concludes that the way they are cast, with its greater emphasis on the limitations rather than on the positive aspects of the matter, may contribute to the risk of disparity in understanding, between the public at large and the public accounting profession, as to what an auditor's responsibility is with respect to the detection of fraud.

On one hand, there seems to be a tendency to view auditors' reports as if they were warranties—absolute assurances against fraud or error—and to ignore the practical limitations on auditors' work, which SAS No. 1 emphasizes. On the other hand, those limitations, even though well understood by the profession, may not be expressed in a persuasive way. The committee believes that a more detailed statement of both the auditor's responsibilities and the limitations of those responsibilities might well be helpful in reducing such misunderstanding. It therefore recommends that the auditing standards executive committee consider restating those sections of SAS No. 1 which relate to the auditor's responsibility for detection of fraud.

In this respect, it seems clear that the auditor has an obligation to discover material frauds that are discoverable through application of customary auditing procedures applied in accordance with generally accepted auditing standards. The auditing profession should, on an ongoing basis, continue to improve the efficiency of customary audit procedures to the end that probability of discovery of material frauds continues to increase within the limits of practicability.

Respectfully Submitted by the
Special Committee on Equity Funding

Marvin L. Stone, *Chairman*
J. T. Arenberg, Jr.
Leo E. Burger
Robert C. Holsen
A. E. MacKay

AICPA Staff
Thomas R. Hanley

February 1975

Dissent to Publication at This Time

Messrs. Arenberg and Holsen dissent to the publication of this Report prior to the termination of significant litigation involving Equity Funding because (a) the rights of certain litigants may be unfairly affected by the premature publication of this Report, (b) new information that may be brought out during the course of the litigation could, as indicated on page 9 of the Report, affect the committee's conclusions, so that publication would turn out to have been premature, and (c) the absence of recommendations for changes in auditing procedures may lead some readers of the Report to believe that the audits were deficient even though the committee, in keeping with its charge, made no attempt to assess fault. In addition, they believe that publication of the Report at this time may establish an unwarranted and potentially dangerous precedent, particularly when, as in this instance, there has been no discussion of the Report with the auditors involved.

Appendix

Appendix

Statement on Auditing Standards No. 1, Section 110—Paragraphs .05, .06, .07 and .08

Detection of Fraud

.05 In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

.06 Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate

internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Accordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively. In the case of fidelity bonds, protection is afforded not only by the indemnification for discovered defalcations but also by the possible deterrent effect upon employees; the presence of fidelity bonds, however, should not affect the scope of the auditor's examination.

.07 When an independent auditor's examination leading to an opinion on financial statements discloses specific circumstances that make him suspect that fraud may exist, he should decide whether the fraud, if in fact it should exist, might be of such magnitude as to affect his opinion on the financial statements. If the independent auditor believes that fraud so material as to affect his opinion may have occurred, he should reach an understanding with the proper representatives of the client as to whether the auditor or the client, subject to the auditor's review, is to make the investigation necessary to determine whether fraud has in fact occurred, and, if so, the amount thereof. If, on the other hand, the independent auditor concludes that any such fraud could not be so material as to affect his opinion, he should refer the matter to the proper representatives of the client with the recommendation that it be pursued to a conclusion. For example, frauds involving "lapping" accounts receivable collections, or frauds involving overstatements of inventory, could be material, while those involving peculations from a small imprest fund would normally be of little significance because the operation and size of the fund tend to establish a limitation.

.08 The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negligence on his part. He is not an insurer or guarantor; if his examination was made with due professional skill and care in accordance with generally accepted auditing standards, he has fulfilled all of the obligations implicit in his undertaking.