SEC Accounting And Auditing Enforcement Actions In The Banking Industry

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Abstract

This paper provides insight into several descriptive issues that help clarify the nature of management fraud in the banking and financial services industry. The SEC's Accounting and Auditing Enforcement Releases (AAER) Nos. 1 to 400, published between 1984 and 1992, were surveyed to identify a sample of banks and other related entities that were the subject of SEC enforcement action for fraudulent financial reporting. Those cases are analyzed and results are reported in this study. Detailed cases are also presented to illustrate the nature of financial statement fraud relating to valuation problems in investment accounts, misstatement of loan reserves, and nondisclosure of material financial information. Implications for research, practice, and teaching are presented.

Introduction

Recently, the Public Oversight Board[1] identified financial statement fraud as the most serious problem faced by the accounting profession (Public Oversight Board, Annual Report 1996-97). The Board believes that financial statement fraud, also referred to as management fraud, is the most demanding and difficult to resolve problem in the accounting profession. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, echoes the significance of management fraud in the accounting profession (AICPA, 1997). The Standard amends the auditor's responsibility to include a charge for obtaining reasonable assurance that audited financial statements are free of material misstatement, including fraud.

Readers with comments or questions are encouraged to contact the authors via e-mail.

Among the reasons for the growing importance of management fraud are its economic cost to society and the potential impact on audit confidence. For example, a 1997 issue of the magazine *Security* (Vol. 34, No. 7, 32-33) reported that fraud by senior managers and executives is 16 times more costly than basic employee fraud. Compared with a median loss of $60,000 in a basic employee fraud incident, the median loss in a case that involves management and senior officers exceeds $1,000,000. During the early 1990s, the accounting profession faced about $30 billion in damage claims, much of which resulted from litigation associated with management fraud (Arthur Andersen et al., 1992). Among the big six, the direct costs of defending those lawsuits totaled approximately $477 million.

Before the turn of the century both auditors and users of audited financial information regarded the detection of fraud as one of the primary purposes of the audit. Throughout most of the twentieth century, however, the profession has viewed its role in detecting fraud as secondary to other purposes of the audit. In contrast, the public has continued to regard fraud detection as an important goal of the audit process. Unattended for several decades, the gap between auditor's perception of their responsibility for fraud and the public's perception of the auditor's role in fraud detection, coupled with a spate of audit failures during the 80s and 90s had a severe impact on audit confidence. Recognizing this potential confidence crisis and the likely consequences for self-regulation, the accounting profession has moved to explicitly recognize fraud detection as one of the functions of the audit. SAS No. 82--which becomes effective for audits of financial statements for periods ending on December 15, 1997--specifically requires auditors to assess the risk of fraud in financial statements and provide reasonable assurance that financial statements are free from material misstatements resulting from fraud.

Notwithstanding the renewed emphasis on fraud detection in auditing financial statements, few auditors actually encountered fraud in financial statements. It is estimated that 80 percent of auditors have experienced two or fewer instances of management fraud during their careers, which averaged 17 years of auditing experience; 40 percent have never worked on engagements involving management fraud (Hansen, McDonald, Messier, and Bell, 1996). It is not clear from these estimates whether management fraud goes undetected in most audit engagements, or that management fraud seldom exists in audit engagements. However, given the pre-SAS No. 53 perception that auditors were not responsible for fraud detection and the number of celebrated fraud cases that were undetected by auditors, it seems plausible that many auditors may have failed to recognize the existence of fraud in those engagements when fraud did, in fact, exist. Whatever the situation, it is evident that, in general, auditors have little experience in fraud detection.

Although SAS No. 82 strongly suggests that it is necessary to understand the nature of financial statement fraud in order to effectively assess fraud risk, few specifics relating to the nature of management fraud are presented in the statement. Moreover, the literature contains little empirical information on fundamental issues such as accounts that are most frequently affected by fraud, persons that are most likely to be perpetrators, the primary motivations for fraud, methods used to perpetrate fraud, and what happens to a company after fraud has been detected and reported. Though a number of individual cases (e.g., MiniScribe, Regina, Kenyon Home Furnishings, ZZZZ Best, Crazy Eddie, etc.) have been reported and discussed in the literature, the authors are not aware of any large-sample studies that analyzed large numbers of actual financial statement fraud cases and provide answers to the fundamental issues described above. This study seeks to fill that void. However, in order to limit the scope of the study and maintain a specific focus, the results published in this paper are restricted to only the banking and financial services industry.

Research Questions

This paper provides a descriptive response to the following questions: (1) Which accounts are most often affected by fraud? (2) Who are the perpetrators of management fraud? (3) What are the primary motivations for management fraud? (4) What methods are used to perpetrate fraud? (5) What happens to a company after an SEC enforcement action? Three detailed cases are also presented to illustrate the nature of selected financial statement fraud. The cases cover improper valuation of investment accounts, misstatement of loan reserves, and nondisclosure of material financial information.

Method

The SEC's Accounting and Auditing Enforcement Releases (AAER) Nos. 1 to 400, published between 1984 and 1992, were surveyed to identify a sample of banks and other related entities that were the subject of SEC enforcement action for fraudulent financial reporting. To be included in the sample, the entity had to be a bank holding company, a dealer/broker, a mortgage company, a savings and loan association, or other financial services enterprise other than an insurance company. A total of 66 entities were identified with an average fraud amount of $100.6 million spanning a two-year period. Table 1 presents additional details on the sample.

Table 1
Fraud Demographics

Description	Sample Size	Mean Fraud Amount ($000) (n=50)	Average Fraud Time Span In Years
Total Sample*	66	$100,608	1.97
Bank Holding	25	138,069	1.33
Dealer/Broker	20	84,511	2.55
Financial Service**	10	19,888	2.89
Mortgage Company	6	6,166	1.67
Savings & Loan	5	229,499	1.60

Sample drawn from the SEC's Accounting & Auditing Enforcement Release Nos. 1- 400, published during the period 1984 to 1992. ** Financial Service is defined as financial planning other than insurance providers.

Results

Which accounts are most often affected by fraud?

On average, SEC actions focus on slightly more than two accounts (2.03) per case. Table 2 shows that the accounts most often involved are loan loss reserves (20%), investments (17%), loans receivable (16%), cash (11%), and revenues (9%). Table 2, Panel B, shows the frequency with which these five accounts represented the focus of the SEC's action among the various types of companies investigated. Bank holding companies and savings and loans institutions are most often investigated for misstatements in their loan loss reserves, followed by their loan accounts. Though not the most frequently investigated account among mortgage companies, loan loss reserves are the focus of investigation in as many as 30% of the cases. The majority of cases involving mortgage companies (60%) involved loan accounts. Among dealer/broker services, investment accounts and cash are the most frequently investigated. Revenue accounts, investments, and cash, in that order, are the most often investigated accounts among financial services enterprises. Overall, the SEC's investigations focus most often on loan loss reserves among the enforcement cases involving loan-related enterprises (bank holding companies, mortgage companies, and savings and loan associations). In contrast, the SEC focuses most often on investment accounts and cash among investment-related enterprises (dealer/brokerage services and financial services).

Who are the perpetrators of management fraud?

Table 3 presents illustrates those parties that are most frequently perpetrators of management fraud. Most management frauds involve collusion among an average of 3.26 officers per case. The five most frequently cited perpetrators are management (general management position or a vice-president position other than accounting), board members, the president, owners, the CEO, and the CFO. External officers are among the perpetrators in 7% of the cases examined in this study. The board and management are most often the perpetrators in loan-related enterprises

Table 2
Accounts Affected by Fraud

Panel A: Summary of Major Accounts Affected By Fraud

Account Title	Number of Occurrences*	Percentage
Loan Reserves	25	20%
Investments	22	17%
Loan Receivable	20	16%
Cash	14	11%
Revenues	11	9%
Accounts Receivable	8	6%
Expenses	5	4%
Common Stock	5	4%
Allowance for bad debts	3	2%
Other	13	10%
Total occurrences	126	

* Each case may involve multiple cases. On average SEC investigations focus on 2.03 accounts per case.

Panel B: Summary of Five Most Affected Fraud By Industry (n = 62)

Industry	Revenue	Investment	Reserves	Loans	Cash	N*
Bank Holding	11%	17%	42%	25%	6%	36
Mortgage Co.	0%	10%	30%	60%	0%	10
Savings & Loan	17%	33%	33%	17%	0%	6
Loan Related (n = 33)	10%	17%	38%	31%	4%	52
Dealer/Broker	7%	36%	18%	7%	32%	28
Financial services	33%	25%	0%	17%	25%	12
Investment Related (n=29)	15%	33%	13%	10%	30%	40

Note: N* indicates the total number of instances when the five accounts were affected by the fraud. Each accounting and auditing enforcement case may focus on more than one type of account. Sixty-two enforcement cases (n) were investigated.

such as bank holding companies, mortgage companies, and savings and loan institutions. Owners, followed by management, are the most frequent perpetrators of fraud in investment-related enterprises such as dealer/broker services and financial services.

What are the primary motivations for management fraud?

Table 4 shows the primary motivations for the frauds examined in this study. The four most frequently observed motivations for fraud are to improve or sustain financial condition of the entity, to facilitate embezzlement, and to facilitate stock issuance. The dominant motivation is, however, to improve or sustain the financial condition of the company (61%). As shown in Table 4, Panel B, efforts to improve or sustain financial condition is among the most frequently observed motivations for management fraud. It accounts for at least 60% of the observed motivations in bank holding companies, savings and loan institutions, and dealer/broker services. Direct embezzlement of company resources, the third most frequently observed motivation, was noted in an average of 13% of the cases involving loan-related enterprises and in an average of 25% of the cases in investment-related enterprises.

Table 3
Officer Involvement in Fraud

Panel A: Summary of Officers/Positions Involved in Frauds (n=54)

Position	# Occurrences	Percent
Management*	35	20%
Board Members	33	19%
President	25	14%
Owners	19	11%
CEO	18	10%
CFO	15	9%
External Auditor	12	7%
Controller	8	5%
Treasurer	7	4%
Marketing	4	2%
Average number of officers per case	3.26	

* a general management position, or a vice president position other than accounting, marketing, or finance.

Panel B: Summary of the Six Officers Most Frequently Involved in Frauds By Industry

Industry	Owners	Board	President	Management	CFO	CEO	N**
Bank Holding	2%	25%	21%	23%	12%	17%	52
Mortgage Co.	0%	15%	15%	31%	23%	15%	13
Savings & Loan	13%	33%	8%	33%	4%	8%	24
Loan Related (n=29)	4%	26%	17%	27%	11%	15%	89
Dealer/Broker	38%	21%	17%	14%	3%	7%	29
Financial services	15%	15%	19%	26%	15%	11%	27
Investment Related (n=25)	27%	18%	18%	20%	9%	9%	56

** Total number of officers involved in the cases examined for each type of enterprise.

What methods are used to perpetrate fraud?

Table 5 summarizes the methods used by management to perpetrate fraud in the cases examined in this paper. Four of the most frequently observed methods are failure to disclose material information (31%), the use of accounting methods that are not supported by GAAP (21%), unsupported accounting entries or books lacking detail (12%), and miscalculating accounting estimates (9%). All together, circumventing internal controls, use of fictitious documents, and early recognition of revenues account for 19% of the fraud methods used in the 62 cases examined. Table 5, Panel B, shows that failure to disclose information and failure to use generally accepted accounting principles account for at least 50% of the methods used in management fraud across all types of enterprises. These two methods, respectively, account for an average of 64% and 80% of the methods used in loan-related entities and investment related entities.

What happens to a company after an SEC enforcement action?

After a management fraud case has been investigated, one of the most frequently observed SEC actions has been a requirement that the company restate its financial statements (see Table 6). Requests for extended audits, penalties,

Table 4
Fraud Motivation

Panel A: Summary of Fraud Motivations (n=63)

Motivation	Occurrence*	Percent
Improve or sustain financial condition	43	61%
Embezzlement	13	19%
Stock Issuance	12	17%
Debt Issuance	2	3%
Total	70	

*Some cases have multiple motivations

Panel B: Summary of Fraud Motivation by Industry (n=63)*

Industry	Stock Issue	Debt Issue	Condition	Embezzlement	N**
Bank Holding	12%	8%	72%	8%	25
Mortgage Co.	38%	0%	38%	25%	8
Savings & Loan	20%	0%	60%	20%	5
Loan Related (n=34)	18%	5%	63%	13%	38
Dealer/Broker	5%	0%	73%	23%	22
Financial	40%	0%	30%	30%	10
Investment Related (n=29)	16%	0%	59%	25%	32

*Some cases have multiple motivations

and cease and desist orders against the company and the parties involved are tied for the second most frequently observed SEC action. In 8% of the cases examined, the SEC has requested a suspension in trade of the company's securities. As shown in Table 6, Panel B, SEC enforcement actions usually have significant consequences for the companies involved. The company continued to exist in its pre-investigation form in only 29% percent of the cases. The company ended in bankruptcy in 38% of the cases; the board of directors resigned in 14% of the cases; the company merged with another entity in 10% of the cases. Trading in the company's securities was suspended in 8% of the cases.

Sample Fraud Cases

Improper valuation of investment accounts: Abington Bancorp, Inc.

Abington Bancorp, Inc. (Abington)[2] is a bank holding company for the Abington Savings Bank, chartered in Massachusetts. During fiscal years 1989 and 1990, Abington failed to recognize declining values of their marketable equity securities. This caused income to be materially overstated by not recording unrealized losses. To avoid recording unrealized losses, changes in marketable equity securities were recognized as reductions in their equity section, instead of the appropriate recognition on the income statement. This technique also allowed Abington to avoid reflecting realized losses at the point of securities sale.

At March 31, 1989, Abington's cost balance of marketable equity securities was $12.7 million. With 80 percent of its portfolio below original cost, many investments had fallen to between 74 and 50 percent of their original cost. The market declines had continued over long periods of time, with one stock failing to reach Abington's cost since 1983. Several securities had not paid dividends over the past few years. Eighteen of the investments were with regionally depressed financial institutions.

Table 5
Fraud Method

Panel A: Summary of Fraud Methods (n=62)*

Fraud Method	Occurrence	Percent
Failure to Disclose Information	40	31%
Non-GAAP Presentation or Method	27	21%
Unsupported Entries or Books Lacking Detail	16	12%
Miscalculating Accounting Estimates	12	9%
Improper Account Classification	10	8%
Circumvent Existing Internal Controls	10	8%
Fictitious Documents	8	6%
Early Revenue Recognition	7	5%
Total methods observed	130	
Average number of methods per case	2.09	

* More than one method was observed in some cases.

Panel B: Summary of Four Most Common Fraud Methods by Industry (n=62)

Industry	Disclosure	GAAP	Entries	Estimates	N**
Bank Holding	38%	28%	15%	18%	39
Mortgage Co.	33%	17%	33%	17%	12
Savings & Loan	50%	25%	13%	13%	8
Loan Related (n=34)	39%	25%	19%	17%	59
Dealer/Broker	52%	6%	17%	4%	23
Financial	38%	46%	8%	8%	13
Investment Related (n=28)	47%	33%	14%	6%	36

As of December 31, 1989, unrealized losses had reached $3.8 million, with $2.2 million from financial institutions. By this time a majority of Abington's financial institution investments were less than 50 percent of their cost. Several of these institutions had received *going concern opinions* by their external auditors. Ten of their non-financial institutions had also experienced substantial market declines. This trend continued as of June 30, 1990, with unrealized losses reaching $4.4 million. Additional investments received auditor's *qualified opinions*, many reporting losses, and some entering bankruptcy. As of the end of the 1990 third quarter, Abington recognized a real loss of $1.9 million on sales of securities. They also wrote down the cost of several financial institution investments by $617,000. However, they still had not recorded a remaining unrealized loss of $3.1 million.

By the 1990 December year-end, Abington realized another $825,000 loss on sales of securities, still not booking a remaining unrealized loss of $2.2 million. At this point, a major portion of their securities had fallen to less than 40% of their original cost. On April 22, 1992 the SEC required Abington to restate all annual and quarterly financial statements issued between March 31, 1989 and September 30, 1991. The SEC further issued a cease and desist order.

Failure to disclose: Bevill Bresler & Schulman, Inc.

Repurchase/Reverse Repurchase Agreements (repo/reverse repo) are generally short-term loans that are collateralized by high-grade government securities (Gardner and Mills, 1994). As an example, a broker (the repo) enters into an arrangement to sell Treasury securi-

Table 6
Aftermath of Fraud

Panel A: SEC Actions Against Entities Involved in Management Fraud

SEC Action (n=41)*	Occurrence	Percent
Restate financial statements	13	27%
Extended Audit	7	14%
Disgorge or Pay Penalty	7	14%
Cease & Desist	7	14%
Disclose Information	5	10%
Suspended Trading	4	8%
Improve Internal Control	3	6%
Other Pending Action	3	6%
Total	49	

* Multiple actions may be taken for each case.

Panel : Company Status after an SEC Enforcement Action

Company Result (n=49)	Occurrence	Percent
Continued	14	29%
Involuntary Bankruptcy	11	22%
Voluntary Bankruptcy	8	16%
Officers\Board Resigned	7	14%
Merged	5	10%
Suspended Trading	4	8%
Total	49	

ties to a third party, the buyer. As part of the agreement, the third party will sell the same securities back to the broker (reverse repo) on a specific date in the future, for a specific price. In its pure form, the seller is borrowing money from the buyer/lender using Treasury securities as collateral. These loan agreements, reaching trillions of dollars, are usually short-term, lasting from overnight to 30 days. A broker who sells a repo is gaining transaction cash to maintain capital requirements. A party buying a reverse repo is investing idle cash on a short-term basis.

Bevill Bresler & Schulman, Inc. (BBS) was a registered Dealer/Broker with the SEC[3], primarily dealing in government and municipal securities. Their June 30, 1984 year-end financial statements reported $588 million in reverse repos (assets) and a near matching balance of repos (liabilities). These balances constituted over 80 percent of BBS's total assets and liabilities. Approximately $295 million of these repo/reverse repo balances were with a related party, Bevill Bresler & Schulman Asset Management Company (AMC).

In the few days preceding year-end, BBS (the lender) entered into a repo/reverse repo transaction with AMC (the borrower). However, BBS allowed AMC to borrow roughly $29 million more than the market value of security collateral given by AMC in the repo agreement. Although collectibility by BBS was questionable, it was neither disclosed nor were reserves for uncollectibility recorded. The related transactions allowed BBS to report a net worth of $20.9 million, when in fact they had a negative net worth of $6.5 million. The risk of a $29 million under collateralized loan was further increased by AMC's limited fiscal year end net worth of $1.8 million. There were also material deviations between BBS's reverse repo (receivable) and AMC's repo (liability) position. BBS's books reported their asset balance to be $43 million greater than AMC's corresponding liability balance. Throughout this time period, BBS's auditors failed to obtain evidence confirming their largest reverse repo position.

In April 1985, BBS was placed under temporary receivership. By May 1985, BBS was taken over by a trustee under the Securities Investor Protection Act. In May 1992, BBS's auditor was suspended from practice before the SEC for a period of three years, required to join the AICPA Practice Section, and take 120 hours of related continued professional education.

Misstatement of loan loss reserves: the case of Brooklyn Savings Bank

Brooklyn Savings Bank, established in Danielson, Connecticut, was a FDIC insured

savings bank.[4] The institution's weak financial condition had been obscured by its failure to establish an appropriate reserve for loan loss and write off non-performing loans. The largest of these nonperforming loans was made to a joint real estate venture, "Thermos of the Thames." Those involved in the ventured planned to transform the vacated "American Thermos" factory at Norwich, Connecticut into residential condominiums. Their reckless misstatements would have allowed Brooklyn to report a meager net income for the fiscal year ended 1989, while in fact the bank had a $14.2 million loss.

The Securities Exchange Commission concluded that Brooklyn's President\Chief Executive Officer was aware of the condition of the Thermos project loan, yet failed to report this information in Brooklyn's financial statements, press releases, and letters to shareholders. Originally, Brooklyn had attempted to secure third party financing for the project, but other financial institutions identified Thermos as a poor credit risk. As the joint venture continued, the construction project faced both serious delays and cost overruns. Thermos had projected adequate sales of the condominiums. This was due in part to Brooklyn's five-year repurchase guarantee at the buyer's full cost. The initial sales were slow and well behind venture projections. As the regional real estate market and overall economy weakened, sales continued to be poor. Finally, in September 1989, Thermos failed to repay a 90-day $1.8 million loan to Brooklyn.

The bank's President was aware of the above information and further knew, through two independent appraisals, that the balance of the Thermos project bank loan exceeded its market value by nearly $4 million. Brooklyn Savings Bank finally wrote-off over $9 million of the Thermos loan during December 1989, relieving its President/CEO of all duties. The temporary leave became permanent in February of 1990. In the following October, Brooklyn was declared insolvent and placed under FDIC receivership.

Summary and Conclusion

This study has provided some insight into the nature of financial statement fraud in the banking and financial services industry. Actual fraud cases investigated by the SEC were studied. The average fraud spans a two-year period, involves $100.6 million, and affects two to three accounts. Loan loss reserves, investments, loans receivable, and cash are the most frequently affected accounts. Most management frauds involve collusion among three to four officers, with the most frequently involved being senior vice presidents, board members and owners, the president, the CEO, and the CFO. Outside directors and officers are seldom involved in fraud. The four most frequently observed motivations for fraud are to improve or sustain financial condition of the entity, to facilitate embezzlement, and to facilitate stock issuance. The dominant motivation is, however, to improve or sustain the financial condition of the company.

The most frequently observed fraud methods involve non-disclosure of material information, use of accounting methods that are not supported by GAAP (21%), unsupported accounting entries or books lacking detail, and miscalculating accounting estimates. All together, circumventing internal controls, use of fictitious documents, and early recognition of revenue account for less than 20 percent of the methods used.

After a management fraud case has been investigated, one of the most frequently observed SEC actions has been a requirement that the company restate its financial statements. Requests for extended audits, penalties, and cease and desist orders against the company and the parties involved are tied for the second most frequently observed SEC action. SEC enforcement actions usually have significant consequences for the companies involved. The company continued to exist in its pre-investigation form in only 29% percent of the cases after an SEC investigation. The company ended in bankruptcy in 38% of the

cases; the board of directors resigned in 14% of the cases; the company merged with another entity in 10% of the cases; and trading in the company's securities was suspended in 8% of the cases.

Suggestions for Future Research

This study has implications for research, practice and teaching. Additional research is needed to extend the study to other industries and to provide more profound insight into the relationships that exist among the descriptive factors examined. For example, future research is needed to examine the relationship between the nature of a fraud and the post-SEC investigation consequences for the company. In terms of practice, the study provides some insight into the nature of financial statement fraud and helps practitioners to anticipate the type of situations they are likely to encounter in seeking to provide reasonable assurance that financial statements are not fraudulently misstated (SAS No. 82). Additional research involving other industries would complement this potential benefit. With regard to teaching, the study provides instructors with material for motivating their discussions of management fraud and in helping students understand some of the underlying characteristics of the problem.

Notes

1. The Public Oversight Board (POB) is an independent private sector body created in 1977 for the purpose of overseeing and reporting on the self-regulating programs of public accounting firms that provide services to SEC registered companies. The POB is responsible for matters related to the integrity of the auditing process.
2. This case is based on the SEC's Accounting and Auditing Enforcement Release No. 370, April 22, 1992.
3. This case is based on the SEC's Accounting and Auditing Enforcement Release No. 384, May 21, 1992.
4. This case is based on the SEC's Accounting and Auditing Enforcement Release No. 305, July 9, 1991.

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