

Selected Cases for ACC 430
Professor Patsy Lee

Metro State College

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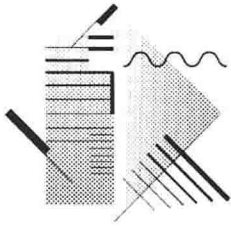
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CASE 1.2

ESM GOVERNMENT SECURITIES, INC.

Jose Gomez achieved his long-sought goal of becoming a partner in Alexander Grant & Company on August 1, 1979. Only thirty-one years old, the outgoing and charming Gomez was recognized by his fellow partners as an individual who would almost certainly rise to the upper management ranks of Alexander Grant during his career. Gomez's bright future with Grant, the tenth largest CPA firm in the United States at the time, seemed all the more obvious when he was named the managing partner of the firm's Fort Lauderdale office while he was still in his early thirties. Unfortunately for Gomez, his potential was never realized. In March 1987, Gomez began serving a twelve-year term in a federal prison in Tallahassee, Florida, after pleading guilty to forgery and fraud charges.

Ironically, Gomez's fate was sealed just a few days following his promotion to partner. During a lunch with Alan Novick, an officer of his largest audit client, Gomez was startled by Novick's admission that the client's audited financial statements of the prior two years contained material errors. The client, ESM Government Securities, Inc., a Fort Lauderdale brokerage firm specializing in government securities, had several million dollars in losses that Novick had concealed from Gomez and his subordinates on the ESM audit team. Because the unqualified opinions issued on the ESM financial statements for 1977 and 1978 had been personally authorized by Gomez, Novick warned him that the disclosure of the material errors could jeopardize his career with Alexander Grant. According to Gomez, Novick repeatedly goaded him with comments such as, "It's going to look terrible for you . . . and you just got promoted to partner."¹ Novick maintained that his firm could recoup the losses that had been concealed from

1. M. Brannigan, "Auditor's Downfall Shows a Man Caught in Trap of His Own Making," *Wall Street Journal*, 4 March 1987, 33.

Alexander Grant if Gomez would not withdraw the audit reports issued on the misstated 1977 and 1978 financial statements. If Gomez insisted on withdrawing the audit reports, Novick warned him that ESM would fail and that a number of parties would suffer as a result, including the customers of ESM and Gomez. Eventually, Gomez capitulated to Novick's arguments.²

At the time Novick admitted that ESM's financial condition had been misrepresented, he was apparently aware that Gomez was experiencing considerable financial problems. Although Gomez was earning a sizable salary as a partner of a major CPA firm, that salary was not sufficient to support the affluent life-style he had adopted. After Gomez agreed to remain silent regarding the ESM fraud, Novick offered to help relieve Gomez's financial problems. In November 1979, Novick issued a \$20,000 check to Gomez to cover past due credit card payments. The following year, after Gomez reportedly complained to Novick that his financial condition had worsened again, Novick provided an additional \$60,000. Court records document that over the course of the seven-year ESM fraud, Gomez received approximately \$200,000 from ESM officials.

If Gomez actually believed at the time, as he alleges, that ignoring the fraudulent misrepresentations in the ESM financial statements was the best alternative for all parties concerned, he was wrong. The relatively small unreported losses in the 1977 and 1978 ESM financial statements would grow to collective losses of more than \$300 million by the spring of 1985. Unlike most financial scandals, which adversely affect the stockholders and creditors of one or a few companies, the ESM scandal triggered a series of events that would eventually rock both the national and international financial markets.

ESM's largest customer, Home State Savings, was an Ohio bank that was owed approximately \$145 million by ESM when the latter ceased operations in March 1985. Home State Savings happened to be the largest of the more than seventy banks in Ohio whose deposits were not insured by the Federal Depositary Insurance Corporation. These banks had formed their own private deposit insurance fund into which each paid annual premiums. When Home State collapsed following the closure of ESM, panic-stricken depositors triggered runs on the other privately insured Ohio banks. Within a matter of days, the governor of Ohio decided to close all of the state's privately insured banks while state and federal regulatory authorities worked around the clock to prevent the economic fallout from the ESM scandal from spreading further. The closure of the Ohio banks and a growing loss of consumer confidence in the government securities market destabilized all of the nation's capital markets. At the peak of the crisis, the U.S. dollar plunged 14 percent in value in the international markets in one day as foreign investors became concerned that the entire U.S. banking system might be jeopardized.

2. These are Gomez's personal recollections of his involvement in the ESM scandal. Former colleagues at Alexander Grant maintain that Gomez's account of his involvement with Novick is not totally accurate. For instance, certain of Gomez's former colleagues charge that he was aware of the ESM fraud prior to 1979.

The impact of the ESM scandal was not restricted to the state of Ohio or the financial markets. Besides Home State Savings, the major customers of ESM were municipalities nationwide, which collectively were owed more than \$100 million by the government securities dealer. When the news of the ESM insolvency broke, the credit ratings of these municipalities plummeted, and many were forced to take immediate and drastic measures to remain solvent. One example was the city of Beaumont, Texas, which was forced to lay off approximately 15 percent of its municipal employees following the closure of ESM.

Possibly the most victimized parties in the ESM fraud were Gomez's colleagues, his fellow partners at Alexander Grant. A proud and respected firm nationwide, Alexander Grant suddenly became the focus of intense scrutiny and adverse publicity. The poor judgment of one partner cost the firm much of the credibility and prestige it had earned over its sixty-year history. To date, Alexander Grant, its successor firm, Grant Thornton, and the company that provided malpractice insurance for Alexander Grant have absorbed total legal judgments and out-of-court settlements of \$175 million stemming from the ESM debacle.

HISTORY OF ESM GOVERNMENT SECURITIES

Ronnie Ewton, Bobby Seneca, and George Mead founded ESM Government Securities, Inc., in November 1975 with a total capitalization of \$75,000. The principal line of business of the firm was buying and selling for customer accounts debt securities issued by the federal government and its various agencies. Ewton, who had a long and checkered career with a number of brokerage firms, was the principal executive of ESM. Ewton hired a close friend, Steve Arky, to serve as the firm's legal counsel and Alan Novick, a Wall Street investment banker who was later to corrupt Jose Gomez, to be the firm's principal securities trader.³

In the mid-1970s, the U.S. government securities market was subject to very little regulatory oversight even though it was, and still is today, the largest securities market in the world. The average daily dollar volume of U.S. treasury bills, notes, and bonds is typically twenty to thirty times larger than the daily sales volume of the New York Stock Exchange. In spite of the enormous size of the government securities market, most private investors know very little about it. Until the mid-1970s, large brokerage firms accounted for nearly all of the daily sales volume in government securities. However, the tremendous growth in the national debt during the Carter and Reagan administrations required the U.S. Treasury Department to begin working with so-called secondary dealers to raise the funds necessary to operate the federal government. These secondary dealers are generally small brokerage houses that deal almost exclusively in the trading of federal debt securities for the accounts of small to moderately sized banks and munici-

3. For an excellent and comprehensive history of the ESM scandal, see: D.L. Maggin, *Bankers, Builders, Knaves and Thieves* (Chicago: Contemporary Books, 1989).

palities. Prior to legislation enacted in the late 1980s, these small government securities brokers were subject only to the regulatory oversight of state securities commissions, which tend to be severely underfunded and relatively ineffective as a result.

One of the most intriguing aspects of the government securities markets is the tremendous amount of leverage available to investors. Margin requirements in securities transactions of publicly owned firms typically average 50 percent, meaning that an investor must put up at least one dollar for every two dollars in stock purchased. In the government securities market, the federal government, because of the huge amount of funds it must raise, has established much more liberal margin requirements. For instance, to purchase \$1,000,000 of government securities, an investor may be required to come up with as little as \$10,000, or 1 percent of the total cost of those securities. Because the market value of government securities may move 2 to 3 percent in any one day in response to fractional changes in market interest rates, an investor could easily experience a 200 to 300 percent one-day rate of return, positive or negative, on an initial investment.

The majority of the transactions in which ESM engaged were repurchase agreements, more commonly known as "repos." In a repo transaction, a government securities dealer sells a customer a large block of federal securities and then simultaneously pledges to repurchase the securities at a later date at an agreed-upon price. Of course, the brokerage firm selling the securities hopes that their value will rise over the period of the repurchase agreement, which may be as short as twelve hours (overnight) or as long as twelve months. In substance, a repo transaction is a short-term loan from the customer to the securities dealer. ESM also engaged in a limited number of "reverse repos," in which it purchased government securities from a customer who simultaneously agreed to repurchase the securities at a later date at a predetermined price. In these transactions, ESM was essentially loaning funds to the other party to the transaction.

In repo transactions, it is critical that the purchaser either take physical possession of the government securities or have a bonded third party assume physical possession. If the purchaser does not take physical possession of the securities, an unscrupulous broker could sell them to another customer. Unfortunately, many of the banks and municipalities with which ESM did business were relatively unfamiliar with the government securities market. As a result, these customers naively relied on ESM to retain the securities or asked the brokerage firm to transfer the securities to a segregated account with a trust company for the term of the repurchase agreement. Even when instructed to transfer customer securities to a trust company, ESM often retained the securities or transferred them to a nonsegregated trust account, which allowed ESM officials to use the securities for whatever purpose they chose.

ESM, like many government securities dealers, also engaged in purely speculative transactions on its own behalf, transactions in which such dealers attempt to predict and profit from future changes in open market interest rates. Soon after joining ESM, Novick convinced Ewton and other ESM executives that he could earn millions of dollars in profits for ESM in speculative trades by utilizing the considerable leverage afforded by the small

margin requirements in the government securities market. Unfortunately, Novick was less than proficient in predicting the future movement of interest rates. Over a short period in 1980, Novick lost more than \$80 million when interest rates leaped dramatically a few weeks after he had gambled that they would fall.

The trading losses incurred by Novick in 1980, when coupled with the much smaller pre-1980 trading losses he had rung up, easily wiped out the equity of the three owners of ESM. At this point, the ESM officers could either publicly admit that their firm was bankrupt or employ on a much larger scale a practice they had begun a few years earlier: using (stealing) customer securities for their own benefit. Sadly, Ewton and his colleagues chose the latter alternative. In spite of the fact that ESM was insolvent by 1980, the firm was able to remain in operation for several more years because of the huge sums of cash it acquired in repo transactions with customers. An accountant hired to reconstruct the history of the seven-year ESM scandal noted that cash flow, not profit, was the lifeblood of ESM: "The name of the game was cash flow. It had nothing to do with profit. As long as there was an ability to deliver enough cash, then whether or not the transactions made money was not relevant."⁴ Of course, ESM could sell the same block of federal securities to several different customers, since the majority of its clients did not insist on taking physical possession of the securities. The positive cash flow that ESM was able to maintain because of such fraudulent practices allowed Novick to continue "playing the market" in an increasingly desperate effort to recoup the millions he had gambled away on earlier trades.

ESM's BOOKKEEPING SCAM

One of the most problematic aspects of the ESM fraud for Alan Novick, its principal architect, was how to conceal his firm's insolvent condition from the Alexander Grant audit team that annually examined ESM's financial records. Of course, Novick had developed this scheme prior to the time he informed Gomez of ESM's unreported losses in 1977 and 1978. ESM Government Securities was actually one of several companies that Ewton and his associates had formed. The other companies were shells with no express business purpose and were not audited by Alexander Grant. Novick used these nonoperating entities to hide the huge trading losses of ESM.

Novick devised a bookkeeping scheme to transfer trading losses incurred by ESM to an affiliated company under the ESM corporate umbrella. For each repo or reverse repo that ESM engaged in, Novick would record a "mirror" intercompany transaction. If the actual transaction with a customer was a repo, then the mirror transaction would be a reverse repo, and

4. Unless noted otherwise, this and subsequent quotations were taken from the following source: U.S. Congress, House, Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, *SEC and Corporate Audits, Part 2* (Washington, D.C.: Government Printing Office, 1985).

vice versa. By covering both sides of each transaction, Novick could close out the “losing” side to the unaudited affiliate and close out the profitable side to ESM, ensuring that the latter appeared to be profitable. After this scam had gone on for several years, the cumulative trading losses transferred to the unaudited affiliate resulted in a huge receivable owed to ESM by the affiliate. This huge receivable did not appear explicitly on ESM’s annual balance sheet.⁵ In fact, the only reference to the mirror transactions was an oblique description of them in the footnotes accompanying the annual balance sheet. In 1984, the reference to these transactions was included in footnote D (see Exhibit 1).

Novick also used the unaudited affiliate to conceal the theft of ESM funds that he and his colleagues diverted for their own personal use or diverted to co-conspirators who were officers or employees of major customers of ESM. Many of these co-conspirators established personal trading accounts with ESM, into which Novick dumped millions of dollars of profits from repo and reverse repo transactions. In return, when ESM had a sudden need for additional government securities, these individuals would supply ESM with securities from their own firms’ vaults.⁶ Over the course of the ESM scam, Novick, his colleagues, and their co-conspirators were the beneficiaries of more than \$100,000,000 of ESM funds, which essentially were stolen from the banks and municipalities that were ESM’s major customers. When these defalcations were added to the trading losses incurred by Novick and to the other investment losses of ESM, the net deficit for the corporate ESM group exceeded \$300 million by the spring of 1985.

Two events in late 1984 eventually proved to be the downfall of ESM. First, Novick collapsed and died at his desk of a massive heart attack in November 1984. Novick was in his early forties at the time of his death but had been under immense stress for several years since he had been responsible for the day-to-day operations of the covert aspects of the ESM scam. Ewton and Steve Arky, ESM’s legal counsel, attempted to persuade Gomez to leave Alexander Grant and assume Novick’s position, but Gomez refused. Apparently concerned that the increasingly nervous Gomez might blow the whistle on the entire operation, Ewton transferred \$100,000 to Gomez’s personal ESM account to keep him on board. Second, a major customer demanded in late 1984 that ESM turn over the securities the customer had purchased in a long-term repo transaction, securities that ESM no longer had. Although ESM stalled the customer for months, eventually Ewton realized that the ESM fraud would soon be exposed, resigned from the firm, and retained the services of a criminal defense attorney.

5. Like many financial institutions, ESM prepared and issued only a balance sheet. In fact, ESM was not required by any regulatory body to issue a balance sheet but chose to do so apparently because many of its customers requested an audited balance sheet before they would transact business with the firm.

6. These securities were allegedly collateral for loans that ESM had made earlier to these customers. Court records, however, document that these loans were grossly overcollateralized and that the true purpose of these transfers of securities was simply to perpetuate the ESM fraud.

ESM Government Securities, Inc.
(a wholly-owned subsidiary of ESM Group, Inc.)
STATEMENT OF FINANCIAL CONDITION
December 31, 1984

ASSETS

Cash	\$ 421,000
Deposits with clearing organizations and others (note B)	182,000
Receivable from brokers and dealers (note C)	3,643,000
Receivable from customers (note C)	73,050,000
Securities purchased under agreement to resell (notes A and D)	2,945,953,000
Accrued interest	406,000
Securities purchased not sold—at market (note A)	26,059,000
Due from parent	2,550,000
Other	61,000
	<u>\$3,052,325,000</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Short-term bank loans (note E)	\$ 47,258,000
Payable to brokers and dealers (note C)	12,266,000
Payable to customers	9,304,000
Securities sold under agreement to repurchase (notes A and D)	2,945,953,000
Accounts payable and accrued expenses	799,000
Commitment and contingencies (notes F and G)	
Stockholders' Equity	
Common stock—authorized, issued and outstanding 500 shares of \$1.00	1,000
Additional contributed capital	4,160,000
Retained earnings	32,584,000
	<u>\$3,052,325,000</u>

The accompanying notes are an integral part of this statement.

NOTES TO STATEMENT OF FINANCIAL CONDITION
December 31, 1984

NOTE A—SIGNIFICANT ACCOUNTING POLICIES

A summary of the significant accounting policies applied in the preparation of the financial statements follows.

Security Transactions

Security transactions are recorded on a settlement date basis, generally the first business day following the transaction date.

Purchases of securities under agreements to resell and sales of securities under agreements to repurchase are considered financing transactions and represent the amount of purchases and sales which will be resold or reacquired at amounts specified in the respective agreements.

EXHIBIT 1
ESM's 1984 Balance Sheet and
Accompanying Footnotes

Exhibit continued on next page

EXHIBIT 1—Cont'd
ESM's 1984 Balance Sheet and
Accompanying Footnotes

NOTE A—SIGNIFICANT ACCOUNTING POLICIES—Continued

Securities Purchased, Not Sold

Securities inventory, which consists of marketable federal government or government agency securities, is carried at market value.

Furniture and Equipment

Furniture and equipment are stated at cost. Depreciation is provided in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives, principally on a straight-line basis over 5 years.

Income Taxes

The company participates in the filing of a consolidated income tax return with its parent. Any tax liability of the affiliated group is allocated to each member company based on its contribution to taxable income.

NOTE B—DEPOSITS WITH CLEARING ORGANIZATIONS AND OTHERS

The company has deposits of cash and securities with commodity brokers to meet margin requirements. The company also has cash escrow deposits with its securities clearing agent.

NOTE C—BROKER, DEALER AND CUSTOMER ACCOUNTS

Receivables from brokers, dealers and customers at December 31, 1984, include outstanding securities failed to deliver. Payables to brokers, dealers and customers at December 31, 1984, include outstanding securities failed to receive. "Fails," all of which have been outstanding less than 30 days, represent the contract value of securities which have not been received or delivered by settlement date. Fails to receive and fails to deliver from brokers and customers were \$7,291,426 and \$9,993,081 respectively at December 31, 1984.

NOTE D—SECURITY TRANSACTIONS

The company entered into repurchase and resale agreements with customers whereby specific securities are sold or purchased for short durations of time. These agreements cover securities, the rights to which are usually acquired through similar purchase/resale agreements. The company has agreements with an affiliated company for securities purchased under agreements to resell amounting to approxi-

AUDIT ISSUES RAISED BY THE ESM DEBACLE

On February 28, 1985, Alexander Grant issued its final opinion on the financial statements of ESM Government Securities (see Exhibit 2). Less than twenty-four hours later, after Gomez admitted his involvement in the ESM scam to fellow partners, Alexander Grant hastily announced that it had withdrawn the unqualified opinion, stating that the opinion could no longer be relied upon. After learning of Grant's withdrawal of its audit report, an attorney for Home State Savings (which was owed approximately \$145,000,000 by ESM) flew to Fort Lauderdale and demanded that ESM officials explain why the audit report had been rescinded. By this point, Ewton was nowhere to be found. Two of his subordinates referred the

mately \$1,621,481,000 and securities sold under agreements to repurchase amounting to approximately \$1,324,472,000 at December 31, 1984. Accrued interest receivable from and payable to the affiliated company at year end were \$11,174,000 and \$64,410,000 respectively.

NOTE E—SHORT-TERM BANK LOANS

Short-term bank loans at December 31, 1984 are collateralized by securities purchased not sold.

NOTE F—RELATED PARTY TRANSACTIONS

Certain common expenses paid by the parent company, including depreciation, are allocated to the subsidiary companies based on transaction volume. The company paid a dividend of \$10,000,000 to its parent company as of December 31, 1984. The company occupies premises leased by the parent company from a partnership of which one of the officers is a partner. Rent expense paid the partnership amounted to \$112,000 for the year ended December 31, 1984 (note G).

NOTE G—COMMITMENTS

The company conducts its operations in leased facilities under noncancellable operating leases expiring at various dates through 2010. The minimum lease payment for one location has been calculated based on current transaction volume (note F) under a 30 year lease. The minimum rental commitments under the operating lease are as follows:

Year ended December 31,	
1985	\$ 162,900
1986	162,900
1987	141,900
1988	112,400
1989	112,400
1990 and thereafter	2,332,400
	<u>\$3,024,900</u>

Rental expense charged to operations approximated \$137,000 for the year ended December 31, 1984.

EXHIBIT 1—Cont'd ESM's 1984 Balance Sheet and Accompanying Footnotes

Home State attorney to an attorney that ESM had retained a few weeks earlier, following the resignation of Steve Arky. The two attorneys then contacted a local accountant and asked the latter to meet them at ESM headquarters the following morning. By midmorning on March 2, 1985, only two hours after the accountant first obtained the ESM records, he informed the attorneys that ESM was insolvent by at least \$200 million.

The congressional subcommittee that investigated the ESM scandal was shocked that such a massive fraud could be detected in a matter of hours when Alexander Grant had failed to detect the scam over a period of seven years. Members of the subcommittee insisted that at least some of Gomez's forty colleagues and subordinates who worked on the ESM audit engagements must have been aware of the fraudulent scheme; however, no other Alexander Grant auditors were ever criminally indicted in

EXHIBIT 2
Alexander Grant's Audit Report
on ESM's 1984 Balance Sheet

[Note: This audit report appeared on the letterhead of Alexander Grant & Company.]

Board of Directors
ESM Government Securities, Inc.

We have examined the statement of financial condition of ESM Government Securities, Inc. (a Florida corporation and wholly-owned subsidiary of ESM Group, Inc.) as of December 31, 1984. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statement referred to above presents fairly the financial condition of ESM Government Securities, Inc. at December 31, 1984 in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Alexander Grant & Company
[signed]

Fort Lauderdale, Florida
January 30, 1985

the case.⁷ In a subsequent civil suit, Gomez testified that little effort had been required on his part to divert the attention of his subordinates away from the fraudulent sections of the ESM financial records: "I thought about when my own audit people would come up with questions that I wouldn't be able to answer without forcing me to lie extensively. That never happened."⁸

The accountant who uncovered the ESM fraud on March 2, 1985, did not unravel the thousands of intercompany transactions that Novick had used to conceal the firm's trading losses and defalcations by employees. Instead, the accountant happened to compare the firm's audited balance sheets with the corporate tax returns filed for the ESM consolidated entity. Because the ESM executives did not want to pay federal taxes on the profitable securities trades diverted to ESM Government Securities, they had instructed the firm's tax accountant from Alexander Grant to prepare a consolidated tax return for the ESM corporate group. Over the period of the fraud, these corporate tax returns clearly demonstrated that the collective ESM operation was consistently losing tens of millions of dollars each year. An attorney in the law firm appointed as ESM's receiver noted that the scam was immediately obvious when the tax returns and audited balance sheets were

7. However, one individual on the tax staff of Alexander Grant did notice a payment in the ESM records that had been made to Gomez. Rather than bringing this matter to the attention of other partners, this individual took it directly to Gomez. Apparently, Gomez was able to fabricate an explanation for the payment that satisfied the individual.

8. Maggin, *Bankers, Builders, Knaves and Thieves*, 215.

compared: "It's incredible because it's so plain. It did not take detective work to find this. You just compare the reported balance sheets and the tax returns and you see the whole thing."⁹

The congressional subcommittee queried expert witnesses in the ESM hearings at length regarding the complex maze of intercompany transactions that Novick used to conceal the huge ESM deficits. The subcommittee members were particularly concerned that Alexander Grant had apparently failed to audit these transactions thoroughly.

MR. TEW [attorney for ESM receiver]: . . . it is critical that auditors inspect interrelated or affiliated transactions, because [in such cases] the client is booking entries with itself. If you can book an entry with yourself, you can commit a massive fraud.

CONGRESSMAN DINGELL: And control both entries?

MR. TEW: Yes, sir. You have it on both sides. You can do what you want. If this company [ESM Government Securities] lost money on a term repo, they would record a reverse repo or a mirror transaction, and move the loss up to the parent company.

Another insightful question posed by the congressional subcommittee dealt with why neither ESM's auditors nor auditors of clients of ESM discovered the constant shortage of securities that was one result of Novick's fraudulent scheme. It seemed apparent to members of the subcommittee that the most basic audit procedures should have uncovered this shortage.

MR. TEW: . . . the first thing you do, one of the first and simplest things, is to do a box count of the securities or confirm that the actual securities are in the possession of the custodian.

CONGRESSMAN DINGELL: To make sure these securities and assets are a) what they purport to be; and b) are physically in the place that they are supposed to be; and c) are in the custody of the people in whose custody they are supposed to be. Isn't that right?

MR. TEW: Correct on all counts. The fundamental confirmation technique is to cover all the issues you just raised.

Auditors of major customers of ESM testified that they had performed confirmation procedures. Unfortunately, in most cases, they had directed their confirmations to Jose Gomez. This testimony incensed Representative Ron Wyden, who was the most severe critic of the auditors involved in the ESM case:

The auditors tell us that they had no choice but to rely on second-party confirmations—in this case, the word of Mr. Gomez—that the collateral for these large loans did exist and did adequately secure their clients' interest. What disturbs me is that the system literally breeds this kind of buck-passing. If the auditors went as far as the system and the rules of their profession require in confirming the collateral, any reasonable person would conclude that once again the auditing system has failed . . . it is my view that the only watchdogs throughout this sorry

9. J. Sterngold, "ESM's Auditor Is Sued." *New York Times*, 16 March 1985, 30.

spectacle were either asleep, forgot how to bark, or were taking handouts from the burglars.

Several of the congressmen were also confused as to why the audit review process of Alexander Grant had failed to uncover the fraud. In particular, representatives of Alexander Grant were questioned regarding the failure of their firm's review process to disclose the obvious contradiction in the ESM financial statements and the ESM tax returns.

CONGRESSMAN LUKEN: What is your [review] system?

MR. KLECKNER [managing partner of Grant Thornton, the successor firm to Alexander Grant & Company]: Every report that is issued by an office is required to receive what we call a basic review within that office. In certain circumstances, the report is required to receive what we call an in-depth review, and in other circumstances, a report is required to receive what we call a technical review, which normally involves people from outside that office.

CONGRESSMAN LUKEN: Would you say that the review system has broken down rather badly here since you say that Mr. Gomez passed the review system?

MR. KLECKNER: I think it's a key question.

CONGRESSMAN SIKORSKI: Can rendering an inaccurate audit opinion be the fault of only one person under your firm's quality control procedure?

MR. KLECKNER: I think it really depends upon the degree and the nature of the manipulation that was taking place.

CONGRESSMAN SIKORSKI: Well, your system allows that manipulation.

MR. KLECKNER: The system is based on a fundamental assumption. The fundamental assumption is that the audit partner is honest.

CONGRESSMAN SIKORSKI: That's right. What kind of system do you have set up to catch dishonest people?

MR. KLECKNER: I would have to admit that I don't think our system starts out to try to question the honesty and integrity of each partner.

In a subsequent court case, testimony obtained by a plaintiff attorney further disparaged the audit review process of Alexander Grant: "Garcia-Pedrosa [plaintiff counsel] got a review partner to admit that he only made cursory investigations of Gomez's ESM workpapers from 1977 to 1982. And there was no refutation of Jose Gomez's testimony that another review partner said, 'I don't understand this s____, so please tell me it's okay and I'll sign it.' " ¹⁰

Congressman John Dingell, the chairman of the congressional subcommittee that investigated the ESM fraud, asked the accountant hired by the firm's receiver to identify the key red flags that should have alerted Alexander Grant auditors that something was wrong at ESM. The first warning signal was the magnitude of the intercompany transactions taking place

10. Maggin, *Bankers, Builders, Knaves and Thieves*, 215.

between ESM and its affiliates. Even more important than the size of these transactions was the lack of an underlying business purpose for them. The inability of the Alexander Grant auditors to follow these huge and suspicious intercompany transactions from "cradle to grave," since the other party to the transactions was an unaudited affiliate of ESM, could easily have been considered a material limitation on the scope of the ESM audits. Ironically, the intercompany scheme utilized by Novick to hide the ESM losses was very similar to the bookkeeping scams used in several classic audit failures in the past, including Continental Vending, Equity Funding, and Drysdale Securities.

Another warning signal that should have raised questions in the minds of Alexander Grant auditors was the exorbitant life-styles that the officers of ESM adopted and flaunted over the short history of their firm. As an example, Exhibit 3 lists the personal assets of Ewton that a bankruptcy judge froze following the collapse of ESM.

Possibly the most important red flag of all was the personal background of ESM's chief executive, Ronnie Ewton. A thorough background investigation of Ewton would have disclosed a number of suspicious incidents in his past. In 1973, Ewton had been censured by the National Association of Securities Dealers, and two of his associates in a pre-ESM brokerage firm

Asset	Estimated Value (net of any mortgage balance)
Residence in Boca Raton, Fla.	\$1,650,000
Residence in Greenwich, Conn.	330,000
5,600-acre horse farm in Aiken, S.C.	Unknown
Polo pony stable and 17 horses	700,000
House and two vacant lots in Boone, N.C.	Unknown
Boat slip in Key Largo, Fla.	Unknown
House and 57 acres in Aiken, S.C.	Unknown
One-fifteenth ownership interest in Hounds Lake Country Club in Aiken, S.C.	Unknown
Five lots in Elk River Country Club in Linville, N.C.	Unknown
One Aston Martin Laconda (automobile)	151,000
One 1984 Chevrolet Corvette	20,000
One Mercedes-Benz, one Cadillac, one Toyota, and several jeeps and trucks	Unknown
70-foot yacht	1,350,000
Partnership interest in horse-breeding operation	Unknown
Account with Provident Securities	400,000
Letter of credit held by Provident Bank	200,000
Partnership interest in 5,600 acres of property in Jasper, Tenn.	Unknown
Partnership interest in Colee Hammock Building	200,000
Mortgages receivable	1,995,279
Partnership interest in Tampa Bay Bandits professional sports franchise	Unknown
Partnership interest in S-J Minerals Partnership	Unknown
Numerous partnership interests in oil and gas ventures and coal-mining projects	Unknown

EXHIBIT 3
Personal Assets of Ronnie Ewton Frozen by Bankruptcy Court Order