Chapter 1

Case 1: External Financial Reporting

Learning objectives

- Determine relevant fraud risks relating to management override in a fictitious government.
- Identify how management override of internal controls can lead to possible fraudulent financial reporting in a fictitious government.

Before we start

This case involves compliance with bond covenants on an interim and annual basis and reporting required information to rating agencies, trustees, and other oversight entities. Because noncompliance with bond covenants could have a material effect on a government's financial statements, it may be considered a significant risk area. Additionally, the potential for management to override existing controls to manipulate financial and operational information to be in compliance with bond covenants might lead the auditor to identify this as a fraud risk area.

Management override is an area of concern for auditors because management may be able to easily access data and systems. In addition, employees may be reluctant to discuss management abuses during the auditor's fraud inquiry procedures. Management override most often occurs in the following areas:

- Journal entries
- Estimates
- Business rationale for transactions
  - Bribes and kickbacks
  - Billing schemes

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA *Professional Standards*), states the auditor should obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Fraud risk factors are events or conditions that

- indicate an incentive or pressure to perpetrate fraud,
- provide an opportunity to commit fraud, or
- indicate attitudes or rationalizations to justify a fraudulent action.

In all areas of the audit, the auditor is responsible for maintaining professional skepticism, which requires an ongoing questioning of whether the information and audit evidence obtained suggests a material misstatement due to fraud may exist. The characteristics of skepticism may help auditors better understand this concept of professional skepticism.

Characteristics of skepticism include the following:

- Questioning mind. Be disposed to inquiry with some sense of doubt.
- Suspension of judgment. Do not pass judgment until appropriate evidence is obtained.
- Search for knowledge. Investigate beyond the obvious with a desire to corroborate.
- Interpersonal understanding. Motivations and perceptions can lead to biased or misleading information (or both).
- Autonomy. Maintain self-direction, moral independence, and the conviction to decide for oneself.
- Self-esteem. Maintain self-confidence to resist persuasion and to challenge assumptions.

Knowledge check

1. Which is not an area in which management override may occur?

   a. Billing schemes.
   b. Journal entries.
   c. Estimates.
   d. Price fixing between two vendors.

Background

Jackson City[1] is a full service, medium-sized city in the west with a relatively small full-time population and a significantly greater population throughout the summer and winter seasons. In the last 40 years the city has grown significantly due to the increased popularity of its ski resorts and enhancement of area state and national parks. Although it is a medium-sized city, Jackson City is one of the larger cities in the state.

To continue to make the city attractive to the ski and hospitality industries, the city council approved issuance of utility revenue bonds to construct a $100m nuclear power plant. Due to the harsh winter storms impacting the city every year, increasing electric power reliability was of great concern to area residents and businesses. The plant was expected to increase the reliability of electric power to citizens as well as the ski resorts, hotels, restaurants, and entertainment venues. As part of the plan to finance the debt service and subsequent operation of the power plant, the city anticipated selling capacity in the plant to the county and other neighboring cities.

When the bonds were issued five years ago,[2] the county (through an interlocal agreement with the city) agreed to purchase up to 30% of the plant's capacity over the following 10 years. In addition, two neighboring cities were interested in purchasing capacity at some point in the future. Debt service requirements were structured to ensure no principal payments were required until one full year after construction of the plant, which occurred two years ago. Principal requirements in the first two years of operations were at reduced amounts and at level amounts for the remaining 28 years of the bond life. Interest incurred during construction was capitalized in accordance with the requirements of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements.* For the last three years, interest expense has been recognized.

Over the last five years, commercial growth in the city has been rapid while the growth in the permanent population has been slower than anticipated. Unfortunately, the county's population and economic growth over the last five years has not occurred at the level anticipated. To date, the county has purchased only 5% of the plant's capacity and it is uncertain when, or if, the county will purchase the remaining 25% of their committed capacity. Under the bond agreement, proceeds from sales of capacity

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[1] All organization names used are purely fictitious as are the individuals depicted therein. Any similarity to real organizations or persons is purely coincidental.

[2] The Governmental Accounting Standards Board (GASB) issued Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*, in June 2018. Under the requirements of the statement, interest costs incurred during construction are expensed in the financial statements prepared using the economic resources measurement focus. This statement is applied prospectively and is effective for periods beginning after December 15, 2019. In this case, the power plant was constructed prior to the issuance of Statement No. 89 and the interest costs incurred during construction are properly capitalized as part of the cost of the related capital asset (under the requirements of GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*).

are required to be deposited into a debt service reserve fund and used to fund principal payments during the last 10 years the bonds are outstanding.

Knowledge check

2. Which is accurate of Jackson City?

    a. Jackson City is a full service, medium-sized city.
    b. The city has grown rapidly over the last 20 years.
    c. Jackson City is one of the smaller cities in the state.
    d. Jackson City issued bonds to construct a new water treatment facility.

The city and the trustee for the bonds entered into a number of covenants with respect to the utility revenue bonds. Should any of the covenants be violated, the bonds may be called by the trustee. Specific relevant covenants are illustrated in the following list:

Jackson City Utility Revenue Bond Covenants
Annual assessment (post-construction) of utility rates to ensure coverage of the required debt service ratio
Imposition of increased utility rates should the annual rate assessment indicate current rates will be insufficient to ensure coverage of the required debt service ratio
External rate analysis to be performed every five years (beginning in the fifth year of operations) by a qualified engineering or electric utility consulting firm
Maintenance of an average annual collection rate of 95 percent of commercial billings and 90 percent of residential billings
Maintenance of utility billing receivables aging at 80 percent due in 30 days, 10 percent due in 60 days, 5 percent due in 90 days, and 5 percent due in over 90 days
Annual actual debt service coverage ratio, based on amounts in the audited financial statements, of at least 1.15 throughout the term of the bonds
Adequate general liability and property insurance (including replacement value) covering plant and equipment
Proper maintenance of the plant and equipment
Conduct all inspections of the plant and equipment as required by relevant federal and state laws governing nuclear power plants.
Annual audited financial statements prepared using generally accepted accounting principles (GAAP)

Jackson City
Utility Revenue Bond Covenants (continued)

Quarterly reporting, including quarter and year-to-date

- monthly billings by customer type;
- monthly collections by customer type;
- aging of receivables by 30, 60, 90, and over 90 days.
- certificate of insurance for the plant and equipment;
- certificates for inspections performed;
- internal and external rate analyses performed; and,
- amounts spent to maintain the plant and equipment.

For the first two years of operations, the city was able to project revenues adequate to cover operating costs and debt service requirements. Amounts due for required principal payments increase in the current year and the internal rate analysis indicated the city should raise rates an average of 10% to meet the required debt service ratio.

The case

The following exchange occurs between the city's finance director, Michael Lee, and the accounting manager, Brandon Scott.

"Brandon, when do you think you will have the electric utility rate analysis finished? We are coming up on the beginning of the budget process and I want to make sure we don't need to be talking about a rate increase. I'm not sure the Chamber of Commerce or the Economic Development Commission would be happy to hear we need to raise utility rates."

"Michael, I have good news and bad news for you. Which do you want first?"

"Let's have the good news first. It's Monday and I don't want the first thing I hear at the office today to be bad news."

"Well, the good news is I knew we were coming up on the budget cycle and I spent the better part of last week on the rate analysis. The bad news is, it looks like we need to raise rates about 10% across the board."

"Wait, I don't understand why we need to raise rates much less as much as 10%. What's causing the increase?"

"Remember the bond agreement allowed for lower principal payments the first two years the plant was operational but then increased them significantly in the third and following years? It's the increase in the principal requirements, making the rate increase necessary."

"I guess with everything else going on I forgot about the increased principal payments kicking in next year. Send me your files and I will go over what you've done to see if there is any tweaking we can do."

“When are you going to give the bad news to our esteemed city manager?”

“I don’t think it’s necessary to say anything to John at this point. Let me see what your numbers look like before we go crying ‘fire’ to him.”

Michael looks over Brandon’s rate analysis during the following week and finds it to be well done and reasonable. The following exchange between Michael and John Rogers, city manager, occurs a week after Michael has finished his review of the rate analysis.

“Hey, John do you have a few minutes? I need to discuss something with you that might impact our budget process this year.”

“Sure Michael, come on into my office and tell me what the issue is.”

“Well, we’ve done our annual utility rate analysis and it looks like we will need to increase our rates about 10% to meet the debt service coverage ratio. You may recall the principal payments increase significantly next year and this is affecting the coverage calculation.”

“Michael, there is no way I can send a rate increase request to the council this year. They aren’t too happy with my performance right now and the nail in my coffin might be this increase in utility rates you think we need.”

“John, I can appreciate the position you are in but I don’t simply ‘think’ we need a rate increase. The analysis is solid and the additional revenue is needed to cover the increased principal requirements. This is not something we can ignore.”

“Well, Michael, I guess this means you will have to find a way to make the numbers work because I will not be taking a rate increase request to the council this year.”

Michael returns to his office where he finds Brandon waiting for him.

“I can tell by the look on your face and the clenched fists that things must not have gone well with John.”

“Yeah, Brandon, I guess you could say that. He let me know in no uncertain terms he will not take a rate increase to the council this year and I will have to make the numbers work. Your work on the analysis was great by the way. There wasn’t anything you omitted even though I wish you had forgotten about the increased principal requirements.”

“Thanks, Michael. Let me know if there is anything I can do to help with this.”

“Sure thing, Brandon. Hey, I don’t recall seeing the county’s capacity payment in your analysis. Maybe it could be the thing we need to spin the numbers in our favor.”

“Well, I don’t think we can because the debt agreement requires us to put capacity payments in a debt service reserve.”

“Darn, I forgot about the reserve requirement. Anyway, you still did a great job, Brandon.”

After Brandon leaves his office, Michael continues to think about the county's capacity payment and if it would affect Brandon's rate analysis.

"Note to self, run Brandon's numbers with the county's capacity payment and see if it makes the numbers work."

A few days later, Brandon meets with Michael to go over the draft of the quarterly reports to the bond trustee and the rating agencies.

"Michael, I hate to be the bearer of bad news again but we have an issue with the accounts receivable aging for the plant revenues."

"You know, Brandon, if your father wasn't one of my fraternity brothers I'm not sure I would like you at this very minute. Just kidding—your job is safe regardless of what bad news you bear."

"Uh, thanks, Michael."

"All right, tell me about this aging issue we seem to have."

"Everyone in the city knows the big timeshare resort out at the base of the mountain is having some cash flow problems because of the big expansion they did a few years ago. Apparently, their cash flow issues are resulting in more than staff layoffs and reduced hours in the restaurants and bars. Until six months ago, they were paying their utility bills by the due date but their payments have been later and later over the last six months. They are one of our largest customers and their late payments are affecting the 30-day receivables."

"Well, Brandon this is an issue. How far off are we from the required ratios?"

"The 30-day receivables for the quarter are only at 70% and the 60-day accounts are at 20%. I guess the resort doesn't want us to cut off their power because they have managed to pay us within the 60-day cutoff period."

"Thank goodness for small miracles, I guess. Do you still keep these files on the departmental server, Brandon? I'd like to go through things before I sign off on sending the reports to the rating agencies and trustee."

"Yes, the files are still on the server. Let me know if you have any questions or need any help with things."

"Sure thing, Brandon."

The next evening, Michael works late to review the quarterly reports and underlying information. Muttering to himself, Michael says:

"There has to be something I can do to these numbers to make them work. Wait a minute, all I need is the 30-day balances to be 80% of receivables. Let's see, I could increase the 30-day accounts or decrease the 60-day and over accounts or a little bit of both. What makes more sense and is something eagle eye Brandon won't notice? I've got it!"

Michael goes into the utility billing system and writes off several larger 90-day and over 90-day customer balances on accounts where the post office has returned the bills to the city as undeliverable. He reruns the aging reports, but these changes do not bring the 30-day accounts to 80%. Still muttering, Michael says:

"I can't really write off any many more accounts because there are no more 'missing' customers. How can I get current account balances in a fully integrated utility billing system? This may sound crazy but what if I set up new customers and then do manual current period bills for them? No, Brandon would notice the increased amounts in a heartbeat. Maybe . . . yes, this will work!"

Michael uses the manual billing option to recreate the resort's bill for the prior month as a current month bill. To avoid a duplicate bill, Michael uses the manual override function to delete the resort's original bill for the prior month. Doing this does not affect the revenue and receivable balances in the control accounts but it does in effect reclassify the resort's prior month bill as a 30-day receivable. Michael reruns the aging reports and the aging is in line with the amounts specified in the bond covenants. He prints hard copies of the aging report for inclusion in the quarterly bond reporting package.

The next morning Brandon sees a haggard looking Michael in the break room.

"Mornin', Michael. It looks like you had a late night. I hope you had a good time."

"Not hardly. I was here late last night working on the aging issue you dumped on me yesterday. It was all for the good as I waved my magic wand and was able to get things where they need to be for the quarter. By the way, I transmitted the e-copy of the reporting package last night and dropped off the hard copies at the Post Office on my way in this morning."

"Wow, I'm not sure what you did but I hope it wasn't illegal! Just kidding."

"Don't worry, Brandon. Everything was on the up-and-up, which is why I get the big bucks."

John Rogers, the city manager, walks in and sees Michael and Brandon talking.

"I sure hope you two are talking about the rate analysis numbers. Michael, when can we talk about this again?"

"I've got some time right now if you want to hear my good news."

"Great! I've got two calls with council members right now but I should be finished with them in an hour. I'll stop by your office when I finish, if this works for you."

"I'll see you in an hour then, John."

Brandon looks at Michael in disbelief and says:

"What did I miss in the analysis? You told me it was great. I realize John wasn't going to support a rate increase next year but I don't know how he can avoid it based on the analysis."

"Brandon, there are times when you have to get creative and be a little flexible and this is one of those times. Follow me to my office and I'll explain things."

A few minutes later Michael is telling Brandon about the changes he made to the rate analysis.

“All right, Brandon, what I am about to tell you stays in this room. First thing I did was eliminate the capitalized interest we had on the books because GASB Statement No. 89 eliminates it for proprietary funds. This means it will decrease our amortization expense going forward, which creates a positive impact on the rate analysis.”

“Wait a minute, Michael, the requirements in Statement No. 89 are to be applied prospectively, which means we won’t be able to eliminate what we have on the books now.”

“Potato, potahto. Do you think anyone will really even know the standards have changed much less as to how? Whether you agree or not, I’m eliminating the capitalized interest for purposes of the rate analysis. It’s only a rate analysis for goodness sake! I’m not sure I want to tell you about the other assumption I made since you don’t seem to agree with my interpretation of Statement No. 89.”

“It’s all right, Michael. Everyone is entitled to their opinion. Go ahead and finish telling me what you did.”

“You know how the bond agreement requires us to deposit any capacity payments in the debt service fund? Well, since the purpose of the rate analysis is to determine if current rates are sufficient to meet the debt service ratio, I decided to cast the analysis using the cash basis rather than the accrual basis. By using this approach, I can justify using the capacity payments as ‘cash’ available for debt service. Using this approach, the numbers tell a totally different story than yours do.”

“Michael, while I can admire your creativity, I cannot agree with using the cash approach for the rate analysis. The reason for the annual rate analysis is also to ensure current rates will provide sufficient revenues to meet the coverage ratio at the end of the year. The bond agreement requires the annual debt service coverage ratio be based on the audited GAAP financial statements. Using the cash basis for the rate analysis apparently eliminates the need for a rate increase but it won’t help us at the end of the year if we don’t meet the coverage ratio. Do you really want to risk defaulting on the bonds next year?”

Looking straight at Brandon, Michael says:

“Let me explain the org chart to you, Brandon. You are the accounting manager, not the finance director, and the buck does not stop with you; it stops with me.

“But Michael, you accessed the rate analysis last and it will have your electronic signature on it.”

“No, Brandon, it won’t because I accessed it using your login and password. You shouldn’t keep that password book in your top desk drawer. By the way, if you mention this conversion to anyone and I am asked about it later, I will deny this conversation. I will also put full responsibility for the rate analysis totally on you and simply cop to not having reviewed it as well as I should have. While I may suffer some reputational damage and lose credibility with the council and John, you *will* lose your job.”

“You’re kidding me, right? I am so out of here.”

Knowledge check

3. Which is accurate of Jackson City?

    a. The city and the trustee for the bonds entered into two covenants with respect to the utility revenue bonds.
    b. Should any of the covenants related to the utility bonds be violated, the bonds may be called by the trustee.
    c. The city is not required to have audited financial statements.
    d. The accounting manager manipulated utility billing and collection records in the current year in order to meet bond covenants.

Exercises

1. Do any of the situations described in this case study represent fraud? If so, what situations and how did they occur?

2. What preliminary audit procedures might have detected this situation?

3. What other audit procedures might have detected this situation?

4. If you were the auditor and discovered this situation, would you communicate this situation to others? If so, to whom? How might this situation affect any planned reliance on internal controls?