

THE US SEC'S CASE AGAINST NATIONAL CENTURY FINANCIAL ENTERPRISES' AUDITORS: THE DANGER IN USING MANAGEMENT REPRESENTATIONS AS SUFFICIENT APPROPRIATE AUDIT EVIDENCE

Kim Capriotti

*Davis College of Business
Jacksonville University
Jacksonville, Florida
USA*

Jill M. D'Aquila

*Davis College of Business
Jacksonville University
Jacksonville, Florida
USA*

INTRODUCTION

Deloitte & Touche, LLP performed annual audits of National Century Financial Enterprises, Inc.'s (NCFE)¹ financial statements from 1999 through 2001. Robert Harbrecht was the audit engagement partner and Brian Spires was the audit engagement manager. NCFE, a private healthcare finance company in the United States, used subsidiaries to issue a note offering to private institutional investors. Trust indentures required NCFE to use the note proceeds to purchase healthcare receivables specific to patients. It was important that NCFE use the proceeds to purchase only high quality healthcare receivables from highly rated providers, such as insurance companies,

¹The enforcement release issued by the Securities and Exchange Commission (SEC) provided the background for this case. Unless indicated otherwise, information in this case is drawn from the following source: Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 2720* (September 19, 2007).

since the note offerings were an asset backed security. This restriction on the use of the note proceeds helped to safeguard these note holders' investments. Harbrecht signed the 2000 unqualified auditor's report based on NCFE's financial statements. This case addresses three areas relating to the 2000 audit: (1) existence of accounts receivable, (2) valuation of accounts receivable, and (3) required disclosures.

Existence of Accounts Receivable

Harbrecht and Spires audited NCFE's 2000 accounts receivable balance with limited substantive procedures, even though accounts receivable was 81% of total assets. The auditors justified reducing the substantive procedures by relying on the internal controls in that area. The auditors gained an understanding of the internal controls relating to payments to and from third parties by making inquiries to management as to the operation of the controls and observing these controls. They performed a walkthrough of the control environment and had discussions with senior and middle management. Thus, the auditors obtained an understanding of the design of controls. Harbrecht and Spires relied primarily on management representation regarding the effectiveness of internal controls in processing payments to and from third parties. Since Harbrecht and Spires were satisfied with this evidence, they chose not to corroborate this information.

NCFE has three accounting systems: 1) the general ledger; 2) the servicing department's system that contained all patient specific healthcare receivable information; and 3) the funding department's system that tracked amounts funded to providers. Theoretically, all three systems should include the same receivables. NCFE provided the auditors with reconciliations for all three accounting systems. NCFE did not reveal any inequity to the auditors. The auditors chose to confirm the accounts receivable balance by sampling from the funding department's accounting system. As a result, the auditors tested reconciliations between the funding department's accounting system and the general ledger. Any loans secured by collateral other than healthcare receivables would appear in the funding department's accounting system without corresponding data in the servicing department's accounting system.

Valuation of Accounts Receivable

The auditors mailed confirmations which requested the recipient to confirm the total amount funded to providers. The auditors believed that total amounts funded to the providers included only healthcare receivables specific to patients, as per trust indenture requirements.

The auditors obtained schedules which NCFE prepared that disclosed advances to some providers not permitted by trust indenture requirements. These advances appeared in the funding department's accounting system without corresponding patient specific data in the servicing department's accounting system. In addition, the auditors did not realize that the largest reconciling item the client disclosed in the schedules was one line entitled "Accounts Over/(Under)Advanced to Seller". NCFE over-advanced amounts to one provider in excess of \$200 million.

More than one-half of the 2000 accounts receivable balance was comprised of advances to related parties. Most of the related parties were insolvent and, thus, unable to repay their loans. Harbrecht and Spires relied primarily on management representations concerning the related parties. NCFE did not reveal this information to the auditors.

Harbrecht and Spires attempted to corroborate management's representation by requesting that NCFE provide a consolidated aging schedule, as outlined in the audit program. This aging would have been instrumental to the auditors in arriving at their own independent estimate of the allowance account. NCFE was unable to provide this schedule. The auditors chose not to perform additional analysis on the aging, review evidence relating to delinquent accounts or perform other alternative procedures. In fact, NCFE had furnished to the auditors schedules detailing account activity by provider.

Based on management's representations, Harbrecht and Spires concluded that NCFE had a low risk of credit and collection losses. In reality, NCFE had substantial difficulty collecting from providers since many providers were financially distressed. In fact, NCFE sometimes waited more than one year to collect amounts. These collection difficulties caused NCFE to reclassify \$110 million of accounts receivable to notes receivable.

Required Disclosures

NCFE had three related parties consisting of customers who were financially distressed and were receiving unsecured loans from NCFE to fund their operating losses. These three related parties represented approximately one-half of NCFE's business. Furthermore, approximately 46% of NCFE's receivable portfolio consisted of these three related parties. NCFE provided the auditors with a schedule of related parties. The auditors evaluated these transactions, but didn't fully understand the nature and business purpose. The auditors did not realize that NCFE was continuing to deal with these parties despite lack of collection, as well as the fact that these advances were not permitted by trust indenture requirements.

NCFE did not disclose in the financial statements the related parties or the trust indenture violations. The auditors had actually identified trust indenture violations as an area requiring heightened audit attention. The auditors relied on client prepared reports which indicated that NCFE had been meeting these requirements. NCFE's investor reports, however, would have revealed that NCFE was not in compliance with trust indenture requirements. NCFE was required to maintain cash reserves and eligible receivables equal to at least 111% of the amounts of notes outstanding. Since NCFE violated this requirement, they risked immediate liquidation and repayment of the notes. NCFE did not reveal this information in the financial statements.

QUESTIONS

1. INTERNAL CONTROL

Question: In this particular case, the auditors relied on internal controls relating to processing payments to and from third parties. As a result, they reduced substantive procedures in this area.

1. Obtain PCAOB Standard #5 and briefly explain the required procedures for auditors when they intend to place reliance on internal controls.
2. Explain whether or not the inquiry and observation in this case was sufficient in testing the design effectiveness or operating effectiveness of internal controls relating to processing payments to and from third parties. If not, provide examples of other types of procedures that should be used.

2. FINANCIAL STATEMENT ASSERTIONS AND EVIDENCE

Question: GAAS states that appropriate evidence is both reliable and relevant. Evidence is relevant if it provides information about the financial statement assertion being addressed. Explain whether the confirmations used by the auditors met the relevance criteria. Include in your response the five broad categories of financial statement assertions relative to account balances, as stated in PCAOB Statement #15. Fully explain your answer.

3. DOCUMENTARY EVIDENCE

Question: Documentary evidence is one major type of evidence obtained in an audit.

1. Explain the types of audit procedures typically performed on documentary evidence.
2. Identify two such procedures where the auditors were deficient with respect to documentary evidence relating to accounts receivable reconciliations.

4. RELATED PARTIES

Question: Explain the term “related party” and the reason why related parties present a special issue in the auditing of financial statements. Comment on the appropriateness of the auditors’ procedures in connection with related parties.

5. MANAGEMENT ESTIMATES

Question: NCFE created an allowance for losses equal to 2% of its receivable portfolio.

1. Explain whether this estimate was sufficient. Use specific facts based on the case to support your position.
2. Reference PCAOB AU 342, Auditing Accounting Estimates, to list required audit procedures to determine the reasonableness of estimates.

6. MANAGEMENT REPRESENTATIONS

Question: To what extent do management representations represent reliable evidence? Use specific facts in this case to provide examples where the auditors relied on management representations. For each example, determine the appropriateness.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the “For Contributors” page of the journal website, <http://gpae.bryant.edu>.

REFERENCES

- Public Company Accounting Oversight Board (PCAOB). 1989. *Auditing Accounting Estimates*. AU 342 (Washington, DC).
- _____. 1998. *Management Representations*. AU 333.
- _____. 2007. *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements*. Standard No. 5.
- _____. 2010. *Audit Evidence*. Standard No. 15.
- Securities and Exchange Commission. Accounting and Auditing Enforcement Release No. 2720 (September 19, 2007). Available at <http://www.sec.gov/litigation/admin/2007/34-56469.pdf>