



## Chapter 1

# CASE 1: INTERIM FINANCIAL REPORTING

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### LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Determine relevant fraud risks relating to management override in a fictitious government.
- Identify circumstances in a fictitious government, which might also be present in an actual government, that could increase fraud risks in a governmental organization.

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### BEFORE WE START

This case involves compliance with bond covenants 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

Professional standards require the auditor to assess the risk of material misstatement due to fraud using the components of the fraud triangle. It is not necessary for all of the following fraud risks to be present for the auditor to conclude there is a specific risk of material misstatement due to fraud:

- Opportunity
- Incentive or pressure (real or perceived)
- Rationalization or attitude

In all areas of the audit, the auditor is required to exercise professional skepticism, which is an attitude requiring the auditor to have a questioning mind and to critically assess audit evidence. The characteristics of skepticism may help auditors better understand this concept of professional skepticism.

Characteristics of skepticism are as follows:

- 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.

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## 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.

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## BACKGROUND

Balsa Wood County<sup>1</sup> is a full service, medium-sized county in the south. The county provides a number of services to the cities within its boundaries through various interlocal agreements. All cities use the County Tax Assessor and Collector to assess and collect their municipal taxes. The county remits collections, net of a two percent administrative charge, to the cities bi-weekly during peak collection periods (such as the first six months after taxes are levied) and monthly during non-peak collection

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<sup>1</sup> All organization names used in this course are purely fictitious as are the individuals depicted therein. Any similarity to real organizations or persons is purely coincidental.

periods. Some cities contract with the county to provide public safety services and the county bills for these services monthly.

Balsa Wood grew slowly until the mid-1950s when oil was discovered near its county seat. The county experienced a significant amount of consistent growth until the mid-1980s. Growth in the state virtually halted in the late 1980s and did not resume until the mid-1990s. Unfortunately for Balsa Wood County, the economic resurgence of the 1990s benefited the surrounding counties and those along the coast rather than Balsa Wood. The state and Balsa Wood County also experienced a significant economic downturn during the “Great Recession” of the late 2000s.

In an effort to compete with the surrounding areas for economic growth, Balsa Wood voters approved a \$50,000,000 general obligation bond issue in the late 1990s. As part of the referendum, the voters approved an annual millage rate of 1.5 mills for debt service on the bonds. Growth and development projections prepared by the county’s consultants indicated the additional 1.5 mills would be adequate to meet the annual debt service requirements.

Proceeds of the bonds were used to fund road improvements and to build a minor league baseball stadium, both in an attempt to attract economic investment in the county. Unfortunately, the county lost its bid for a minor league baseball expansion team and the stadium facility is used mainly for area concerts and high school sporting events. Very little economic or population growth has occurred in the county since it issued the general obligation bonds. The county’s population has remained stable in total with more residents moving from the smaller cities in the rural portions of the county to the county seat rather than to neighboring counties.

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## KNOWLEDGE CHECK

2. Which is accurate of Balsa Wood County?
  - a. Balsa Wood County is a full service, medium-sized county.
  - b. The county provides no services to the cities within its boundaries through various interlocal agreements.
  - c. Balsa Wood grew quickly until the mid-1950s.
  - d. Balsa Wood issued bonds to construct a new water treatment facility.
3. Which is accurate of Balsa Wood County?
  - a. The county remits collections, net of a two percent administrative charge, to the cities bi-weekly during peak collection periods (such as the first six months after taxes are levied) and monthly during non-peak collection periods.
  - b. A few cities use the county tax assessor and collector to assess and collect their municipal taxes.
  - c. Growth in the state accelerated in the late 1970s.
  - d. The county has not needed to increase tax rates in recent years.

4. Which is accurate of Balsa Wood County?

- a. The stadium facility is used mainly for area concerts and high school sporting events.
- b. The current county manager convinced the county commission to build the baseball stadium.
- c. The county has recently been awarded a minor league baseball expansion team.
- d. The county is on the verge of declaring bankruptcy under Chapter 7.

The county and the trustee for the bonds entered into a number of covenants with respect to the general obligation 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:

<b>Balsa Wood County General Obligation Bond Covenants</b>	
Annual assessment of the voter-approved 1.5 mills for debt service requirements.	
Imposition of additional <i>ad valorem</i> taxes should taxes from the 1.5 mills be insufficient to meet annual debt service requirements.	
Any taxes generated by the 1.5 mills in excess of annual debt service requirements are required to be deposited into an interest and sinking fund for early retirement of the bonds.	
Maintenance of an average annual <i>ad valorem</i> tax collection rate of 95 percent.	
Maintenance of a cumulative <i>ad valorem</i> tax collection rate of 80 percent in the first two quarters after the tax levy.	
Adequate property insurance covering the replacement value of the stadium.	
Proper maintenance of the baseball stadium facility and equipment.	
Tri-annual appraisals of the baseball stadium facility and equipment.	
Annual audited financial statements prepared on the GAAP basis.	
Quarterly reporting including quarter and year-to-date	
<ul style="list-style-type: none"><li>• budget-based financial statements for the general and water and sewer funds;</li><li>• tax levies and collections;</li><li>• certificate of insurance for the baseball stadium facility and equipment; and,</li><li>• amounts spent to maintain the baseball stadium facility and equipment.</li></ul>	

For the past four years, the county needed to increase its operating millage rate to provide sufficient funds to meet the annual debt service requirements on the general obligation bonds. However, the county chose to use accumulated unrestricted fund balance amounts to “balance its budget” in lieu of raising property taxes or reducing services.

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## THE CASE

*The following exchange occurs after the first quarter of the fiscal year between the county manager, Diane Young, and the finance director, Robert Evans.*

“Diane, I wanted to let you know I finished the annual and first quarter bond reporting package last night. We barely complied with our covenants last year and the first quarter does not look good. I am not sure we are going to meet the 80 percent ad valorem collection covenant next quarter. I know this is not good news but I wanted you to be aware of the situation.”

“Thanks, Robert. I certainly appreciate the heads up on this. As you know, the commission is looking for something else to blame on me and I am not sure how much longer I will have a job here. Violating our bond covenants might be the excuse they need to get rid of me.”

“That would be a real shame, Diane. I don’t see how they can blame you for their mistakes. You were not even here when we built that white elephant baseball stadium and the roads that lead to nowhere. I guess they don’t give you any credit for the parks and recreation programs you created to keep people from leaving the county.”

“You and I know this but we also know a county manager is only as good as his or her last fiscal year. Things might work out for me if I can convince the big box store developer to build here. They are supposed to be making their decision sometime in the next several months. Hopefully, we won’t violate any bond covenants between now and then. I don’t think anyone would want to invest in a county that can’t even pay its bills!”

“I, and a lot of others around here, think you are doing a great job considering the mess you inherited from our last county manager. Hopefully, things will work out with the big box people. I’ll certainly do everything I can to help you keep your job.”

*During the next few months, Robert monitors maintenance expenditures for the stadium and tax collections to make sure the county will meet its covenants.*

Expenditures for maintenance of the stadium were delayed due to the medical leave of absence taken by the public works director. Even though the county is evaluated annually as to its stadium maintenance covenant, Robert does not want to take any chances in the interim.

*Robert calls the public works superintendent, Ken Alda, to solicit his help.*

“Hey Ken, this is Robert Evans over in finance. I’m working on something here and was wondering if you could help me with it.”

“I’ll try Robert. What do you need?”

“I know the painting of the stadium locker rooms is scheduled for the fourth quarter when the use is minimal. However, I need to show the analysts in New York we are spending money on the stadium each quarter. With your boss being out on medical leave, we delayed a lot of maintenance at the stadium. Do you think you could process a purchase order for the painting this quarter?”

“Well, Robert, that’s not really my area of expertise. The boss is real funny about the quality of the work we have done at the stadium. I would hate to do something he wouldn’t like or approve. Besides, the place is booked almost every weekend now that the playoffs have started. It would be pretty difficult to get things painted with all those kids running in and out every week.”

“Yeah, I know. I don’t want to put you in a bad place but I am really looking for some help here. What if you process a purchase order but don’t issue it? Then, after the quarterly reports are run, you can cancel it. This way, I’ll get what I need to show the folks in New York and you won’t be in trouble with your boss.”

“You’re the guy in charge of the numbers, if you say this will work, I don’t have a problem with it. I’ll take care of it this afternoon.”

“Thanks a lot, Ken. I appreciate it.”

*At the end of the second quarter, Robert prepares the financial statements and other information required by the bond covenants. As he had suspected, the cumulative 80 percent tax collection rate was not achieved for the first two quarters. The county collected only 70 percent of its tax levy in the first two quarters. Robert is very concerned not only for the county manager’s job but also for his own if he is unable to show the county has complied with its bond covenants.*

Muttering to himself, Robert says “There has to be a way to get these collections up to 80 percent. What can I do.. .wait, let me see what we collected the first week of this quarter!”

Looking at the collections made during the first week of the third quarter, Robert finds the additional collections bring the cumulative collection rate to 75 percent.

Still muttering, he says “I can journal entry the subsequent collections into the second quarter and then reverse them in the third quarter for reporting to the trustee. That will get me close, but still no cigar. What else can I do?”

After taking a break to walk the halls, Robert pumps his fist and says “Yes! I know what to do” and runs back to his office. Pulling up the tax collection information for the cities in the county, Robert determines municipal collections during the last month of the second quarter were higher than in prior years. He also notes that taxes collected during the last two weeks of the second quarter have not yet been remitted to the cities.

After making a few calculations, Robert determines he can get the cumulative tax collection ratio to 81 percent by “borrowing” funds from the cities. Because of the higher than normal municipal collections, the cities will still receive an amount comparable to the same period in the prior year. He prepares journal entries to make the second and third quarter adjustments and reversals and also prepares the bank draft requests to transfer the adjusted amounts to the various cities. Using the adjusted second quarter information, he prepares the quarterly bond compliance reporting package and readies it for mailing.

*The next morning Robert meets with the county manager to update her on the situation.*

“Diane, I wanted you to know I completed the second quarter reports for the New York folks last night and everything worked out fine. I admit I was a little worried these last few months about the numbers but I managed to make things work. You are too good of an administrator to lose and I did not want to be responsible for you losing your job here.”

“I doubt anyone would have blamed you if I lost my job, Robert. It is great to know that at least I don’t have to worry about violating any bond covenants. Thanks for making my day!”

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## KNOWLEDGE CHECK

5. Which is accurate of Balsa Wood County?
- a. The county and the trustee for the bonds entered into two covenants with respect to the general obligation bonds.
  - b. Should any of the covenants related to the general obligation bonds be violated, the bonds may be called by the trustee.
  - c. The county is not required to have audited financial statements.
  - d. The county manager manipulated property tax collections in the current year in order to meet bond covenants.

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## 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?