

LIFE PARTNERS: FRAUDULENT ACTIVITIES AND MATERIAL MISSTATEMENTS

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SYNOPSIS

The industry of trading life insurance policies is fairly new to the financial market and saw a significant amount of prosperity during the dawn of the twenty-first century. During this period, Life Partners Holdings, Inc. (hereafter referred to as “Life Partners” or “the company”) prospered as a leading firm in the industry. However, on January 4th, 2012, the Security and Exchange Commission (SEC) charged Life Partners, and three of its senior executives with claims of fraudulent disclosure and involvement in a corrupt accounting scheme. Thus, this paper specifically analyzes the case of Life Partners by identifying the fraudulent activities that it engaged in against its investors and by demonstrating the material misstatements that it made in the revenue recognition process. Furthermore, this paper discusses the implication of this case by describing “Professional Skepticism” and “Due Diligence” as key characteristics of independent auditors.

RESEARCH METHODOLOGY

The case study is originally based on publicly available information, which includes (1) SEC documents such as SEC Accounting and Auditing Enforcement Releases and (2) press articles published in the newspapers such as Wall Street Journal. With the source documents, we identified and analyzed Life Partners’ fraudulent activities and material misstatements. Also, we searched relevant financial accounting standards and auditing standards which are applicable to this case.

RELEVANT COURSES AND LEVELS

This case can be used for senior or graduate students in an auditing, intermediate accounting or business ethics class. This case is developed to be covered in one and half class hours and expected to require about four hours for students’ preparation and discussion outside classroom.

BODY OF THE CASE

Background: Incorporation & Success

Life Partners was established in 1991 in Waco, Texas making this company the oldest participant in the secondary market for life insurance policies. Life Partners at its prime was a publicly traded company listed on the NASDAQ under the ticker LPHI. During its tenure as a broker for life settlements, Life Partners sold more than \$1.3 billion of fractional interests in individual's life insurance policies to more than 20,000 investors (Maremont, 2015). Over an eight year span in the early 2000's Life Partners generated more than \$392 million in sales and participated in over 162,000 transactions with a client base that stretched across the globe (*Business Wire*, 2015). According to a *Wall Street Journal* article titled, "Odds Skew against Investors in Bets on Strangers' Lives," "Life Partners' fiscal year ended in Feb. 28, 2009, earned \$29.4 million on \$113 million of revenue, for a rich profit margin" (Maremont, 2010). "During its window of operation, Life Partners was spearheaded by its founder and Chief Executive Officer Brian Prado, its President and General Counsel Scott Peden and its Chief Financial Officer David Martin."

Life Partners is considered to be the oldest participant in the secondary market for life insurance policies. Over its life span, Life Partners principal, if not singular, revenue stream came from brokering these life settlement transactions. According to the Securities and Exchange Commission's suit against Life Partners – *Securities and Exchange Commission v. Life Partners Holding Inc., Brian D. Pardo, R. Scott Peden, and David M. Martin* – "In a life settlement transaction, a life insurance policy owner sells the policy to a purchaser, and the purchaser becomes an 'investor' in the sense that the purchaser receives the death benefit when the policy matures (*i.e.*, the insured dies)" (SEC, 2012, p. 2). This is the outlay of the initial transaction. Then, the purchaser (the investor) will make a lump-sum payment in exchange for the policy, and thus will assume the responsibility of paying the premiums on the policy until its maturity. In most cases, an individual's life insurance policy will be sold in parts or pieces to multiple investors. Therefore, more than one investor will own a piece of another person's life-insurance policy (SEC, 2012). This is the general definition of the type of transaction from which Life Partners gained virtually all of their revenues.

Life Partners considers themselves to be one of the oldest firms in the industry. However, this "boast" should be taken lightly since the industry itself is still in its adolescence. The industry revolving around secondary-market life insurance policies was conceived in the tail-end of the twentieth century and saw a significant amount of prosperity during the dawn of the twenty-first century. However, many have critiqued this investment vehicle as somewhat taboo. The purchasing of a stranger's life insurance policy and essentially cashing out on their death is a foreign concept to some, if not outright immoral. Thus, the industry itself has always seen its fair share of scrutiny.

The industry has had a hard-time finding the same success it had in the early stages of the twenty-first century after being hit hard by the recession that plagued the United States in the early 2000's, a continuing increase in life expectancy of life insurance policy holders and the withdrawal of investment banks that funded the initial growth of the industry. After the recession

hit, many investors decided to leave this new market that was plagued with uncertainty for a safer means of investment (i.e. Treasury Securities and Certificates of Deposit). The future of the life settlement industry is quite uncertain, if not bleak (Postal, 2014).

However, during its time within the industry, Life Partners prospered as a leading brokerage firm. To better understand how they prospered, let us take a look at how they generated revenues from their life settlement transactions. “Life Partners derives revenue from the life settlement transactions it brokers by keeping the difference between what investors pay to acquire a policy and what the policy owner receives from the sale” (SEC, 2012, p. 3). There can be more than one investor tied to each life insurance policy, and in most cases there are multiple investors who own a fraction of a policy. Included within the initial purchase price that an investor pays for a policy are funds that will cover all future premium payments necessary to maintain the policy for the duration of the insured’s life expectancy. These investor paid funds are placed in an escrow account by Life Partners. Thus Life Partners earns their revenue from the difference between the purchase price and the sale price, minus the escrowed funds and various transaction costs. If the insured outlives their life expectancy, then the investor is required to continue payment of premiums even after all funds are expunged from the escrow account. If the investor decides to not continue paying the premium payments then the policy will lapse (SEC, 2012).

“In a life settlement transaction, the estimate of an insured’s life expectancy (‘LE’) is a critical factor in determining the purchase price that investors are willing to pay. Investors will pay more to acquire life settlements that have shorter LEs” (SEC, 2012, p. 4). The reasoning behind the desire for policies with shorter LEs is because it reduces the amount of premium payments that the investor will have to pay, and also reduces the time in which the investor will receive a return on their investment. However, the estimate of the insured’s life expectancy is not only a critical factor for investors: it is also a critical factor for Life Partners themselves.

Since Life Partners’ revenue model consists of capturing the spread between purchase price of the policy and the amount paid to the policy seller, the LEs are crucial to the company’s revenues and profit margins. The shorter the LE of the insured, the greater the spread between the purchase price and the sale price (SEC, 2012). Thus, if a short-term LE does not pay-out – meaning that the insured outlives their LE, then Life Partners benefits. Essentially, the investors are taking a gamble on policies that hold short LEs.

Life Partners revenue stream flows solely from these life settlement transactions. Their revenue model is designed to capture the difference between the purchase and sale prices of the insurance policy, minus any transaction costs. The company facilitates sales of fractionalized interests in single life insurance policies to multiple investors (SEC, 2012). Life Partners not only survived throughout the turmoil that struck the industry in the early 2000’s but prospered. Life Partners enticed investors with the promise of high-return rates on their investment vehicles, while they themselves netted a considerable gross profit from the transactions. According to *Wall Street Journal* article, “Odds Skew against Investors in Bets on Strangers’ Lives”, “Attractive projected returns for clients are part of the company’s success. Life Partners topped Fortune magazine’s 2009 list of fastest-growing small companies (Maremont and Scism, 2010).”

Now let's see how they really maintained such high yields during a time where the industry itself was struggling.

If it is too good to be true...

On January 4th, 2012 the Securities and Exchange Commission charged Life Partners, and three of its senior executives with claims of fraudulent disclosures and an accounting scheme (SEC, 2012). At the root of this problem was Life Partners' systematic use of materially underestimated LEs. These materially underestimated LEs not only misled investors, but significantly inflated Life Partners' revenues.

Life Partners has, "since at least 1999, systematically used materially underestimated LEs in order to inflate its revenues" (SEC, 2012, p. 4). Prior to 1999, Life Partners used co-founder Dr. Jack Kelly out of Reno, Nevada as their underwriter for LEs. However, in 1999 Dr. Kelly unexpectedly passed away. CEO Brian Prado hired Dr. Kelly's partner Dr. Donald Cassidy to be the new underwriter for Life Partners' LEs. Prado hired Cassidy without completing a proper vetting process. In fact, Prado hired Cassidy on the spot at Kelly's funeral without verifying if Cassidy had any experience in the underwriting of LEs (SEC, 2012).

Dr. Cassidy had no prior experience in the underwriting process for LEs, nor did he ever receive any type of formal training. Dr. Cassidy based his methodology for underwriting off of a method he claimed his predecessor (Kelly) used, but this claim has never been verified (SEC, 2012). "As of February 8, 2011, Cassidy had never researched the methodology used by life settlement underwriters. In fact, in the ten-plus years he has worked for Life Partners, Cassidy never modified his methodology or evaluated his track record of LEs" (SEC, 2012, p. 3-4). By February of 2009, ninety percent of the relevant policies brokered by the company had exceeded the LE that was underwritten by Dr. Cassidy. In 2007 Life Partners paid out \$12.8 million in a civil suit brought forth by the Colorado Securities Commission for the company's failure to disclose the "high frequency rate" of the policy owners outliving their LEs (SEC, 2012).

This brings us to a major point in the case: how is the underestimation of policy holders' LEs representative of fraud? By systematically using the underestimated LEs rendered by Cassidy, Life Partners misrepresented the company's public findings with the SEC from 2006 through 2011 when the underestimation of LEs was a contingent risk. This misrepresentation of LEs left shareholders (investors) with a false impression that Life Partners could continue to capture profit margins and revenues that it had historically posted. Furthermore, it encouraged investors to invest in policies that had a misrepresented probability of a return on the investment. Finally, this underestimation of LEs is considered a fraudulent activity which materially impacted the company's revenues and profits. According to a *Wall Street Journal* article, titled "Odds Skew against Investors in Bets on Strangers' Lives", Life Partners "has made large fees from its life-insurance transactions while often significantly underestimating the life expectancies of people whose policies its customers invest in" (Maremont and Scism, 2010).

The SEC alleged in their January 4th, 2012 lawsuit against Life Partners Holding, Inc. that Prado, Peden and Martin all knew about the fraud that was conceived through the underestimation of LEs. There are three specific instances that the SEC lists in which the three

executives of the company willingly misrepresented the underestimation of LEs. The first instance was during quarterly conference calls when Prado lied about the company's track record by promising "double-digit" returns to its investors. These "double-digit" returns omitted over 2,900 policies in which the insured outlived Cassidy's projected LE. Second, Peden further concealed the fraud by stating that Cassidy's methodology for calculating LE was on-track with the industry standards and norms. The industry uses a Valuation Basic Table ("VBT") which only includes a populace that has been underwritten for life insurance. However, Peden knew that Cassidy did not use the VBT but instead used a Census which had the entire populace of the United States as its control. Cassidy's use of the Census table deviated from industry norms. Third, in August of 2010 Peden and Martin knowingly misrepresented information to their independent auditors E&Y. They provided E&Y with a spreadsheet of what they claimed was three-hundred of the most "recent" maturities that their company had paid. However, this spreadsheet which included all policies dating back to Fiscal Year 2000, excluded up to 1,230 policies for which the insured outlived Cassidy's LEs (SEC, 2012).

To better understand the severe implications that the underestimation of LEs has on Life Partner's business and coincidentally their customers, you can take a look at the numbers provided through the SEC's case against the company. In their 2012 lawsuit, the SEC charged that Cassidy generated average life expectancies of 3.8 years and 4.6 years for the periods of 2000-2005, and 2006-2010, respectively. These predictions, due to improper and skewed prediction methodology that Cassidy used, were way off the mark. The SEC found that the life expectancies for the aforementioned periods should have been 8 and 9 years longer, respectively. According to the SEC in their filings, Cassidy's prediction rates were abysmal. These rates were covered up by Life Partners, when senior management (specifically Peden) defended Cassidy's practices by stating that they were in line with industry standards. However, Cassidy utilized methods that did not account for medical improvements, new mortality rates and accurate census information (SEC, 2012). Additionally, as you can see the Table 1 which was extracted from the SEC's 2012 filing against Life Partner's, the percentages of policies exceeding LE are staggering.

The SEC alleged that Life Partners systematically committed fraudulent actions against its investors and the SEC itself by underestimating LEs of insured policy owners they were selling to investors. This was done intentionally, and Life Partners made multiple attempts to cover their actions up. By using underestimated LEs, Life Partners extracted significantly more revenue from investors than it would have if they would had industry norm Les been utilized. From 2006 to 2011, it is estimated that Life Partners gained more than \$400 million in revenue by using underestimated LEs. Finally, by continually using LEs that were materially misstated they were knowingly artificially inflating the policy values on their financial statements (SEC, 2012).

Government Watchdog Makes Claim of Accounting Fraud

The SEC also alleged that Life Partners' revenue recognition model did not adhere to the Generally Accepted Accounting Principles (GAAP). Furthermore, the SEC alleged that Life Partners' disclosures to its auditors regarding revenue recognition were also intentionally misleading.

As depicted in Figure 1, the proper recognition for a typical life settlement transaction brokered by the company includes three parties: the seller (the insured), the buyer (the investor) and the broker (Life Partners). The transaction is commenced by the seller. An original policy holder who wants to receive cash benefit in advance before the insurance benefit is actually realized (the insured dies) would have an incentive to sell the policy in advance if there is an opportunity to sell it to a third-party. The policy owner creates a "Seller Agreement" which grants Life Partners an option to purchase the policy on behalf of investors at an agreed upon sales price. The transaction is not listed as sold until the "Closing Date" which is defined as the date upon which the payment for the transaction is transferred from an escrow account to the seller. An important clause in this part of the transaction is the "Recession Date" which is 15-days after the "Closing Date." Within those 15 days, the seller can cancel the transaction. Also, if the seller dies within those 15 days then the policy does not transfer to the buyer but instead remains with the seller. The second part of the transaction is initiated by the buyer, which is identified by the brokerage firm through an independent network. The buyer deposits funds into an escrow account held by the firm with a signed, but undated, "Policy Funding Agreement" which outlines all the details of the purchase. Finally, the broker submits all of the relevant forms from both the buyer and seller to the escrow agent. The transaction is complete on the "Closing Date" when the consideration for the purchase of the transaction is transferred to the seller (SEC, 2012).

"As a result of Life Partner's practice of prematurely recognizing revenue and failing to appropriately impair its own investments, they materially misstated net income from at least Fiscal Year 2007 to the third quarter of Fiscal Year 2011" (SEC, 2012, p. 7).

The SEC's case against J. Brain Laib, CPA (one of Life Partners' independent auditors) brings to light the revenue recognition fraud that Life Partners perpetuated. This case is found as *The Securities and Exchange Commission v. J. Brain Laib, CPA, and Respondent*. According to this case, "Rather than wait until the Closing Date to recognize revenues, Life Partners routinely recognized revenue as of the date listed on the Policy Funding Agreement. "This date purportedly represented the date when the investor committed to purchase an interest in the policy (SEC v. Laib, 2012, p. 4)." GAAP was violated because the company is recognizing revenues before they are realized or realizable. Since Life Partners does not receive any money from the investor or any promise of money from the investor on the date listed on the Policy Funding Agreement, its revenue recognition is fraudulent. Furthermore, it was reported that Life Partners manually backdated these forms in order to recognize revenues in periods that were more beneficial to themselves and not when the transactions occurred. Additionally, Life Partners did not wait to recognize revenue once 100% of the insurance policy was sold. Instead, they operated on a pro-rata formula. If 2% of the policy was sold to an investor, they would recognize 2% of the revenue. Life Partners is not entitled to the proceeds of a sale until the entire policy is purchased by investors, thus making any pro-rata revenue assumptions material misstatements. Finally, the last charge was that Life Partners improperly recognized revenues from transactions that occurred after a period ended. According to the original lawsuit brought forth by the SEC, "Pardo and Peden developed, and Martin implemented, a policy that authorized the Company to recognize a given quarter revenue from events that occurred as many as 15 business days after the quarter closed" (SEC v. Life Partners..., 2012, p. 35). Through

adherence to this policy, Life Partners violated GAAP by recording quarterly revenue based on events that occurred in a future quarter. Based on these SEC allegations, Life Partners engaged in numerous fraudulent accounting transactions and knowingly attempted to conceal them.

Where were the auditors? What was the fallout?

The SEC brought forth a law suit against J. Brian Laib, CPA who served as the independent audit partner for the Life Partners engagement from 2005 to 2009 (he was with Murrell Hall, McIntosh & Co. LLP from 2005 to 2008, and Eide Bailly LLP from Feb. 2008 to 2009). The SEC alleged that in connection with the 2005 audit, Laib identified risks of material misstatements but failed to maintain a level of professional skepticism and he failed to respond appropriately to such risks that were in relation to the revenue recognition practices of Life Partners. The SEC also alleged that if Laib had properly planned and performed the 2005 and 2006 audits, he could have caught the premature revenue recognitions. There is evidence that Laib concluded that the revenue recognition process by Life Partners was very aggressive, boarding on fraudulent, and he knew they were backdating forms. However, these claims are not reported in his audit documentation. Both Murrell Hall and Eide Bailly's audit documentation provided Laib with the necessary means to test the existence, completeness and accuracy of the signed transaction documents (Sales Agreements, Policy Funding Agreements, and funding status reports). Still, Laib from 2005 to 2009 failed to evaluate whether Life Partners' revenue recognition policy was in accordance with GAAP. Through a lack of due diligence and care, as well as professional skepticism, Laib failed to read through, or instruct a team member to read through, the transactional documents in sufficient detail to determine whether or not the revenue was recognized in accordance with GAAP. Laib also failed to correctly use both Hall and Bailly's audit work papers which provided him with detailed breakdowns of Life Partners' settlement transactions. Ultimately, Laib failed at his job as an independent auditor. Laib lost his CPA license and was found guilty of engaging in improper professional conduct (SEC v. Laib, 2012).

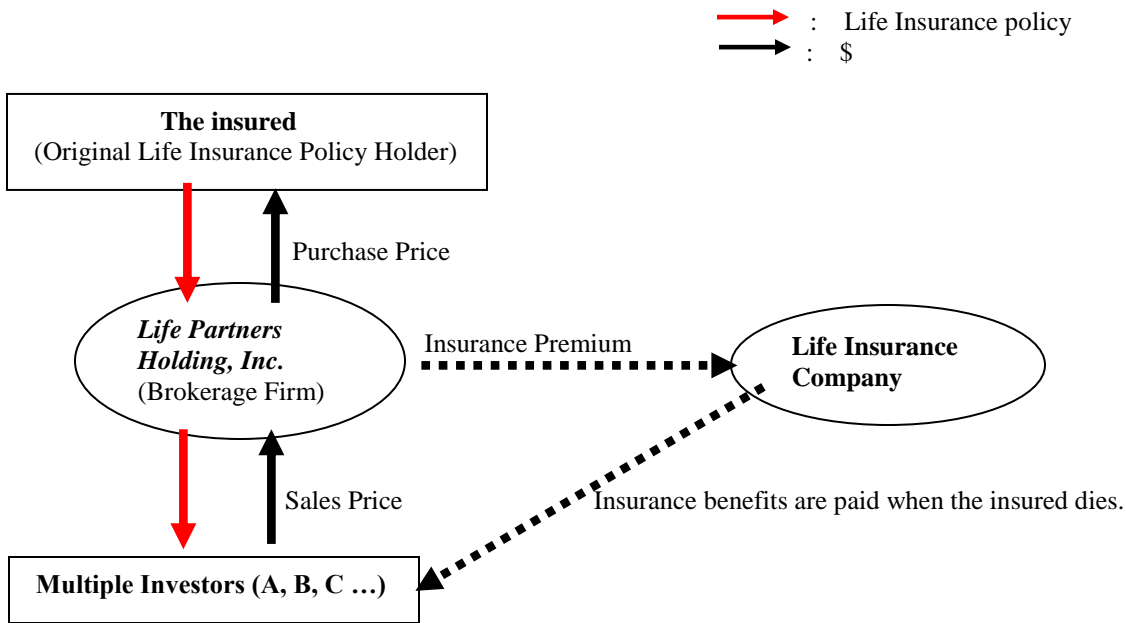
After Laib resigned from the audit engagement in 2010, E&Y were engaged as Life Partners' independent auditors for the Fiscal Year of 2010. However, in June of 2011 E&Y terminated its audit engagement with Life Partners and revoked its audit opinion on their 2010 financial statements.

On December 3, 2014 a federal judge ordered Life Partners Holdings, Inc. to pay out \$15 million in legal fees and \$23.7 million in civil suits. The judge also ordered CEO Pardo to pay \$6.2 million as civil penalty and Peden to pay \$2 million in a civil penalty (Reuters, 2014). On January 20, 2015 Life Partners filed for Chapter 11 Bankruptcy and lists debts upwards of \$50 million while its stock price dropped to a record low of \$0.12 per share (Kary, 2015). On February 23, 2015 Life Partners received a letter from the NASDAQ stating the company is being delisted from the exchange (*Businesswire*, 2015). Finally, the SEC banned CFO David M. Martin from performing as an accountant, in *Securities and Exchange Commission v. David M. Martin, Respondent* (SEC v. Martin, 2014). Life Partners Holdings, Inc. is currently operating as a former shell of what it once was. The company set up a subsidiary to pay its debts, but it no longer participates in the trading of life settlements.

Table 1: Policies Exceeding LE

Fiscal Year	Policies Exceeding LE
2006	88%
2007	88%
2008	89%
2009	90%
2010	91%

Figure 1: Flow of Life Settlement Transaction



QUESTIONS

1. In the Securities and Exchange Commission’s case against Life Partners’ former independent auditor, J. Brian Laib, CPA, they accuse Laib of not performing his audit engagement in accordance with GAAS. Please, explain what is meant by “Professional Skepticism” and “Due Diligence”. Do you agree that Laib conducted the audit engagement without professional skepticism or due diligence? Explain. Also, describe any other characteristics that Laib should have portrayed during his audit engagement.

2. In the Securities and Exchange Commission’s case against Life Partners’ former independent auditor, J. Brian Laib, CPA, they accuse Laib of not performing his audit engagement. According to the Securities and Exchange Commission, Life Partners Holding, Inc. did not follow proper Generally Accepted Accounting Principles (GAAP) in their revenue recognition. Do you agree with the SEC’s assessment? What is the proper revenue recognition model under GAAP? How did Life Partners violate these principles?

3. **What procedures should Laib have used to ensure that the transactional documentation was accurate and free of material misstatements?**
4. **A major problem of this case study was the underestimation of the insured's life expectancy. In your own words describe how this issue impacted all parts of Life Partners' business. How may this underestimation been avoided or caught?**

INSTRUCTOR'S NOTES: LEARNING OBJECTIVES

1. Students will be able to understand revenue recognition rules under GAAP and identify in this case the firm's improper accounting practices which violate them.
2. Students will be able to identify in the case the fraudulent activities the firm committed.
3. Students will be able to describe characteristics auditors should possess when they conduct their audit engagements.
4. Students will be able to describe proper auditing procedures under GAAS to ensure that the transactional documentation was accurate and free of material misstatements.

INSTRUCTOR'S NOTES: ASSIGNED QUESTIONS AND THEIR SOLUTIONS

1. **In the Securities and Exchange Commission's case against Life Partners' former independent auditor, J. Brian Laib, CPA, they accused Laib of not performing his audit engagement in accordance with Generally Accepted Auditing Standards (GAAS). Describe in detail along with relevant standards how Laib did not follow GAAS in terms of required key characteristics independent auditors should possess. Also, describe any other characteristics that Laib should have portrayed during his audit engagement.**

First, Laib conducted the audit engagement without professional skepticism or due diligence. Professional skepticism and due diligence are outlined in the PCAOB's *AU Section 230A*, "Due Professional Care in the Performance of Work". According to this standard, "Due professional care is to be exercised in the planning and performing of the audit and the preparation of the report" (AU 230A.01). This standard continues by stating, "Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence" (AU 230A.07). As stated in the case, Laib knew that something was not right with Life Partners' aggressive recognition of revenues and that some of the transactional documents were back-dated. Although he knew something was not necessarily right with the accounting performed by Life Partners, he did nothing to pursue his assumption. He did not document this in his audit work papers. He did not pursue the issue with Life Partners management or anyone else in his audit firm. His negligence resulted in the continuation of this improper accounting treatment with Life Partners committing more fraud and his ultimate loss of his SEC practice.

Also, Laib should have consulted and followed the "Principles of Professional Conduct" that are stated in the AICPA's *Code of Professional Conduct*. These principles include responsibility, public interest, integrity, objectivity and independence, due care, and scope and nature of services. Specifically, Laib violated the principles of responsibility, public interest and

integrity. The responsibility principle states, “Members should exercise sensitive professional and moral judgments in all their activities” (0.300.020.01). The public interest principle states, “Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism” (0.300.030.01). Finally, the integrity principle states, “Members should perform all professional responsibilities with the highest sense of integrity” (0.300.040.01). By conducting the audit engagement in the manner that he did, Laib did not follow any of these principles. By allowing Life Partners to continue with their improper accounting techniques, he was exposing the public (the investors specifically) to fraud.

2. In the Securities and Exchange Commission’s case against Life Partners’ former independent auditor, J. Brian Laib, CPA, they accuse Laib of not performing his audit engagement. According to the Securities and Exchange Commission, Life Partners Holding, Inc. did not follow proper Generally Accepted Accounting Principles (GAAP). How did Life Partners violate GAAP? Do you agree with the SEC’s assessment? What is the proper reference under GAAP?

In the SEC’s case against J. Brian Laib, CPA – *Securities and Exchange Commission v. J. Brian Laib, CPA, and Respondent* – the SEC outlines the correct revenue recognition model under GAAP. The SEC states,

“Under GAAP, revenue can be recognized only when it is both (i) realized or realizable and (ii) earned. Revenue is “realized or realizable” when products or services (in this case, life settlements) are exchanged or readily convertible to known amounts of cash or claims to cash. Revenues are “earned” when “the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues” (SEC, 2012, p. 4).

Life Partners is recognizing revenue incorrectly. Life Partners realizes revenue before it is actually realized or realizable. When Life Partners recognizes revenue on a date prior to the Closing Date they are recognizing revenue that does not exist. It is far too early and extraneous circumstances may occur that will make that revenue ultimately unrecognizable. Examples of these circumstances are included in the Recession Date. This date is a 15-day period in which the seller (the insured) can cancel the transaction and keep the policy to themselves. This will void any sale to the seller or any commission or revenue awarded to Life Partners. Additionally, the insured could die during that 15-day window thus making the sale of the policy null and void.

Life Partners also accounts for revenues on a pro-rata basis. This is a violation of GAAP. The entire policy may be sold but not a fraction of it. If they sell 20% of a policy, they cannot account for 20% of that policy as revenue because the other 80% of the policy still has not been sold. They are essentially accounting for a portion of a revenue that may or may not come their way. The revenue at that stage is neither realized nor realizable. Finally, in order for revenue to be recognized it must be accounted for in the period that the transaction occurred. Life Partners are violating GAAP by back-dating transactional documents that they are using to record revenue.

In order for Life Partners to have their revenue recognition model flow comply with GAAP they can only recognize the revenues when the Closing Date has occurred and the 15-day recession period has transpired. Otherwise, they are recognizing revenue they have not earned. Also, they must only recognize a transaction as revenue when the entire policy has made its way through the pipeline to the Closing Date. They cannot fractionalize these policies and record the revenues of portions sold on a pro-rata basis. Finally, they cannot alter transactional documents because it is not only forgery but a complete misstatement of the transaction. They must go by the Closing Date and nothing more. Otherwise, they will continue to recognize revenue in an improper accounting period.

3. What procedures should Laib have used to ensure that the transactional documentation was accurate and free of material misstatements?

According to *The Securities and Exchange Commission v. J. Brian Laib, CPA, and Respondent*, “Murrell Hall and Eide Bailly’s 2005 through 2009 audit work papers document certain testing that was designed to confirm the existence, completeness, and accuracy of signed transaction documents, included Sales Agreements, Policy Funding Agreements, and funding status reports” (SEC, 2012, p. 6). Laib should have made sure that, all members of the audit engagement team in each of the fiscal year audits knew how to properly test these transaction documents.

As the audit engagement partner in charge of the audit, Laib should have satisfied PCAOB’s *Auditing Standard No. 10 – “Supervision of the Audit Engagement”* as a guide when supervising the audit engagement. Standard 10 states, “The engagement partner is responsible for the engagement and its performance. Accordingly, the engagement partner is responsible for proper supervision of the engagement team members and for compliance with PCAOB standards” (AS 10.03). Laib is responsible to make sure his audit team fully understands the nature of their audit work papers.

Laib was aware that there were material risks that involved with the transactional documents used by Life Partners. Therefore, Laib should have followed PCAOB’s *Auditing Standard No. 13 – “The Auditor’s Responses to Risk of Material Misstatement”*. This standard states, “For significant risks, the auditor should perform substantive procedures, including tests of details that are specifically responsive to the assessed risk” (AS 13.11). Furthermore, “If the auditor identifies deficiencies in controls that are intended to address assessed fraud risks, the auditor should take into account those deficiencies when designing his or her response to those fraud risks” (AS 13.12). Laib found there is both a risk of material misstatement with the falsification of dates and there is an inherent risk of fraud. If these dates are being manipulated through back-dating, then there are no internal controls in place within Life Partners to catch this fraud. Laib should examine the transactional documents in their entirety, as well as, assuring himself that there are sufficient and appropriate internal controls established to catch these actions before they become recognized in the accounting records.

According to the PCAOB’s *Auditing Standard No. 3 – “Audit Documentation”*, “The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient

detail to provide a clear understanding of its purpose, source, and the conclusions reached” (AS 3.04). Laib did not complete his audit documentation to the degree that was required. He did not document the problems with the transactional documents nor did he document the problems with Life Partner’s revenue recognition model.

4. A major problem of this case study was the underestimation of the insured’s life expectancy. In your own words describe how this issue impacted all parts of Life Partners’ business. How may this underestimation been avoided or caught?

The major problem at the core of this case study was the underestimation of the insured’s life expectancy. This underestimation of the life expectancy (LE) of the insured is an issue that plagued all aspect of Life Partners’ business enterprise within Life Partners and with the investor community. This problem begins with Dr. Cassidy who is responsible for underwriting all of the policies that Life Partners brokers. He is consistently underestimating the LE of those insured. He has had no prior training or job experience in underwriting LEs. Dr. Cassidy is using a method that is not accurate. It is against the industry norms, and is practically designed to make sure that the insured’s LE will be underestimated. Another problem is the executive officers are doing nothing to stop this. In fact, they are exacerbating these actions by allowing them to go on. This is most likely because Life Partners receives a greater revenue and thus profit margin from underestimated LE policies. The investors are being manipulated and mislead. They are purchasing investments that are supposed to yield a certain return, but they never meet their returns because the information about the investment is fabricated. Finally, the underestimated LE policies are causing the Life Partners’ revenues, profit margins and ultimately financial statements to be grossly misstated. This is affecting the shareholders and potential shareholders of the company (since it is a public corporation listed on the NASDAQ – LPHI) who presently, or could potentially, invest in the company’s shares. It is also misleading the SEC and all other public oversight boards, as well as the company’s external auditors.

The underestimation of LEs could have been avoided by hiring a professional underwriter who has professional training and a solid background in the underwriting for LEs and by establishing an internal department within Life Partners to keep track of all policies and record the policies in which those insured outlast their predicted LEs. This internal department could run diagnostics on this information and discover why these irregularities are happening. Some of the insured will outlast their predicted LEs, but it should never be on the level that was experienced at Life Partners. Finally, the company’s external auditors need to be wary of these vast underestimations and how they are impacting the company’s financial statements. The previous auditors never identified this underestimation and flagged it as a serious problem.

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