

ESM Government Securities, Inc. (“ESM”) was in the business of selling and repurchasing government securities through repurchase and reverse repurchase transactions. ESM is wholly owned by ESM Group, Inc. (“Group”) who also owned Financial Group, Inc. (“Financial”). Financial has been insolvent since 1978.

A repurchase transaction is one in which ESM would purchase government securities and then sell the securities to a customer with the stipulation that at the maturity of the security, ESM would buy back, or repurchase, the security from the customer. These repurchase transactions had a defined term, and were therefore called term repos. A reverse purchase transaction is the opposite of a term repo; ESM would agree to purchase securities from a customer with the understanding that the securities would be repurchased upon the maturity of those securities.

At the end of 1984, the intercompany account between Group and Financial showed Financial owed Group \$246,922,347 and the net amount owed by Group to ESM on net intercompany repos was \$297,009,000.

Financial made significant personal loans to individual officers of ESM companies which had grown to approximately \$38,000,000 as of March 31, 1985.

1. Using these facts, and the financial statements on the following two pages, describe the potential fraud schemes employed by ESM.
2. Are there any other issues that tweak your curiosity with respect to these financial statements?
3. Should the disclosures in ESM’s financial statements report the intercompany transactions with Group?

ESM Government Securities

STATEMENT OF INCOME (In Thousands)	12/31/81 <u>(unaudited)</u>	12/31/82 <u>(unaudited)</u>	12/31/83 <u>(unaudited)</u>	12/31/84 <u>(unaudited)</u>
Security Income	\$ 64,857	\$ 27,415	\$ 6,080	\$ 12,882
Other Income	(29,550)	29,040	28,112	15,543
Interest Income	<u>128,250</u>	<u>132,939</u>	<u>175,262</u>	<u>346,223</u>
Total Income	163,557	189,394	209,454	374,648
Bond Process Exp	6,621	9,711	9,153	6,098
Officer Salaries	801	1,806	2,846	3,106
Other Salaries	407	500	714	278
Salesmen Commission	439	580	477	1,026
Other Expenses	980	1,141	7,706	1,396
Interest Expense	<u>128,250</u>	<u>132,939</u>	<u>166,203</u>	<u>346,223</u>
Total Expenses	<u>137,498</u>	<u>146,677</u>	<u>187,099</u>	<u>358,127</u>
Net Income	<u>\$ 26,059</u>	<u>\$ 42,717</u>	<u>\$ 22,355</u>	<u>\$ 16,521</u>

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BALANCE SHEET (In Thousands)	12/31/81 <u>(audited)</u>	12/31/82 <u>(audited)</u>	12/31/83 <u>(audited)</u>	12/31/84 <u>(audited)</u>
ASSETS				
Cash	\$ 1,767	\$ 1,046	\$ 339	\$ 421
Deposits with Clearing Org's	25	25	25	182
Rec from Brokers	60	1,084	2,192	3,643
Rec from Customers	40,523	21,073	16,163	73,050
Securities Purch-Resell Agreement	1,323,340	738,924	2,252,555	2,945,953
Accrued Interest	433	1,257	7,375	406
Securities Purch-At Market	161,484	182,674	402,004	26,059
Due From Parent	0	0	0	2,550
Other	0	0	0	61
TOTAL ASSETS	<u>\$1,527,632</u>	<u>\$946,083</u>	<u>\$2,680,653</u>	<u>\$3,052,325</u>
LIABILITIES & EQUITY				
S/T Bank Loans	57,282	80,350	91,832	47,258
Payable to Brokers	478	3,624	4,815	12,266
Payable to Customers	4,047	1,426	3,683	9,304
Securities Sold-Resell Agreement	1,323,340	738,924	2,457,555	2,945,953
Accrued Expenses	796	596	927	799
A/P to Parent & Affiliates	127,604	95,861	92,183	0
TOTAL LIABILITIES	1,513,547	920,781	2,650,995	3,015,580
Common Stock	1	1	1	1
Add'l Contrib Capital	4,160	4,160	4,160	4,160
Retained Earnings	9,924	21,141	25,497	32,584
TOTAL LIABILITIES & EQUITY	<u>\$1,527,632</u>	<u>\$946,083</u>	<u>\$2,680,653</u>	<u>\$3,052,325</u>