TRAVELERS

Accountants Risk Management Newsletter

FOR PROFESSIONAL LIABILITY

Accountant Or Chef: Being Vigilant For Client Employees That Are 'Cooking The Books'

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A disconnect often exists between a CPA's professional responsibility for detecting embezzlement/fraud/theft and the general public's understanding or expectation of a CPA's duties. AICPA Professional Standards include the responsibility to inform the appropriate level of management if the CPA learns of any information or evidence indicating embezzlement/fraud/theft may have occurred. But how far does this duty go?

Embezzlement is the act of wrongfully appropriating funds that have been entrusted into your care but which are owned by someone else. Accounting embezzlement is the manipulation of accounting records to hide theft of funds. Business owners hire accountants with the expectation that the CPA will discover wrongdoing. When embezzlement/fraud/theft is uncovered, and lawyers get involved, the lawyer for the client may allege that the CPA should have identified and informed the client of red flags such as suspicious activities or internal control deficiencies. While you may believe that longtime clients would not pursue such a claim, you should know that long-time relationships mean nothing in the face of six and seven figure losses. While you cannot prevent a lawsuit from being filed, steps can be taken to minimize the risk exposure and provide sufficient ammunition to defend the claim.

By way of example, Firm A, a prominent accounting firm, had been performing review services on behalf of its client, Client Z, for ten years. There was nothing unusual about Client Z's business, in terms of cash flow, income statement, and year end reports, and the revenue ebbed and flowed with the general health of the economy. Firm A provided a thorough engagement letter each year specifically setting forth the scope of the review and clearly spelling out what the services were not intended to uncover, including embezzlement/fraud/theft. Firm A also required that Client Z provide a Management Representation Letter each year. Over the ten year relationship, the same CPA for Firm A handled the majority of each annual review, leading to a 'comfortable' process from year to year. Early on, the CPA identified deficiencies with the internal controls including the fact that one individual was responsible for all accounting duties. The CPA verbally informed Client Z's management over the course of several years, always receiving the response that the employee was 'trusted' and was 'part of the family'. In fact, that employee had been with Client Z for nearly twenty-six years. After a few years of identifying the concern verbally to management and receiving the same response not to worry about it, the CPA stopped making an issue of the deficiencies with internal controls. He never included his concern in writing and never documented Client Z's response to his concern. As it turns out, Client Z's bookkeeper had embezzled nearly two million dollars over the span of twelve years (pre-dating Firm A's engagement), with the bulk of the embezzlement taking place in the final three years of the engagement. A suit was filed and the key issue was whether the scheme employed by the employee should have been uncovered during the annual reviews. Interestingly, management for Client Z denied ever being informed of any concerns or deficiencies with internal controls. Ultimately, the claim was resolved for a fraction of the amount embezzled, but only after significant time, hassle, and litigation fees; most, if not all, the time and fees could have been avoided if only the CPA's concerns were documented in writing, and more importantly, that the concerns continued to be expressed each year of the engagement.

Regardless of the scope of the engagement, whether an audit, review, or compilation, and regardless of a very specific engagement letter detailing the scope of the engagement, the following steps should be followed for all clients:

- Evaluate the risk of the client and the engagement: Sometimes it is better to fire a client than to risk the cost and hassle of a lawsuit. It should raise red flags for the accountant if a client ignores or dismisses weaknesses with internal controls raised by the accountant.
- Use engagement letters on all engagements: Again, an engagement letter does not prevent a lawsuit when embezzlement/fraud/theft is uncovered. However, a well drafted engagement letter that specifically describes the scope of services sets the expectations of the client and is important evidence in assisting with the defense of a lawsuit.
- Be aware of red flags: Accountants need to be vigilant whether the engagement involves an audit, a review, a compilation, or other accounting services. Even if the assessment of internal controls is not part of the engagement, an accountant should not ignore glaring issues with internal controls. Be skeptical on all engagements; skepticism is important especially for long-time engagements where it is easy to become 'comfortable' with the client's employees.

- If you see something, say something: While it is not the responsibility of the accountant to correct the problem, the accountant should at least inform the client of concerns, including the following:
  - Separation of job functions: If all accounting/bookkeeping responsibility is concentrated in only one or two individuals, the accountant should point out the risk to client management. This includes opening of mail, reviewing monthly bank statements, and preparing monthly bank reconciliations.
  - Limit access to company checks.
  - Whoever prepares checks should not be the same person who signs the checks. When possible, always require two signatures on checks.
- Document concerns and document the response of the client: Anytime a concern is raised to client management, it should be done both verbally and in writing. Memories fade over time, especially when six or seven figure losses are at issue. Not only is it important to document concerns when first expressed, it is important to document the concerns with every engagement, including the response of management, even if the same concern and response occurs year after year. This becomes critical evidence in defending a lawsuit.

Accountants need to appreciate that business owners/managers, especially for small to mid-size companies, focus their energy and time on the daily work and growing the business. Owners/managers often place too much trust in long-time employees and often fail to institute basic internal controls. It is incumbent on accountants to emphasize to clients the value of a fraud prevention program.

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