Subject: Controller defalcation

Services: Review

Sterling Strip Malls (SSM), a commercial real estate development company in Florida, engaged the accounting firm of Oldham, Hughes & Booker (OHB) to perform review services in order for Sterling to qualify for construction bonds.

OHB provided SSM with an engagement letter stipulating that the review: 1) would not contemplate obtaining an understanding of internal control or assessing control risk; 2) could not be relied on to disclose any errors, irregularities, or illegal acts, including fraud or defalcations, that may exist; and 3) would include a report that would state in part, "All information included in these financial statements is the representation of the management of Sterling Strip Malls."

The terms of the letter were discussed with the owner of SSM, Robert Sterling, and a notation was made in OHB's file that Sterling understood the terms, although he never signed the engagement letter. Sterling and his controller, Paul Peterson, did sign a management representation letter, indicating that SSM's financial information was accurate and in conformance with GAAP.

Sterling had absolute trust in Peterson and gave the controller complete control over all aspects of the financial records, including accounts receivable, accounts payable, making bank deposits, processing payroll, signing checks, and reconciling bank records.

Unknown to Sterling and OHB, Peterson had been engaged in a complex embezzlement scheme in which he posted payments for payroll taxes but never actually made the payments. He instead diverted the funds to another account from which he wrote checks to pay for personal expenses. At one point during the review, bank account reconciliation items totaling about $150,000 came to the attention of the OHB accountant, who questioned the controller about the items and received assurances from Peterson that the items were due to legitimate delays in deposits being posted.

After OHB had completed reviews of SSM financial statements for three years, Peterson suddenly disappeared. Albert Woods, a CPA and business planning consultant to Sterling, was hired by Sterling to step in as controller. Woods then discovered the failure of SSM to pay its payroll taxes as well as the embezzlement by Peterson. The amount embezzled totaled about $100,000, but the failure to pay payroll taxes resulted in penalties and interest totaling about $250,000, a liability that caused SSM to lose its credit and to declare bankruptcy.

Sterling then sued OHB for negligent representations in the SSM financial statements. A summary of the alleged damages in the suit included the value of Sterling's business, about $1 million, plus approximately $400,000 of Sterling's personal funds invested in an attempt to save his company. Added to the $100,000 embezzled and the $250,000 in penalties and interest, total alleged damages came to $1.75 million.

Test your ability to guess the jury's judgment.

Question 1. What percentages of responsibility did the jury assign to:

Peterson (the embezzler): _____%

Sterling (the owner): _____%

OHB (the CPA firm): _____%

Question 2. How much of the total alleged damages did the jury assess against the CPA firm?

$__________

Answers to War Story Quiz

Answer #1 — The jury assigned: 20 percent of the responsibility to Peterson (the embezzler); 18 percent to Sterling (the owner); and 62 percent to OHB (the CPA firm).

Answer #2 — The jury determined that 95 percent of the alleged damages were to be awarded ($1.66 million), resulting in an award of $1.03 million against the accounting firm, and $332,000 against the embezzler, who was long gone.

Postscript: When the jury deliberated on the issues, it focused on the bank reconciliation items of $150,000. Jurors acknowledged that the CPA's inquiry was correct in going to the controller, who was the embezzler, but they were dissatisfied with the "vague" answer that the controller provided about delays in deposits. They were also dissatisfied with the fact that the inquiry and answer were not documented. The jury ultimately decided that the CPA should have performed additional procedures to "achieve limited assurance" that there were no material modifications to the statements. The quality of the witnesses was also a major factor. The business owner presented himself well as the pitiful, victimized party, motivating the jury to look for a way to make him "whole" again.

Loss Prevention Tips

A survey commissioned by CAMICO in 2003 showed that 71 percent of survey respondents expected an accountant to uncover fraud if the accountant is hired by a company to review financial statements, but is not retained to perform an audit. When asked in 2001, a mere 40 percent had that expectation. (See article on page 4.)

Professional standards and resources often focus on the detection and prevention of fraud in audit engagements, but the public generally expects CPAs to uncover fraud, regardless of the services being rendered, to police the financial reporting of their clients, and to make sure that their clients are honest and law-abiding.

For CAMICO's guidance, see "**CPAs uncover fraud, regardless of the services being rendered**" on page 2, and "**Client Acceptance and Review**" on page 3.

"War Stories," drawn from CAMICO claims files, illustrate some of the dangers and pitfalls in the accounting profession. All names have been changed.

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