

War Story 3 - Defalcation, Compilation

Subject:

Defalcation

Service:

Compilation

Situation:

Joe Thomas, CPA, has been an active member of the local Widows and Orphan Foundation (WOF) for the past seven years. As the resident CPA of the organization, Joe typically donates most of his time and prepares the annual financial statements for a nominal fee of \$75. Working closely with Alex Down, bookkeeper and treasurer, Joe is able to complete the financial statements within a week by performing what he considers a compilation. With WOF's financial statements behind him, Joe departs for a month-long vacation abroad.

Upon his return, he learns that Alex has left the organization and the newly appointed treasurer has discovered several discrepancies in the organization's records. A \$500,000 stock purchase was made, but WOF never received certificates or notice regarding the investments. Additionally, several forged checks were uncovered. The new treasurer suspects that Alex and the stockbroker stole the \$500,000 and were responsible for the forged checks. However, since they have disappeared, the treasurer turns to Joe for answers.

Joe is unable to shed light on the situation and claims to have no connection to that aspect of the organization's finances because he only did a compilation once a year.

Complaint:

WOF alleges that Joe was negligent by not uncovering the missing stocks and forged checks during his engagement.

Result:

Although Joe claims that he was doing a compilation, much of the language he used verbally and in the engagement letter suggests that he was doing much more. His letter states that he would "review certain entries to verify..." and "audit the organization's records..." These misleading statements were the primary justification for the lawsuit, holding Joe responsible for researching the accuracy of the financial statements.

Joe's case was settled out of court for \$75,000. A separate suit for \$750,000 is still pending against the agent who sold the stock to WOF.

Loss Prevention Tips:

If Joe's engagement letter was tailored for the WOF engagement, the new treasurer would have clearly understood the services that Joe was performing. Joe's engagement letter should have defined his scope of practice as a compilation and he should have outlined WOF's responsibilities as a client. Joe also communicated poorly by using terms such as "audit" and "review" loosely. Never use jargon or ambiguous language in your engagement letter.

Joe's personal involvement with WOF and his desire to "do a good deed" also blinded his professional judgment and skepticism on this engagement. As a member of the organization, Joe felt it was his duty to do this engagement every year. He never took time to screen the organization as a client or evaluate the responsibility and risk he might be taking on as a CPA.

For a mere \$75, Joe was willing to take on a great deal of risk. He should have charged what his services were worth or at least taken measures to protect himself by documenting the information that Alex was responsible for providing.