

FORENSIC RISK MANAGEMENT

A Sharpened Fraud Focus Reduces Litigation Risk

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Two articles in the inaugural issue of the *Journal of Forensic Accounting* contribute empirical support for the continued existence of an expectations gap. Farrell and Healy¹ document that accountants do not believe they should be responsible for searching for fraud despite the existence of SAS No. 82 – Consideration of Fraud in a Financial Statement Audit. Gramling et al.² point out that financial statement preparers and users expect auditors to assume a greater role in detecting and reporting fraud than do auditors themselves. Given the present litigation environment, auditors should be concerned about these findings. In the end, courts and juries are the ultimate arbiters of an accountant's responsibilities or duties to a client or third party. In some instances, compliance with applicable standards such as GAAS or GAAP will not insulate an accountant from liability. The following case is an illustration of just how far a court can go in holding an accountant liable.

Facts of the Case

The Appellate Division of New York, an intermediate appellate court, upheld a judgment against a public accounting firm for failing to report an employee embezzlement scheme to a client. Interestingly, the accounting firm's liability arose from a review, not an audit, engagement.³

The appeal arose from a \$211,000 state trial court judgment against the accountants. Edward Nezelek Construction Company, Inc. (Nezelek) engaged an accounting firm, Esserman & Pelter (E&P), shortly after forming the company in 1983. Nezelek hired its bookkeeper in 1986. This bookkeeper had previously been employed by another E&P client, and E&P was aware that she had been dismissed by this client under circumstances involving alleged theft. E&P discussed the background of the bookkeeper with Nezelek upon learning of her hire. The content of the communication, beyond noting a "troubled past," was a matter of dispute at trial.

Despite implementation of a requirement that checks could only be signed by a corporate officer when accompanied by supporting invoices, the bookkeeper embezzled funds for over two years by executing what Joseph Wells, CFE calls a "concealed check scheme." She established bogus bank accounts using names similar to those of Nezelek's subcontractors. She would then present checks payable to these fictitious entities to authorized corporate signers, during busy times, for signing. She then deposited the checks into the bogus accounts for her own personal use. The fraud scheme continued until the IRS came knocking.

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