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# Professional negligence

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# Professional Negligence

THE following case, which attained considerable publicity, illustrates the point of the preceding article. It is stated as reported without first-hand knowledge of the facts. The case involves an engagement where accountants not only failed to apprise the client of a dangerous situation, but also failed to detect an embezzlement until after it had grown to large proportions.

The comptroller of a large manufacturing concern was successful in misappropriating more than a million dollars of the company's money. His operations extended over a period of three years before being brought to light. The comptroller, in addition to the ordinary duties of such an official, was authorized to sign all company checks. As a result he was able to effect embezzlement by fraudulent transfer of funds between company banks.

Several plants were operated by the company in various sections of the country, some at distant points. Bank accounts, considerable in number, were carried at the different plants, but were controlled by the main office of the company. Transfers of funds between banks were made frequently, and in large amounts. At times transfers were effected by the remittance of checks drawn on one bank in favor of another; at other times bank drafts were purchased at the home office bank and remitted.

The company's accounting procedure provided that when a transfer check was issued, it was credited to the bank on which drawn, and charged to an account called "Funds in Transit." In due course the payee bank reported the receipt of the check or bank draft, and an entry was made to charge that bank and to credit "Funds in Transit." In the usual run of business, therefore, an individual item did not remain very long in the "Funds in Transit" account.

The defaulter obtained his funds in the following manner. He drew checks on banks with large balances, in favor of the home office bank. These checks ostensibly were for the purpose of buying drafts to be sent for deposit in other banks at outside points. The checks were entered regularly in the cash book, being charged to "Funds in Transit." Instead of actually buying the drafts, however, the comptroller deposited the checks in the home office bank to the credit of another business concern which he owned and operated.

In cases of such manipulations, there were of course no advices received by the company from the banks to which the diverted funds were supposed to have been transferred. The items were allowed to remain in the "Funds in Transit" account for a number of days, but not over the end of a month.

Near the end of the month the comptroller concealed the shortage by "kiting" checks. He drew checks on the home office bank aggregating the amount of the shortage, and forwarded them for deposit in the banks where the original transfers were supposed to have been deposited. The checks were not entered in the records until the following month. They were mailed at such times as to reach the payee banks before the close of the month, but not to reach the home office bank, on which they were drawn, until after the close of the month, so that they would not be included in the current settlement of the latter.

At the same time the comptroller put through an entry clearing the "Funds in Transit" account and charging the banks in which deposits of unentered checks had been made. The same process was repeated at the end of each month. The amounts involved gradually increased as the shortage became greater.

At the end of the month, after the unentered checks had been deposited and credited by the payee banks, the balances shown on the monthly bank statements agreed with those shown in the cash book. Accountants accepted this agreement as final for nearly three years. The shortage was eventually discovered by making a comparison between the dates of transfer checks and the dates of the corresponding deposits. The checks used in the manipulation uniformly bore dates from several days to a month prior to the dates on which they were shown by the banks as being deposited, during which time they remained in the "Funds in Transit" account.

Proper reconcilement of the bank accounts, including a comparison with the cash records or check books, of late deposits made as shown by the bank statements, should have disclosed the shortage at the time of the first audit after the commencement of the irregularity.

This case illustrates the danger of permitting the comptroller of a company to sign checks. His duties are to safeguard the funds by exercising control over the financial activities of the treasurer. The functions of comptroller and treasurer should not be performed by the same individual.

## Diversified Trustee Shares

AN interesting development of the principle of the investment trust has been brought to our attention recently. The investment trust, although long popular in Great Britain, is comparatively new in America. The past few months, however, have witnessed the introduction of the principle into American finance, and a number of developments have taken place.

As used abroad, the investment trust is a corporation organized to make available to the general investor the stocks and bonds of other companies, thereby in a measure relieving him of the task of finding safe investments for his money. The corporation issues shares or debenture bonds to investors. With the funds so obtained, it acquires large blocks of securities in other companies, and distributes the income therefrom to its own stockholders.

The trustees or directors of the corporation commonly are allowed to use their own discretion in the purchase of securities. Controlling interests in other companies are sometimes acquired, although such is not always the case. At times funds from the sale of new issues are derived by corporations chiefly from such investment trusts.

The corporation usually is able to investigate more thoroughly the securities it buys than is the individual investor. It is also able to diversify its holdings to a greater extent, and thus in many cases to reduce materially the risk of loss to the individual. In addition, it offers a ready field for the disposal of new issues by other companies.

The American development thus far has proceeded along slightly more cautious lines. The following is a case in point.

A corporation recently was formed for the purpose of creating "trustee shares representing a full participating ownership in the capital stocks of leading American corporations." The shares are brought out in different issues, one issue representing one combination of stocks, another a different combination, etc. The corporation has made three issues to date. The last was operated as follows.

A certain number of shares of stock in selected corporations was purchased in the open market. The stocks were chosen from those of well-known corporations. An attempt was made to make the list as diversified as possible. It included industries engaged in various lines of busi-