

Public Relations Associates: Investigating Cost Assignment Fraud

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Public Relations Associates (“PR”) is a full-service public relations firm, in Hollywood, California. PR began as a three-person operation in 1999 and has grown to over 200 employees. In 2007, *PRWeek* recognized PR for outstanding performance in its regional firm category. PR offers numerous types of public relations services including business and product launches, brand building, lead generation, special event support, investment attraction, reputation building, and crisis management.

PR’s accounting system is relatively straightforward. Data entry for routine transactions, such as client billing and vendor payment, is completed by accounting staff. An accounting supervisor, who reports to the controller, approves all routine transactions. The controller provides a higher-level approval for any non-routine transactions and reports to the Chief Financial Officer. The information technology business process assists the accounting function by designing any new reports needed from the system and printing checks. The portion of the organizational chart applicable to the accounting functions is presented in Figure 1 (See Appendix A, Figure 1).

Services are performed for a client only after both parties have executed a service contract. Many costs related to a particular contract are considered *pass-through* costs by PR—they are merely passed on to the client. In PR’s cost management system, these costs are labeled *client-absorbed costs*.

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Other costs related to contracts are simply absorbed by PR as a cost of doing business (labeled in the cost-management system as *PR-absorbed costs*). Generally, if a cost can be specifically identified with a contract, it is treated as a client-absorbed cost (e.g. facility rental, printing, photography, video production, etc.).

PART I: PLANNING THE INVESTIGATION

Curious Costs

In October 2009, Luz Chen was completing her routine budget analysis, including an examination of PR's cost reports. She noted two invoices issued by a company named ThunderStorm Productions Inc., which had been recorded as PR-absorbed costs. She considered these invoices curious because only a small number of vendors provide materials and services that are not client-absorbed. Thus, whatever services ThunderStorm provided should probably be borne by clients. Chen assumed the costs were miscoded and asked the production biller, Ron Bloomfield, to retrieve the invoices in order to correct the apparent miscoding that occurred almost a year earlier.¹

Approximately one week after her initial request, Chen had yet to receive the invoices from Bloomfield. She met him at his office door on his way into work. Bloomfield informed her that he had searched for them diligently with no luck. Then he had recalled the auditors requesting numerous invoices. He was sure that the two ThunderStorm invoices were in that paperwork. The auditors apparently had failed to return the invoices to the corporate files.

Back at her office, Chen phoned the audit manager to request that the invoices be returned. Without hesitation, the audit manager replied that all documents belonging to PR had been promptly returned to files shortly after completion of the audit. As Chen hung up the phone, she caught a glimpse of Bloomfield leaving the office.

¹ A production biller is the PR terminology for an accounting staff member who processes accounts payable.

On the day following the face-to-face request for the invoices, Bloomfield phoned in sick. Four business days passed without any word from Bloomfield. Chen attempted to phone Bloomfield, leaving a trail of voicemail messages at various contact numbers. Finally, Chen reached Bloomfield's girlfriend who responded that he had been diagnosed with "walking pneumonia" at the emergency room and would be unavailable to work until he had recovered from his illness.

Investigation

In Bloomfield's absence, Chen phoned you, recognizing your accomplishment as a fraud examiner. You completed your accounting degrees together at North Central University. Chen provided the brief summary of events and explained that she was quite suspicious of Bloomfield. She explained that, before confronting him again, she wanted to know exactly what was going on and the extent to which he was involved (if at all). Chen also wanted as few people as possible to know about this problem. She trusted that you would help her investigate the issue quietly. She did not want any other PR employees to get involved. Several big client deadlines were on the horizon, and they could ill afford any distractions or idle gossip. Furthermore, she was anxious about Gene Rotman learning of the issue—he would be very concerned about clients of his firm thinking that PR was not a well-oiled machine. You agreed to meet Chen the following morning.

Requirement

You are preparing for your meeting with Chen. She has told you all she knows about the situation. Your goal is to organize your thoughts concerning what you need to find out and how to do so. Prepare a listing of investigative procedures that you will perform, as well as what you will be looking for or hoping to obtain from those procedures. Identify those steps that you will be able to complete at the PR office the following morning versus those steps that will require additional

legwork. Where possible, indicate the instances where your findings on one procedure will lead to one or more follow-up procedures, implying a chronological order.

PART II: RESULTS OF THE INVESTIGATION

The Investigation

Following a brief recap of facts with Chen, you requested a listing of all checks issued to ThunderStorm. Chen had run the report the previous evening and discovered 93 ThunderStorm invoices totaling \$305,116 paid between February and October, 2009. Only the first invoice, dated December 16, 2008, was available for review. The remaining 92 invoices should have been stored in various filing cabinets on the fourth floor of the office building; however, they were currently missing from the office. The sole invoice, coincidentally, was loose in a file cabinet. Your review of the December 16 invoice revealed the information shown in Exhibit 1 (See Appendix A, Exhibit 1).

You began to review other invoices on the report and noticed several curious things. Invoice numbers identified an invoicing pattern not indicative of a company conducting normal business operations. Curiously, the first invoice received by PR appeared to be the first in a series or batch (#1001). Invoice # 1038 was dated on March 18, 2009, and Invoice # 1040 was dated on April 3, 2009. If using pre-numbered invoices (as most businesses do), a business conducting normal business operations would most likely issue more than two invoices over a five-week period. Another example was the sequencing of Invoice # 1288, dated March 5, 2009 and Invoice # 1278, dated April 27, 2009. The invoice numbers appeared incorrectly sequenced relative to their respective dates. Additionally, many invoices reflected the same amounts over the three-year period.

You were anxious to check the vendor address against employee addresses (with a particular interest in Bloomfield) and to speak with Anna Shelley, whose initials were on Invoice #1001.

However, you first needed to fully understand the vendor payment process. Chen described it as follows:

In addition to me, two other people have the access to add a new vendor to the accounting system: Anna Shelley (Accounting Supervisor) and Gene Rotman (CFO). I only approve a vendor if Shelley is unavailable. Rotman receives the request only if Shelley and Chen are unavailable. Unfortunately, the system doesn't really reflect who adds a vendor—we've never worried about it, given that only the three of us have that access. Any accounting staff can enter an invoice into the accounts payable system to create an invoice payable, provided a valid vendor already exists in the system.

Each week, one of the accounting staff prints a report of the invoices requiring payment and submits the report and corresponding invoices to Shelley for approval. Shelley verifies each invoice against open purchase orders, placed by employees throughout the firm, which should be in the system. (Sometimes employees fail to enter a purchase order—we've been working on better compliance with this procedure.) Shelley can authorize payment of invoices less than \$5,000. However, invoices greater than \$5,000 required a secondary approval by me (or Rotman, in the case of my absence). Approval is indicated by our initials and a date-stamp. Once each invoice on the report is approved, Shelley clears the open purchase order in the system and returns the report and approved invoices to the accounting staff. The staff then electronically submits the report of approved invoices to the IT department, who prepares the checks for payment. The checks are printed with Rotman's signature. The signed checks are returned to the accounting staff for mailing.

Given the correspondence of Bloomfield's absence with Chen's discovery of the ThunderStorm invoice, you decided to check ThunderStorm's payment address with his and other employees' addresses. The payment address on the original invoice corresponded to the address in the Accounts Payable vendor files. The vendor address did not correspond exactly to any employee address. However, two employees had addresses in the 90232 zip code—Ron Bloomfield and Don Lo.

To gather additional background information on Bloomfield and Lo, Chen arranged an impromptu meeting for you with the human resources manager. You learned the following about these employees. Ron Bloomfield began employment with PR in June 2007. He was initially hired as a temporary employee on the accounting staff, but became full-time in August of the same year. His

performance evaluations, administered by his supervisor, Shelley, were consistently positive. Don Lo joined PR in January 2008, in response to an ad for a Microsoft Certified IT Specialist placed with Monster.com. Lo's primary responsibility was to keep the company's Windows-based server running. Lo's performance evaluations, signed by his supervisor (Swinson), were average except for once when he "failed to meet expectations." Comments by Swinson indicated that Lo had been absent from work during the final quarter of the year, with little explanation. Furthermore, during this same period, Lo had acted disrespectfully toward a fellow employee during a heated phone conversation witnessed by other IT personnel. He had apparently lost his cool attempting to provide technical support via phone. According to the human resources manager, PR had not run a background check on either employee. However, each employee provided a previous employment reference, which was verified.

From the human resource manager's office, you headed to Anna Shelley's office. She too was unfamiliar with the vendor called ThunderStorm Productions. She examined the one invoice and the report of all invoices printed by Chen, but could not recall reviewing or approving any of them, despite her initials on the document. She commented that the initials might not be her hand-writing, though it was hard for her to be certain. As she continued to examine the report, she commented that all invoices submitted by ThunderStorm Productions were for amounts less than \$5,000, falling within her level of approval. As she sat contemplating the one original invoice, her expression changed. She explained that she had taken medical leave from work for approximately five weeks during late November and early December of 2008.

It was almost lunch time, so you decided to grab lunch and check out ThunderStorm's location. An image returned by *Google Earth* when you typed in the invoice address (3816 Lucia Avenue, Suite 372, in Culver City) showed a commercial area. The same address in *Google Maps*

revealed a UPS Store at the address. Upon arrival, you realized that Suite 372 was simply a leased mailbox within the UPS Store. After pressing the UPS employee a bit, and explaining the urgency of the matter, he disclosed that Suite 372 indeed belonged to ThunderStorm Productions. However, he could not (or would not) provide a company representative's name from the lease.

On the way back to PR, you considered what to do next. The circumstances seemed to point to Bloomfield; however, you were not ready to discount Lo just yet. Your next step would be to image the hard drives of their computers, preferably after hours, and search for files and email related to ThunderStorm Productions. You would interview Lo and Bloomfield (if present) the following day.

Back at the PR offices, you explained your plan to Chen, and then indicated that you would need to ask Rotman about the invoices to be certain. Rotman's assistant, Helen Mendoza, indicated that he was out of the office, but she might be of help. Chen had described her as "Gene's right hand," so you decided to ask her about the vendor. You were taken aback when Mendoza indicated that she did remember the vendor, ThunderStorm Productions. She had added the vendor for Bloomfield, on a day when Shelley, Chen, and Rotman were away from the office. She recalled phoning Rotman, who told her to "just handle it," which was his typical response when he was out of town. The unique name of the vendor had stuck with her. When asked about access to do so, she explained that as Rotman's administrative assistant, it was necessary for her to be able to act on his behalf in his absence. She indicated that she had not signed the invoices, however.

Leaving Rotman's office, you spotted Chen headed toward you, practically running, exclaiming something about what she had found while you were gone. You followed Chen back to her office as she began to explain about some security logs. She had requested to see the building security logs for the past several months. Bloomfield had signed into the building on Sunday, October

16, 2009—the Sunday after he was originally asked to produce the ThunderStorm Production invoices (October 12). The security log also showed that Bloomfield signed into the building on Sunday, October 23, the first Sunday after he called in sick (October 18). According to PR personnel, there was no legitimate business reason for his presence at the office on either date.

That evening, Chen accompanied you to Bloomfield's office. You imaged the hard drive and then began to filter through the data using forensic software. You discovered multiple deleted documents containing data from the ThunderStorm Productions invoices. It appeared that Bloomfield had been creating the invoices on his office computer. He must have mixed them in with legitimate invoices arriving in the mail. He would generate a purchase order in the system and would forge Anna Shelley's initials on the invoices.

Epilogue

You were never able to interview Bloomfield. Over the next week, the human resources manager attempted to contact him and requested his immediate presence at the office to discuss the ThunderStorm Productions matter. He never replied. PR terminated Bloomfield's employment on November 3, 2009, due to his failure to provide medical certification to account for his unexcused absence and for refusing to cooperate during the investigation.

You and Chen met with the executives of PR, including Rotman, to discuss your findings. They subsequently hired an attorney for legal assistance. At the close of the meeting, Rotman asked for specific recommendations on how the vendor payment process should be improved to avoid such a calamity in the future. You agreed to compile the information within the week.

Requirement

Write a letter to the Board of Directors of PR responding to Rotman's requests for specific recommendations to improve the vendor payment process. Describe how your recommendations

address specific weaknesses that facilitated the ThunderStorm Productions fraud, where applicable. Be sure to write professionally. The letter should be concise, well-organized, and contain headings, bullet points, or diagrams if needed to aid readability.

INSTRUCTOR NOTES

The purpose of this case is to allow students to step into the role of fraud examiner, from planning an investigation to reporting recommendations to the board of directors. The case helps to develop critical thinking and written communication skills. The two-part design of the case provides a rich and realistic case study. Students are initially presented limited information from the company's corporate controller, who suspects fraud. They must use this information to sketch out an investigative plan, including who to interview (and in what order), what data to analyze, what documents to examine, etc. Once students submit their investigative plans, Part II of the case takes students through the investigation as if they are the examiner. Thus, the case presents the fraud examiner's thought pattern as the investigation progresses. Interviews take place, documents are provided, the results of data analysis are presented, and as the examiner reacts to these results, the fraud is gradually revealed. Through the investigation, the case introduces internal control weaknesses which allowed the fraud to occur. Students must diagnose these weaknesses when the CFO requests corrective recommendations. Students must communicate their recommendations in writing to the board of directors. The learning objectives for each part of the case are described in Appendix B.

The case is designed for any course that includes fraud examination or forensic accounting techniques. The case allows students to practice and apply concepts and techniques studied in these courses. Though we believe the case is most effective if both parts are used together in sequence, each part may be assigned independently of the other.² The requirements of Part II—diagnosing control weaknesses that facilitated the fraud—also may be useful in undergraduate or graduate auditing courses in the context of internal control or fraud risk assessment.

² If only Part II is assigned, the instructor should provide the text of Part I solely for the purpose of introducing the company and the controller's suspicion.

The instructor may assign the case in various ways depending on the desired allocation of class time, individual versus team work, and grading required. One way to assign the case uses a mix of individual and group effort, in- and out-of-class work, and less grading of written deliverables for the instructor. Students read Part I of the case and arrive prepared to discuss it. Students then complete the requirements for Part I together as a class, with no formal written deliverable. The instructor leads the class through brainstorming an investigative plan and provides feedback on the strengths/weaknesses of the plan (using the teaching notes). Following this discussion, the instructor distributes Part II of the case. Students complete the written deliverable individually outside of class and submit it later for grading. We find that allowing a relaxed, group effort on Part I immediately engages the students and piques interest in the case without sacrificing accomplishment of the learning objectives.³

SUGGESTED SOLUTION

Part I: Planning a Fraud Investigation

Using a bull's-eye approach, this investigation would start with analyzing related data, process to interviewing individuals for information purposes, then zeroing in for interviews with suspected perpetrators. At the PR office the following morning, students should consider further analyzing available documentation, such as

- original invoices or correspondence from ThunderStorm Productions
- cancelled checks issued to ThunderStorm Productions
- vendor database files.

³ An alternative, which requires additional class time but potentially less grading, is to divide the students into teams for Part II. On the due date, the class would hold a "Board meeting" wherein one team is randomly chosen to present their recommendations to the class, which represents the Board of Directors. The class would be allowed to question the presenting "fraud examiners." With this modification, the instructor may require either a team written deliverable or no written deliverable.

Students would be analyzing these documents for such things as unusual billing patterns (concerning the dollar amounts, dates, or numbers of the invoices), the check endorsement and vendor bank, the vendor address, common accounts payable employee submitting the invoices, etc. The review of company documents might also include personnel records of any suspected perpetrators. These records provide employee addresses (which may be cross-referenced with vendor addresses) as well as previous performance evaluations for an employee. It is apparent from Chen's phone call that she considers Bloomfield the key suspect; however, students should be open-minded to other potential perpetrators/accomplices, as well as the possibility that Bloomfield is not responsible. Other on-site procedures that can be performed include public record searches of potential perpetrators and forensic imaging and review of their company computers.

Students should also plan to conduct interviews of PR Associates personnel, particularly any personnel suspected to be directly or indirectly involved with the fraud. Note that initially only interviews—not interrogations—are performed. At this stage of a fraud investigation, investigators are gathering evidence to discover a fact pattern prior to making any determinations of whether a fraud has occurred and who perpetrated any fraud identified. Students should recognize how greatly Luz Chen must aid the investigation. The visit to PR should begin with a careful interview of Chen in which as many relevant facts as possible can be gathered for use when carrying out the remainder of the investigation. Further, her wishes to keep the investigation confidential likely will necessitate her intervention at various points throughout the investigation. For example, students could provide Chen with interview questions and have her conduct the interviews as a follow-up to invoice issues that cannot be answered because of the illness of the production biller.

A potential line-up of interviewees, beyond Chen, might go as follows

- Anna Shelley: for an explanation of the A/P process and any specific information she may have about the vendor Thunderstorm, particularly any peculiarities with the related documentation and payment
- Accounting staff: for any specific information she may have about the vendor Thunderstorm, particularly any peculiarities with the related documentation and payment
- Gene Rotman: for any specific information she may have about the vendor Thunderstorm, particularly any peculiarities with the related documentation and payment
- Human Resources Manager: to request personnel records for Bloomfield and any other potential perpetrator identified

Students should note, however, that they will be unlikely to schedule an interview with Ron Bloomfield as his claimed illness has prevented him from reporting to work.

Additional legwork will be needed to gather additional facts for the investigation. Students might mention that a visit to the vendor's location is important. Further, the investigator could request that Chen contact the vendor for a second copy of the invoice. An investigator can drive by both the vendor's location and Bloomfield's home to observe whether the business appears legitimate and whether Bloomfield appears to be residing in the home. Students should note that no direct contact should be made since this investigation is being conducted confidentially.

Part II: Results of the Investigation

The following list of recommendations and management action plans are possible answers that students might provide. While we believe this is a relatively comprehensive set, students may contribute additional legitimate recommendations.

- Under the current accounts payable process, three employees have the authorization to establish new vendors within PR's vendor master file—the accounting supervisor, the controller, and the CFO. PR will obtain better control if the authority to establish a vendor is provided to the controller level and above. Those individuals with authority must ensure appropriate requirements are met prior to creating the vendor account. Examples of requirements include
 - a. Dun & Bradstreet checks
 - b. reference checks to ensure existence and legitimacy of new vendors
 - c. cross referencing of physical address and phone number to employee addresses and phone numbers, and
 - d. a site visit to verify existence (if feasible).

If the profile of PR vendors makes it too costly to implement each of these steps for all vendors, PR should consider categorizing potential vendors according to invoice totals or frequency expected. Vendors with smaller or less frequent invoices would only be subject to certain of the checks (such as a. and c. above). The accounts payable system should reflect when and by whom the vendor was added to the system, perhaps in the vendor history.

Suggested Management Action Plan:

- Restrict new vendor additions to Luz Chen, Controller, and in her absence, Gene Rotman, CFO, who will cross-check all new vendor addresses with employee addresses to ensure no matches are discovered. (This step should also be performed for existing vendors, given that this control was not previously in place.)
- Contact accounts payable software vendor for feasibility of modifying the vendor history file to store the date and employee who added the vendor.

- Request that Albert Swinson (IT Director) modify system permissions so that only the logins for the Controller and CFO are permitted to perform the vendor addition function within the system.
- Under the current invoice approval process, any accounting staff may enter an invoice for payment as long as the vendor exists in the system. Invoices are approved at the point of payment due (check run). Invoices should be approved by a supervisor/manager *prior* to entering them into the system. This allows a matching of the invoice to an approved purchase order (and receiving report, if applicable) well in advance of the check run. The thresholds for required approval are appropriate.

Suggested Management Action Plan:

- Restrict invoice approval to Anna Shelley, Accounting Supervisor (for invoices less than \$5000), and Luz Chen, Controller (for invoices greater than \$5000). Utilize a method of authorization that is difficult to duplicate, such as a signature stamp, secured by these individuals.
 - Prior to approving an invoice for payment, check for an *approved* purchase order from the appropriate division of PR.
- Currently, business divisions throughout the PR firm are not uniform in a purchase order approval process and are not diligent about restricting purchased except with an approved purchase order. These limitations directly impact the effectiveness of proper payments and reduction of fraudulent purchases and billings within the accounts payable process.

Suggested Management Action Plan:

- Reconsider/redesign the approval process for purchases throughout the firm, limiting the approval for procurements to business unit purchasing managers.

- Request that Albert Swinson (IT Director) modify system permissions so that only these purchasing managers are permitted to enter purchase orders and receive a purchase order number within the system. (Contact system vendor for feasibility of necessary modifications to software, if necessary.)
 - Require that only approved purchase orders (containing a system-provided purchase order number) be forwarded to vendors.
- In the current process, approved invoices are returned to any accounting staff member, who electronically submits the payment report to the IT department for check processing. Thus, accounting staff currently have the opportunity to insert unapproved/fictitious invoices for payment after the supervisor/manager has approved a batch of invoices for payment. Invoices should be delivered directly from the approver (manager/supervisor) to the IT department for check processing. Furthermore, the approver (manager/supervisor) should review the printed checks to ensure that no extraneous invoices were processed in the check run.

Suggested Management Action Plan:

- Select one accounting staff member who will not enter vendor invoices for payment (i.e., not a production biller). Restrict the check request process to this accounting staff member.
- Restrict review and approval of the check listing report to Luz Chen, Controller, who will sign and date the report. Utilize a method of authorization that is difficult to duplicate, such as a signature stamp, secured by these individuals. (Alternatively, the software might allow for “electronic signature” of the invoices on the report. Contact the system vendor to check on this feasibility.)

- Require that the approved report be forwarded to the IT Department directly by the approver (Luz Chen, Controller). A copy of the report is provided to the accounting staff member responsible for the check request process.
- Require that the printed checks plus the check register be forwarded directly to the accounting staff member responsible for check requests by the IT Department. The staff member will compare these against the copy of the Controller-approved check listing report to ensure both reports are the same. Following this verification, the accounting staff member will stamp the invoices “paid” and indicate the appropriate check number on each invoice. Any discrepancies found will require additional review by the Controller prior to issuance of vendor checks.
- Currently, the absorbed costs are reviewed periodically but on no specific schedule. These reports should be reviewed monthly as part of the month-end closing activity to ensure all PR-absorbed costs are proper.

Suggested Management Action Plan:

- Require that Luz Chen, Controller, review the expense accounts, as part of the monthly closing process, to ensure that all PR-absorbed costs are normal. Any abnormalities should be followed up with whatever division generated the charges.
- Additional preventative action steps include:
 - Vendor addresses will be routinely cross checked against employee addresses.
 - All facility access will be immediately deactivated for those employees terminated from employment or who voluntarily resign.
 - Mandatory vacations will be implemented for all employees and administered in three-day increments.

Figure 1

Organizational Chart for PR Associates

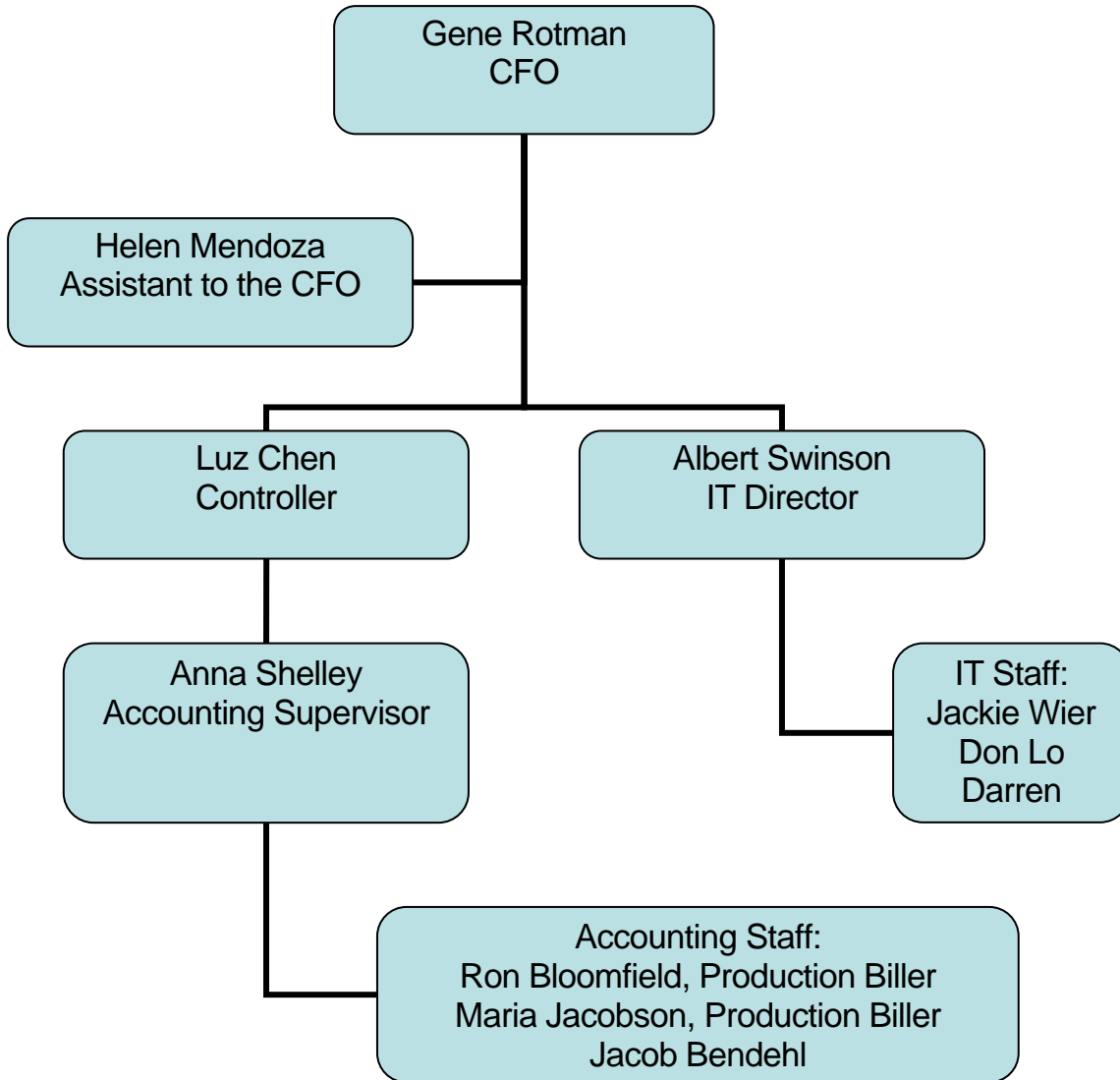


Exhibit 1

Information Contained on the Only ThunderStorm Productions Invoice

Logo: ThunderStorm Productions Inc.
Address: 3816 Lucia Avenue, Suite 372, Culver City, CA 90232
Phone: 866-335-7665
Fax: 310-267-2244
Fed Tax ID: 71-1535527
Invoice #: 1001
Date: December 16, 2008
Amount Due: \$4,500.00
Description: Photography fees, 3 hours labor cost, digital materials and
mastering

The invoice was date-stamped on January 20 of the following year with the initials "AS."

Appendix B

Learning Objectives of the Case

Part I: Planning a Fraud Investigation

The requirements of Part I are designed to enable students to enhance several skills related to effective fraud investigation, including to:

- Evaluate a set of facts, surrounding an alleged fraud, to determine what additional information is needed.
- Identify and order investigative steps needed to collect additional information related to an alleged fraud.

Part II: Results of the Investigation

This portion of the case is designed so that students gain experience being able to:

- Recognize conditions that facilitated a fraud, by evaluating the results of an investigation.
- Communicate to an organization recommendations resulting from a fraud investigation.

The opinions of the authors are not necessarily those of Louisiana State University, the E.J. Ourso College of business, the LSU Accounting Department, or the Editor-In-Chief.