

**The Obvious Fraud: A Short, Problem-Based Case Study to Highlight Inappropriate
Fraud Examination Techniques**

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INTRODUCTION

Assume you are an internal auditor for a large, multinational, manufacturing organization with a division in Mexico. One of your responsibilities is to investigate allegations made on the company's fraud hotline. When you arrive at work one morning you learn an anonymous tip was left on the hotline that alleges fraud involving the division manager.

"Pat's significant other is a fraudulent vendor," was the anonymous tip left on your company's fraud hotline. Pat is a division manager at your company.

"Wow. I can't believe this guy is so blatant," you're thinking as you review some accounts payable invoices while following up on this anonymous tip. The invoice that caught your attention is shown in Table 1.

A quick search of the AP file reveals a total of three invoices like the one in Table 1, all for identical amounts but on different dates. The division manager, Pat, has the authority to approve payment of invoices for less than \$10,000. It is obvious to you that the manager has created a shell company. You happen to know that Pat's significant other is named Kim, hence the name Kimco Marketing. There is no documentation to support these transactions other than the invoices, all of which are purportedly for marketing services.

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The manager's office is not more than 30 feet away and Pat can be seen at the desk. You throw the invoices in a file, grab your buddy in the next office, and head for Pat's office. After all, it doesn't take a brain surgeon to know what's going on here.

ASSIGNMENT

Your class will be divided into teams. Your team should assume you are the internal auditors going to interview Pat. After reading the scenario above, your initial task is to brainstorm about how you will confront Pat about the fraud allegation. Next, compile a written list of the questions you will ask in the interview with Pat and the sequence in which they will be asked. Ultimately, your objective is to determine whether a fraud has been committed and, if so, obtain a confession from Pat. At the conclusion of this planning session be prepared to interview Pat (who will be portrayed by your instructor).

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

INTRODUCTION AND OBJECTIVES

This case is based upon an actual fraud investigation that was conducted at a Fortune 500 company. The mishandling of that investigation resulted in no punitive action against the fraudster and allowed the fraudster to recover damages from the victim company for wrongful termination. The primary objective of this case is to demonstrate what not to do when one suspects fraud or wrongdoing. A secondary objective is to illustrate how important it is to be prepared for an admission-seeking interview.

Problem-Based Learning

This case utilizes the innovative, problem-based learning (PBL) method introduced to the accounting discipline by Johnstone and Biggs (1998) and Milne and McConnell (2001), and illustrated in an accounting education context by Durtschi (2003, 2010). PBL approaches to instruction originated in medical schools but have application to a wide variety of other disciplines. PBL consists of giving either an individual or team of students a realistic, ill-defined problem set in a real-world context. It is an investigative approach to learning and therefore results in an active learning process as recommended for accounting programs by the Association to Advance Collegiate Schools of Business (AACSB).

Within a typical PBL assignment, the students' initial task is to identify the additional information necessary in order to solve the case. Students must then ascertain where to find that information, which could require interviews with the appropriate parties. Finally, students are required to evaluate, analyze, and synthesize the information they obtain to develop a proposed solution, which generally takes the form of a supervisor-defined work product.

Consistent with AACSB proposed learning objectives, the aforementioned interview procedures and written solution requirements foster student growth from both oral and written communication perspectives. The context of the current case study further enhances AACSB accounting curriculum learning objectives by offering an environment whereby students must utilize critical thinking skills to ascertain a series of questions designed to obtain the necessary information during an admission-seeking interview.

PBL in Fraud Education

Most published fraud cases present the details of a scheme, who perpetrated the fraud, and how they were caught. The focus is on what can be learned from the case after-the-fact. We refer to these as “20-20 hindsight” cases and they play a valuable role in fraud education. They are especially useful to help students identify the red flags of fraud and to determine how the control environment could have been modified to prevent the fraud from occurring.

However, 20-20 hindsight cases suffer from several weaknesses. First, in many real-world fraud examinations the investigator does not know who is perpetrating a fraud or what scheme or schemes they are using. The critical role of the fraud examiner or forensic accountant is to determine who is actually perpetrating the fraud and how.

Second, 20-20 hindsight cases do not help students develop investigative or interviewing skills. By their very nature, these cases tell their reader what happened. Students do not get an opportunity to develop a fraud theory, collect evidence to test the theory, revise the theory as necessary in light of the evidence or lack thereof, and synthesize the results into a meaningful report.

The PBL approach puts students in the role of an investigator who does not know many of the facts related to a potential offense. The process is purposely unstructured and mirrors

practice by being iterative when the evidence fails to support the fraud theory. Within the context of using PBL in fraud education, we refer to these types of cases as the “20-20 foresight” approach. They require students to develop their own vision of the fraud, not merely read another person’s rendition of what happened.

Motivation

The current case study aims to illustrate the importance of interview preparation and following recommended protocol when conducting a fraud examination. In forensic investigations, the ACFE and others recommend working from the outside in. That is, gather documentary evidence, interview cooperative witnesses, build a case file, and then confront the alleged fraudster(s) near the conclusion of the investigation. This is illustrated by Wells (2003) in Exhibit 1 and by Albrecht et al. (2010) in Exhibit 2.

What seems like common sense to those of us in this field is not always so apparent to those not trained in fraud examination. This case is primarily based on the experience of a Fortune 500 company. They discovered that their division manager at a foreign subsidiary was committing fraud. The company employees immediately confronted the fraudster and terminated him the same day. The fraudster denied the allegations, destroyed key evidence that could have proven the allegations, and sued the company for wrongful termination. Ultimately the company suffered a six figure loss from the embezzlement compounded by a six figure settlement of the wrongful termination suit.

The aforementioned case did not begin with an anonymous tip. We have added this element of the case based upon the recently reported situation at Renault (Jones and Lublin, 2011). Anonymous tips are often useful in fraud examinations, but the Renault case provides

additional motivation for the lesson we are striving to impart in this case; fraud investigations should be done in a careful, methodical manner:

“Renault is the poster child for why you want to approach these situations with a sense of balance, and not have people rush to judgment,” according to Robert Fatovic, the chief legal officer at Ryder Systems, Inc. (Jones and Lublin, 2011).

In the Renault case the company fired three top executives based upon an anonymous tip and an incomplete investigation. The employees were steadfast in professing their innocence. Ultimately, the company learned it was apparently the victim of a hoax (Gauthier-Villars, 2011) and publicly apologized to the fired employees (Moffett and Pearson, 2011).

It is easy to tell students what to do and what not to do in a lecture format. This case was written so that they can see what could happen if they do not follow the appropriate investigation process. In our experience, a short, simulated interview demonstrating the incorrect approach is much more engaging, and entertaining, than simply telling students the proper way to conduct an investigation; as a result, students are much more likely to attain, and retain, our learning objectives.

IMPLEMENTATION

This brief, case study is designed for an introductory course in fraud examination. It could be used as a stand-alone exercise or in conjunction with a module on interviewing procedures/techniques or obtaining documentary evidence. The case could also be incorporated into an auditing class when discussing the appropriate steps to take when the auditor suspects fraud. The names used in this case study are gender neutral to facilitate use by either a male or female instructor.

The case is intentionally directed to get students thinking about the interview, not about whether they should conduct the interview. The lead author has used this short case several times during the first day or two of class and had good “success” getting students to take the bait and proceed to confront the fraudster. It is imperative that the instructor reinforce the auditor’s belief that this is an obvious case of fraud so that students will maintain their focus on immediately conducting an admission-seeking interview.

We use this case during the first class period of an introductory fraud examination class. Students are provided the case study and given about 15 minutes to prepare for the exercise. We encourage students to discuss the case in groups of two. To motivate all students to participate, we require each group to complete the requirements in writing and submit their work before we begin the classroom simulation. Students are also told that one of the teams will be chosen to conduct the simulated interview.

If the class is in a mediated classroom, the instructor can create a directory on the classroom computer with a name to connect it to the fraud. We simply use the name Kimco Marketing. Before the interview begins, we make sure the computer is projected onto the classroom screen.

After students have completed a brief brainstorming and planning period, we then ask for a team to volunteer to come to the front of the room where Pat may be found working in his/her office. Alternatively, the instructor can randomly choose a group to interview the fraudster. This is where the fun begins.

No matter what the students ask Pat, the fraudster explains it away. During the interview he pauses to send text messages. When they ask him to stop, Pat casually says he needs to text his significant other, presumably to let her know their scheme has been detected. In the midst of the questioning he gets up, goes to the computer which is projected onto the classroom screen, and proceeds to erase a directory of information labeled Kimco Marketing while the interviewers watch helplessly. If they threaten termination, he calmly responds that company policy says he cannot be terminated without cause. Eventually, the students will relent and terminate the interview. Or, the instructor can control the timing by simply telling the interviewers he or she will not continue the conversation.

All told, this is about a 30 - 40 minute exercise depending upon how long it takes the interviewers to recognize that they made a mistake by confronting Pat before they had the evidence to prove their allegations. By *showing* them what can happen in a situation like this, rather than simply *telling* them in a lecture, we believe they retain the lesson better. We conclude by telling them what actually happened to the Fortune 500 Company in a similar situation. We have found this to be an effective, and entertaining, way to bring this lesson to life, and to show them that they can save their future employers a good bit of money by conducting investigations, and interviews, in the proper sequence.

TEACHING NOTES

There is no solution, per se, to this case. The moral of this story is that the auditors should have conducted a thorough examination, collected all available documentary evidence, interviewed cooperative witnesses, and only then confronted the fraudster. This approach maximizes the odds that the examiners will be able to get a confession from an evasive target.

When the instructor distributes the case assignment, she should stress that this is a rather simple, obvious case of fraud. Although this is not true, we want students to jump to this conclusion so that we can illustrate the error of following this approach. At some point after distributing the assignment, but before the role play begins, we also like to show a humorous YouTube video: <http://www.youtube.com/watch?v=THNPmhBI-8I>. We use this clip to further embellish the notion that this fraud investigation will be quite easy, nothing like brain surgery.

The most important thing the instructor must do, in his or her role play as the fraudster, is to be evasive. The entire case rests upon showing the students that evidence is needed to obtain a confession, not mere hunches. Even if those hunches are correct, they must be proven with evidence to support actions such as termination or prosecution. When the accusation precedes the investigation, the examiner is giving the target an opportunity to destroy evidence, concoct an alibi which cannot be refuted, discuss the allegations with co-conspirators, and otherwise defeat the investigation.

The remainder of this teaching note will provide the instructor with some illustrative questions and answers that might take place during the simulated interview. The instructor is encouraged to be creative in formulating their own responses to unforeseen questions; the only wrong answer in this case is a confession since it would reinforce an inappropriate approach to an allegation of fraud.

We have a copy of an invoice from Kimco Marketing. What services are we receiving from this vendor?

They provide marketing support to help us reach the local market. None of us here from the home office know the local customs so we decided to hire an outside contractor to help us achieve the sales plan.

How did you select this vendor?

I think one of the people in our marketing group recommended them.

Do you know anyone personally who works for this company?

Not really. Since we've hired them I've obviously communicated with them about our needs, expectations, and budget for this engagement.

Doesn't your individual authority to approve invoices for payment cease at \$10,000?

Yes. I always get my supervisor's approval for invoices exceeding \$10,000.

We have identified two additional invoices that are identical to this particular invoice in all respects with the exception of the date of the services and date of the invoice.

Did this company perform the same services on three separate occasions for our entity?

I'd have to review the three invoices, but if they billed us for those services and I approved payment then they must have provided the services. Since they are doing the same type of work for us each period they probably just use the same template for billing.

Each of the three invoices total \$9,750. Isn't this odd that these invoices are all just under your \$10,000 individual authority level?

I never really thought about it. I'm sure there are lots of other invoices that are around \$10,000; some amounts are above it and some amounts are below it. The important thing is that I

always follow the company policy of getting my supervisor's approval for payments exceeding \$10,000.

How do consulting services, as contained as a line-item in the invoice, differ from marketing support or market research services?

That is a good question for the vendor. We retained them to help us penetrate several key markets in the region. They have been delivering results. Their billings are within the range we agreed upon at the outset of the engagement. Since everything seems to be going well, I haven't seen any reason to micromanage their billing procedures.

Do you have any examples of the work product that Kimco produced as a result of any or all of the work presented on these invoices?

Sure. I can name at least three, new clients that we have as prospects due to the efforts of Kimco. The potential future profits from these sales prospects will dwarf the small amount we are paying Kimco for their services.

Did a representative from Kimco physically visit this office or location to perform the services represented on the invoices?

No. They can't generate sales leads sitting here in the office. They are out in the field promoting our company and securing leads. That is the type of thing that most of us here, being from the home office, wouldn't know how to do in the local market. That's the whole reason we hired an outside consultant. Would you know how to market our products in this region?

Did anyone from this office or location work with the Kimco employee(s) during their time on-site?

I just told you, they do not do their work on-site. They do their work in the field. And, no, we do not accompany them on their fieldwork. I can ask them about that, but I suspect they will not want to train one of our people to do their job.

Isn't your significant other named Kim?

I'm single. I date a lot. Kim is a common name.

We happen to know you did date a person named Kim. This invoice appears to be from a company owned by that person. Are you sure you don't know who owns Kimco Marketing?

Look, I've already told you I have an active social life. If you had a picture, I might recognize her, but I don't recall the name. This is a business deal anyway. My personal life doesn't have anything to do with my work performance.

(The instructor should disengage from the conversation along the way to work on their cell phone, presumably to send a text message to the significant other.)

Could you please refrain from using your cell phone while we are visiting about this invoice?

Oh, sure. I am just trying to keep up on my work so I don't get behind on an important assignment. I'll be done with this in a moment.

(The instructor continues their text message and talks out loud while texting it K-I-M.)

Who was that message to?

It was to a vendor. I wanted them to know you're nitpicking their invoice.

(The instructor abruptly gets up and goes to the computer and slowly but surely deletes the directory labeled Kimco Marketing. If the interviewers object, the instructor simply ignores them. The instructor could leave it in the Recycle Bin to later remind students that it is still easily

accessible. Or, it can also be deleted from the Recycle Bin and you could discuss more sophisticated tools that can recover deleted files.)

Would you please focus on our questions?

Sure, but I've got work to do.

This is a fraudulent bill and the vendor did not provide any services to our company. Why did you approve this bill?

I have no idea why you think this bill is fraudulent. I approve numerous bills every day and I have no reason to believe this one is not legitimate. What proof do you have that it is inappropriate?

You had your significant other create a shell company to bill us for services we have not received. Why don't you just admit this and make it easier on yourself?

I don't know what you're talking about. I need to get back to work. Are all auditors as paranoid as you? I'm guessing you had an unpleasant childhood.

Lying will not help you. You could be fired for lying to us.

Have you reviewed the employment laws in this country and my employment contract? I cannot be terminated without cause. There is nothing wrong with hiring a consultant to help us with our marketing. If anything, I should get a promotion for the idea.

So, you deny your involvement in this scheme?

There is no scheme.

Since you won't cooperate, we are going to recommend that you be terminated.

Good luck. I don't want to continue this conversation if you're going to be that way.

Table 1: Kimco Marketing Invoice

Kimco Marketing
Marketing Specialists for the Mexican Region
La Quemada 3909, Benito Juarez
03020 Ciudad de Mexico

INVOICE

February 20, 2011

Pat U. Lyonsack
E. Z. Pickens Conglomerate, S. A.
Andres Bello 29
Mexico City, Distrito Federal 11560 Mexico
+52 55 5519 4698

Invoice Number: 10001

DATE	DESCRIPTION	AMOUNT
1/10/2011	Marketing Fieldwork	3500.00
1/22/2011	Market Research	3000.00
2/1/2011	Marketing Support Services	3250.00
TOTAL DUE		\$ 9750.00

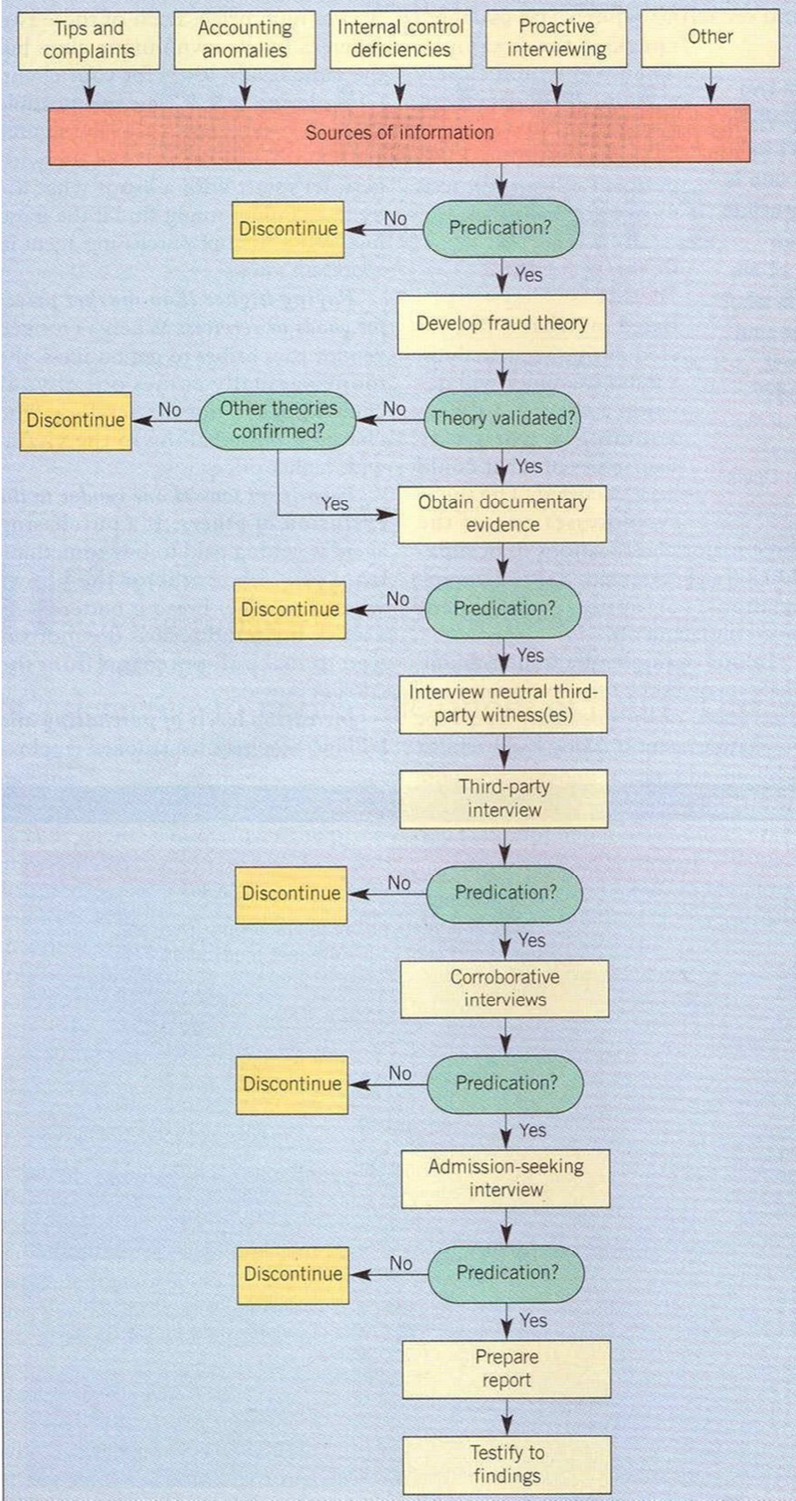
Please remit the total amount due within 10 days

Thank You,



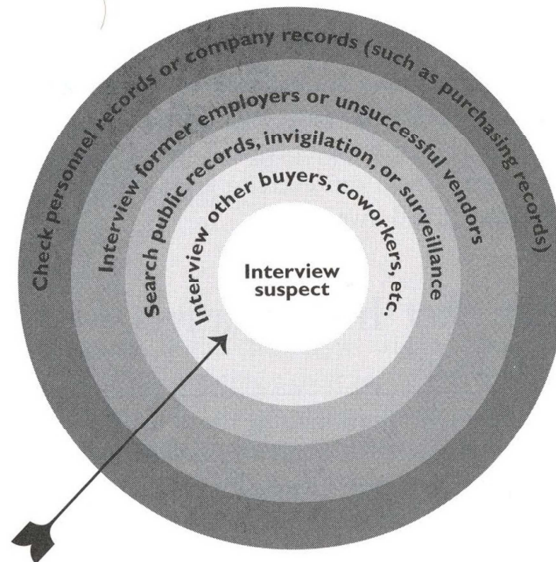
Holly Unlikely, Billing Clerk

Exhibit 1: The Fraud Examination Process - Wells



Source: Wells, Joseph T. 2003. Sherlock Holmes, CPA, Part 1. *Journal of Accountancy*. August: 88.

Exhibit 2: The Fraud Examination Process – Albrecht et al.



Source: Albrecht, W. Steve, Conan C. Albrecht, Chad O. Albrecht, and Mark F. Zimbelman. 2009. *Fraud Examination*. 3rd Edition: 208.

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