THE ‘NO WIND NO WAVES:’ PROCUREMENT FRAUD INVESTIGATION

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INSTRUCTOR’S NOTE

CASE SYNOPSIS

On November 10, 2014, Don, board chair and CEO of DuPower Tire Corporation, received an anonymous e-mail accusing Eric, the company’s Procurement Division manager, of taking kickbacks for several years. Don understood that it would be impossible to launch an internal investigation without alerting Eric (“No wind, no waves.”). He therefore followed a suggestion from DuPower’s CPA to hire Robert, an experienced forensic accountant at the W&Y Consulting Firm, as a (quiet) forensic investigator to prepare a risk- and evidence-based report describing the client company’s inherent risks, internal controls, and residual risks in its procurement activities with specific focus on the main issues of the company and specifically on Eric’s position.

CASE OVERVIEW

On November 10, 2014, an anonymous e-mail appeared in the inbox of Don, board chair and CEO of the DuPower Tire Corporation. He was shocked at the content of the message, which stated that Eric, the manager of the company’s procurement division for the preceding 21 years, had been receiving kickbacks. Don had complete confidence in Eric’s supply chain management skills whenever a materials shortage occurred, Eric always found a supplier who had sufficient stock to ensure that DuPower customers got their orders filled on time. Eric had worked for the company for almost 23 years, making him eligible for the DuPower employee stock plan. Since he held 3% of the firm’s total outstanding shares, Don figured that Eric “*wouldn’t do anything to hurt the company or shareholders because he is one of them.*” However, the e-mail gave specific details about the alleged kickbacks, and the whistleblower seemed to also be involved in the kickback activity.

Remembering the Chinese proverb, “*No wind, no waves,*” Don thought about ways to confirm what the e-mail stated. He understood that it would be impossible to launch an internal investigation without Eric’s knowledge. He also knew that he could not make any accusations without hard evidence, and that any proof would have negative consequences for the company’s image and share price.

With no firm solution at hand, Don called Yang, a certified public accountant at the TLC firm that DuPower hired two years before as an external auditor. After listening to Don’s story, Yang said, “*The only solution is to appoint an independent forensic accountant to investigate the possible kickbacks. I know someone named Robert who is one of the best. He’s a certified fraud examiner and senior forensic accountant at the W&Y consulting firm. He has a lot of experience investigating corporate corruption”*. Don accepted Yang’s suggestion and hired Robert as (quiet) forensic investigator to prepare a risk and evidence-based report describing the client company’s inherent risks, internal controls, and residual risks in its procurement activities with specific focus on the main issues of the company and specifically on Eric's position (Crumbley et al, 2013).

Considering the size of DuPower Tire and the amount of capital involved in its public offering, Robert assembled a team of 15 forensic auditors to investigate the firm's procurement transaction cycle.

TEACHING NOTES

Learning Objectives

The goal of this lesson plan is for students to learn: (a) how to identify risks within the framework of enterprise risk management (ERM) as suggested by the Committee of Sponsoring Organizations of the Tread way Commission (COSO), and (b) how to apply fraud triangle theory to detect fraud and misconduct.

Scope

This lesson plan can be used with auditing and forensic accounting students, who will benefit from practicing skills in the areas of risk identification, detection strategies, and techniques for investigating procurement transaction cycles.

Teaching Approach and Discussion Questions

The main question in the story is whether or not Eric was involved in kickback activity. Looking at the situation from the perspective of forensic accountants, students will be asked to consider and discuss four questions:

a. Is there any risk of kickbacks being concealed in the procurement activities of the DuPower Tire Corporation?

b. Where and how do kickbacks generally get paid in such situations?

c. Does Eric have the motivation/incentive and opportunity to get involved in kickbacks?

d. What points should be communicated to DuPower's CEO and Board of Directors in a final report?

Students should be encouraged to analyze case information from the perspective of ERM to discuss question (a). After identifying risks in DuPower's procurement procedures, students should investigate questions (b) and (c) from a fraud triangle perspective. After identifying and discussing the most important issues, students will practice their skills in communicating risk information and writing a risk-based forensic report.

Case Analysis and Teaching Suggestion

According to a survey conducted by KPMG (2014), kickback misconduct in Taiwan increased from 27% in 2009 to 39% in 2013. Internationally the increase over the same period was from 29% to 40%. Acts of misconduct arise from conflicts of interest, but are generally concealed in the day-to-day transactions of companies. Since kickbacks pose significant risk that cannot be neglected, companies must find ways to prevent, detect, and respond to kickback instances.

The above-mentioned COSO ERM framework was designed to support risk prevention, risk detection, and response activities. ERM is a process enacted by boards of directors, managers, and other personnel that can be applied in strategy settings and in all departments of an enterprise. It is designed to identify potential events, to manage risks within a company's "*risk appetite,"* and to provide reasonable assurance regarding the achievement of entity objectives (COSO, 2004).

The ERM framework requires forensic accountants to take a portfolio view of risk, with the first step being to understand the target entity's business model, objectives, and strategies for achieving those objectives. The second step is to understand the risk involved in executing its strategies, and the degree of risk that managers and board members are willing to accept in alignment with those strategies.

The third step is to identify which events might exert negative impacts on strategies and achieving objectives. The fourth step is to assess the extent of potential negative impacts of identified events, and to use qualitative and quantitative risk assessment methodologies to measure the likelihoods of their occurrences. The fifth step is identifying how an entity responds to these risks, and evaluating whether the entity's responses will be helpful for mitigating them. The sixth step is determining whether an entity has control policies and procedures to ensure that its risk responses can be carried out. The seventh step is to communicate an internal and external residual risk portfolio in a form and with a time frame that allows all employees to carry out their responsibilities. The final step is to conduct ongoing evaluations and to communicate deficiencies.

According to the ERM framework, if the likelihood of kickback activity is high, then a forensic accountant needs to consider the motivations of potential participants in order to execute the fraud triangle theory, which identifies the three main elements of fraud as incentives/pressure, opportunities, and rationalization. Motivations result from incentives/pressure. Opportunities are associated with internal environments. Rationalization entails how individuals explain and/or justify their misconduct.

INSTRUCTIONS FOR DISCUSSION QUESTIONS

a. Is there any risk of kickbacks being concealed in the procurement activities of the DuPower Tire Corporation?

To address this question, students need to analyze the case using the ERM framework and relevant information regarding DuPower's business model, organizational structure, risk culture, and industrial environment. First, students should clarify DuPower's internal environment, business objectives, and strategies, and then try to identify events that might exert negative impacts on the firm's procurement activities. After identifying risks inherent to procurement procedures, students can brainstorm about DuPower's response to those risks, and about whether or not the response adequately reduces the potential risks identified in the procurement activities. Next, students need to evaluate whether DuPower has implemented appropriate internal control policies and procedures in support of risk responses, and to brainstorm about the best assessment technology for evaluating residual risk throughout the procurement process. Finally, students need to assess kickback probability in the residual risk portfolio of DuPower's procurement activities.

b. Where and how do kickbacks generally get paid in such situations?

If responses to question (a) indicate a high level of kickback risk, students need to carefully investigate where and how kickbacks might be paid. The case background provides clues regarding industry trends (i.e., materials price trends) and DuPower's financial performance. Students need to take these clues and clarify where and how kickbacks might be paid from Eric's perspective.

c. Does Eric have the motivation/incentive and opportunity to get involved in kickbacks?

Students who determine from answering question (b) that kickbacks definitely occurred must explain their thinking and use any supporting evidence they find in the case study. They must use detection and investigative techniques to speculate on Eric's motivation and opportunities to receive kickbacks.

d. What points should be communicated to DuPower's CEO and Board of Directors in a final report?

According to the ERM framework, it is the responsibility of a forensic accounting firm to prepare a risk and evidence-based report describing the client company's inherent risks, internal controls, and residual risks in its procurement activities. The report should contain evidence on how risks identified via the ERM framework provide opportunities for kickbacks. In the report, students must discuss whatever motivation Eric might have had to receive kickbacks. Last, the reports should include suggestions for resolving the main issues and those regarding Eric brought up by this case.

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