

Articles

Payroll Internal Controls: Ignoring Payroll Controls May Lead to Bankruptcy or Worse

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Payroll fraud poses a significant risk to small businesses, often resulting in devastating financial consequences that go well beyond the value of the initial theft. Businesses may face penalties, interest, and back taxes for failures to report and remit employment taxes—costs that can cripple operations or lead to closure. Despite the seriousness of this risk, payroll internal controls are frequently overlooked or poorly implemented, particularly in small enterprises with limited oversight.

This paper presents two real-world payroll fraud mini-cases designed to address this gap in both business practice and business education. By engaging students in analyzing these cases, educators can help future business professionals understand the necessity of strong payroll internal controls, responsible tax reporting, and effective risk management. These cases can be used in introductory business and accounting classes as well as upper-division fraud or forensic accounting courses to promote critical thinking, discussion, and an applied understanding of internal control failures.

INTRODUCTION

Payroll fraud remains one of the most common and financially damaging forms of employee embezzlement, particularly in small businesses where internal controls are often minimal or poorly enforced. For business owners, the consequences extend far beyond the amount stolen—unpaid payroll taxes trigger significant penalties and interest, and personal liability may be assessed against responsible individuals. As a result, what begins as a hidden internal fraud can quickly evolve into an existential threat to the business.

These risks are well known in the business world, yet they are underrepresented in many undergraduate business and accounting curricula. The disconnect between classroom instruction and real-world risk leaves students—and, eventually, business leaders—ill-prepared to prevent, detect, or respond to payroll fraud. Business leaders have a clear need for employees and managers who understand internal controls, tax compliance, and the broader implications of fraud on an organization's financial health and legal standing.

This paper responds to that need by introducing a set of classroom-ready, real-world mini-cases that bring payroll fraud and internal control concepts to life. The cases are built around actual forensic accounting investigations, tailored to highlight the procedural gaps and managerial failings that enabled the fraud. Students are encouraged to think critically about roles, responsibilities, and oversight in payroll processes, as well as the legal and ethical consequences of neglecting them.

While the accounting profession continues to face challenges in attracting and retaining students (Ellis, 2022), one area that consistently sparks interest is fraud and forensic accounting. Embedding fraud education into business and accounting courses—particularly through case-based, interactive learning—can engage students in meaningful ways. Student-centered active learning through case studies encourages discussions about real-world problems and promotes critical thinking and analysis (Rybarczyk, 2007). This supports industry leaders' demands for a more relevant accounting curriculum that focuses on real-world situations, thereby supporting higher-order cognitive skills (Gupta & Marshall, 2010). These higher-order cognitive skills, or critical thinking skills, have various meanings depending on who is asked. However, Wolcott and Sargent (2021) summarize critical thinking to mean a person's ability to apply "technical knowledge within a decision-making process to address realistic workplace problems." Introducing students to real-world payroll fraud cases that require applying classroom knowledge to authentic business challenges equips them to meet industry demands for stronger critical thinking skills. It also prepares the next generation of business leaders to design effective payroll controls, recognize warning signs of fraud, and respond appropriately to potential internal threats.

These mini cases offer insight for small business managers and owners into the ramifications of payroll fraud. Additionally, integrating fraud education within the introductory accounting courses and continuing the education in upper-division courses can also help improve the interest in and perception of accounting as a profession (Rezaee &

Burton, 1997). The mini cases provide educators with tools to meet both business needs and student interests, thereby strengthening the pipeline of future professionals equipped to safeguard businesses from internal threats.

BRIEF LITERATURE REVIEW

Accounting students and accounting professionals are asking for increased fraud education, coupled with active learning that enhances critical thinking (Marshall & Bolt-Lee, 2016). The literature supports that the use of cases increases analytical thinking through active learning strategies. Incorporating fraud education at the introductory accounting level can also increase student engagement with the subject, potentially helping increase the accounting student pipeline for the accounting profession.

Students are requesting more education and training in forensic accounting. With corporate fraud cases continually dominating the news cycle, students think that greater coverage of forensic accounting is needed in the curriculum (Ebaid, 2022). This demand for adding forensic accounting to the business and accounting curriculum encompasses a multitude of skills, including auditing, accounting, statistics, information technology, legal prowess, and social skills (Tiwari & Debnath, 2017). Teaching strategies that can incorporate these skills in an experiential learning manner will help students transform their knowledge and theories into actions that can be applicable in their real-world professions (Beck et al., 2017). Case studies are a creative learning pedagogy that enhances both decision-making and critical thinking skills.

The 2013 study by Daniels, Ellis, and Gupta asked accounting practitioners and accounting educators about the importance of incorporating fraud and forensic accounting into the accounting curriculum. At the time of this study, very few business schools offered a separate course or program in fraud or forensic accounting. Both groups found significance in educating students about forensic accounting, with internal control selected as the number one topic of importance (Daniels et al., 2013). While both practitioners and educators agree that the demand for forensic accounting services will continue to increase, there are differences of opinion on what forensic accounting content should be covered (Kramer et al., 2017). Practitioners value topics outside of traditional accounting and support techniques that add an experiential learning component. Practitioners and users of forensic accounting services argue that exposing students to real-world accounting fraud situations will enhance the practical knowledge of the students (Kern & Weber, 2016; Lehman & Heagy, 2017). Incorporating real-world mini-cases in introductory accounting courses, then building on this experiential learning piece throughout the business and accounting curriculum, could help better prepare the business and accounting students of tomorrow.

Payroll Fraud

The Association of Certified Fraud Examiners (ACFE) reports that the majority (86%) of fraud cases involved asset

misappropriation and mostly occurred in small to medium-sized business enterprises (ACFE, 2024). Additionally, the report indicates that companies lose about 5% of their revenues due to fraud each year, significantly contributing to small business failure (ACFE, 2024). Fraud and asset misappropriation remain a concern to management, as they reduce the ability of a business to effectively use its resources (Brink & Witt, 1982).

In the non-profit sector, payroll and check tampering fraud were the most common types of fraud identified (Yusuf et al., 2023). More commonly, overstated hours worked or issuance of checks for fictitious employees top the list. However, failure to remit payroll taxes is also a form of payroll fraud. Companies are required to withhold and remit Federal Insurance Contribution Act (FICA) taxes for all employees. The FICA taxes, social security disability insurance (SSDI), and medical health insurance (MHI) equal 7.65% of an employee's gross pay. The employer then needs to match the employee's withholding percentage for its portion of FICA taxes, resulting in a tax remittance of 15.3% of the employee's gross pay to the federal government. The opportunities for fraud for failure to remit the required taxes are rampant without proper internal control procedures.

Multiple studies on fraud have found that employee frauds are mostly motivated by greed and personal circumstances (Othman & Ameer, 2022; Sánchez-Aguayo et al., 2021; Strischek, 2022). The most recent study by the ACFE offers new insight into occupational fraud and how to prevent it. Position within the company, gender, age, education level, and department of expertise all play roles in the type and magnitude of the fraud (ACFE, 2024). Othman and Ameer (2022) found that fraud perpetrated by employees is mostly perpetrated by middle-aged women, and that small businesses are more vulnerable to fraud in their payroll systems. Occurrences of fraud are enhanced by the business when an employee has multiple responsibilities, is in a position that provides opportunity to commit fraud, and has limited oversight (Othman & Amerr, 2022; Yusuf et al., 2023). Employees facing personal financial pressures may view their access to company funds as an opportunity for misappropriation—a classic illustration of the fraud triangle (Othman & Amerr, 2022). The three elements of the triangle are opportunity, motivation, and rationalization. Opportunity arises when there are limited or no internal controls over the financial systems to which an employee has access. Motivation often stems from financial distress, such as addiction, gambling losses, or mounting medical bills. Rationalization allows the employee to justify the act, for example, by thinking, *"I will pay it back next month,"* or *"I deserve this."* To mitigate this risk, management and owners of SMEs can implement preventive measures such as segregation of duties, whistleblowing programs, formal approval processes, and an internal audit function (Warren et al., 2023).

The following mini-cases were developed to meet the growing demand for fraud education that integrates real-world accounting examples. They respond not only to the needs of business and accounting students but also to the

interests of business professionals seeking practical tools to understand and mitigate payroll fraud risks. By incorporating these mini-cases into introductory business, introductory accounting, and upper-division accounting courses, students can analyze actual payroll fraud incidents, identify internal control weaknesses, and research the legal and financial ramifications for both the business and the individual perpetrator. Business professionals can likewise use these cases for training purposes, reinforcing awareness of internal control vulnerabilities and illustrating the consequences of inadequate oversight. The two cases presented here are based on real investigations conducted by the lead author and her firm, with names, businesses, and locations changed to preserve confidentiality.

CASE 1 – IT’S NOT THE USED CAR SALESMAN YOU CAN’T TRUST

The Setting

Sam Smalley was the owner of a successful used car dealership limited liability company (LLC) in Texas. The company was divided into three departments: sales, automotive repairs, and administrative. The administrative department included a controller, Todd Talley (who had an accounting degree but was not a certified public accountant), a payroll clerk, and an accounts receivable/accounts payable clerk.

The duties and responsibilities of the administrative personnel were as follows:

- Controller: Reviews, approves, and submits the electronic payroll register information for direct deposit. Submits the federal and state tax reports and initiates the electronic tax deposits. Interacts with tax authorities in response to any notices. Reviews and approves accounts payable aging schedules. Co-signs/approves payments to vendors. Submits payments to owner for second signature/approval. Reviews and follows up with accounts receivable aging schedules.
- Payroll clerk: Reviews and approves employee timesheets. Prepares the payroll register to the controller.
- Accounts Receivable/Accounts Payable Clerk: Maintains the amortization and payment schedules of amounts due from customers. Records and maintains the vendor invoice information regarding amount and due dates.

Todd Talley was interviewed and hand-picked by Sam Smalley. A background check was never completed, nor were references contacted. Mr. Talley’s experience with handling electronic employment tax filings and payments convinced Mr. Smalley that Mr. Talley was the correct person for the position.

Mr. Talley provided hard copies of the employment tax returns to the owner to confirm that all tax deposits/payments had been made on a timely basis. When Mr. Smalley received any Internal Revenue Service (IRS) notices, he turned over the responsibility to resolve any issues to Mr. Talley. Mr. Talley did not earn vacation time until after spending a minimum of 1 year on the job. After 18 months

on the job, the controller was told to take a vacation. He complied and took a 1-week vacation.

Teaching Notes Introductory Business Course

Learning Objectives

1. Understand basic internal controls in a small business
2. Recognize the importance of employee vetting and oversight
3. Develop awareness of operational risk and ethical decision-making

Key Concepts to Emphasize

1. Segregation of duties
2. Importance of background checks
3. Consequences of over-reliance on a single employee
4. Ethical responsibility of owners/managers

Classroom Discussion Guide

1. What are internal controls, and why are they important for small businesses?
2. What went wrong in the hiring and oversight process?
3. How might Sam Smalley have better supervised his administrative department?
4. What are the risks of not checking an employee’s background or qualifications?
5. What might happen when a business owner delegates too much authority?

Assignment Prompts

1. Draft a short memo advising Sam on improvements that don’t require hiring more staff.
2. Identify five potential red flags in the controller’s conduct and explain why they matter.

Teaching Notes Introductory Accounting Course

Learning Objectives

1. Introduce the concept of internal controls and fraud risk
2. Understand the flow of accounting responsibilities in a small business
3. Identify weaknesses in the segregation of duties and reconciliations

Key Concepts to Emphasize

1. Internal control principles (authorization, documentation, reconciliation)
2. Payroll process accountability
3. Importance of vacation as a fraud detection mechanism
4. Role of source documents and audit trails

Classroom Discussion Guide

1. Map the duties of each administrative employee. Where do conflicts of overlap occur?
2. Which key accounting controls are missing or weak?
3. How could a one-week vacation uncover fraud?
4. How should payroll and tax remittance be monitored?

Suggested Classroom Activity

Use a flowchart to diagram the company's accounting operations. Highlight control weaknesses and propose fixes.

Homework Prompts

1. Find one case of payroll fraud in a small business. Summarize what happened and connect it to Sam's company.
2. Recommend three internal control improvements that could be implemented without hiring more staff.

Teaching Notes for Advanced / Forensic Accounting Course

Internal Revenue Code (IRC) §§ 3102 and 3111 discuss the Federal Insurance Contributions Act (FICA) taxes and employer withholding responsibilities. IRC § 6672 discusses the consequences of failure to pay or an attempt to evade these taxes. Congress passed the Employment Taxes and the Trust Fund Recovery Penalty to further encourage prompt payment of withheld taxes.

Learning Objectives

1. Apply knowledge of payroll fraud and tax obligations
2. Use the Internal Revenue Code to assess legal responsibilities
3. Evaluate fraud red flags and design effective internal controls

Key Concepts to Emphasize

1. Trust Fund Recovery Penalty (IRC § 6672)
2. Liability for FICA taxes (IRC § 3111, 3102)
3. Fraud triangle elements (opportunity, pressure, rationalization)
4. Employer liability post-bankruptcy

Discussion Topics

1. Was Sam Smalley potentially a "responsible party" under IRC § 6672
2. If the business files for bankruptcy, can Smalley or Talley still be personally liable?
3. Could Talley have committed payroll tax fraud? What controls might have caught this earlier?

4. How could Sam use forensic accounting techniques to detect and prevent fraud?

Research Assignment

1. Read IRS documentation on the Trust Fund Recovery Penalty. Write a brief explaining who is liable and why.
2. Find a real-world case of payroll tax fraud prosecuted under IRC § 6672 and analyze the facts and outcomes.

Capstone Option (Group or Individual)

Write a three to five-page forensic accounting report assessing the risk of payroll fraud at Sam's company. Include red flags, risk factors, applicable legal standards, and recommendations for remediation.

Case Outcome

An IRS collection officer eventually visited Mr. Smalley in person with paperwork initiating the garnishment of the business's bank account for delinquent employment taxes, accrued interest, and related civil penalties. Mr. Smalley was told that his company owed almost \$1 million in delinquent employment taxes. Upon further investigation, it was found that Mr. Talley had been embezzling the funds rather than paying them to the tax authorities. The controller was fired, and the company was forced into bankruptcy. However, bankruptcy did not release all liability. Mr. Smalley was personally liable for the trust portion¹ of the employment taxes under the Trust Fund Recovery Penalty regarding responsible persons.

Mr. Smalley elected not to pursue charges against Mr. Talley, effectively leaving the embezzlement unaddressed by the criminal justice system. A forensic accountant for this case indicated that, in practice, some forensic accounting professionals discourage business owners from pursuing criminal charges in embezzlement cases, citing concerns that the publicity could damage the business's reputation. Instead, these advisors often recommend civil litigation as a means of attempting to recover the stolen funds. However, civil litigation can be both costly and ineffective: businesses must immediately incur legal fees, judgments can be difficult to collect, and recoveries are often minimal. These challenges are compounded when the business is simultaneously responsible for repaying back employment taxes, penalties, and interest to the IRS, which does not accept employee embezzlement as a valid reason for nonpayment.

Pursuing criminal charges, by contrast, shifts the legal costs to the state and the defendant, and, if the perpetrator is convicted, the outcome becomes public record. Criminal proceedings can also result in court-ordered restitution managed through the court or probation department, and a

¹ "Trust portion" refers to those amounts withheld from the employees' gross payroll.

criminal record serves as a deterrent to future misconduct by making the offense visible to potential employers.

CASE 2 – BUSINESS OWNER BEWARE! IT’S NOT YOUR MONEY!

The Setting

Dave Douglas and Freddy Fine were the owners of a nurse staffing corporation that serviced over 20 states in the United States. Care4You, Inc. would charge its clients a fee for placing nurses in hospitals, healthcare facilities, and doctors’ offices. The corporation was responsible for paying the nurses’ wages.

The company had a minimal administrative staff. Mr. Douglas and Mr. Fine oversaw the scheduling of the nursing staff, who were all employees of the corporation. They hired a bookkeeper to handle the customer receipts and payment of operating expenses. A part-time employee assisted the owners with the payroll tracking.

The part-time employee had no experience with payroll software. Instead, she was trained to track each employee’s time using electronic spreadsheets. The spreadsheets were also used to calculate the weekly employee withholdings and net pay. It was from those spreadsheets that the payroll checks were issued.

When time allowed, and in anticipation of quarterly employment tax return filings, Mr. Douglas would input the payroll spreadsheet information into a payroll software package. Because his time was so limited, neither he, Mr. Fine, nor the part-time employees would reconcile the manual payroll to the computerized payroll reports.

No employee was responsible for filing employment tax reports or paying the employment taxes. Rather, Mr. Douglas and Mr. Fine decided they would file the reports and make the tax payments themselves.

All went as planned for the first five years, in that the above-described procedures were followed. Eventually, Mr. Douglas and Mr. Fine found that they were having cash flow problems and began skipping the employment tax payments. Within months of the first payment not being sent to the tax authorities, Care4You, Inc. received a notice from the IRS requesting the required federal employment tax payment. The owners ignored that first notice and many that followed.

Mr. Douglas and Mr. Fine could never get back on track with their business cash flow needs or make timely employment tax payments. Eventually, they stopped filing the employment tax returns.

A year later, the owners had a visit from an IRS collection officer who wanted action regarding the corporation’s non-filing and non-payment history. Mr. Douglas and Mr. Fine agreed to catch up on the return filings, stay current with the employment taxes, and start a payment plan to pay off the delinquent taxes, civil penalties, and interest. However, they never acted on the agreement but, instead, continued handling business as they had before.

Teaching Notes Introductory Business Course

Learning Objectives

1. Understand the importance of basic internal controls.
2. Recognize management’s responsibility for compliance with employment tax laws.
3. Appreciate the legal and financial risks of mismanaging payroll taxes.

Key Concepts to Emphasize

1. Internal control fundamentals (e.g., assigning responsibilities, separation of duties).
2. Legal obligations of business owners regarding payroll taxes.
3. Basic consequences of noncompliance: IRS notices, penalties, and criminal charges.

Classroom Discussion Guide

1. What were the key weaknesses in the company’s payroll and tax payment processes?
2. Why is it risky for owners to handle tax filings themselves without oversight?
3. What are some low-cost ways this company could have ensured tax compliance?
4. What are the potential long-term consequences of ignoring IRS notices?

Assignment Prompts

Role-play an IRS meeting between the owners and a revenue officer. What should the officer ask? What might the owners promise? How should the office respond?

Assignment Idea

Write a business advisory memo to a startup owner, summarizing three key lessons learned from Care4You’s mistakes and offering practical internal control tips.

Teaching Notes Introductory Accounting Course

Learning Objectives

1. Connect accounting responsibilities with legal reporting obligations
2. Identify how poor documentation and lack of reconciliations create audit risk
3. Analyze cause and effect relationships between poor controls and financial/legal issues.

Key Concepts to Emphasize

1. Reconciliation between manual and software systems
2. Importance of tracking and remitting payroll taxes
3. Red flags in accounting (missing reports, single-point failure, manual-only processes).

Discussion Guide

1. Identify all steps involved in payroll processing at Care4You. Which controls are missing?
2. What accounting records would the IRS want to examine during a payroll tax audit?
3. How could even one employee have improved internal control here?
4. Why is it dangerous to delay reconciling or filing payroll tax returns?

Classroom Activity

Assign groups to redesign the payroll process using existing personnel. Have each group propose a three-person system that ensures accuracy and compliance.

Homework Prompts

1. Research IRS publication guidance for small businesses on employment taxes. Summarize the most important filing/payment responsibilities.
2. Create a simple checklist that any small business owner could use monthly to stay in compliance.

Teaching Notes for Advanced / Forensic Accounting Course

Internal Revenue Code (IRC) §§ 3102 and 3111 discuss the Federal Insurance Contributions Act (FICA) taxes and employer withholding responsibilities. IRC § 6672 discusses the consequences of failure to pay or an attempt to evade these taxes. IRC §§ 7201 and 7203 discuss the criminal penalties of failure to pay or file.

Learning Objectives

1. Apply legal codes (IRC §§ 3111, 6672, 7201, 7203) to real-world cases.
2. Assess personal vs. corporate liability for employment tax violations
3. Understand the criminal and civil implications of payroll fraud and tax evasion

Key Concepts to Emphasize

1. Trust Fund Recovery Penalty (IRC § 6672).
2. Liability for FICA taxes (IRC § 3111, 3102).
3. Criminal penalties for tax evasion and willful failure to file/pay (IRC §§ 7201 & 7203).
4. Signs that a forensic accounting investigation is necessary.

Advanced Discussion Guide

1. Based on IRS definitions of “responsible party,” are Mr. Douglas and Mr. Fine personally liable under § 6672?
2. Is the company’s behavior better described as negligence or willful evasion under § 7201 or § 7203?

3. What steps would a forensic accountant take to uncover the true extent of cash flow problems?
4. If Care4You filed bankruptcy, would the owners still be liable for trust fund taxes? Why?

Research Assignment

1. Using IRS primary source materials, identify the criteria the IRS uses to establish personal liability under § 6672.
2. Compare a real-life payroll tax fraud case to Care4You. What similarities and differences stand out?

Capstone Writing Option

Write a forensic audit engagement letter and initial investigative plan outlining what documents you would request and what procedures you would use to identify payroll fraud and trace missing cash flows.

Case Outcome

IRC § 7201 imposes criminal charges against “any person who willfully attempts in any manner to evade or defeat any tax imposed by [USC Title 18] or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.”

IRC § 7203 imposes criminal charges against “any person required under [USC Title 18] to pay any estimated tax or tax, or required by this title or by regulations made under the authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such estimated tax or tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than \$25,000 (\$100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of prosecution.”

Mr. Douglas and Mr. Fine were criminally investigated by the IRS for the non-filing of employment tax returns, filing false employment tax returns, and/or non-payment of employment taxes.

Pursuant to the investigation, it was found that the owners had been withdrawing cash from the corporation that came from the employee withholdings, which was the source of the cash flow problems. The IRS referred its investigation to the Department of Justice for prosecution. The owners were indicted and tried for filing false employment tax returns and failure to pay the appropriate taxes.

During the trial, it was revealed that:

1. Mr. Douglas did not always input the correct information into the employment tax software from which he printed the employment tax returns. This resulted in lower amounts of employment taxes reported to the taxing authorities.

2. Mr. Fine specifically identified the withheld funds from the nursing payroll as the monies to which he and Mr. Douglas would withdraw for personal use. All employment taxes for the administrative personnel were properly reported and paid to the government.
3. Those actions supported the intent and knowledge of the employment filing requirement to prove that the non-filed returns were not a result of ignorance, lack of education, or knowledge.

Both owners were convicted and sentenced to prison.

CONCLUSION

These mini cases provide students and business professionals with the opportunity to analyze real-world payroll fraud scenarios and observe the tangible consequences of fraudulent activity. In both cases, regardless of whether the

perpetrator was an employee or the business owner, the owner ultimately bore legal responsibility and faced severe repercussions. Using authentic cases to identify and address internal control weaknesses fosters the critical thinking and fraud prevention skills essential for success in today's business environment.

Beyond skill development, these cases also help bring accounting concepts to life, making the subject more engaging and potentially increasing students' interest in pursuing accounting as a career. For small businesses, the lessons are clear: fraud, embezzlement, and asset misappropriation remain ever-present risks, but having knowledgeable and well-trained professionals on staff can significantly reduce the likelihood and financial impact of these threats.

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