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**Title: INTERNATIONAL FRAUD:
A MANAGEMENT PERSPECTIVE**

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Universitat Ramon Llull



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International Fraud: A Management Perspective

By

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As can be seen from reading my dissertation, my experience as an ESADE Ph.D. student has been excellent. I have truly enjoyed my doctoral studies. While obtaining a Ph.D. is always filled with multiple emotions, the biggest emotion I have is one of gratitude.

I would like to thank my family. Mom and Dad, thank you for all your support and advice and helping me to realize my dreams. Conan, thank you for your encouragement, guidance, and friendship – I will forever be grateful for all of your help.

Jenny, I could not have completed this goal without you. Thank you for moving to Spain with me, supporting me, inspiring me, and giving me the encouragement that I needed to complete this project. You are a wonderful wife and I will love you forever. Grace and Eva, my two little girls, thank you for giving me the desire to be a little better each day – I love you.

To the Reader: Because the dissertation is in the form of published articles, many of the publications are in the PDF form taken from the original publication.

As a result, the order of the dissertation and table of contents is in the form of eight short chapters. The page number at the beginning of the chapter corresponds to the page number of the dissertation. The page numbers within the chapters corresponds to the page number of the volume in which the article was originally published.

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Chapter 1: Introduction

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International Fraud: A Management Perspective

Introduction

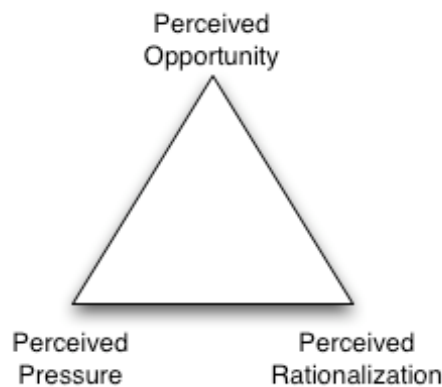
The purpose of my dissertation is to better understand international fraud from a managerial and humanistic perspective. For many years, the accounting field has studied fraud, the consequences of fraud, and various aspects of fraud. Researchers within the accounting field have helped us to better understand the seriousness of the fraud problem, the nature of fraud, how to detect fraud, and how to investigate fraud. However, an accounting-only perspective is somewhat limited. To understand why scandals such as Enron, WorldCom, Parmalat, Vivendi, and other large scale frauds occurred, we must not only look at these events from an accounting perspective, but also from humanistic and cultural perspectives. Accounting, for the most part, is not equipped to research fraud from a humanistic approach. As a result, the purpose of my dissertation is twofold: First, to introduce the study of fraud to the mainstream management field. Second, to understand fraud from a managerial perspective.

In order to reach the first objective, I have and will continue to publish fraud-related research in mainstream management journals. However, at times, it has proved difficult to publish this topic in mainstream management journals. In these situations, we have sent our cultural and humanistic fraud-related research to accounting and finance journals where the research has been well received. In order to reach the second objective, the analysis in this dissertation has attempted to study fraud from a managerial perspective. This dissertation is

a first step only, and my colleagues and I will continue to research managerial fraud for years to come.

Classical fraud theory has long explained the reasons that an individual becomes involved in financial statement (or any type of) fraud. This theory suggests that individuals become involved as a result of the fraud triangle, explained as a opportunity, pressure, and rationalization (Cressey, 1953). These three elements are demonstrated in figure 1 below:

FIGURE 1
Classic Fraud Motivation Model



The first element of the fraud triangle is a perceived pressure. Most pressures involve a financial need, although non-financial or perceived pressures, such as greed, the need to report better than actual performance, a challenge to beat the system, or even fear can motivate fraud. These pressures do not have to be real; they simply have to seem real to the perpetrator.

The second element of the fraud triangle is perceived opportunity. The perpetrator must believe that he or she can commit the fraud and not get caught or, if he or she gets caught, nothing serious will happen. An example of a perceived opportunity would be a CEO or CFO manipulating financial numbers

and believing that the media and or shareholders will not find out or that the problem will go away during the next quarter or year. Like pressures, opportunities don't have to be real; they must only be perceived as real by the perpetrator.

Compendium of Publications

The following dissertation builds upon the fraud triangle. The dissertation is very non-traditional in that it brings together a compendium of papers on the subject of fraud – six in total. Five of the six papers have already been published in peer review publications. The only paper that has not already been published is currently under revise and resubmit status at the *Journal of Business Ethics*. Based on advice from several colleagues, I may pull this paper from review at the *Journal of Business Ethics* and submit the paper to the *Academy of Management Review* – the premier management journal.

Below are the official regulations on presenting a doctoral thesis in the form of a compendium of publications (approved by the doctoral committee on June 13, 2006):

RAMON LLULL UNIVERSITY REGULATIONS ON DRAFTING DOCTORAL THESES IN THE FORM OF A COMPENDIUM OF PUBLICATIONS

(Approved by the Doctoral Committee on 13th June 2006)

- 1. A doctoral thesis in the form of a compendium of publications will be made up of articles on a single line of research.**
- 2. Articles will only be accepted from publications that have a “peer review” evaluation system and/or which are indexed in scientific classifications.**
- 3. Published articles, or articles which have been accepted for publication, will only be accepted for those articles written subsequent to the date of registration of the PhD student in the Doctoral or official Master programmes.**
- 4. Co-authors of the published articles will provide their written consent regarding the use of the article as part of the doctoral student’s thesis.**
- 5. Co-authors of the published articles will be excluded from forming part of the thesis board of examiners.**
- 6. Co-authors of the articles published and used in a thesis who do not hold a doctoral degree are required to renounce in writing their right to use the article in another thesis. In the event that the published articles have been sourced from more than one research team, the Doctoral Committee will have the right to consider justified exceptions regarding the application of these regulations.**
- 7. The thesis will have a general introduction which should present the published works, justification of the thematic unit, a copy of each published work, an overall summary of the results, their discussion and the final conclusions**

The first paper entitled, “Financial fraud: The How and Why” was published in the *European Business Forum*. The *European Business Forum* is an initiative of CEMS (Community of European Management Schools and International Companies) targeted to business executives worldwide. In the paper published in *European Business Forum*, we build upon the classical fraud model of pressure, rationalization, and opportunity. We further expand the model so that pressures include corporate and personal position, compensation plan structure, and externally imposed expectations. The new model also includes the perceived opportunities of external oversight and monitoring, internal monitoring and control, environmental complexity and related parties, and lack of knowledge or education. Finally, rationalizations is expanded to include level of personal ethics, environmental ethics, need to succeed, and rule-based accounting standards.

The major points of the article are the following: (1) Understanding why and how individuals commit fraud is the key to fraud prevention, (2) Pressure to commit fraud combined with opportunities to do so have led to many financial statement frauds in recent years, (3) Some people are able to rationalize fraudulent actions by arguing that they will benefit themselves or their companies, (4) To prevent fraud, it is necessary to reduce the pressure and opportunities, but also to hire people of sufficient integrity who will not rationalize fraudulent behavior.

To both my surprise and my advisor Simon Dolan’s surprise the article that was published in the *European Business Forum* was well received from both the business and academic communities. The article was quoted in several

newspapers including the prestigious *Times of London Newspaper*. Excerpts from the *Times of London Newspaper* (online version) are included below:

Case study: Why people commit fraud - Times Online

http://www.timesonline.co.uk/tol/life_and_style/career_and_jobs/g...

The screenshot shows the Times Online website interface. At the top, there are advertisements for 'Waitrose' and 'Car Locator'. The main header features the 'TIMES ONLINE' logo and navigation links for various sections like NEWS, COMMENT, BUSINESS, SPORT, LIFE & STYLE, and ARTS & ENTERTAINMENT. The article title is 'Case study: Why people commit fraud', with a sub-headline 'Classic fraud theory explains the motivations for fraud as a triangle of perceived opportunity, perceived pressure and rationalisation'. The article text discusses the prevalence of fraud and the 'fraud triangle' theory. The right sidebar contains several widgets: 'emporio' (Financial Accountant, Marketing Coordinator), 'FOCUS ZONE' (Galaxy of Stories), 'QUICKLINKS' (Su Doku, Now Interactive), and 'NOW RECRUITING' (Deloitte, network, NAO, Nigel Wright).

1 of 3

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Emerald Publishing, one of the leading publishing companies that specialize in academic journals, also did a press release regarding the article. Below is a portion of the press release from Emerald publishing company:

FOR IMMEDIATE RELEASE

Emerald Editors in the news

New editorial team of Cross Cultural Management featured in The Times and European Business Forum

A feature on financial fraud by the new editorial team of **Cross Cultural Management**, the UK's leading source of research on multicultural management issues, has been published in the *The Times* and *European Business Forum*.

The article, entitled "Financial Fraud: the How and Why" was written by Professor Simon Dolan and Chad Albrecht, both of the ESADE Business School in Spain, was published in the *European Business Forum* and further in *The Times*, 19th July 2007.

The article examines the fraud triangle of perceived opportunity, perceived pressure and opportunity. Professor Simon Dolan comments, "Chad and I are delighted that our research has been so well received. Fraud and corruption are cancers that eat away at society's productivity. Firms need to learn from ethical lapses of their counterparts so that they do not follow in their footsteps.

"Moving forwards, we aim to use our academic expertise to further improve the quality of features in Emerald Group Publishing's **Cross Cultural Management** and make it a 'must have' title for any manager looking to develop a cross cultural and assertive team."

Professors Dolan and Albrecht are currently on the lookout for authors who wish to provide contributions which address intracultural, intercultural and transcultural management issues.

Professor Dolan comments, "We are actively seeking writers who can provide our readers with new and interesting insights into Cross Cultural Management. If you're an author, academic or have Cross Cultural Management experience that you'd like to share, we want to hear from you".

Cross Cultural Management: An International Journal is published by Emerald Group Publishing Limited, world-leader publisher of journals and databases in the fields of management, library and information services and engineering. It seeks to be the leading source of research on multicultural management issues. The journal addresses cross cultural management from all management angles.

The second paper entitled, “Exploring the Recruitment of Individuals into Financial Statement Fraud Schemes” is currently under revise and resubmit status at the *Journal of Business Ethics*. While this paper is not yet published, the paper has gone through a peer-review evaluation as it was presented at the 2007 European Academy of Management conference in Paris, France. Three different reviewers at the *Journal of Business Ethics* have also reviewed the paper. While the *Journal of Business Ethics* is an ISI journal and has a relatively high impact factor, the journal does not have the prestigious of being a top-tier publication within the mainstream management field. As a result, when I was interviewing for a full-time position at various universities (HEC Paris, EGADE at the Tec de Monterrey, and Utah State University) several professors, as a part of the application process, reviewed the paper at each university. At all three universities, it was recommended that I pull the paper from the *Journal of Business Ethics* and submit the paper to a more prestigious journal such as *The Academy of Management Review*. As a result, I may follow their advice and pull the paper from the *Journal of Business Ethics*.

In the paper, a model is proposed that describes the process by which individuals within organizations are recruited and become involved in financial statement fraud schemes. The article again builds upon the fraud triangle. The fraud triangle explains how one individual becomes involved in unethical acts – but it does not explain how multiple individuals can become involved in the acts. This paper takes the fraud triangle a step further by providing a dyad reciprocal framework that is inspired by the French and Raven taxonomy of power. The model addressed the process of recruitment, wherein one individual influences

another individual to participate in financial statement fraud. It is proposed that this initial dyad effect is extended to multiple relationships throughout the organization and eventually leads to normative acceptance of other illegal or unethical acts. This in turn, has a negative effect on the organization as a whole.

The third paper of my dissertation entitled, "The Role of Power and Negotiation in Online Deception" appeared in the *Journal of Digital Forensics, Security and Law*. The paper was also presented and went through a peer review evaluation at the 2006 AMCYS conference, one of the premier academic conferences in the information systems field. The paper is somewhat interesting because it takes the basis of my dissertation – fraud and power – and then applies the principles on fraud and power to the Internet. Today, as a result of the advent of the Internet, there is an unlimited supply of possible victims and potential perpetrators. Perpetrators of fraud are no longer limited to geographic boundaries. An individual in Nigeria can easily con a victim in Spain out of hundreds of thousands of Euros because of the Internet. Ten years ago, this would have probably been impossible or at least very difficult to do because of geographic limitations.

The paper attempts to advance theoretical understanding of the important role of both power and negotiation during online deception. By so doing, the paper provides insight into the relationship between perpetrator and victim in Internet fraud. In an attempt to better understand Internet fraud and online deception, the article attempts to build an interactive model, based upon the dimensions of power and negotiation from the management and psychological literature. Using the model presented, the article examines the

effects of the Internet on the communication process that takes place between perpetrator and victim. The article also discusses some of the major tactics employed to appeal to each power type in predominant fraud forms and explores future types of fraud.

The fourth paper of my dissertation is entitled, "Current Trends in Fraud and its Detection." The article was recently published in the 17th issue of *Information Security Journal: A Global Perspective*. This journal is published by Taylor and Francis and has a readership of more than 48,000 academics and professionals. The journal is circulated in more than 129 countries. The journal informs its readers of best practices, as well as research into current and upcoming issues in information security.

The article discusses the basic nature of fraud, including the major accounting scandals of the last decade. The article also discusses the role of auditors and if auditors should be held liable for not detecting financial statement fraud. The article examines recent standards, rules, and acts put in place after the major frauds of the 1990s and early 2000s, including Sarbanes-Oxley, new rules by the NYSE and NASDAQ, and SAS 92. Finally, the article discusses whether these new standards, rules, and acts will have an impact to deter financial statement frauds from occurring in the future.

The fifth paper that is presented in my dissertation also has to do with fraud. The title of the article is, "Financial Statement Fraud: Learn from the Mistakes of the U.S. or Follow in the Footsteps of its Errors". The article was published in the journal *Corporate Finance Review*. The publisher of the journal is Thomson, one of the leading publishers in management education. At the time

the article was published, the journal was in its 12th year of publication.

This article was an invited publication. In other words, the editor of the journal emailed me and asked if he could send the paper through the peer review process and then publish the article in *Corporate Finance Review*. When we originally submitted our first paper to the *European Business Forum*, the paper was more academically written and was somewhat long – around 6,000 words. Because the *European Business Forum* is a professional journal, targeted to managers, we were forced to cut down the original version to around 3,500 words. After the success of the article in *European Business Forum*, the editor Morgen Witzel, who serves as editor of both *European Business Forum* and *Corporate Finance Review* emailed us to see if we would be willing to publish the original, longer, academic based version of the paper in *Corporate Finance Review* – of course we were willing. In the article we propose a fraud model to explain the various factors that may influence an executive to commit fraud. The model builds upon classical fraud theory.

The sixth paper of my dissertation isn't really a paper but is more of a commentary and discussion between myself and two professors, one from George Washington University and one from Virginia Polytechnic Institute in the United States. The article is titled, "A Comment on Koerber and Neck's (2006) 'Religion in the Workplace: Implications for Financial Fraud and Organizational Decision Making'". The article was published in the *Journal of Management, Spirituality, and Religion*.

In Koerber and Neck's original article they argue that the adoption of religion in the workplace can create an environment that leads to a greater

possibility of fraud. This logic flows from the proposition that a culture embedded in religion allows the fraud triangle to develop by creating a greater opportunity for fraud to occur. I believe that Koerber and Neck have pointed out some interesting points. However, in the commentary, I challenge their proposition that religion in the workplace will increase an organization's overall susceptibility to fraud. I base this proposition on two key elements of the fraud triangle – pressure and rationalization. In the commentary, I propose that, by examining the entire fraud triangle – not just one element of the fraud triangle – organizations embedded in religion may have an overall minimized risk of financial fraud.

Justification of the Thematic Unit

It is almost impossible to open any newspaper today without reading headlines relating to fraud and other forms of corruption within organizations. Enron, WorldCom, Waste Management, Xerox and Cendant are just a few examples of companies in the United States whose executives have participated in unethical actions. However, financial scandals are not limited to the United States. Organizations in Europe, Asia and other parts of the world have been involved in similar situations. Celebrated non-U.S. cases include: Parmalat (Italy), Harris Scarfe and HIH (Australia), SKGlobal (Korea), YGX (China), Livedoor Co. (Japan), Royal Ahold (Netherlands), and Vivendi (France). The business community worldwide has experienced a syndrome of ethical breakdowns, including extremely costly financial fraud.

The Association of Certified Fraud Examiners (ACFE) regularly conducts one of the most comprehensive fraud studies in the United States. First conducted in 1996 and then redone in 2002 and 2006, the ACFE study, called *Report to the Nation on Occupational Fraud & Abuse*, is based on actual fraud cases by certified fraud examiners who investigate the frauds. The 2006 study estimates that within the United States, organizations lose 5 percent of their annual revenues to fraud of various forms. Applied to the United States gross domestic product, this 5 percent figure would translate to approximately \$652 billion in fraud losses.

Because fraud affects how much we pay for goods and services, each of us pays not only a portion of the fraud bill but also for the detection and investigation of fraud. Most people believe that fraud is a growing problem. Most researchers agree that the number of frauds committed seem to be increasing. However, even more alarming than the increased amount of fraud cases is the size of discovered frauds.

In earlier times, if a criminal wanted to steal from his or her employer, the perpetrator had to physically remove the assets from the business premise. Because of fear of being caught with the goods, frauds tended to be small. However, with the advent of the Internet, computers, and complex accounting systems, employees now need only to make a telephone call, misdirect purchase invoices, bribe a supplier, manipulate a computer program, or simply push a key on the keyboard to misplace company assets. Because physical possession of stolen property is no longer required and because it is just as easy to program a computer to embezzle \$1 million, as it is \$1,000, the size and number of frauds have increased tremendously.

The unethical actions of executives within each of these organizations have resulted in job losses, lawsuits, economic downturn, and a plethora of other negative

consequences for individuals and society as a whole. In my dissertation, I justify the subject of fraud examination because of the rampant and large frauds that take place in organizations throughout the world today. It is my belief that financial frauds and other forms of organizational corruption have an immense impact on the world we live in. As my own advisor, Simon Dolan, has suggested it is not enough to simply understand fraud and why it occurs, rather it is important to understand the strategies that are employed by individuals – in the case of this research – the strategies that are used to influence others to participate in fraud schemes. It is my hope that this research will aid in the prevention of future ethical lapses and be the basis for additional research to better understand fraud and corruption in cultures throughout the world.

Previous research has suggested that a key element of fraud prevention is educating employees and others about the seriousness of fraud and informing them what to do if fraud is suspected. Educating employees about fraud and providing fraud awareness training helps ensure that frauds that do occur are detected at early stages, thus limiting financial exposure to the corporation and minimizing the negative impact of fraud on the work environment. Education includes instructing employees, vendors, customers, and other stakeholders of what the organization's expectations are. I further justify the subject of fraud as the theme for my dissertation because the dissertation is making a difference in the real world by providing fraud awareness, education, and training to managers throughout the world. The research presented in this dissertation adds to the existing literature on fraud awareness and education. As such, many of the principles discussed in the dissertation, will be the basis for further research within our academic field.

Summary of Dissertation

As can be seen from the explanations above, all six papers presented in the following dissertation deal with the issue of fraud in the workplace. Several of the papers deal specifically with financial statement fraud, one paper deals with fraud via the Internet, one paper deals with the relationship between fraud and religion, and several papers deal with the fraud triangle and fraud in general. The six papers are summarized in the table below:

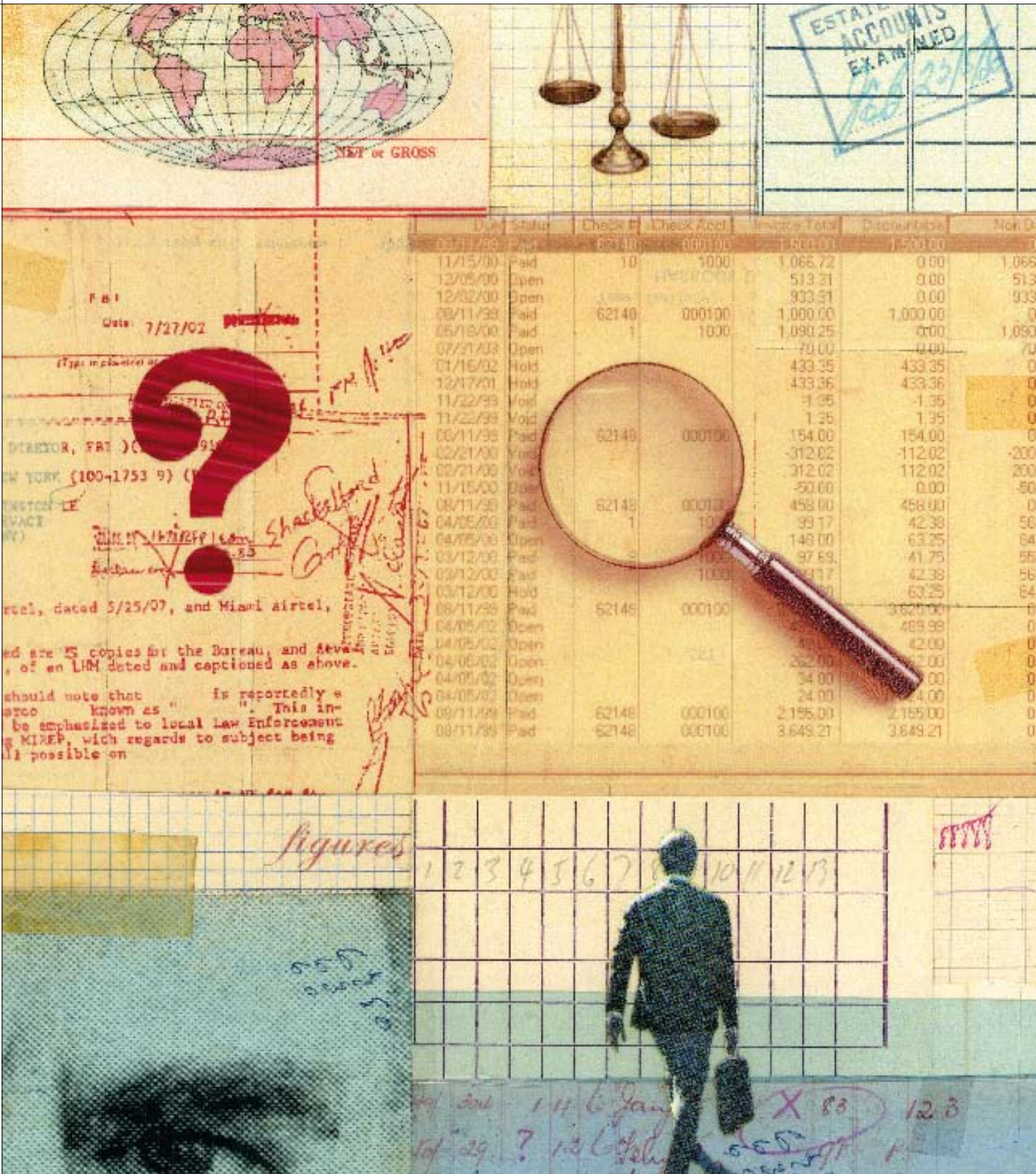
Title	Peer Review	Journal	Issue	Publisher	Other Information
Financial Fraud: The How and Why	Yes	European Business Forum – Published	Summer, 2007 – Issue 29	Official publication of CEMS Schools	Quoted Extensively in the Times of London Newspaper. Circulation of article more than 48,000.
Exploring the Recruitment of Individuals into Financial Statement Fraud Schemes	Yes	Journal of Business Ethics	Under second revise and resubmit	Kluwer Publishing – Netherlands.	Impact Factor Journal. Earlier version of the paper was presented at the 2007 EURAM conference.
The Role of Power and Negotiation in Online Deception	Yes	Journal of Digital Forensics, Security, and Law – published	Volume 1, Issue 4 – January, 2007	Published by Longwood University - Virginia, USA	Earlier version of the paper was presented at 12th AMCIS conference.
Current Trends in Fraud and its Detection	Yes	Information Security Journal – published	Volume 17, Issue 1 – March, 2008	Taylor and Francis Publishing – London, England	Official publication of the CISSP and the SSCP. Circulation of journal to more than 48,000 professionals.
Financial Statement Fraud: Learn from the Mistakes of the US or Follow in the Footsteps of its Errors	Yes	Corporate Finance Review – published	Volume 12, Issue 4 – January 2008	Thomson Tax & Accounting – New York, USA.	Invited Paper from Editor. Based on the article that first appeared in the European Business Forum.
A Comment on Koerber and Neck’s (2006) “Religion in the Workplace: Implications for Financial Fraud and Organizational Decision Making.	Yes	Journal of Management, Spirituality & Religion – published	Volume 4, Issue 1 – January, 2007	Published by JSMR – London, England	This is a commentary between two authors and myself regarding the relationship between organizations embedded in religion and fraud.

Chapter 2: Article One

Financial Fraud: The How and Why

(Quoted in the *Times of London*)

2. Financial Fraud: The How and Why	22
2.1. Why People Commit Fraud	35
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By Chad Albrecht, Conan C Albrecht and Simon Dolan

Financial fraud: the how and why

Understanding the conditions in which fraud occurs is the key to its detection and prevention.

Illustrations: Martin O'Neill

In recent years, it has been nearly impossible to open any business newspaper or magazine without seeing headlines relating to various types of corruption. One type of corruption has been especially prevalent – fraudulent financial statements. While Europe has experienced several financial statement frauds, including those of Parmalat, Royal Ahold and Vivendi, they have not been nearly as devastating as those in the US. Enron, WorldCom, Fannie Mae, Waste Management, Sunbeam, Qwest, Xerox, Adelphia, Tyco:

these and many other recent financial statement frauds have shocked the business world. In this article, we present the classic model of fraud theory, and then discuss how this model can be expanded in a way that can help European firms.

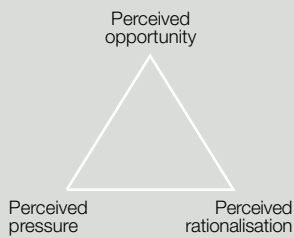
The cost of all frauds – especially financial statement fraud – is extremely high. For example, when a company manipulates its financial statements, the market value of that company's stock usually drops considerably, sometimes by as much as 500

times the amount of the fraud. Six of the top ten bankruptcies in US history occurred in 2002. A record 186 companies, with a combined \$369m in debt, filed for bankruptcy in that year. When a company such as WorldCom declares a \$102bn bankruptcy, nearly every person who has a pension or owns mutual fund shares is hurt financially. Indeed, the cost of these financial statement frauds was borne by the entire country. When a financial statement fraud occurs, the decline in market value and lost revenue for a company can be astronomical.

Why people commit fraud

Classic fraud theory explains the motivations for fraud as a triangle of perceived opportunity, perceived pressure and rationalisation, as shown in Figure 1 (see page 36). Every perpetrator of fraud faces some kind of pressure. Most pressures involve a financial need, although non-financial pressures, such as the need to report results better than actual performance, frustration with work, or even a challenge to beat the system, can also motivate fraud. Research has shown that these pressures do not

Figure 1: Classic fraud motivation model



have to be real, they simply have to seem real to the perpetrator.

The second element of the fraud triangle is perceived opportunity. The perpetrator must believe that he or she can commit the fraud and not get caught, or if he or she gets caught, nothing serious will happen. Like pressures, opportunities do not have to be real; they only must be perceived as real by the perpetrator.

Third, perpetrators need a way to rationalise their actions. Common rationalisations are: "it's for the good of the company", "the scheme is only temporary", "we've no other option", "we are not hurting anyone", "it's for a good purpose", and so on.

Perceived pressures, perceived opportunities, and rationalisations are essential to every fraud.

Whether the fraud is one that benefits the perpetrators directly, such as employee fraud, or one that benefits the perpetrator's organisation, such as financial statement fraud, the three elements are always present. In the case of financial statement fraud, for example, the pressure could be the need to meet analysts' expectations or debt covenants, the opportunity could be a weak audit committee or poor internal controls, and the rationalisation could be "we're only getting over a temporary slump in business".

To understand what motivates individuals to become involved in financial statement fraud, consider the case of the following two firms. Firm A has overall income increasing over time, but there are several slumps along the way. Firm B's income increases consistently over time without slumps. Since Firm B's earnings are more predictable, and since stock prices and market values are a function of both risk and return, Firm A's more risky income stream will result in its stock price being significantly lower.

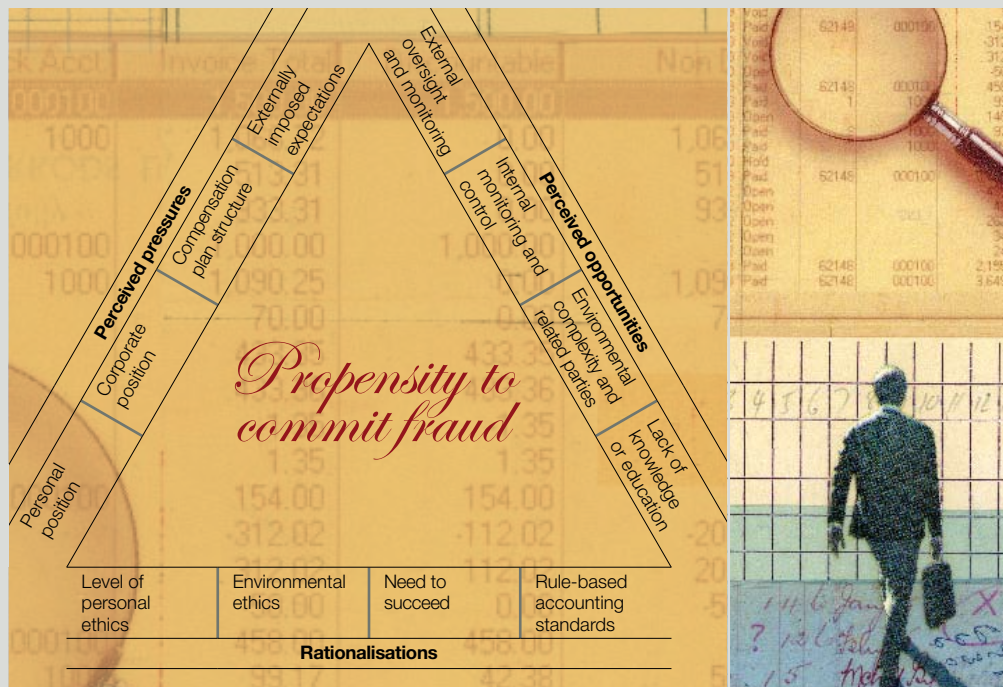
Executives understand this risk/return trade-off. They also know the punishment that is meted out to firms with Firm A-type earnings streams. Accordingly, when Firm A's earnings reach a temporary apex and appear to be decreasing for the next period, there is huge pressure to "cook the books". This increases when the executives themselves hold shares and share options, for a decrease in price will hurt them as well as the company.

Proposed fraud model

In this section, we propose a "propensity to commit fraud model". This builds upon classical fraud theory by listing the various factors that contribute to pressure, opportunity and rationalisation.

Perceived pressures: The traditional fraud model states that pressures (perceived or real) increase the likelihood that a person will commit fraud. Factors include corporate and personal position, compensation plans and external expectations.

Figure 2: Propensity to commit fraud model



A company's financial position is largely a result of its performance and the level of growth it is trying to achieve. Most of the companies that committed financial statement fraud in the past few years had large amounts of debt and leverage. This placed tremendous financial pressure on executives, not only to have high earnings (to offset interest costs), but also to report earnings to meet debt and other covenants. Enron's derivatives-related liabilities increased from \$1.8bn to \$10.5bn in 2000.

In the 1990s and early 2000s, many of the problems at US companies were masked by the good economy. History has now shown that several of the frauds were actually being committed during the boom years, but the economy hid the behaviour. The boom also caused executives to believe their companies were more successful than they were. Sundaramurthy and Lewis (2003) found that extended periods of prosperity can reduce a firm's motivation to comprehend the causes of success, raising the likelihood of faulty attributions.

Managers can also feel significant pressure when their personal financial status is at risk. For example, they may feel their job is in jeopardy if performance falls below a certain level. The fear of losing one's job as a result of poor financial performance has contributed to various frauds throughout the past decade.

A CEO, or any other employee, can feel significant pressure when company success is directly linked

to his or her compensation plan. Indeed, many of the recent frauds exhibited signs of misplaced executive incentives. Executives of several fraudulent companies were endowed with hundreds of millions of dollars in share options and/or restricted shares that made it far more important to keep the stock price rising than to report financial results accurately. In many cases, this share-based compensation far exceeded executives' salary-based compensation. The attention of many CEOs shifted from managing the firm to managing the stock price, and all too often this turned into fraudulently managing the financials. Compensation structure is one of the most prominent reasons for financial statement fraud.

Externally imposed expectations include any performance expectations placed on an individual or company by those outside their immediate environment: financial analysts, competition, and even family members. During the past decade, unachievable expectations by Wall Street analysts contributed to recent scandals. Company boards and management, generally lacking alternative performance metrics, used comparisons with the stock price of "similar" firms and attainment of analyst expectations as important de facto performance measures. Each quarter, the analysts forecasted what each company's earnings per

In Brief

- > **Understanding why and how individuals commit fraud is the key to fraud prevention.**
- > **Pressure to commit fraud combined with opportunities to do so have led to many financial statement frauds in recent years.**
- > **Some people are also able to rationalise fraudulent actions by arguing that they will benefit themselves or their companies.**
- > **To prevent fraud, it is necessary to reduce the pressures and opportunities, but also to hire people of sufficient integrity who will not rationalise fraud.**

share would be. The forecasts alone drove price movements of the shares, imbedding the expectations in the price of a company's shares. Executives knew that the penalty for missing the "street's" estimate was severe: falling short of expectations by even a small amount would harm the company's share price.

Perceived opportunities: Increased opportunities lead to an increased propensity to commit fraud. Our model includes opportunities relating to external oversight and monitoring, internal monitoring and control, environmental complexity and the existence of related parties and lack of knowledge or education.

External oversight includes audit firms, government agencies, or any other external monitoring a firm or individual may have (such as industry or regulatory oversight). During the past decade in the US, accounting firms have, in some cases, used audits as loss leaders to establish relationships so they could sell more lucrative consulting services. The rapid growth of the consulting practices of the "Big 5" accounting firms, which was much higher than the growth of other consulting firms, attested to the fact that it is much easier to sell consulting services to existing clients than to new ones. But the provision of consulting services caused some auditors – notably Arthur Andersen – to lose their focus and become business advisers rather than auditors. This affected these companies' abilities



to provide independent monitoring, and this helped to create conditions in which fraud could take place.

Internal monitoring and control includes oversight provided by boards, and audit and compensation committees. One of the purposes of boards of directors is to oversee the high-level policymakers of a company. The board is an important element of corporate control and is often perceived as the final control for shareholders. A board that fails to accept this responsibility dooms the corporate control process by letting executives operate unchecked, without proper feedback on corporate or personal performance.

Within the board, the audit and compensation committees assume vital control responsibilities. The audit committee oversees the work of the external and internal auditors, and the risk assessment function within the corporation. The compensation committee oversees executive cash and equity compensation, loans and other forms of remuneration. Many of the companies involved in corporate wrongdoing had aggressive executives who ran roughshod over their boards, and audit and nominating committees. An important oversight control was missing and the control environment was decayed. Recently, the board members of WorldCom and Enron agreed to personally accept some responsibility for their companies' wrongdoing and to make personal payments to victims.

The perceived opportunity to

commit fraud is affected by the environmental complexity. Greater complexity makes it harder for auditors, boards and external bodies to understand the exact financial state of a company. Complex companies or divisions within companies provide CEOs and employees places to hide fraudulent activities. Related parties also make it possible to hide fraudulent transactions. Lincoln Savings and Loan was one company that used relationships to commit fraud. In Lincoln's case, it structured sham transactions with certain straw buyers (related parties) to make its negative performance appear profitable. The management of ESM Government Securities hid a \$400m financial statement fraud by creating a large receivable from a non-consolidated related entity.

While relationships with all parties should be examined to determine if they present opportunities for or exposure to fraud, relationships with financial institutions, related organisations and individuals, external auditors, lawyers, investors and regulators should be

considered especially carefully.

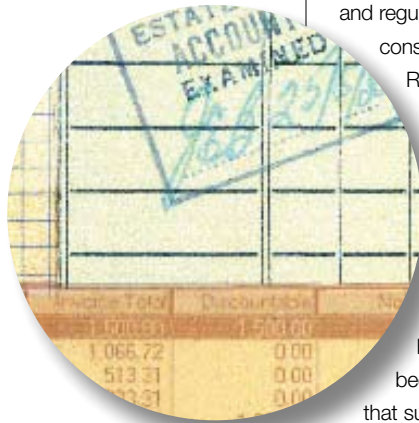
Relationships with financial institutions and bond-holders are important because they provide an indication of the extent to which the company is leveraged.

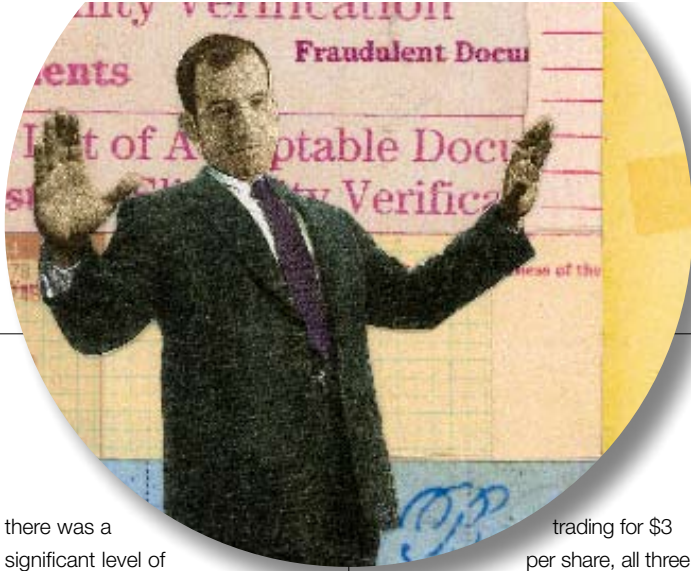
Sometimes people become victims of fraud because perpetrators know that such individuals may not

have the capacity or knowledge to detect their illegal acts. Such people are easy to deceive. Perpetrators often target older, less educated or non-native-speaking people because they find them to be easier victims. When perpetrators believe that auditors and other monitoring bodies are not likely to catch them, perceived opportunity increases.

Perceived rationalisations: These are measures of the ability people have to defend, explain or make excuses for their actions. Increased ability to rationalise increases the probability that people will commit fraud. It has long been recognised that people who are dishonest tend to rationalise more than people who are honest. One definition of honesty is "the virtue of refusing to fake the facts of reality" (Hsieh 2005). When people are honest, there is no need to make excuses for faking reality. Researchers have found that fraud can be greatly reduced by hiring honest people, who tend to be more goal-oriented and are able to delay gratification. Dishonest people tend to have a "live for today, I've got to have it now" attitude. Honest people do not try to "beat the system".

A less ethical person will have a greater propensity to commit fraud, given a constant level of opportunity and pressure. A mediating factor in personal ethics is the level of greed an individual has. Greed can decrease a person's ethics and make fraud easier to rationalise. In the frauds researched for this article,





there was a significant level of greed on the part of executives, investment banks, commercial banks and investors. Each of these groups benefited from the strong economy, the high level of lucrative transactions and the apparently high profits of companies. None of them wanted to accept bad news. As a result, they sometimes ignored negative news and entered into bad transactions. In the Enron case, various commercial and investment banks made hundreds of millions from Enron's investment banking transactions, on top of the tens of millions in loan interest and fees (McLean 2001). None of these firms alerted investors about its derivative or other underwriting problems. In October 2001, after several executives had abandoned Enron and negative news about Enron was reaching the public, 16 of 17 security analysts covering Enron still rated the company a "strong buy" or "buy".

Enron's outside law firms were also making high profits from its transactions. These firms failed to correct or disclose any problems related to the derivatives and special purpose entities, and helped draft the requisite legal documentation.

Finally, the three major credit rating agencies, Moody's, Standard & Poor's and Fitch/IBC – all receiving big fees from Enron – did nothing to alert investors of problems. Just weeks before Enron's bankruptcy filing, after most of the bad news was known and Enron's stock was

trading for \$3 per share, all three still gave investment grade ratings to Enron's debt.

While some individuals may be honest or dishonest regardless of the circumstances, most people are affected by their co-workers and organisations. People's ability to rationalise is affected by the ethics of those around them. Companies with strong codes of ethics that are supported by policies, ethical modelling at the top, and anonymous feedback measures provide strong ethical environments for their employees (Anand et al. 2004).

While some people may be **honest or dishonest** regardless of circumstances, most people are affected by their **co-workers**

Additionally, psychology and organisational behaviour research explain that people have different achievement needs. Researchers have found that subjects with higher achievement needs set higher goals and perform better than those with lower achievement needs (Matsui et al. 1981). People who have a greater need to achieve consider their contribution and participation in success to be important, and they find it enjoyable to work hard, to be compared to a standard and to be challenged. They feel the need to establish themselves as experts and excel

above others (Dunning et al. 1989; Deci and Ryan 1980).

Individuals with a higher need to succeed will have a greater ability to rationalise fraud if given adequate opportunity and overpowering pressure. For example, these individuals will rationalise cheating on exams because they feel significant pressure to achieve high scores. In the financial world, individuals with a high need to succeed may rationalise fraud to make financial success appear possible.

A rationalisation specific to financial statement fraud is rule-based accounting standards. In contrast to accounting practices

(or the lack of them) can be exploited for new, often complex financial arrangements. As an example, consider the case of Enron. Even if Andersen had argued that the accounting for Enron's Special Purpose Entities (SPEs) was not appropriate, it would have been impossible for the auditors to make the case that Enron's accounting violated specific rules. Even in the aftermath of Enron's bankruptcy, it was not immediately clear whether any laws had actually been violated.

Conclusions

Fraud and corruption are cancers that eat away at society's productivity. They reduce the effectiveness and efficiency of economies, and have very high costs for individuals and companies throughout the world. The model we have proposed provides insight into why financial statement fraud occurs, and it is a useful way for shareholders, board members and others to think about issues such as incentives for executives. By better understanding what caused major ethical lapses to occur in the US, Europe can prepare itself to avoid similar ethical breakdowns. In the end, we will learn from the mistakes of the US, instead of following in its footsteps.

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Chapter 3: Article Two

Exploring the Recruitment of Individuals into Financial Statement Fraud Schemes

(Also presented at the 2007 EURAM Conference)

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Exploring the Recruitment of Individuals into Financial Statement Fraud Schemes¹

Abstract:

In this paper, we propose a model that describes the process by which individuals within organizations are recruited and become involved in financial statement fraud schemes. A dyad reciprocal framework is developed, inspired by the classical French and Raven taxonomy of power. The model addresses the process of recruitment, wherein one individual influences another individual to participate in financial statement fraud. It is proposed that this initial dyad effect is extended to multiple relationships throughout the organization and eventually leads to normative acceptance of other illegal or unethical acts. This in turn, has a negative effect on the organization as a whole.

Keywords: Corruption; Organizational Culture; Recruitment; Collusion; Power; Financial Statement Fraud; and Influence.

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Financial Statement Fraud

In recent years, corruption and other forms of unethical behavior in organizations have received significant attention in the management literature (Bandura, Barbaranaelli, Caprara, & Pastorelli, 1996), investment circles (Pujas, 2003), and regulator communities (Farber, 2005). Scandals at Enron, WorldCom, Xerox, Quest, Tyco, HealthSouth, and other companies have created a loss of confidence in the integrity of the American business (Carson, 2003) and even caused the accounting profession in the United States to reevaluate and reestablish basic accounting procedures (Apostolon & Crumbley, 2005). In response to the Enron scandal, the American Institute of Certified Public Accountants issued the following statement:

“Our profession enjoys a sacred public trust and for more than one hundred years has served the public interest. Yet, in a short period of time, the stain from Enron’s collapse has eroded our most important asset: Public Confidence.” (Castellano and Melancon, 2002, p. 1)

Financial scandals are not limited to the United States alone. Organizations in Europe, Asia and other parts of the world have been involved in similar situations. Celebrated non-U.S. cases include: Parmalat (Italy), Harris Scarfe and HIH (Australia), SKGlobal (Korea), YGX (China), Livedoor Co. (Japan), Royal Ahold (Netherlands), and Vivendi (France). The business community worldwide has experienced a syndrome of ethical breakdowns, including extremely costly financial statement frauds.

Financial statement fraud has been defined as an *intentional* misrepresentation of an organization’s financial statements (National Commission on Fraudulent Financial Reporting, 1987). An organization’s financial statements are the end product of the accounting cycle and provide a representation of a company’s financial position and periodic performance. The accounting cycle includes the procedures for

analyzing, recording, classifying, summarizing, and reporting the transactions of a business or organization. Financial statements are a legitimate part of good management practice in a wide variety of domains (Power, 2003).

Financial statements are prepared by, and are the responsibility of, company management (Financial Accounting Standards Board, 1979). Accounting is the process through which financial statements are prepared. It is the epistemic consonance and rationale of economic science between government and the public via the mode of official reporting with auditors and accountants, thereby contributing to the discharge of government accountability and the obtaining of a consensus regarding possible future courses of economic management (Suzuki, 2003). Financial statements include presentations of financial data that are prepared in conformity with some comprehensive basic form of accounting. Financial reporting, which comes in the form of financial statements, provides information for the purposes of investment and credit decisions, assessment of cash flow prospects, and the evaluation of enterprise resources, claims to those resources, and changes in them (Financial Accounting Standards Board, 1979).

How and Why Financial Statement Fraud Occurs

Unfortunately, in recent years, various organizations have experienced massive financial statement frauds. Because financial statements play such an important role in society, organizations, and the economy, it is important to understand how and why, in some organizations, financial statements are manipulated. “How” and “why” financial statement frauds are committed in organizations represents two different and separate issues that are not yet fully understood. “How” financial statement fraud is committed has been the subject of much scholarly debate in the accounting profession. In fact, the recent Sarbanes-

Oxley Act that was passed by the United States Congress in 2002 was an attempt to address the issues of “why” financial statement frauds are committed and to curb financial statement fraud within the United States,

The accounting research community has given considerable attention to the subject of how financial statement fraud is perpetrated and, those efforts, have led to substantial gains in the fight against fraud and other forms of corruption. However, “why” fraud is committed within organizations has received less attention. Research that has addressed “why” fraud is committed has generally focused on various theories of management, especially that of agency theory (Albrecht, et al, 2004).

Agency theory, first proposed by Jensen and Meckling (1976), describes a principal-agent relationship between shareholders and management, where top managers act as *agents* whose personal interests do not naturally align with company and shareholder interest (Jensen and Meckling, 1976). Agency theory stems from economic models that argue that most people are motivated by self-interest and self-preservation. Several researchers have applied agency theory to recent frauds in an attempt to explain why executives may have rationalized their involvement in various types of fraud, especially manipulating reported earnings. These researchers have asserted that management committed fraud because it was in their personal, short-term interest (Davis, Shoorman, Donaldson, 1997). In an attempt to curb financial statement fraud and other deviant management behavior, researchers have suggested that organizations structure management incentives in ways that align management behavior with shareholder goals. Furthermore, researchers have argued that organizations should create controls to limit the opportunities for executives to maximize their own utility at the expense of shareholder interest. When the interest of top management is brought in line with the interest of shareholders, agency theory

argues that management will fulfill its duty to shareholders, not so much because of any moral sense of duty to the shareholders, but because doing what shareholders request also maximizes their own utility (Donaldson & Davis, 1991). Furthermore, Eisenhardt (1989) suggested that designing an optimal control mechanism between the principal and agent is in the principal's best interests.

Agency theory is an effective tool to analyze recent financial statement frauds and continues to be a basis for research into the topic of corrupt organizations. However, because agency theory focuses primarily on why a manager (or multiple managers) would commit financial statement fraud to maximize their perceived self interest and not how they recruit other individuals into the schemes to assist them with the fraud, we do not use the context of agency theory in this paper. Agency theory is excellent in understanding how financial statements get started; it is not so helpful in understanding how others in an organization, including those who often do not benefit personally from the frauds, are recruited as participants.

In the last few years, there has been an increased volume of research by scholars from the organizational community into the issues of fraud and other forms of corruption from a humanistic approach. Recent research in this area has addressed circumstances that influence self-identity in relation to organizational ethics (Weaver, 2006), collective corruption in the corporate world (Brief, Buttram, & Dukerich, 2000), normalization and socialization, including the acceptance and perpetuation of corruption in organizations (Anand, Ashforth & Mahendra, 2004), the impact of rules on ethical behavior (Tenbrunsel & Messick, 2004), the mechanisms for disengaging moral control to safeguard social systems that uphold good behavior (Bandura, 1999), and moral stages (Kohlberg, 1984). In addition to this work, there has been

substantial research over the last 25 years into the various aspects of whistle blowing in corrupt organizations (Dozier & Miceli, 1985; Near & Miceli, 1986).

While this research has increased our knowledge of corruption in organizations and sheds light on the issue of financial statement fraud, this research does not explain how one or more corrupt individual(s) persuades other individuals to become involved in dishonest acts. Understanding the way that individuals, who would otherwise make ethical decisions, become recruited into a financial statement frauds would provide valuable knowledge that could help reduce the magnitude of financial statement frauds and lead to earlier detection of such frauds.

Classical Fraud Theory

Classical fraud theory has long explained the reasons that an individual becomes involved in financial statement (or any type of) fraud. This theory suggests that individuals become involved as a result of the fraud triangle, explained as a perceived opportunity, perceived pressure, and rationalization (Cressey, 1953). These three elements are demonstrated in figure 1 below.

Insert Figure 1 About Here

The first element of the fraud triangle is a perceived pressure. Most pressures involve a financial need, although non-financial or perceived pressures, such as greed, the need to report better than actual performance, a challenge to beat the system, or even fear can motivate fraud. These pressures do not have to be real; they simply have to seem real to the perpetrator.

The second element of the fraud triangle is perceived opportunity. The perpetrator must believe that he or she can commit the fraud and not get caught or that if he or she gets caught, nothing serious will happen. An example of a perceived opportunity would be a CEO or CFO manipulating financial numbers and believing

that the media and or shareholders will not find out or that the problem will go away during the next quarter or year. Like pressures, opportunities don't have to be real; they must only be perceived as real by the perpetrator.

Third, fraud perpetrators need a way to rationalize their actions as acceptable. Common rationalizations are "It's for the good of the company," "We need to do this to get over this financial hump," "We have no other option," or "We owe it to the shareholders," etc.

These three elements comprise the fraud triangle. The importance of the fraud triangle in explaining fraud has gained popularity in recent years. In 2002, the American Institute of Certified Public Accountants – the leading United States accounting professional organization – integrated the fraud triangle into SAS 99, *Considerations of Fraud in a Financial Statement Audit*, to help better train and prepare auditors to detect fraud when conducting financial statement audits.

The initial contributor to the fraud triangle was Edwin Sutherland (1949) in his book, *White Collar Crime*. As a result of this book, Edwin Sutherland was credited with coining the term white-collar crime. According to Sutherland, white-collar crime is very different from street crime. Sutherland identified white-collar crime as an act that often involves violation by a trusted person. Furthermore, he suggested that those who commit white-collar crime are usually in positions of power and high status. Sutherland suggested that white-collar crime is usually committed by those who do not see themselves as criminals but individuals who perceive themselves to be good citizens of the community.

Donald Cressey (1953) was also a key contributor to the fraud triangle. Cressey, one of Sutherland's students, wrote the book, *Other People's Money*. In doing the research upon which his book is based, Cressey conducted interviews

averaging 15 hours in length with 133 prison inmates who had been convicted of embezzlement. The book published by Cressey ultimately dealt with the social psychology of the violation of trust. Using analytical induction, Cressey developed a general statement about embezzlement behavior. Although not claiming predictive power for the theory, he established three conditions, all of which must be present for the crime to take place. The person must have: (1) financial problems defined as non-sharable, (2) an opportunity to violate trust, (3) rationalization for the act.

Later, Albrecht, Romney, Cherrington, Paine, & Roe (1981) introduced Sutherland's and Cressey's work into the business literature. After significant analysis, they concluded that Cressey's three factors were accurate and labeled them as the fraud triangle. They further concluded that the three factors worked together interactively so that if more of one factor was present, less of the other factors needed to exist for fraud to occur. They also determined that pressures and opportunities need not be real, only perceived to be real.

Collusion between Perpetrators

While the fraud triangle helps to explain why one person becomes involved in a financial statement fraud, it does not explain how that individual persuades or influences other people to become involved in fraudulent acts. The fraud triangle is limited in that it only provides a one-dimensional psychological analysis of the initial perpetrator of the fraud.

Recent research into financial statement fraud has suggested that nearly all financial statements frauds are perpetrated by multiple players within the organization working together (The Committee of Sponsoring Organizations of the Treadway Commission, 2002). Research has shown that most financial statement frauds are collusive, meaning that the act involves more than one perpetrator (Association of

Certified Fraud Examiners, 2006). At a Business Week forum for chief financial officers the following was stated:

“At that forum, participants were queried about whether or not they had ever been asked to “misrepresent corporate results.” Of the attendees, 67% of all CFO respondents said they had fought off other executives’ requests to misrepresent corporate results. Of those who had been asked, 12% admitted they had “yielded to the requests” while 55% said they had “fought off the requests.” (Schuetze, 1998 p. 2)

This statement, along with recent research on financial statement fraud suggests that multiple individuals in management are approached to behave unethically when preparing financial statements, which leads us to our first proposition:

Proposition 1: In order for a financial statement fraud to occur and be perpetuated, it is necessary for multiple members of an organization to work together.

Even with the considerable attention that has been given to ethics in both the accounting literature and in practice, there is still a significant gap in knowledge regarding the relationship that takes place between the potential conspirator of a financial statement fraud and the principle conspirator of a financial statement fraud. In others words, we still do not know the processes by which one individual – after he or she has become involved in a financial statement fraud –recruits other individuals to participate in financial statement fraud schemes.

Similarly, the management and ethics communities do not fully understand how these same relationships affect the overall organizational culture of an organization. To this end, this paper examines the process of how collusive acts—particularly those of financial statement fraud—occur in organizations, thereby providing insight into the evolutionary process of how entire managements become involved in financial statement frauds.

Organizational Cultures

Organizational cultures have been defined as a set of shared, taken-for-granted implicit assumptions that a group holds and that determines how it perceives, thinks about, and reacts to various environments (Schein, 1992). It is the values of individuals within an organization that affect the organizational culture as a whole (Dolan, 2006). Organizational cultures do not become ethical or unethical by chance. Rather, they are influenced and even comprised of the ethical decisions of individuals (Jackson & Schuler, 2006). As individuals lower their ethical standards and as these individuals affect the standards of others, the overall culture is lowered. In this paper, it is argued that by looking at how individuals recruit potential co-conspirators into a financial statement fraud, it is possible to better understand how individuals - who would otherwise make ethical decisions - can become involved in illegal or unethical acts. Therefore, the focus of this paper is on how individuals use power to recruit others to participate in financial statement frauds. In examining the process by which individuals become involved in financial statement fraud, a model is proposed that draws upon literature from both the social psychology and the management fields.

The Concept of Power Revisited

The word power in Spanish is “poder”; in French it is “pouvoir”, both words meaning, “to be able to.” These translations provide insight into the English word for power – to be able to influence another person or outcome. Weber (1947) introduced power as the probability that a person can carry out his or her own will despite resistance. It is argued throughout this paper that when a financial statement fraud takes place, the conspirator has the desire to carry out his or her will – influencing other people to act and do as the perpetrator wishes – regardless of resistance. Most of the power literature since Weber’s time has generally agreed with this basic definition (Bacharach & Lawler, 1980).

In the last 30 years, various theories and taxonomies of power have emerged. The most prominent of these approaches are the power-dependence theory (Emerson, 1962), Kipnis, Schmidt, and Wilkinson's typology of influence tactics (Kipnis, Schmidt, & Wilkinson, 1980), and the French and Raven framework of power (French and Raven, 1959). Recent research has suggested that these theories of power have become the most commonly referenced frameworks for understanding power in the management literature (Kim, Pinkley & Fragale, 2005).

Power-dependence theory (Emerson, 1962; Blau, 1964) provides a framework for conceptualizing relative and total power. In this framework the, "Power of Person A over Person B is equal to and based upon the dependence of B upon A." This dependence is based on two factors: (1) it is inversely proportional to the availability of the outcome through alternative sources, and (2) it is directly proportional to the value at stake. Power-dependence theory's central idea is that A's power over B is directly related to the degree to which B is dependent on A. Alternatively, B's power over A depends on the degree to which A can receive greater benefit from the relationships with B than A can get from alternative relationships.

The typology of influence tactics by Kipnis, Schmidt, and Wilkinson (1980) focuses on identifying and categorizing tactics that managers commonly use to try to get others to comply with their requests. This approach provides nine different dimensions, including: pressure, legitimization, exchange, coalition, ingratiation, rational persuasion, inspirational appeal, consultation, and personal appeal. These nine dimensions show how one's power relationship with others can influence the likelihood that these different influence tactics will be used.

French and Raven (1959) proposed that power is comprised of five separate variables, each stemming from the different aspects of the relationship between an

actor and his or her target of influence. Specifically, French and Raven suggested that A's power over B is determined by (1) A's ability to provide benefits to B (reward power), (2) A's ability to punish B if B does not comply with A's wishes (coercive power), (3) A's possession of special knowledge or expertise (expert power), (4) A's legitimate right to prescribe behavior for B (legitimate power), and (5) the extent to which B identifies with A (referent power).

While power-dependence theory provides a good explanation of power in general and provides a basis from which to conceptualize both relative and total power, it does not give insight into the valuation of a relationship. Nor does power-dependence theory provide a basis for how one's power is likely to be used. The typology of influence tactics by Kipnis, Schmidt, and Wilkinson (1980) discusses how power is used; however, the framework focuses only on what people do after a power relationship has been established and does not take into account antecedent or relational determinants. While the framework by French and Raven is somewhat limited in that it does not focus on the implications and tactics used in a power relationship, it does provide a solid foundation by providing a basis of how power is derived. This is beneficial when discussing the recruitment of individuals into fraud schemes because it provides a framework of how power is derived in the relationship between two individuals. As a result, in this paper, we use the French and Raven framework as a basis for analyzing the recruitment of individuals into fraud schemes. Most researchers agree that the French and Raven framework of power is beneficial under these circumstances (e.g. Dapiran & Hogarth-Scott, 2003).

Recent research that treats power as a relational construct has shown that it is *perceived* power, rather than actual power, that affects the desired outcome in a given situation (Wolfe & McGinn, 2005). Regardless of whether A actually has any power

over B, if B perceives A to have power, then this becomes real power and A can use this power over B in the recruitment process. Hence, these five types of power as described by French and Raven (1959) can be classified as perceived reward power, perceived coercive power, perceived expert power, perceived legitimate power, and perceived referent power. This line of reasoning is consistent with Fishbein and Ajzen's (1975) theory for the role of attitude and intentions in explaining future behavior. In this paper, the idea is introduced that, and applied to financial statement fraud, that perceived power is used to influence the recruitment of potential co-conspirators by real conspirators.

Descriptions of Perceived Power

Perceived *reward* power is the ability of the conspirator to convince potential co-conspirators that he or she will provide desired benefits through participation in a financial statement fraud. Promises of a large bonus, large rewards from valuable stock options, other types of equity payments, or job promotions are all examples of perceived reward power.

Perceived *coercive* power is the ability of the conspirator to make the potential co-conspirator perceive potential punishment if he or she doesn't participate in a financial statement fraud. This potential punishment is usually based on fear (Politis, 2005). If the potential co-conspirator perceives that the perpetrator has the ability to punish him or her in any way, the perpetrator begins to exercise a form of coercive power over that individual. Financial statement fraud is often committed because CFOs or other subordinates fear that they may lose their job, receive public humiliation, be discriminated against as a whistle-blower, or be punished in other ways.

Perceived *expert* power is the ability of the conspirator to use influence through means of expertise or knowledge. An example of a financial statement fraud that appears to have been the result of perceived expert power is Enron. Certain members of management claimed to have expert knowledge regarding complicated business organizations and arrangements.² Individuals--who would have otherwise refused to join the conspiracy based upon personal ethical standards--convinced themselves that the conspirators knew more about the complex transactions than they did and that those knowledgeable individuals must understand what they were doing. When conspirators deceive others into believing that they have more expert knowledge or expertise than someone else, they are using perceived expert power.

Perceived *legitimate* power is the ability of Person A to convince Person B that A truly does have real power over him or her. In business settings, individuals such as the chief executive officer or other members of management claim to have legitimate power to make decisions and direct the organization – even if that direction is unethical. In this way, conspirators assume authoritative roles and convince potential co-conspirators that their authority is legitimate. Individuals with whom this power is exerted on often feel tensions between loyalty and ethics.

Perceived *referent* power is the ability of the conspirator to relate to the target of influence (co-conspirators). Conspirators using reference power will build relationships of confidence with potential co-conspirators. Perceived reference power is the ability of Person A to relate to Person B. Perpetrators often use perceived reference power to gain confidence and participation from potential co-conspirators when performing unethical acts. Many individuals, when persuaded by a trusted

² While some financial statement frauds involved easily understood transactions (e.g. WorldCom), Enron was a very complicated fraud that involved off-balance sheet Special Purpose Entities (SPOs, now called Variable Interest Entities), and transactions that occurred between Enron and these various off-balance sheet entities.

friend to participate in a financial statement fraud, will rationalize the actions as being justifiable.

While these five types of power represent the various ways that someone can have power or “influence” over another person, it is important to realize that Person A only has power over Person B to the extent that B allows himself or herself to be influenced. For example, close friends (referent power) are many times able to influence individuals in ways that others can’t; however, these friends only have power over the individual to the extent that the individual allows them to influence him or her. A person can freely choose to defy the person exerting power if they so choose to do so.

The Recruitment Process

Senior management of public companies are often under tremendous financial pressures. These pressures may come from Wall Street expectations, personal expectations, a competitive environment, or other factors (Albrecht, Albrecht & Albrecht, 2004). Chief executive officers may, in response to these pressures, be unethical for various reasons, including executive compensation incentives (Matsumura & Shin, 2005), a lack of an effective code of conduct (Stevens, Steensma, Harrison & Cochran, 2005), short-term behavior (Fassin, 2005), ethical leadership (Knights & O’Leary, 2005), and ethical preferences (Das, 2005). Frauds such as Enron, WorldCom, and Global Crossing reveal a common pattern. This pattern usually involves the CEO exerting substantial pressure on subordinates, such as the CFO, to meet short-term financial goals. When these pressures cannot be met, the CFO and others sometimes use aggressive accounting –a grey area between earnings manipulation and outright fraud (Leavitt, 1998), or when aggressive accounting is not enough, they use illegal accounting practices to meet expectations (Powell, Jubb, Lange & Longfield-Smith, 2005).

Since the stakeholders of public companies expect financial results to improve quarter after quarter, management sometimes rationalizes the accounting gimmicks as

temporary and being done only “to get over an immediate financial hump.” However, because financial statement manipulation in one period compounds the amount of loss in subsequent periods--especially when financial results do not improve--the financial manipulations usually get larger and larger until they are so egregious they are detected or crumble from within (Wells, 2005). While most financial statement frauds are intended to be short-term, most eventually become large financial statement frauds, with nearly as much fraud committed in the last periods of the fraud as in the fraud’s entire history (Albrecht et al., 2006).

Prior studies have shown that most financial statement frauds involve some combination of the chief executive officer, chief operations officer, chief financial officer, controller, other vice presidents, board of director members, and lower-level accounting personnel (The Committee of Sponsoring Organizations of the Treadway Commission, 2002). In order to better understand the relationship between these various players, we evaluate the recruitment process that takes place between the initial conspirator (such as the CEO) and potential co-conspirators (such as the CFO), and then the relationship between the potential co-conspirators (such as the CFO) and various other players (CFO Subordinates). We evaluate these relationships after the co-conspirator has been recruited into the fraudulent activities.

We propose that a person in a position of power (Person A), such as a CEO—as a result of various factors such as outside or personal pressure—uses at least one of the five types of power to influence a subordinate (Person B), such as a CFO to participate in the financial statement fraud. This process is described below:

Insert Figure 2 About Here

Whether or not the individual (person B) is recruited into the financial statement fraud depends upon various factors such as the desire of this individual

(Person B) for a reward or benefit, the individual's fear of punishment, the individual's perceived level of personal knowledge, the individual's level of obedience to authority, and the individual's personal relationship needs. The model displayed is interactive meaning that these five variables or power types work together. Thus, we propose the following:

Accordingly, we propose the following:

Proposition 2: In a financial statement fraud, individuals in the organization will recruit other members of the organization to participate in the act through the use of various types of perceived power.

Proposition 3: The success of Person A to influence Person B is positively related to B's susceptibility to the various types of power.

For example, if reward power were being used to influence another person, and the individual in position B had a specific need for a reward or benefit, then the perceived reward or benefit that A must provide doesn't have to be as significant as if B were not in need of such a reward or benefit. In this sense, when a successful recruitment has taken place, there is a balance between B's susceptibility of power and A's exertion of power.

Once the potential co-conspirator (position B) becomes involved in the unethical scheme, it is proposed that this person often switches to position A, becoming another conspirator. Along this same line of reasoning, we propose:

Proposition 4: There is a positive relationship between the likelihood of a person's recruitment into a fraud scheme and the probability that person will recruit others to participate in the fraud scheme.

Using his or her own perceived power with his or her subordinates, this person now recruits others to participate in the unethical acts. This spillover effect continues until an individual either blows the whistle or until the scheme(s) becomes so large and egregious that it is discovered. This process is shown in figure 3 below.

Insert Figure 3 About Here

The Influence of Organizational Culture

The subject of culture, especially national culture, has attracted significant analysis in recent years. Culture has been explained as, “the collective programming of the mind that manifests itself not only in values, but also in superficial ways, including symbols, heroes, and rituals” (Hofstede, 2001, p.1). Schwartz (2005) has provided a typology that derives value dimensions for comparing cultures by considering three of the critical issues that confront all societies. However, neither the Hofstede nor the Schwartz typologies of cultural dimensions focus on specific cultural dimensions within an organization. This focus can be found in Schein’s (1996) work on the three cultures of management. These three groups include the “operators”, the “engineers”, and the “executives”. The difference between these three groups represents different levels of power within the organization. This theory bridges the gap between power theory and cultural change by analyzing change within an organization. The “operators” include those individuals in the organization who are physically involved with either producing or making the goods or services that fulfill the organization’s mission. Operators include the line employees. Individuals in this group do not usually make changes within the organization, nor do they create organizational learning programs. Rather, these individuals are typically those with whom these types of plans are implemented. These individuals almost always work at the ground level of an organization.

The “engineers” in an organization are the core designers of any functional group. These individuals are those who create programs, whether financial, technical, research, or other. There is a core technology that is the base for what any organization does. The engineers are those who design and monitor this technology for the organization. These individuals typically propose solutions that don’t involve

people. Engineers prefer to have systems, machines, routines, and rules that are completely and totally reliable and automatic. The engineers have a tendency to rule out the “human needs” that are involved in the organization.

The “executives” typically share a common belief centered on the financial status of the organization for which they are responsible. The most important part of their role in an organization is the financial responsibility of the organization to the shareholders. The executives’ biggest concern is keeping the stock price and dividends as high as possible (Donaldson & Lorsch, 1983) so as to maximize shareholder return. To an executive, the world is an increasingly competitive and complex place. Therefore, in the mind of the executive, compromises must be made and chances have to be taken in order to be successful. Furthermore, to the executive, financial criteria is treated as paramount (Schein, 1996).

These three groups are important because, in the beginning, it is the executives who are typically involved in financial statement frauds. However, as the fraud continues, and as more and more individuals become involved in financial statement frauds, both individuals from the operator and the engineer group may become involved. It has been suggested that spoiled organizational images may transfer to many organizational members (Sutton & Callahan, 1987). Therefore, the once ethical organization, with no members involved in financial statement fraud or other unethical acts, gradually transforms itself into an organization that fosters unethical behavior, with various individuals now involved in committing financial statement fraud or involved in other corrupt practices. In the process, individuals, as a result of socialization (Anand et al., 2004), begin to understand and accept the scheme and rationalize their acts as justifiable. This process has a direct negative effect upon the culture of the organization.

Insert Figure 4 About Here

During this process, the organization's culture not only suffers as a result of more individuals being recruited into the financial statement fraud, but also because other unethical acts—as a result of improper modeling, inadequate or missing labeling, and lack of personal integrity by the members of the executives group—become justifiable.

Proposition 5: There is a positive relationship between the number of individuals within an organization involved in a financial statement fraud scheme and the ethical behavior of the organization as a whole.

Taking into account the cultures of management it is possible to see how executives, through the various types of power, can encourage a complete change within the organization as the cycle of recruitment continues to be perpetrated.

Discussion and Opportunities For Future Research

The greatest challenge of researching the roles power and other organizational issues play in financial statement fraud is that these issues are still in their infancy, especially from an organizational perspective. In order to advance this knowledge, some basic questions must be addressed with regards to this key issue. Questions such as the nature, causes, and consequences of financial statement fraud need to be evaluated empirically.

Auerbah and Dolan (1997) suggest that understanding the various types of power does not tell us how power is used to influence others. Rather, they explain that it is important to understand the strategies that are employed by individuals – in the case of this research – the strategies used to influence others to participate in financial statement fraud. Specifically, research must address the exact schemes that Person A uses to influence Person B. Further research must also address how these schemes vary from organization to organization.

With financial statement frauds being perpetrated throughout all parts of the world, there is a need to address the international aspects of power. We must better understand how a country's culture affects the schemes that are employed by individuals to influence others. This research must address issues such as whether one type of power is more dominant than the other types of power regardless of the culture. In recent years, several excellent frameworks for studying cultural values have emerged including Hofstede (1980), Schwartz (1992, 1994), Trompenaars (1993) and recently the framework provided by House, et al (2004). An interesting line of research would attempt to see how different cultural values affect the different types of power in recruiting individuals to participate in fraudulent behavior.”

Similarly, it is important to understand if one type of power always plays a dominant role in organizational corruption or is the type of power that is most effective situationally. Along this same line of reasoning, research must address if individuals may be inherently susceptible to certain types of power. We must examine how differences in personalities and backgrounds affect responses to power, especially the way that different personalities respond when coupled with the influence to participate in financial statement fraud and other forms of organizational corruption.

In this paper, the framework provided by Schein (1996) was used to illustrate the affect organizational cultures play in recruitment schemes. In particular, this paper illustrated how operators, engineers, and executives function within and react to the power framework. However, there are various other frameworks that could be used as a reference point for organizational cultures. For example, Sackmann (1997) provides an excellent framework with which to evaluate the various players, including their various roles. Further research must take into account these alternative

frameworks, and evaluate how power is used within each. Similarly, research must address whether power is used differently in each of the frameworks.

Some basic descriptive studies might address the range of criteria that individuals use to define the relationships they have with those who are in positions to exert power. This area must address how the various types of powers are defined. Furthermore, various constructs such as the desire for a reward or benefit, the fear of punishment, the lack of knowledge, the level of obedience, and relationship needs must be understood more fully. Understanding the emotions surrounding these constructs may help us understand why some people become involved in organizational corruption while others do not. There is a lack of knowledge concerning how emotions play into the power scheme. Specifically, research needs to be conducted that will assess whether the emotions of individuals, including both the recruiter and those recruited, may play in the success of these schemes.

This paper is limited in that the model proposed has attempted only to show that the use of power is a part of the process that takes place in financial statement frauds. However if, after further testing, the model proves valid, it may be possible to infer the model to the process that takes place, not only in the recruitment of financial statement fraud participants, but also in the recruitment of other types of unethical acts.

Conclusion

This paper has proposed a dyad reciprocal model to explain the process by which individuals recruit other individuals to participate in financial statement frauds. The paper has postulated that French and Raven power framework provides an explanation into the ways in which individuals influence others to participate.

Previous research has suggested that a key element of fraud prevention is educating employees and others about the seriousness of fraud and informing them what to do if fraud is suspected (Albrecht et al., 2006). Educating employees about fraud and providing fraud awareness training helps ensure that frauds that do occur are detected at early stages, thus limiting financial exposure to the corporation and minimizing the negative impact of fraud on the work environment. Education includes instructing employees, vendors, customers, and other stakeholders of what the organization's expectations are. If the model presented in this paper proves accurate with further testing; then shareholders will have a valuable tool to assist them in educating employees and others about fraud. This education should help to deter fraud and other forms of corruption within organizations.

We believe this is the first paper that has examined the process by which individuals are recruited into fraudulent acts. As such, this paper fills an important void in the organizational literature. The practical application of this knowledge should have a positive effect upon the business community. For many years, the fraud triangle, although it has a limited predictive ability, has provided the accounting and criminology fields with a basis as to why individuals participate in fraudulent behavior. The fraud triangle has been used to further educational, research, and practical agendas. As such, it has provided a framework to reference when establishing safeguards and other controls to protect businesses from fraud. It has allowed the scientific community to better understand what makes an individual become involved in financial statement fraud. As a result, it has provided guidance that has helped structure both preventive and detective controls to protect and limit the susceptibility of businesses to financial statement fraud and other forms of

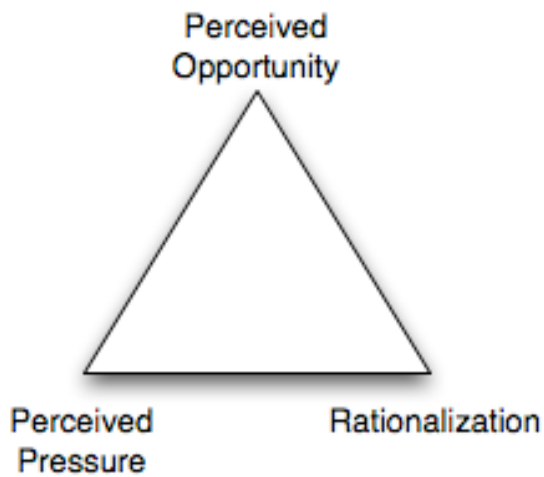
corruption. Unfortunately, the fraud triangle only helps explain how the initial perpetrators get involved in fraudulent acts.

The model described in this paper provides a valuable corollary to the fraud triangle. Used together, we can not only understand why individuals get involved in fraud in the first place but also how they recruit others to participate with them. If the model described in this paper is used by organizations in their fraud prevention programs, employees should be better able to identify various types of power that can be used to recruit them to participate in financial statement fraud schemes. For example, if an employee is asked by a colleague to do something that the employee feels may be unethical for one reason or another, yet that employee is going to do the act simply because he or she feels that the colleague has more knowledge about the project or assignment, the employee will recognize that expert power is involved and will be motivated to find out more information about what exactly is going on before doing what is asked. Similarly, if an individual is approached by his or her boss to do something that person may feel is unethical, he or she should be able to identify the type of power (legitimate) that is being used and be able to make an informed decision about participating in the act or not. Similar examples could be given for each type of power. The practical application of the model is the empowerment of knowledge to potential recruits into financial fraud schemes so that these individuals can make informed decisions about the influence and power that are being exerted upon them by other individuals.

The model proposed in this paper, based upon the French and Raven framework of power, has created another tool, in addition to the fraud triangle, for individuals to use in the fight against fraud and corruption within organizations. Instead of simply explaining how one individual becomes involved in fraud, such as

is the case with the fraud triangle, the model presented provides an explanation of how many individuals become involved in financial statement fraud. The model further explains how fraud is perpetrated throughout the various levels of the organization, giving insight into the important phenomenon of how entire organizations become involved in financial statement fraud. If this model can be validated through further analysis, the practical application of the model will provide a foundation for further research. Furthermore, practitioners will have a valuable tool with which to assist them in the deterrence of fraud. The model will provide a background from which to create schemes and actions to limit organizations' susceptibility to financial statement fraud as well as other possible forms of corruption.

Figure 1: The Fraud Triangle



Source: Albrecht, W. S., Romney, M., Cherrington, D., Paine, R. and A. Roe (1981).

Figure 2: Dyad Reciprocal Model

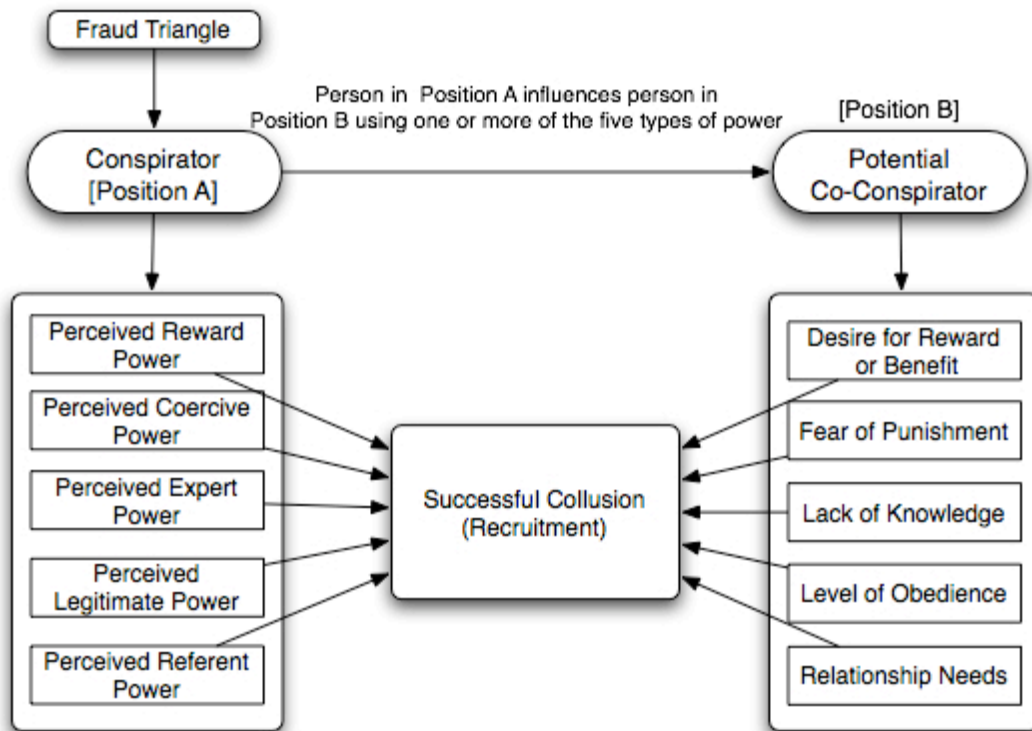


Figure 3: Potential Conspirator becomes Conspirator

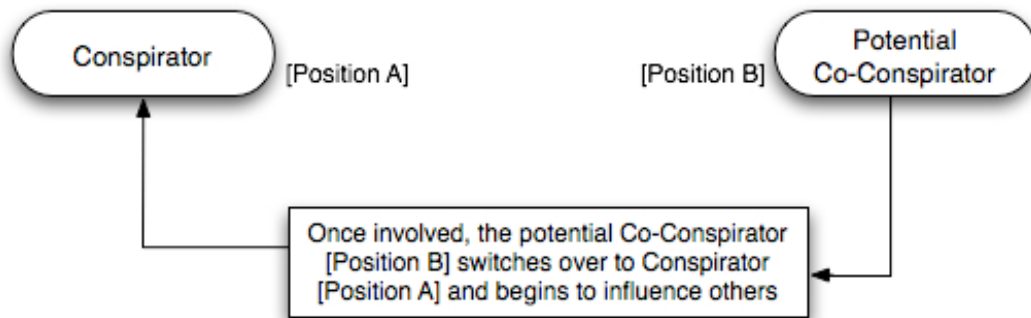
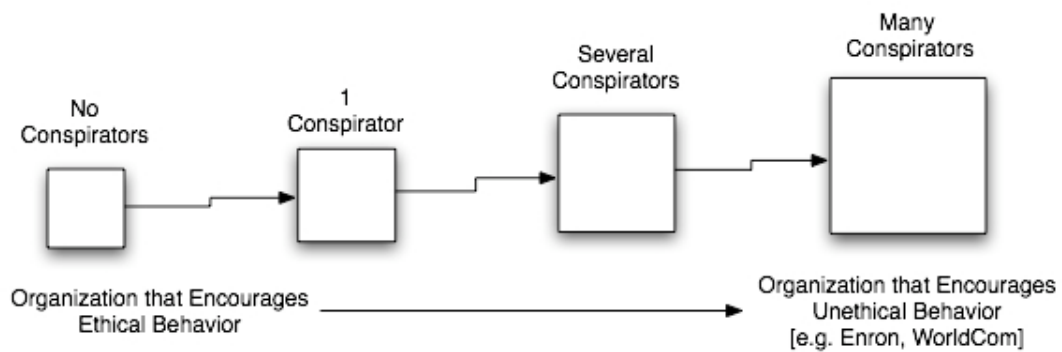


Figure 4: Organization that Encourages Ethical Behavior Converts to an Organization that Fosters Unethical Behavior



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Chapter 4: Article Three

The Role of Power and Negotiation In Online Deception

(Also presented at the 12th AMCIS Conference)

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The Role of Power and Negotiation in Online Deception^{*1}

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ABSTRACT

The purpose of this paper is to advance theoretical understanding of the important role of both power and negotiation during online deception. By so doing, the paper provides insight into the relationship between perpetrator and victim in Internet fraud. The growing prevalence of Internet Fraud continues to be a burden to both society and individuals. In an attempt to better understand Internet fraud and online deception, this article attempts to build an interactive model, based upon the dimensions of power and negotiation from the management and psychology literature. Using the model presented, the article examines the effects of the Internet on the communication process that takes place between perpetrator and victim. Finally, the article discusses some of the major tactics employed to appeal to each power type in predominant fraud forms, as well exploring future types of fraud.

Keywords: Internet, fraud, cybercrime, power, negotiation, deception

1. INTRODUCTION

Over the last several decades, the subject of fraud has received substantial attention in nearly all fields of management. Frauds such as Enron, WorldCom, Tyco, and Adelphia have resulted in a mistrust of the United States accounting standards and profession, causing accounting rule makers and government regulators to reevaluate and reestablish basic accounting

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procedures (Apostolon and Crumbley, 2005). Large frauds around the world such as Parmalat, Harris Scarfe, HIH, Royal Ahold and SK Global show that these disasters are not just occurring in the United States, but are prevalent throughout the world. One conservative estimate suggests that organizations in the United States lose more than six percent of their total revenue as a result of various types of fraud (Association of Certified Fraud Examiners, 2004).

As described above, fraud has a large impact on society. However, in the last few years, as a result of technology and the explosive growth of the Internet and e-commerce, Internet fraud has become a major concern for consumers, merchants, and governments (Balsmeier et. al., 2004, National White Collar Crime Center et al. 2004). Gartner estimates that growth in electronic commerce and online financial services during the next three years alone will be one to three percentage points lower than if people had improved online protection. In the 12 months prior to May 2005, within the United States alone, 2.4 million people lost \$929 million to Internet fraud (Richmond, 2005). Many of these on-line consumer frauds are aimed at the uneducated, unaware, elderly, or immigrants, preying upon the most weak and susceptible of society (Locovich, 2005; Marlowe and Atilas, 2005). In the past, committing fraud was more difficult and resulted in paper trails and other physical evidence. However, today a perpetrator can steal, conceal, and transfer assets with only the click of a mouse.

Almost daily, new frauds and scams arise using the Internet and other technological advances as the tools to perpetrate the crimes. Individuals throughout the world are approached with fraudulent business deals, false money transfers, and other misleading exchanges in chat rooms, by email, on Internet pop-ups, or during Internet auctions. It has been suggested that 3 main areas of fraud exist on the Internet: securities law violations, crime and fraud in electronic commerce, and deceitful acts by Internet companies or individuals (Baker, 2002).

Internet fraud perpetrators exert considerable effort in order to influence and gain power over their faceless victims. An individual in a Internet chat room who claims to have private information about a public company, citizens of Nigeria who claim to have access to substantial funds, or illegitimate companies who con consumers into providing personal financial information are all examples of perpetrators' attempts to gain power over unwary victims.

Given the enormous costs of fraud and the growing prevalence of Internet fraud, the goal of this research is to advance theoretical understanding of the power that perpetrators use when influencing victims via the Internet. Specifically, the research proposes an interactive model combining the dimensions of power and negotiation from the management and psychological literature and applying it to the fraud process. The article then goes on to explain the role of the Internet and other technological advances on fraud using

this model.

It has been suggested that there are two primary methods used to get something from others illegally: physical force and deception (Albrecht, et. al., 2006). Fraud is defined as:

A generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representation. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those, which limit human knavery (Webster's New World Dictionary, 1964).

2. EXISTING MODELS OF FRAUD

Classic fraud theory explains the motivations for fraud as a triangle of perceived opportunity, perceived pressure, and rationalization, as shown below:

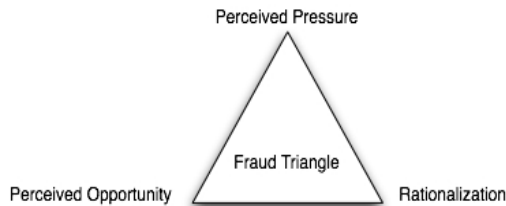


Figure 1. Fraud Triangle

The initial contributor to this model was Edwin Sutherland in his 1949 book, *White Collar Crime*, for which he is credited with coining the term. According to Sutherland, white-collar crime is different from street crime in many ways. It is committed by those of high status and power, it often involves violation by a trusted person in professions such as medicine, law, accounting, banking and business, and it is usually committed by individuals who do not see themselves as criminals. White-collar crime is believed to occur more frequently in large, rather than small businesses, and the general assumption is that prosecutors and judges are more lenient on white-collar criminals than on street-level criminals.

One of Sutherland's most famous students was Donald Cressey who wrote the book, *Other People's Money* (1953). In the studies on which his book is based, he conducted interviews averaging 15 hours in length with 133 prison inmates who had been convicted of embezzlement. This book, published in 1953, is an investigation of the social psychology of the violation of trust, a subject that Cressey was concerned with throughout his career. By a procedure known as analytic induction, he developed a general statement about embezzlement

behavior. Although not claiming predictive power for the theory, he established three conditions, all of which must be present for the crime to take place. The persons must have: (1) financial problems defined as non-sharable, (2) an opportunity to violate trust, (3) rationalization of the act.

Albrecht et al. (1979, 1981) introduced Sutherland's and Cressey's work into the business literature. They concluded that Cressey's three factors were on target and labeled them as the fraud triangle. They further concluded that the three factors worked together interactively so that if more of one factor were present, less of the other factors needed to exist for fraud to occur. One of the main limitations of this model is that it only describes the factors that influence the perpetrator, and does not discuss the relationship between perpetrator and victim. Nor is the fraud triangle specific to online deception. Rather, it is an all-encompassing model to explain the variables involved when someone is involved in any type of fraud.

Unfortunately, research investigating online deception is limited (Nikitkov and Stone, 2006). Some of the most common online deception tactics are based on the Bowyer (1982) and Bell & Whaley (1982, 1991) taxonomy of cheating and deception. Johnson et al (2001), as well as Grazioli and Jarvenpaa (2000, 2003a, 2003b) have applied the taxonomy to classify the various techniques employed in Internet deception. In addition, recent research into online deception has addressed specific types of fraud such as auction fraud (Chua and Wareham 2004), spoofing (Dinev, 2006), and spamming (Hann et al, 2006). However, much of this recent research lacks any explicit theoretical explanation, but describes the phenomenon on a surface level. As an exception, Pavlou and Gefen (2005) examine how online fraud, combined with many other factors such as trust, institutional structures, trust in community of sellers, and past buying experience can lead to psychological contract violations between the buyer and seller and thereby influence purchasing behavior. Finally, some of the literature from the economics field has investigated incentives for fraudulent behavior as well as possible changes to legal structures that would change these incentives (Snyder 2000, Bywell and Oppenheim 2001).

While prior literature has addressed various aspects of online fraud such as common deception techniques, we only have a limited theoretical understanding of the relationship between perpetrator and victim in an online environment. The Internet presents a unique set of circumstances for consumers in that it does not provide the normal social or spatial cues that they typically use to estimate the risk of fraud. Moreover, online fraud is a covert crime, and society often places less emphasis on the prosecution of these nonviolent crimes. In addition, Internet frauds tend to be of moderate nominal amounts to minimize scrutiny, and often cross legal jurisdictions, thereby reducing the motivation or ability of authorities to prosecute them (Chua and

Wareham, 2004). As a result of the nature of this relatively novel medium, we argue for the need for a specific theory that addresses the relationships between the potential perpetrator and the potential victims of fraud as it is facilitated through the Internet.

Our paper proceeds by proposing an interactive model, based on French and Raven's framework on power, to explain the relationship that takes place between perpetrator and victim. Online deception is different from other types of fraud in that it is necessary for the victim to submit to the will of the perpetrator in order for a perpetrator to be successful. In this sense, a negotiation must take place. In the following section we discuss negotiation, its definition, and its role in the process of online deception.

3. DEFINITION OF NEGOTIATION

Negotiation has been defined as "an interpersonal decision-making process by which two or more people agree how to allocate scarce resources" (Thompson, 2000). Both researchers and practitioners have spent much time and resources to better understand the negotiation process (Lewicki, et. al., 1999) and its' various influences, including the negotiators' bargaining history and its' effects on future negotiation performance (O'Conner et. al., 2005). When a fraud takes place, the fraudulent transaction can be described as a negotiation. In the fraud setting, the perpetrator and victim make an interpersonal decision to allocate resources, with the victim transferring resources to the perpetrator (often for some promised return or false representation). When the fraud takes place, from both the perpetrators and the victims' perspectives, a successful negotiation has taken place. It usually isn't until some time later that the victim learns that he or she has been deceived into a fraudulent negotiation.

Proposition 1: When a fraud takes place, the victim believes he or she has participated in a successful negotiation.

4. DEFINITION OF POWER

Since the process of negotiation and its effect on individuals and transactions was first introduced into the psychology literature, one of the fundamental variables that has been studied has been that of power (Marwell et al., 1969). Power is a critical factor and fundamental element for success in the negotiation process (Kim et. al., 2005). Weber (1947) introduced power as the probability that a person can carry out his or her own will despite resistance. When a fraud takes place, the perpetrator has the desire to carry out his or her will – taking advantage of the victim through deceit – regardless of resistance. Most of the power literature since Weber's time has supported his basic definition (Bacharach & Lawler, 1980). In order to understand power, French and Raven (1959) introduced a framework that has, arguably, become the most commonly referenced appraisal with regards to power in the management literature (Kim et. al, 2005).

Proposition 2: Understanding the relationship between power and negotiation in the fraud process can help researchers and practitioners understand, research, and evaluate fraudulent transactions more fully.

French and Raven (1959) propose that power is comprised of five separate variables, each stemming from the different aspects of the relationship between the actor and the actor's target of influence. It has been said that these five power bases have stood the test of time (Dapiran and Hogarth-Scott, 2003). Specifically, French and Raven suggest that A's power over B is determined by (1) A's ability to provide benefits to B (reward power), (2) A's ability to punish B if B does not comply with A's wishes (coercive power), (3) A's possession of special knowledge or expertise (expert power), (4) A's legitimate right to prescribe behavior for B (legitimate power), and (5) the extent to which B identifies with A (referent power). Using these five definitions it is possible to divide power into various categories and create five subtypes of power. Figure 2 presents the five types of power.

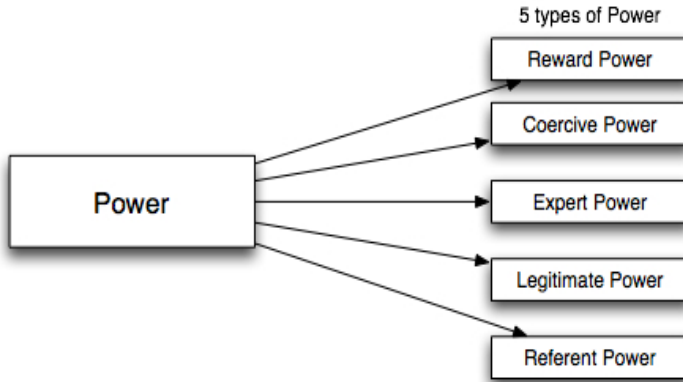


Figure 2: Five Types of Power

This model explains the types of power that are used in the relationship between the actor and the actor's target of influence. However, recent research on these types of power in the negotiation process has shown that it is perceived power, rather than actual power, that affects the outcome of any given negotiation (Wolfe and McGinn, 2005). Even if A doesn't actually have power over B, if B perceives A to have power, then it is as if A truly has power in the negotiation process. Hence these five types of power can be classified as perceived reward power, perceived coercive power, perceived expert power, perceived legitimate power, and perceived referent power. In this paper, we introduce the idea that, applied to fraud, perceived power is used as a means to influence the negotiation between the perpetrator and the victim. As can be

seen above, the perpetrator must deceive the victim into negotiating using one of the five types of perceived power.

Proposition 3: To fully comprehend the role of power in fraudulent transactions, it is necessary to interpret the five different types of power as perceived power.

Perceived reward power is the ability of the perpetrator to convince the victim that he or she will provide the desired benefits through a negotiation. The promise of a monetary reward for participation in a Nigerian money scam, the promise of validation of personal information in a phishing operation, or the promise of high-paying jobs as a bogus mystery shopper are all examples of reward power.

Perceived coercive power is the ability of the perpetrator to make the victim perceive potential punishment if he or she doesn't participate in the negotiation. This potential punishment is usually based on fear (Politis, 2005). If the victim perceives that the perpetrator has the ability to punish him or her in any way the perpetrator begins to exercise a form of coercive power over that individual. Perceived coercive power is a tool often used by CEOs, CFOs, and other executives when a financial statement fraud takes place. Executives will often use coercive power to influence employees and others to participate in the fraud. These individuals fear they may lose their jobs, or be discriminated if they do not participate. Perpetrators can use coercive power, via the Internet, in at least four ways (1) by gaining personal information about the victim through spoofing, sniffing, or data theft, (2) through processes such as click through frauds or other physical fraudulent means, (3) deceiving the victim to believe that the perpetrator can do physical harm to them, and (4) persuading the victim that if they do not act now the opportunity will be lost.

Perceived expert power is the ability of the perpetrator to use influence through means of expertise or knowledge. Examples of frauds that involve perceived expert power include perpetrators who claim to have access to non-public or other sensitive information or perpetrators who claim to have a special knowledge of a given activity. Deceiving a victim into believing that a perpetrator has expert knowledge or expertise is using expert power to influence a victim. In one of the most well known frauds of all time, Charles Ponzi conned victims into believing that he had expert knowledge in foreign postal coupons. Charles Ponzi claimed that he could make significant profit for investors by purchasing stamps in Spain for about 1 cent (N.Y. Times, 1920) and selling them in America for six cents. Using this "expert knowledge" he deceived individuals out of millions of dollars and gave birth to the popular phrase "Ponzi Scheme."

Perceived legitimate power is the ability of a perpetrator to convince victims that he or she has some form of real power over them. Often, this type of fraud involves individuals claiming to represent the individual's church, community,

or organization. The perpetrator assumes some form of authoritative role and convinces the victim that such authority is legitimate. An example of this type of fraud is the “Greater Ministries” fraud. Individuals were told to invest money into programs such as the “Double Your Money” program and the “Faith Promises Program.” Members of the congregation were promised that they would double their money in just 17 months. The fraud involved over 18,000 individuals who lost more than \$448 million. In 2001, five leaders of the Greater Ministries International Church were convicted in United States federal court on a total of 72 counts of conspiracy, wire and mail fraud, and money laundering (Gibelman and Gelman, 2003).

Perceived reference power is the ability of the perpetrator to relate to the target of influence. Perpetrators will build relationships of confidence with a victim via an Internet chat room or other media. Perpetrators often use perceived reference power to gain confidence from victims and deceive them into fraud. Perceived reference power is possible because perpetrators characteristics, unlike other criminals, are very similar to the general population’s characteristics (Romney, 1980). When fraud does occur, one of the most common reactions by those around the fraud is denial. Victims can’t believe that he or she, a trusted friend, would deceive them and behave dishonestly (Albrecht, 2006).

5. DECEPTION

There are many cases where deception has been used in the negotiation process (Schweitzer, 1997). Not only is deception a part of many negotiations, but it has also been suggested that deception increases as the incentives for performance increase (Tenbrunsel, 1998). Deceitful negotiation has been used to fraudulently manipulate individuals throughout history. In the negotiation process it is deception that allows the perpetrator to falsely exercise power over the victim. The theory of deception identifies seven operational tactics employed to deceive a victim (Grazioli and Jarvenpaa 2003b; Johnson et al. 2001). As a primarily tactical model, it compliments our model of power types, suggesting the specific mechanisms that the con artist may employ to realize specific power forms over the victim.

For example, research suggests that con-artists pretending to be businesses prefer masking, and relabeling, thereby achieving expert and legitimate power (Grazioli and Jarvenpaa, 2003a). Specifically focused on the Internet, Grazioli and Jarvenpaa (2000) studied the effectiveness of dazzling, inventing, and relabeling for disguising fraudulent web sites, often used to achieve reward, expert and referent power.

Table 1. Available Tactics in the Theory of Deception
(Grazioli and Jarvenpaa 2003b)

Tactic	Definition
Masking	Hiding or destroying critical information
Dazzling	Disguising critical information
Decoying	Distracting the victim's attention away from critical information.
Mimicking	Assuming someone else's identity, or impersonating someone else.
Inventing	Making up information.
Relabeling	Presenting information in a misleading way.
Double play	Suggesting to the victim that the victim is taking advantage of the deceiver.

6. POWER AND DECEPTION ON THE INTERNET

Along with the developments in the Internet, opportunities to commit fraud and unethical acts have become more available. The Internet has created opportunities to exert perceived power and negotiation skills that were unheard of 20 years ago. And as technology continues to advance, perpetrators find new means and ways to deceive individuals and commit fraud.

Proposition 4: The Internet has become a significant, new instrument in the negotiation process between perpetrators and victims.

According to U.S. Federal Bureau of Investigation statistics (2004), the majority of perpetrators of Internet fraud make contact with the victim through e-mail (63.5%) or a webpage (23.5%). Internet auction fraud was by far the most common (71.2%), but in terms of the size of the losses, check fraud (\$3,600), Nigerian letter fraud (\$3,000), and confidence fraud (\$1,000) were the largest.

It has been suggested that fraud like other crime, can best be explained by three distinct factors: (1) a supply of motivated offenders, (2) the availability of suitable targets, and (3) the absence of capable guardians (Cohen and Felson, 1979; Krambia-Kapardis, 2001).

First, the Internet supplies a gathering place for an endless supply of offenders. The connectivity and global reach provided by the Internet means that these offenders can be anywhere in the world and through the Internet can communicate with anyone. Communication through email, the primary method of contacting victims, is instantaneous and practically free due to low transaction costs. The Internet also allows offenders the ability to easily customize their scams to individual users and the flexibility to quickly change the scam once it is discovered. In auctions alone, Chua and Wareham (2004) identified 11 different types of fraud, and state that "con artists know that

developing specialized fraud schemes increases their profits while minimizing their risk of capture” (p. 33).

Second, the Internet supplies numerous suitable targets. Victims can be approached through e-mail, chat rooms, pop-up ads, websites and numerous other media via the Internet. Web sites like eBay, with its 181 million registered users worldwide, provide offenders with easy access to a large number of potential victims. However, access to potential victims is not exclusive to the Internet. Perpetrators of fraud can obtain personal information in a number of ways, including: stealing wallets, purses or credit cards; stealing mail or through sending a fraudulent address change form; through viruses or spyware; or through unsolicited emails or telephone calls, and in over half the cases the offender has a prior relationship with the victim (Diller-Haas, 2004).

Third, the Internet provides a perfect scenario for fraudulent activity with few or no capable guardians. The Internet has no boundaries; it crosses communities, cultures, and countries. Much fraud crosses national and international legal jurisdictions, and, hence, perpetrators have little risk of getting caught or punished. For example, while many states within the United States have statutes relating to cybercrime such as money laundering, identity theft, online gambling, and cyber stalking, there is no standard and the rules vary from state to state (Brenner, 2001). Because most of these statutes were written before the Internet existed, the statutes only relate to property, computer, or other types of illegal acts and do not specifically address cybercrime. Fraud is a covert crime, making collection of evidence for prosecution difficult; it is nonviolent so it receives less evidence by society and lower priority by law enforcement; most Internet frauds are small and thus victims have little incentive to prosecute; and when offenders are caught they often receive light sentences (Chua and Wareham, 2004).

Proposition 5: Fraud is becoming more widespread because the Internet supplies a gathering place for an endless supply of offenders, offers numerous suitable targets, and provides a scenario for fraudulent activity with few or no capable guardians.

7. A COMPREHENSIVE MODEL

To understand the interaction between power, negotiation, and the Internet, the following model is presented. On the left are French and Raven’s five types of power. The offender will use the five types of power to deceive the victim into the negotiation. The middle box represents deception, which is enhanced through technological advances, such as the Internet, electronic commerce, or any other technological media used for communication. The right hand box represents the victim, including the victim’s emotions that the perpetrator will try to manipulate and use in the deception process. The successful negotiation is the final outcome of the perpetrator using power to deceive, via the Internet, the victim by manipulating the victim’s emotions.

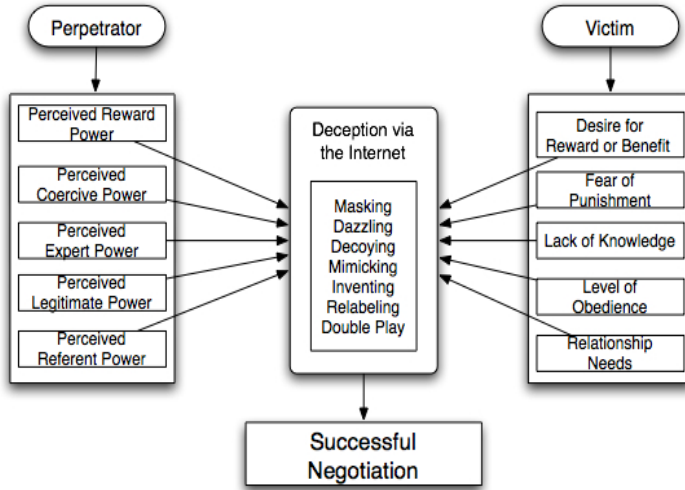


Figure 3. The Cybercrime Framework

In all scams, there is some perceived reward that is never fully realized, or is misrepresented in some way, whether in the form of money, which never arrives, or goods or services, which are not provided or are somehow less than that which was promised. The key to whether the negotiation is successful or not hinges on the perception on the part of the victim as to the size of the reward as well as the victim's perception that the offender is legitimate. The perceived expert power has a positive relationship with perceived legitimate power. Furthermore, the perceived referent power is increased through repeated interactions between offender and victim, and also has a positive relationship with perceived legitimate power. Coercive power is generally used to create the impression that the offer is unique and for a limited time, and can create a sense of urgency in the negotiation.

To illustrate this model, we present the top ten Internet scams of 2005 in Table 2 (Internet Fraud Watch, 2005). In the table, we posit how each type of fraud appeals to a specific type of power, as well as the predominant deceit tactics employed to exercise each power.

Table 2. Internet Crime within the Cybercrime Framework

Perpetrator	Perceived Reward Power	Perceived Coercive Power	Perceived Expert Power	Perceived Legitimate Power	Perceived Referent Power
Victim	Desire for a Reward or Benefit	Fear of Punishment	Desire for a Need or Want	Level of Obedience	Relationship Needs
Deception via the Internet	<ul style="list-style-type: none"> • Dazzling • Decoying • Mimicking • Inventing • Relabeling 	<ul style="list-style-type: none"> • Mimicking • Inventing • Double play 	<ul style="list-style-type: none"> • Decoying • Dazzling • Mimicking • Relabeling 	<ul style="list-style-type: none"> • Decoying • Mimicking • Relabeling • Double play 	<ul style="list-style-type: none"> • Dazzling • Mimicking • Inventing • Double play
Auctions	Seller misrepresents product; Shilling/collusion artificially increases price	Auction fever-buyers must act before auction close	Seller may pose as expert in antiques or one-of-a-kind merchandise. Cut and paste from real experts	Reputation scores – can be inflated by seller Seller poses as reputable company	Trust relationship created through community forums
General Merchandise	Seller misrepresents product		Seller may pose as expert in antiques or one-of-a-kind merchandise. Cut and paste from real experts	Seller poses as reputable company	Seller creates trust through interactions with buyer
Nigerian Money Offers	Promise of large financial rewards	Offer is confidential and for a limited time		Offender poses as high government official – gives evidence of legitimacy	Appeals to needs of under-developed regions
Fake Checks	Victim perceives that checks are valid			Victim perceives that offender represents a legitimate company	Offender creates trust relationship through interactions with victim
Lotteries	Promise of large financial rewards	Offer is for a limited time		Offender poses as a reputable institution	
Phishing	Victim expects validation of personal information	Offender argues that user data has been stolen hence possible injury – updates required		Offender poses as a reputable institution known to the victim	
Advance Fee Loans	Victim is promised loan in spite of his/her bad credit			Offender poses as a reputable institution	

Table 2 (continued). Internet Crime within the Cybercrime Framework

Information/Adult Services	Victim receives expected services but with hidden conditions			Offender poses as a legitimate institution	
Work-at-Home	Promise of large financial rewards		Offender poses as expert in home businesses	Offender poses as a reputable institution	
Internet Access Services	Cost of services misrepresented or services not provided			Offender poses as a reputable institution	

Perceived reward in auctions can be manipulated through various means. The seller can engage in shilling or bid shielding, where the price of the goods is artificially driven up through some behavior on the part of the seller. This creates the impression that the goods are more in demand than they actually are, resulting in higher bids from “legitimate” buyers. The goods can also be misrepresented, where the seller describes an item incorrectly and thus the actual reward is less than what is perceived. Auctions also have a coercive nature, where the buyers feel that they must act immediately or lose a unique opportunity.

Perceived expert power can be exercised in auctions, for example, in the case of goods which are supposedly antiques or one-of-a-kind, and the seller poses as a knowledgeable collector.

Perceived legitimate power can be created through the reputation scores which are maintained on auction sites based on the number of situations where the buyer is satisfied or dissatisfied. These scores can be manipulated through “phantom” trades where the seller poses as a buyer on various trades and gives him or herself positive ratings, thus artificially elevating his or her reputation score.

Finally, perceived referent power can be obtained through reputation scores as well as other community forums on the auction sites, where buyers and sellers can interact and perpetrators can gain the confidence of their potential victims.

For each power form, we explore how the Internet enables specific tactics such as mimicking, inventing, and relabeling. The increased anonymity, global reach and low barriers to entry of the Internet enable fraudulent activity from all parts of the world.

8. RECOMMENDATIONS FOR THE MANAGEMENT OF ON-LINE FRAUD

The model that has been presented may prove to be of great value to practitioners, regulators, and academics. Even more importantly, this model may be of great help in protecting the common individual or consumer from being defrauded online. As discussed earlier, perpetrators of fraud typically prey upon the susceptible – the elderly, immigrants, uneducated, or those who find themselves in a desperate situation.

While the model successfully describes current well-known fraud types, it can also be used to generate generalized predicative statements concerning future fraud forms. For example, all of the perpetrator and victim characteristics have a positive relationship to the possible occurrence of fraud. However, there are a number of power types and deception methods that are particularly salient to Internet fraud. While any discussion of future fraud forms is clearly speculative, it is worth noting that most fraud forms have existed for many years. The majority of frauds occurring online today have their origins long before the development of the Internet (Albrecht et al. 2006). Even phishing is a variant of identity theft that has been practiced for years; the Internet simply permits a far more efficient execution. Accordingly, table 3 outlines a number of generalized fraud types, their victim and perpetrator characteristics, primary deception mechanisms as well as their alignment towards successful execution on the Internet. While this analysis is a simplification, our assumption is that future online frauds will likely be novel variants of traditional forms. As such, we highlight fraud forms that have a high proclivity with the Internet, and thereby have a higher likelihood of occurring in future forms.

Opportunities for easy money or rewards will likely continue to occur in a variety of forms on the Internet. The Internet permits a number of techniques for manipulating or falsifying information to entice victims to send money in the hopes of future gain. Moreover, the vast reach of the Internet allows perpetrators to broadcast their lures to a broad audience, and efficiently identify and communicate with victims with a propensity to fall for the temptation of easy money.

Likewise, the relative ease with which digital technology can replicate and manipulate non-existent, stolen or counterfeit products suggests that criminals will continue to employ these techniques in a variety of ways. In a similar vein, digital technology and the Internet enable institutional or expert legitimacy to be easily replicated, thereby permitting criminals to emulate legitimate scientific, legal or business institutions in a process of selling bogus pharmaceuticals, or medical, psychiatric, legal or business services.

However, frauds that leverage personal relationships to a high degree will be less likely. In this situation, we can think of “the power of personal persuasion” where perpetrators leverage personal or professional relationships to coerce

victims. While we do not eliminate the possibility, the use of rich communication media and other social cues to manipulate victims makes these types of fraud less likely to occur exclusively via the Internet. Rather, the possibility for hybrid frauds, where the Internet is used for initial contact, and further negotiation occurs in person, is certainly feasible.

Table 3. Generalized Fraud Types, Their Victim and Perpetrator Characteristics, Primary Deception Mechanisms as Well as Their Alignment towards Successful Execution on the Internet

Fraud	Perpetrator Power	Victim	Deception via Internet	Proclivity with Internet
Offer for easy money or rewards Check or money transfer scams	Perceived reward power Perceived expert power Perceived legitimate power Perceived coercive power	Desire for rewards or benefit Lack of knowledge Level of obedience Fear of punishment	Dazzling Inventing Relabeling Mimicking Decoying	<i>Medium-High</i> The Internet is well aligned towards intimate communication with victim and manipulation/decoying of relevant information. This makes useful for frauds where the victim is coerced to send money in the hopes of obtaining future rewards.
Merchandise at “too good to be true prices” Counterfeits, stolen products	Perceived reward power Perceived expert power	Desire for rewards or benefit Lack of knowledge	Dazzling Mimicking Inventing	<i>Very High</i> The relative ease with which information and images can be obtained, modified and reproduced is very high, making the Internet an excellent medium for this type of fraud.
Fake or illegal pharmaceuticals or other medical, legal or professional services	Perceived expert power	Lack of knowledge Level of Obedience	Mimicking Inventing Relabeling	<i>Very High</i> Institutional or expert legitimacy can be easily replicated on the Internet
Personal cons Fake loans or financial transactions Fake business ventures	Perceived coercive power Perceived referent power Perceived legitimate power	Fear of punishment Level of obedience Relationship needs	Masking Inventing Double play	<i>Low</i> These “personal” frauds are highly dependent on the perpetrator’s ability to leverage personal or professional power over victim.
Stealing confidential information, phishing, identity theft	Perceived legitimate power Perceived referent power	Fear of punishment Level of obedience	Mimicking Relabeling	<i>Very High</i> Institutional or expert legitimacy is easily reproduced on the Internet

Finally, techniques for collecting confidential information on victims will likely continue in tact with the technology that ensures its prevention.

Computer security experts have long acknowledged that the weakest security holes in any socio-technical system are not technical, but human. As previously argued, digital technology enables the relatively easy replication of institutional legitimacy, thereby enticing obedient victims to divulge confidential information.

In conclusion, any discussion of future fraud forms on the Internet should highlight the salient features of the technology that provide a catalyst for fraud. The Internet has a very broad reach, and perpetrators can efficiently communicate with a broad group of potential victims and trigger responses that identify them as susceptible to fraud (e.g. victim characteristics). Secondly, digital technology permits perpetrators to easily replicate legitimate products, or services that are in fact, non-existent or counterfeit. This is further enabled by a similar use of technology to emulate well-known businesses or institutions to support claims of legitimacy in a variety of fraud forms, be they financial, counterfeit, or phishing/identity theft frauds.

9. FUTURE RESEARCH

Our model identifies five types of power, the primary tactics utilized to realize the power, and the common fraud types where these elements are manifest. The next step in this research is rigorous empirical validation with both aggregate data analysis as well as controlled experimentation. Understanding the ways in which perpetrators of fraud are able to exert these five types of power across the Internet is a first step towards helping regulators, companies and individuals develop better strategies for its control and prevention.

The strength of this model lies in the fact that it explains the relationship that takes place between perpetrator and victim, specifically in an online environment. Moreover, understanding the techniques employed, and how potential fraud victims self-select themselves in response to these mechanisms will enable policy makers and consumers to understand the overall process of online deception and decrease the overall risk of current and future frauds.

Education is the key to preventing fraud. If the model proves accurate with further testing, consumer protection agencies will have a valuable tool to assist them in the deterrence of fraud. Furthermore, consumers will be able to identify potential perpetrators who would try to exploit them using the five types of power discussed. If consumers can become more aware of their susceptibility to these types of frauds, they will become more aware of potential situations where they are susceptible to fraud. In other words, the model may help identify areas where the probability of on-line fraud occurring is higher.

The purpose of this paper has been to advance theoretical understanding of the specific power forms that perpetrators use when influencing victims in fraudulent transactions. The model has combined the dimensions of power and

negotiation from the management and psychological literature as well as Internet fraud research from the Information Systems field. We have examined the moderating effects of the Internet on the communication and fraud process between perpetrator and victim, as well as deception tactics employed to realize each power type in frequently occurring fraud forms.

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Chapter 5: Article Four

Current Trends in Fraud and its Detection

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Current Trends in Fraud and its Detection

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ABSTRACT This article discusses the basic nature of fraud, including the major accounting scandals of the last decade. The article also discusses the role of auditors and if auditors should be held liable for not detecting financial statement fraud. The article examines recent standards, rules, and acts put in place after the major frauds of the 1990s and early 2000s, including Sarbanes-Oxley, new rules by the NYSE and NASDAQ, and SAS 92. Finally, the article discusses whether these new standards, rules, and acts will have an impact to deter financial statement frauds from occurring in the future.

KEYWORDS fraud, forensic accounting, fraud audits, fraud detection, financial statement fraud, fraud examination

INTRODUCTION

Executives and employees of most organizations conduct business with integrity. Their financial statements are transparent and represent the financial state of the organization. However, some succumb to pressures and opportunities to make their companies look better than they really are. These individuals often seek to unduly enrich themselves in their stewardship roles, increase their financial status, or gain the respect of others through a dishonest image. While it may seem that fraud is centered in certain industries, this small minority of dishonest people exists in every profession and industry.

Society has long held that the protector—the “public watchdog (*United States v. Arthur Young & Co.*, 1984)”—against this dishonest minority in public companies is the financial statement auditor. In the United States, Arthur Levitt, former chairman of the Securities and Exchange Commission (SEC), explained an auditor’s role this way: “America’s auditors were given a franchise by the Securities Acts of 1933 and 1934 to provide the public with accurate audited statements of companies . . . And their mission, the reason for all of that, was to *protect the public investor from financial fraud* (PBS, 2002)¹.”

Over the last decade, there have been numerous frauds discovered in companies throughout the world. These frauds include Enron, WorldCom, Cendant, Adelphia, Parmalat, Royal Ahold, Vivendi, and SK Global. In most cases, it was alleged that the auditors should have detected the frauds and, as a result, they were sued for performing negligent audits. In order to determine whether auditors should be held liable for fraud, it is important to review why these large scale frauds occurred and the legislation and rules that have been instituted since their occurrence. In this article, we discuss the role of a financial statement audit and whether or not auditors should be held responsible

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for financial statement fraud. We describe why fraud occurs and the “perfect storm” that led to the large-scale accounting scandals of the past decade. We review U.S. fraud standards and regulations, new exchange rules by both the NYSE and NASDAQ, and new regulations under the Sarbanes-Oxley regulation. Finally, we evaluate whether these new standards, rules, and acts are sufficient to reduce fraud in the future.

WHY FRAUD OCCURS

Fraud researchers have found three elements common to all frauds. These three elements of the *fraud triangle* are (1) perceived pressure, (2) perceived opportunity, and (3) some way to rationalize the fraud as acceptable and consistent with one’s personal code of ethics (Albrecht et al., 2006a). Whether the dishonest act involves *fraud against a company*, such as employee embezzlement, or *fraud on behalf of a company*, such as management fraud, these three elements are always present. Figure 1 illustrates the fraud triangle.

Every fraud perpetrator faces some kind of *perceived pressure*. Most pressures involve a financial need, although nonfinancial pressures such as the need to report results better than actual performance, frustration with work, or even a challenge to beat the system, can also motivate fraud. Note that this element is perceived pressure, not necessarily real pressure. Pressures perceived by one individual, such as a gambling addiction, may not be pressures to another individual. Examples of perceived financial pressures that can motivate fraud on behalf of a company (i.e., financial statement fraud) are financial losses, falling sales, failure to meet Wall Street’s earnings expectations, or the inability to compete with other companies.

Fraud perpetrators must also have a *perceived opportunity* that allows the fraud act. Even with intense perceived pressures, executives who believe they will be caught and punished rarely commit fraud (Albrecht et al., 2006b). Executives who believe they have an

opportunity to commit and/or conceal fraud often give in to their perceived pressures. Perceived opportunities to commit management fraud include factors such as a weak board of directors or inadequate internal controls.

Finally, fraud perpetrators must have some way to *rationalize* their actions as acceptable. For corporate executives, rationalizations to commit fraud might include thoughts such as “we need to keep the stock price high,” “all companies use aggressive accounting practices,” or “it is for the good of the company.”

These three elements of the fraud triangle are interactive. With fraud, the greater the perceived opportunity or the more intense the pressure, the less rationalization it takes for someone to commit fraud. Likewise, the more dishonest a perpetrator is and the easier it is for him or her to rationalize deviant behavior, the less opportunity and/or pressure it takes to motivate fraud.

REASON RECENT LARGE-SCALE FRAUDS OCCURRED

The fraud triangle provides insight into why recent financial statement frauds occurred. In addition to the factors that motivate a person to commit fraud, there were several specific elements that led to the large-scale frauds of the past decade (Albrecht et al., 2004). These elements contributed to a perfect storm that led to the massive frauds of the last few years.

The first element of this perfect storm was the masking of many existing problems and unethical actions by the expanding economies of the 1990s and early 2000s. During this time, most businesses appeared to be highly profitable, including many new “dot-com” companies that were testing new and unproven (and many times unprofitable) business models. The economy was booming, and investment was high. In this period of perceived success, people made nonsensical investment and other decisions.² The advent of investing over the Internet for a few dollars per trade brought many new, inexperienced people to the stock market. It is now clear that many of the frauds revealed since 2002 were actually being committed during the boom years, but that the apparent booming economy hid the fraudulent behavior.³ The booming economy also caused executives, board members, and stockholders to believe that their companies were more successful than they actually were and that their companies’ success was primarily a

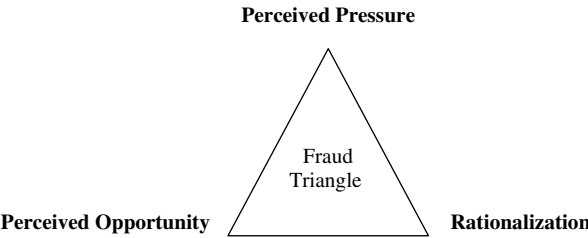


FIGURE 1 The Fraud Triangle.

result of good management. In addition, research has shown that extended periods of prosperity can reduce a firm's motivation to comprehend the causes of success, raising the likelihood of faulty attributions (Sundaramurthy and Lewis, 2003).

The second element of the perfect storm was the moral decay that had been occurring in the United States and around the world. Political correctness did many good things for society, but it also veiled dishonesty in new language that allowed some to rationalize fraudulent behavior. Many role models in sports, politics, and movies were no longer examples of honesty and integrity. While some may argue that role models have been dishonest or immoral throughout history, the significantly increased access in recent decades to their behavior through widespread media coverage, Internet sites, blogs, and general transparency affected the existing workforce and the young alike. Whatever measure of integrity one uses, dishonesty appears to be increasing.

The third element of the perfect storm was misplaced executive incentives. For example, agency theory's solution of aligning executive pay with company performance was practiced to the extreme in many cases (Jensen and Meckling, 1976). Executives of many fraudulent companies were endowed with hundreds of millions of dollars in stock options and/or restricted stock that placed more pressure on keeping the stock price rising than on reporting financial results accurately. In many cases, this stock-based compensation far exceeded executives' salary-based compensation. The attention of many CEOs shifted from managing the firm to managing the stock price. At the cost of countless billions of dollars, managing the stock price all too often turned into fraudulently managing the financials.

The fourth element of the perfect storm—and one closely related to the last—was the often unachievable expectations of Wall Street analysts that primarily targeted short-term behavior. Company boards and management, generally lacking alternative performance metrics, used comparisons with the stock price of "similar" firms and attainment of analyst expectations as important defacto performance measures. These stock-based incentives compounded the pressure induced by analyst expectations. Each quarter, analysts, often coached by the companies themselves, forecasted each company's earnings per share (EPS). The forecasts alone drove price movements of the

shares, embedding the expectations in the price of a company's stock. Executives knew that the penalty for missing the Street estimate was severe—even falling short of expectations by a small amount, despite otherwise strong performance, might drop the company's stock price by a considerable amount.

The fifth element in the perfect storm was the large amounts of debt and leverage held by each of these fraudulent companies. This debt placed tremendous financial pressure on executives to not only have high earnings to offset high interest costs but also to report high earnings to meet debt and other covenants. For example, Enron's derivatives-related liabilities increased from \$1.8 billion to \$10.5 billion during 2000 alone. Similarly, WorldCom had more than \$100 billion in debt when it filed history's largest bankruptcy. During 2002 alone, 186 public companies, including WorldCom, Enron, Adelphia, and Global Crossing, recorded \$368 billion in debt filed for bankruptcy (*Portland Business Journal*, 2003).

The sixth element of the perfect storm was the nature of U.S. accounting rules. In contrast to accounting practices in other countries such as the United Kingdom and Australia, U.S. generally accepted accounting principles (GAAP) are much more rule-based than principles-based.⁴ If a client chose a particular questionable method of accounting that was not specifically prohibited by GAAP, it was hard for auditors or others to argue that the client couldn't use that accounting method. The existing general principles already contained within GAAP notwithstanding, when auditors and other advisors sought to create competitive advantages by identifying and exploiting possible loopholes, it became harder to make a convincing case that a particular accounting treatment was prohibited when it "wasn't against the rules." Professional judgment lapsed as the general principles already contained within GAAP and SEC regulations were ignored or minimized. The result was that rather than deferring to existing, more general rules, *specific* rules (or the lack of *specific* rules) were exploited for new, often complex financial arrangements, as justification to decide what was or was not an acceptable accounting practice.

Consider the case of Enron. Even if Andersen had argued that Enron's Special Purpose Entities (SPEs) weren't appropriate, it would have been impossible for Andersen to make the case that they were against any *specific* rules. Some have suggested that one of the

reasons it took so long to get plea bargains or indictments in the Enron case was because it wasn't immediately clear whether GAAP or any laws had actually been broken.

A seventh element of the perfect fraud storm was the opportunistic behavior of some CPA firms. In some cases, accounting firms used audits as loss leaders to establish relationships with companies so they could sell more lucrative consulting services. The rapid growth of the consulting practices of the Big 5 accounting firms, which was much higher than the growth of other consulting firms, attested to the fact that it is much easier to sell consulting services to existing audit clients than to new clients. In many cases, audit fees were much smaller than consulting fees for the same clients, and accounting firms felt little conflict between independence and opportunities for increased profits. In particular, these alternative services allowed some auditors to lose their focus and become business advisors rather than auditors. This is especially true of Andersen; it had spent considerable energy building its consulting practice only to see that practice split off into a separate firm (now called Accenture). Privately, several Andersen partners admitted that the surviving Andersen firm and some of its partners had vowed to "out consult" the firm that separated from them.

The eighth element of the perfect storm was greed by executives, investment banks, commercial banks, and investors. Each of these groups benefited from the strong economy, the high level of lucrative transactions, and the apparently high profits of companies. None of them wanted to accept bad news. As a result, they sometimes ignored negative news and entered into unwise transactions.⁵ For example, in the Enron case, various commercial and investment banks made hundreds of millions from Enron's lucrative investment banking transactions, on top of the tens of millions in loan interest and fees. None of these firms alerted investors about derivative or other underwriting problems at Enron. Similarly, in October 2001, after several executives had abandoned Enron and negative news about Enron was reaching the public, 16 of 17 security analysts covering Enron still rated the company a "strong buy" or "buy" (<http://fitzgerald.senate.gov/legislation/stkanalyst/analystmain.htm> http://www.cfo.com/article.cfm/3015411/2/c_3046616). Enron's outside law firms were also making high profits from Enron's transactions. These firms also failed to correct

or disclose any problems related to the derivatives and special purpose entities, but in fact helped draft the requisite associated legal documentation. Finally, the three major credit rating agencies, Moody's, Standard & Poor's and Fitch/IBC—who all received substantial fees from Enron—also did nothing to alert investors of pending problems. Amazingly, just weeks prior to Enron's bankruptcy filing—after most of the negative news was out and Enron's stock was trading for \$3 per share—all three agencies still gave investment grade ratings to Enron's debt (<http://www.cdfa.net/cdfa/press.nsf/pages/275>).

Finally, the ninth element of the perfect storm was three types of educator failures. First, educators had not provided sufficient ethics training to students. By not forcing students to face realistic ethical dilemmas in the classroom, graduates were ill-equipped to deal with the real ethical dilemmas they faced in the business world. In one allegedly fraudulent scheme, for example, participants included virtually the entire senior management of the company, including but not limited to its former chairman and chief executive officer, its former president, two former chief financial officers, and various other senior accounting and business personnel. In total, there were more than 20 individuals involved in the earnings overstatement schemes. Such a large number of participants points to a generally failed ethical compass for the group. Consider another case of a chief accountant. A chief financial officer instructed the chief accountant to increase earnings by an amount somewhat over \$100 million. The chief accountant was skeptical about the purpose of these instructions but did not challenge them. Instead, the chief accountant followed directions and allegedly created a spreadsheet containing seven pages of improper journal entries—105 in total—that he determined were necessary to carry out the CFO's instructions. Such fraud was not unusual. In many of the cases, the individuals involved had no prior records of dishonesty—and yet when they were asked to participate in fraudulent accounting, they did so quietly of their own free will.

A second educator failure was not teaching students about fraud. One author of this paper has taught a fraud course to business students for several years. It is his experience that most business school graduates would not recognize a fraud if it hit them between the eyes. The large majority of business students don't understand the elements of fraud, perceived pressures

and opportunities, the process of rationalization, or red flags that indicate the possible presence of dishonest behavior. When they do see something that doesn't look right, their first reaction is to deny a colleague could be committing dishonest acts.

The third educator failure has been to neglect exploration of possible relationships between various theories of management behavior and fraudulent activity. Stewardship theory and agency theory are among many theoretical models that have implications in fraud acts.

Figure 2 shows how these nine perfect storm elements fit into the fraud model.

U.S. FRAUD STANDARDS AND REGULATIONS

With respect to auditing standards in the United States, prior to the disclosure of the major frauds of the past decade, the relevant fraud-auditing standard was SAS 82. On October 16, 2002, the Auditing Standards Board (ASB) approved a new standard, Statement on Auditing Standard No. 99: *Considerations of Fraud in a Financial Statement Audit*. This new standard gave U.S. auditors expanded guidance for detecting material fraud.

Statement on Auditing Standard No. 99 established standards and provided guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). SAS 99 did not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of

material misstatement, whether caused by error or fraud (as described in AU sec. 110.01). However, it did establish standards and provide guidance to auditors in fulfilling their responsibility, as it relates to fraud.

SAS 99 required, as part of planning the audit, that there be a brainstorming session among the audit team members to consider the susceptibility of the entity to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. SAS 99 also required auditors to gather the information necessary to identify the risk of material misstatement due to fraud, by doing the following:

- Making inquiries of management and others within the entity.
- Considering the results of the analytical procedures performed in planning the audit (the proposed statement also requires that the auditor perform analytical procedures relating to revenue).
- Considering fraud risk factors.
- Considering certain other information.

SAS 99 also required auditors to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess those risks after taking into account this evaluation. It also required auditors to respond to the results of the risk assessment. SAS 99 did not change an auditor's responsibility to detect material fraud in financial statement audits, nor did it change management's responsibility to establish controls to prevent and detect fraud. SAS 99 did, however, require an auditor to gather and consider much more information in assessing fraud risks and provided guidance on how

Element of the Fraud Triangle	Element of the Perfect Fraud Storm
Perceived Pressures	3. Misplaced executive incentives
	4. Unrealistic Wall Street expectations
	5. Large amounts of debt
	8. Greed
Perceived Opportunities	1. Good economy was masking many problems
	6. Selective interpretation of rules-based accounting standards
	7. Behavior of CPA firms
Rationalization	2. Moral decay in society
	9. Educator failures

FIGURE 2 Fraud Model.

management can establish anti-fraud programs and controls. SAS 99 required that fraud be considered throughout the entire audit process and encouraged auditors to use non-predictable audit procedures when performing audits.

NEW EXCHANGE RULES

After the major frauds of the past decade, both the NYSE and NASDAQ issued broad new rules for listed companies. These rules required that boards of directors assign responsibility for oversight of the financial reporting process to an audit committee, composed of a subgroup of the board and required that all listed companies have audit committees made up entirely of outside directors.

In response to high-profile corporate failures, Harvey Pitt, the former chairman of the SEC, requested NYSE and NASDAQ to review their listing standards with an emphasis on all matters of corporate governance. Based on that request, both the NYSE and NASDAQ conducted extensive reviews of their listing standards for corporate governance and filed corporate governance reform proposals with the SEC in 2002. In April 2003, the SEC issued Rule 10A-3, which directs all stock exchanges to prohibit listing of any security of an issuer that is not in compliance with the audit committee requirements specified in Rule 10A-3. On November 4, 2003, the SEC approved, with certain modifications, the corporate governance reforms proposed by NYSE and NASDAQ. These new corporate governance reforms were meant to provide more scrutiny of corporate financial reports, the auditing process, and the integrity of management. Basically, the reforms required that audit committee (and most board) members be independent, that the audit committee retained and dealt with the external auditors, that nominating procedures for new board members were in place, and that independent directors met separately from management and were involved more in the governance of companies.

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (Officially the Public Company Accounting Reform and Investor Protection Act of 2002, also referred to in practice as Sarbanes, Sarbox, or SOX). The Act, which applies in general to publicly held companies and their audit firms, dramatically affected the accounting profession

and impacts not just the largest accounting firms but any CPA actively working as an auditor of, or for, a publicly traded company. The basic implications of the Act as they relate to auditors and fraud are summarized below.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act had board implications for both auditors and companies. In an effort to better oversee auditors and their responsibilities to detect fraud, the Act established the Public Company Accounting Oversight Board (PCAOB). Its stated purpose is to “protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.” Although a private entity, the PCAOB has many government-like regulatory functions, making it in some ways similar to the private Self Regulatory Organizations (SROs) that regulate stock markets and other aspects of the financial markets in the United States. Under Section 101 of the Sarbanes-Oxley Act, the PCAOB has the power to:

- Register public accounting firms that prepare audit reports for issuers;
- Set auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports by issuers;
- Conduct inspections of registered public accounting firms; and
- Conduct investigations and disciplinary proceedings concerning and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms (including fines of up to \$100,000 against individual auditors, and \$2 million against audit firms).

Since the implementation of the Sarbanes-Oxley Act, the PCAOB has shown that it will be active in its role of oversight. In an exclusive interview published in the August 2004 *CFO Magazine*, William McDonough, the PCAOB’s first chairman said, “The best way for accountants to win back the confidence of the American people is to do it voluntarily. But if they won’t do it voluntarily we will make them do it. That’s the tough part of tough love.” Speaking about accounting firms, he further said, “Our capabilities [range] from quiet advice to putting them out of business.” In a

2005 interview, McDonough was asked the following question: “How do you respond to auditors’ insistence that it isn’t their job to detect fraud?” He answered, “We have a very clear view that it is their job. If we see fraud that wasn’t detected and should have been, we will be very big on the tough and not so [big] on the love.” McDonough further stated, “With relatively few exceptions, they [the auditors] should find it.” (http://www.cfo.com/article.cfm/3015411/2/c_3046616)

Sarbanes-Oxley also required that several changes be made to company boards of directors, including the following:

- *Auditors report to audit committee.* Now, auditors will report to and be overseen by a company’s audit committee, not management. Audit committees must approve all auditor services and the auditor must report any new information to the audit committee, including disagreements with management. The kinds of services auditors can provide were also limited dramatically in an effort to curtail auditor conflicts of interest.
- *Audit partner rotation.* The lead audit partner and audit review partner must be rotated every five years on public company engagements.
- *Employment implications.* An accounting firm will not be able to provide audit services to a public company if one of that company’s top officials (CEO, controller, CFO, chief accounting officer, etc.) was employed by the firm and worked on the company’s audit during the previous year.
- *Whistleblower protection.* The audit committee is responsible to establish procedures for receiving the dealing with complaints and anonymous employee tips regarding accounting, control, and/or auditing irregularities (i.e., a hotline).
- *Independence of board.* Each member of the audit committee must be a member of the board of directors and must be “independent” in that they only receive compensation for their service on the board. They cannot be paid by the company for any other consulting or advisory work.

Sarbanes-Oxley also required that issuers of public stock and their auditors must follow new rules and procedures in connection with the financial reporting and auditing process, including the following.

- *Second partner review and approval of audit reports.* The new regulatory board will issue or adopt standards requiring auditors to have a thorough second partner review and approval of every public company audit report.
- *Management assessment of internal controls.* Management must now assess and make representations about the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- *Audit reports must contain description of internal controls testing.* Sabanes-Oxley required every audit report to independently attest to the company’s internal control structures, including a specific notation about any significant defects or material noncompliance found on the basis of such testing.

Have Standards, Rules, and Acts Been Sufficient to Reduce Fraud?

New compliance and fraud detection changes can only be successful if they either (1) eliminate the factors that contribute to fraud or (2) help auditors to be more effective in detecting fraud. The fraud triangle provides insight into their effectiveness because it provides a framework for evaluating how these acts reduce or eliminate fraud pressures, opportunities, and rationalizations. Table 1 combines the elements of the fraud triangle and perfect storm. It further gives insight into how the new standards address these elements.

In considering whether the new standards have helped auditors better detect or prevent fraud, the answer is a qualified and limited ‘yes.’ Auditors have been more proactive in brainstorming possible frauds, working with audit committees and management to assess fraud risks, and have developed additional tests to search for fraud indicators. However, regardless of how vigilant their audits are, it will never be possible to prevent or detect all frauds because of the massive nature of accounting records and the need to perform limited sampling and substantive testing, the nature of fraud, reluctance of people to come forward with fraud information and the nature of fraud detection. GAAS (Generally Accepted Auditing Standards) auditors are not trained in determining when people are telling the

TABLE 1 Analysis of New Fraud Standards Against Fraud Triangle

Element of the Fraud Triangle	Element of the Perfect Fraud Storm	Have the Standards Sufficiently Addressed These Issues?
Perceived Pressures	<ul style="list-style-type: none"> 3. Misplaced executive incentives 4. Unrealistic Wall Street expectations 5. Large amounts of debt 8. Greed 	None of the new standards or rules has addressed perceived pressures. Executive incentives (equity compensation, etc.) have not been dealt with, the role of analysts in providing earnings guidance and setting expectations hasn't been eliminated, firms have increased amounts of debt and, with the higher and higher amounts of executive pay, it doesn't seem that greed has been eliminated.
Perceived Opportunities	<ul style="list-style-type: none"> 1. Good economy was masking many problems 6. Selective interpretation of rules-based accounting standards 7. Behavior of CPA firms 	The new standards and rules go a long way in addressing perceived opportunities. By strengthening the roles of auditors, audit committees, boards of directors, and regulators, we do believe the behavior of both CPA firms and boards have changed. The economy isn't as strong but will go through cycles; rules-based accounting hasn't changed.
Rationalization	<ul style="list-style-type: none"> 2. Moral decay in society 9. Educator failures 	None of the new standards or rules has addressed the level of moral decay. Studies on integrity and related topics (cheating in school) would indicate that integrity is decreasing, not getting better. Educators must start teaching quality ethics and fraud courses, but they are still mostly elective and small.

truth or are being deceptive, when documents are real or forged, whether collusion is taking place, or whether fictitious documents have been created. The best GAAS auditors can do is to provide “reasonable assurance” that most material financial statement frauds are detected.

POSSIBLE SOLUTION: FRAUD AUDITS

To provide more than reasonable assurance that financial statement fraud is not being committed, *fraud audits* rather than GAAS audits need to be performed. To illustrate the differences between fraud and GAAS audits, consider a case where one of the authors was an expert witness. In this company, it was discovered that management had been intentionally overstating revenues and assets, resulting in materially misstated financial statements. The GAAS auditors were sued by the shareholders for failure to detect the fraud earlier (the fraud had been going on for three years during which time clean audit opinions were issued). Once there was suspected fraud (called predication of

fraud), the company’s audit committee retained special counsel to investigate. The retained special counsel hired a different Big 4 CPA firm to conduct a fraud audit. The fraud audit provided evidence that, in fact, fraud had occurred and discovered its extent and how it was committed and concealed. These fraud determinations were made after the special counsel and the CPA firm it engaged had spent over 50 times as much time as the GAAS audit had taken and charged a fee 70 times higher than the GAAS auditor’s fee⁶. The fraud auditors physically confiscated all computers of suspected perpetrators, interviewed hundreds of individuals (some multiple times and who, by the time of the fraud audit, were cooperating) and audited 100% of the transactions in the suspected accounts. The nonfraudulent accounts that had been examined by the GAAS auditors were not examined by the fraud auditors.

Another difference between fraud and GAAS audits is in sampling methodology. Since the early days of auditing, statistical sampling has been used to limit audit work to a relatively few number of records. This

TABLE 2 GAAS vs. Fraud Audit

	GAAS Audit	Fraud Audit
Purpose	Provides reasonable assurance that financial statements are prepared in accordance with GAAP.	Detects and investigates suspicions of fraud. If extensive enough, could provide absolute assurance that material financial statement fraud isn't occurring.
Scope	GAAS auditors are not looking for specific problems with the company, but rather are engaged to look at and issue an opinion on the overall financial statements.	Fraud audits investigate suspected fraud, often targeting only a handful of accounts. There is always predication and sometimes individuals have already confessed to fraud and provided insights into where to look. If fraud audit approaches were done on the entire financial statements, the cost would be exorbitant.
Method	GAAS auditors must rely on sampling which introduces sampling error.	Fraud auditors analyze all transactions that are within the scope of the audit, completely eliminating sampling error.
Procedures	Reperformance, analytics, documentation, confirmation, observation, physical examination, and inquiry, all performed with as little disruption as possible	GAAS audit procedures plus surveillance, extensive interviews, seizing of computers and other items, and confiscation of records, all performed without forewarning and without regard to disruption of business.
Timing	Occur in a predictable and consistent manner with the majority of the audit happening close to or shortly after year end.	Occur when there is predication—an allegation or suspicion of fraud, and can occur at any time during the year, without notice or warning. Without predication, fraud audits would be extensive and expensive.
Reason for Testing Controls	GAAS auditors test internal controls to see if they work and to establish the scope of their audit. They also examine controls as required by 404.	Fraud auditors test controls to see where there is a potential for fraud and then look to see if control weaknesses have been abused to commit fraud. They realize that a lack of controls provides fraud opportunities.
Reliance on Management	There is not the time or the economic resources to corroborate all information provided by management. GAAS auditors must often rely on management representations because it is economically infeasible not to do so. They neither assume that management is honest or dishonest.	Fraud auditors rarely, if ever, rely on management representations because they already have the suspicion that management cannot be trusted and is committing fraud—that is the reason they were engaged.
Training	GAAS audits are performed by Certified Public Accountants, individuals trained in GAAS and GAAP. Becoming a CPA requires little specific fraud training beyond a basic audit course. CPAs are trained to provide a vast array of financial services.	Fraud audits are usually conducted by Certified Fraud Examiners (CFEs), or other similarly trained professionals. CFEs understand auditing and accounting, and are also required to have significant skills in forgery identification, detection and investigation methods, interviewing, criminal profiling, and how perpetrators use conspiracy, lying, deceit, and fraud schemes. CFEs are trained to detect and investigate fraud.
Exposure to Fraud	GAAS auditors are rarely exposed to fraud as most of their clients do not commit financial statement fraud. With 17,000 public companies, and only a handful being investigated for fraud, a GAAS auditor may go an entire career without ever seeing a financial statement fraud. Fraud is the exception in a GAAS audit.	Fraud auditors live on a constant diet of fraud. Detecting and investigating fraud is what they do, and most clients they are engaged by have a high suspicion of fraud. Investigation is the expectation in a fraud audit.

was necessary because it was cost-prohibitive to audit the entire population. This approach works well for traditional audit purposes: the detection of routine anomalies in the system. Routine anomalies are caused by weak controls or unintentional errors in accounting systems. These anomalies occur at regular points throughout a transaction set because they are routine. Samples that are taken using good statistical theory are representative of the entire population, thus allowing generalization from the sample to an entire transaction set.

In contrast, frauds are not representative, routine, or regular. They are the result of an (or several) intelligent human being intentionally circumventing controls and hiding his or her tracks. Red flags indicative of fraud are lumpy; they might exist in a few transactions or in just one part of a data set. If an auditor samples 5% of the data during an audit, he or she is effectively taking a 95% risk that the few fraudulent transactions will be missed.

Table 2 identifies some of the major differences between a GAAS audit and a fraud audit.

We realize that fraud audits are more expensive (both in time and money) than traditional GAAS audits. It is not possible to conduct fraud audits on all financial statement audit engagements. However, some aspects of fraud audits could be introduced into auditor training and engagement practices. For example, today's transaction sets are almost always electronic in nature and allow increased use of full-population analysis. Sampling can be reduced or even eliminated in many areas if auditors were trained in using computers to automate analyses. This change would require training in relational databases, queries, and macros/scripting.

Another aspect of fraud audits that could be incorporated is a better understanding of fraud schemes and their indicators or red flags. SAS 99 requires auditors brainstorm and "consider" the possibilities of fraud during audits, but significant progress could be made on using proactive fraud techniques to actively search for potential frauds during audit performance.

As the audit profession continues to move forward, litigation against auditors probably provides one of the strongest incentives to ensure that auditors remain vigilant in their application of SAS 99 and in their efforts to detect fraud. The most productive steps that could be taken to reduce fraud would be for regulators

and organizations to reduce some of the incentives and pressures that encourage fraudulent behavior. For example, eliminating the providing of earnings guidance and Wall Street's setting of earnings expectations may be one way to reduce pressure on individuals in management.

Recent rulings, especially Sarbanes-Oxley, has temporarily appeased the public and reinstated some level of trust in auditors and audit opinions. We are concerned that additional frauds—which will inevitably occur despite recent rulings—may reduce or even shatter this fragile trust. Long-term reductions in fraud will only occur when the three fundamental areas of the fraud triangle are confronted, addressed, and ultimately reduced.

ACKNOWLEDGEMENT

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NOTES

1. Likewise, Douglas R. Carmichael, the first chief auditor and director of professional standards for the Public Company Accounting Oversight Board, stated that "auditors should recognize that detection of fraud is clearly an important objective of an audit. That has been true for over 60 years, but the literature of the profession ha[s] not forthrightly acknowledged that objective. It is important that auditors take SAS 99 seriously and conduct audits in a manner that makes it probable fraud will be detected (Carmichael, 2003).
2. A common joke among academics during this period was that the way to value a dot-com company was to multiply its loss by a "-1" to get a positive number (since they were all losing money). You then multiplied that number by 100. If the stock price was lower than that number, you bought the stock. If the stock price was higher than that number, you bought the stock anyway.
3. One apparent fraud was already ongoing in 1997 when a senior financial manager at the firm suggested that the financial statement manipulation be discontinued. His suggestion was ignored and the fraud was discovered in 2003.
4. In 2003, the SEC acknowledged that U.S. GAAP may be too "rule-based" and wrote a position paper arguing for more "principles-" or "objectives-based" accounting standards.
5. A March 5, 2001, *Fortune* article included the following warning about Enron: "To skeptics, the lack of clarity raises a red flag about Enron's pricey stock. . . the inability to get behind the numbers combined with ever higher expectations for the company may increase the chance of a nasty surprise. Enron is an earnings-at-risk story. . ." (<http://www.fortune.com/fortune/print/0,15935,369278,00.html>)
6. This serves as a good example of what was stated in the first codified auditing standard, (now superseded), Statement on Auditing Procedure (SAP) No. 1, *Extensions of Auditing Procedure* (1939),

where it stated, "To exhaust the possibility of all cases of dishonesty or fraud, the independent auditor would have to examine in detail *all transactions*. This would entail a *prohibitive cost* to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard there from, and place an undue burden on industry."

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Chapter 6: Article Five

Financial Statement Fraud: Learn form the Mistakes of the US or Follow in the Footsteps of its Errors

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FINANCIAL STATEMENT FRAUD: LEARN FROM THE MISTAKES OF THE U.S. OR FOLLOW IN THE FOOTSTEPS OF ITS ERRORS

FINANCIAL STATEMENT FRAUD: LEARN FROM THE MISTAKES OF THE U.S. OR FOLLOW IN THE FOOTSTEPS OF ITS ERRORS ¹

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The authors propose a fraud model to explain the various factors that may influence an executive to commit financial statement fraud. The model builds upon classic fraud theory.

In recent years, it has been nearly impossible to open any business newspaper or magazine without seeing headlines relating to various types of corruption. One type of corruption—fraudulent financial statements—has been especially prevalent. Although Europe has experienced several financial statement frauds, by companies such as Parmalat (Italy), Royal Ahold (Netherlands), and Vivendi (France), these frauds have not been nearly as devastating as frauds in the United States, by companies such as Enron, WorldCom, Fannie Mae, Waste Management, Sunbeam, Qwest, Xerox, Adelphia, and Tyco.

In this article, we explain how the United States is attempting to curb financial statement fraud and what Europe can do to learn from the US's mistakes. We begin with a discussion of the significant cost of fraud and corruption to companies and the economy as a whole. We then present our own expanded model of classic fraud theory and explain how the model can help European firms.

The cost of all frauds—especially financial statement frauds—is extremely high. For example, when a company manipulates its financial statements, the market value of that company's stock usually drops considerably, sometimes by as much as 500 times the amount of the fraud.

Exhibit 1 lists the ten largest corporate bankruptcies in US history. The four companies whose names are in bold font—WorldCom, Enron, Global Crossing, and Adelphia—were companies associated with massive financial statement frauds. Also note that six of the top ten bankruptcies in US history occurred in 2002. When a company like WorldCom declares a \$102 billion bankruptcy, nearly every person who has a pension or owns

mutual fund shares is hurt financially. Indeed, the cost of these financial statement frauds was borne by the entire US.

Exhibit 1.

Ten Largest Bankruptcies in US History, with Bankruptcies due to Financial Statement Fraud Bolded

Company	Assets (Billions)	When Filed
1. WorldCom	\$101.9	July, 2002
2. Enron	\$63.4	Dec., 2001
3. Texaco	\$35.9	April, 1987
4. Financial Corp of America	\$33.9	Sept., 1988
5. Global Crossing	\$25.5	Jan., 2002
6. Adelphia	\$24.4	June, 2002
7. United Airlines	\$22.7	Dec., 2002
8. PG&E	\$21.5	June, 2002
9. MCorp.	\$20.2	March, 1989
10. Kmart	\$17.0	Jan., 2002

Why do people commit fraud?

Classic fraud theory explains the motivations for fraud as a triangle of perceived opportunity, perceived pressure, and rationalization. Every fraud perpetrator faces some kind of pressure, which is the first element of fraud. Most often the pressure involves a financial need, although nonfinancial pressures—such as the need to report results that are better than actual performance, frustration with work, or even a challenge to beat the system—can also motivate fraud. Research has shown that these pressures don't have to be real; they simply have to seem real to the perpetrator.

The second element of the fraud triangle is perceived opportunity. The perpetrator must believe that he or she can commit the fraud and not get caught (or, that if he or she does get caught, nothing serious will happen). Like pressures, opportunities don't have to be real; they only must be perceived as real by the perpetrator.

Third, fraud perpetrators need a way to rationalize their actions as acceptable. Following are some common rationalizations: It's for the good of the company; the scheme is only temporary; we have no other option; we are not hurting anyone; it's for a good purpose.

Perceived pressure, perceived opportunity, and rationalizations are essential to every fraud. Whether the fraud is one that benefits the perpetrator directly or one that benefits a perpetrator's organization, the three elements are always present. In the case of financial statement fraud, for example, the pressure could be the need to meet analysts' expectations or debt covenants, the opportunity could be a weak audit committee or poor internal controls, and the rationalization could be that you are only getting over a temporary slump in business.

To understand better what motivates individuals to become involved in financial statement fraud, consider two hypothetical firms: Firm A, which overall increases its income over time but with several dips along the way; and Firm B, which increases its income to an extent similar to Firm A, but does so consistently over time. Since Firm B's earnings are more predictable and since stock prices and market values are a function of both risk and return, Firm A's more risky income stream will result in its stock price being significantly lower.

Corporate executives understand this risk/return tradeoff. They also understand the high punishment that is levied on firms with earnings trajectories similar to Firm A. Accordingly, when Firm A's earnings reach a temporary apex and appear to be decreasing for the next period, there may be tremendous pressures to cook the books.

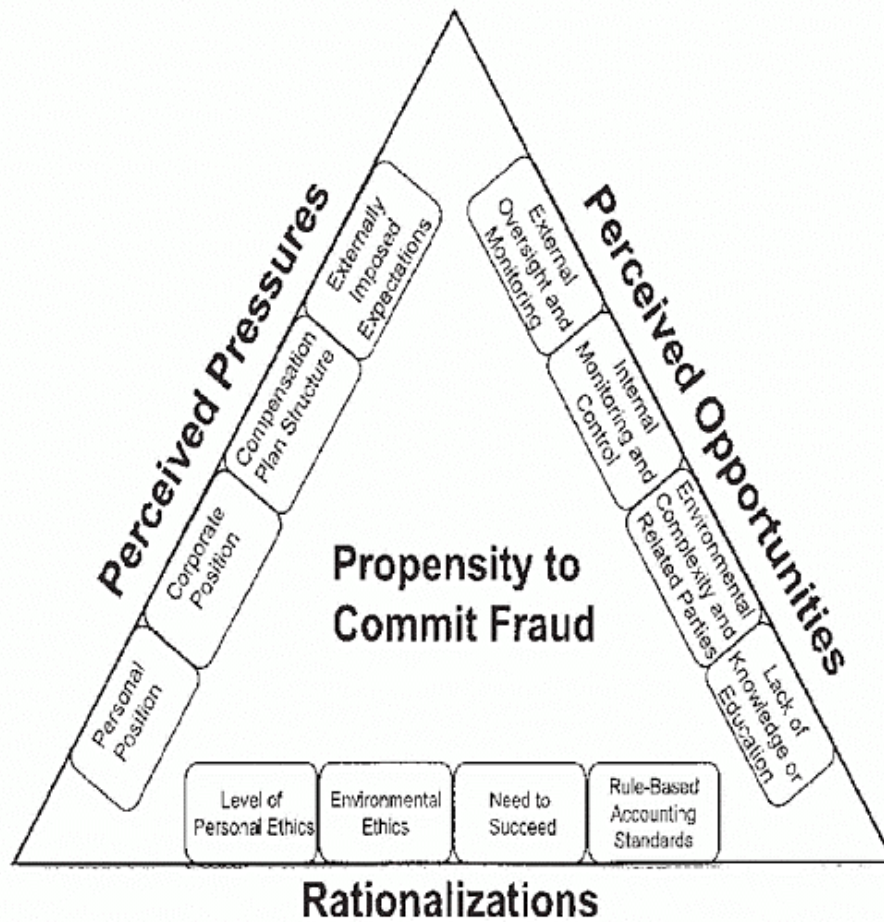
At this point, many executives rationalize that they cannot report a lower income and have the company's stock price punished. Therefore, they adjust the numbers to be more in line with analysts' expectations.

Proposed fraud model

Exhibit 2 builds upon classical fraud theory. In proposing this model, we have maintained the traditional triangle of the original fraud model (of pressure, rationalization, and opportunity) and have added various factors that contribute to it. We will now discuss each of these contributing factors in greater detail.

Exhibit 2.

Propensity to Commit Fraud



Perceived pressures. The traditional fraud model states that increased pressure (whether perceived or real) increases the likelihood that a person will commit fraud. Corporate and personal position, compensation-plan structures, and external expectations are three factors that significantly contribute to the element of pressure.

Corporate position. A company's financial position is largely a result of its past performance and the level of growth it is attempting to achieve. Most of the companies that committed financial statement fraud in the last few years had a large amount of debt and leverage. This debt placed tremendous financial pressure on executives not only to have high earnings but also to report high earnings to meet debt and other covenants. For example, during 2000, Enron's derivatives-related liabilities increased from \$1.8 billion to \$10.5 billion. Similarly, WorldCom had over \$100 billion in debt when it filed history's largest bankruptcy. During 2002 alone, 186 public companies with \$368 billion in assets filed for bankruptcy.²

In the 1990s and early 2000s, many companies' financial problems were masked by the good economy. During this time, most businesses appeared to be highly profitable, including many "dot-com" companies that were testing new (and many times unprofitable) business models. The economy was booming, and investment was high. During this period of perceived success, people often made nonsensical investment decisions. The advent of investing over the Internet for a few dollars per trade brought many inexperienced people into the stock market. Several frauds that were revealed after 2002 were actually being committed during the boom years, but the booming economy hid the fraudulent behavior.³ The booming economy also caused executives to believe that companies were more successful than they were and that companies' success was primarily a result of good management actions. Sundaramurthy and Lewis, for example, posit that extended periods of prosperity may reduce a firm's motivation to comprehend the causes of success, raising the likelihood of faulty attributions.⁴ In other words, during boom periods many firms do not correctly identify the reasons behind their successes. Management usually takes credit for good company performance. When company performance degrades, boards often expect results similar to those in the past without new management styles or actions. But since management often does not correctly understand the reasons for success in the past, it may incorrectly assume that past management methods would continue to work. In addition, many CEOs feel increased pressure when the economy is bad. In some cases, this pressure contributes to fraudulent financial reporting and other dishonest acts.

Personal position. Individuals can feel significant pressure when their personal financial status is in jeopardy. The traditional fraud model focuses on an individual's personal position as the primary definition of pressure. As can be imagined, the fear of losing one's job as a result of financial performance has contributed to various frauds throughout the last decade.

Compensation plan structure. A CEO (or any other employee) can feel significant pressure when company success is directly linked to his or her compensation plan. Indeed, many of the recent frauds exhibited signs of misplaced executive incentives. For example, aligning executive pay with company performance was practiced to the extreme in many cases. Executives of several fraudulent companies were endowed with hundreds of millions of dollars in stock options and/or restricted stock that made it far more important to keep the stock price rising than to report financial results accurately. In many cases, this stock-based compensation far exceeded executives' salary-based compensation. For example Bernie Ebbers, the CEO of WorldCom, had a cash-based salary of \$935,000 in 1997. Yet, during that same period, he was able to exercise hundreds of thousands of stock options receive corporate loans totaling \$409 million for purchase of stock and other purposes.⁵ The attention of many CEOs shifted from

managing the firm to managing the stock price. At the cost of countless billions of dollars, managing the stock price all too often turned into fraudulently managing the financials. The compensation plan structure is one of the most prominent motivations for financial statement fraud.

Externally imposed expectations. Externally imposed expectations include any performance expectation placed on an individual or company by those outside the immediate environment. Those who oversee individuals—such as bosses or boards of directors—set the majority of compensation plans. However, external expectations, such as those placed upon individuals by financial analysts or the competition, also contributed to recent financial scandals.

During the last decade, unachievable expectations by Wall Street analysts who targeted only short-term behavior also contributed to recent scandals. Company boards and management, generally lacking alternative performance metrics, used comparisons with the stock price of “similar” firms as important de facto performance measures. These stock-based incentives compounded the pressure induced by analysts' expectations. Each quarter, the analysts, often coached by companies themselves, forecasted what each company's earnings per share (EPS) would be. These forecasts alone drove shares' price movements, imbedding the expectations in the price of a company's stock. Executives knew that the penalty for missing Wall Street's estimates was severe—even falling short of expectations by a small amount would drop the company's stock price.

Consider the following example of a fraud that occurred recently. In this company, Wall Street made EPS estimates for three consecutive quarters.⁶ These estimates are shown in Exhibit 3 .

Exhibit 3.

Wall Street EPS Estimates

Firm	1st Qtr	2nd Qtr	3rd Qtr
Morgan Stanley	\$0.17	\$0.23	
Smith Barney	0.17	0.21	0.23
Robertson Stephens	0.17	0.25	0.24
Cowen & Co.	0.18	0.21	
Alex Brown	0.18	0.25	

Paine Webber	0.21	0.28	
Goldman Sachs	0.17		
Furman Selz	0.17	0.21	0.23
Hambrecht & Quist	0.17	0.21	0.23

Based on these data, the consensus estimate was that the company would have EPS of \$0.17 in the first quarter, \$0.22 in the second quarter, and \$0.23 in the third quarter. As post-fraud investigations have revealed, the company's actual earnings during the three quarters were \$0.08, \$0.13, and \$0.16, respectively. In order not to miss Wall Street's estimates, management committed a fraud of \$62 million or \$.09 per share in the first and second quarter and a fraud of \$0.07 per share in the third quarter. The management improperly inflated the company's operating income by more than \$500 million before taxes, which was more than one third of the reported total operating income.

Perceived opportunities. Increased opportunities provide an increased propensity to commit fraud. Our model (Exhibit 2) includes the opportunities of external oversight and monitoring, internal monitoring and control, environmental complexity and the existence of related parties, and the lack of knowledge or education.

External oversight and monitoring. External oversight and monitoring includes external audit firms, government agencies, or any other external monitoring a firm or individual may have. Among some CPA firms there was a prevalent lack of monitoring opportunistic behavior over the past decade within the United States. Accounting firms sometimes used audits to establish relationships with companies in order to sell more lucrative consulting services. The rapid growth of the consulting practices of the "Big 5" accounting firms attested to the fact that it was much easier to sell consulting services to existing audit clients than to new clients. Audit fees were often much smaller than consulting fees for the same clients, and accounting firms felt little conflict between independence and increased profits. In particular, these alternative services allowed some auditors to lose their focus and become business advisors rather than auditors. This was especially true of Arthur Andersen, which spent considerable energy building its consulting practice only to see that practice split off into a separate firm called Accenture. Privately, several Andersen partners have admitted that the surviving Andersen firm and some of its partners had vowed to "out-consult" the firm that separated from them.

Internal monitoring and control. Internal monitoring and control includes the internal control environment, internal control activities, and the level of monitoring and oversight by boards, audit committees, and compensation committees. One of the purposes of boards of directors is to oversee the high-level policymakers of a company. The board is an important element of corporate control and is often perceived as the final control for shareholders. A board that fails to accept this responsibility dooms the corporate control

process by letting executives operate without proper feedback. Inactive board members become a "rubber stamp" that fails to detect wrongdoing or critique corporate processes. Within the board, the audit and compensation committees assume vital control responsibilities. The audit committee oversees the work of the external and internal auditors and the risk assessment function within the corporation. The compensation committee oversees executive cash and equity compensation, loans, and other forms of remuneration. Unfortunately, many of the companies that were involved in corporate wrongdoing had aggressive executives who ran roughshod over their boards, audit committees, and nominating committees. As a result, an important oversight control was missing and the control environment was decayed. Recently, the board members of WorldCom and Enron agreed to accept personally some responsibility for their companies' wrongdoing and to make personal payments to victims.

Environmental complexity and related parties. The perceived opportunity to commit fraud is affected by the environmental complexity individuals work within and the related entities they deal with. Increased levels of complexity make it more difficult for auditors, boards, and external bodies to understand the exact financial state of a company. Complex companies or divisions within companies provide CEOs and employees with the opportunity of hiding fraudulent activities. Related parties make it possible to hide fraudulent transactions.

Enron is an example of fraud in which environmental complexity and related parties made the dishonest acts possible. Enron had a very complex company structure resulting from mergers and fast growth. Enron's management also used special entities (related parties) to hide fraud and losses while keeping up the appearance that the company was successful. Lincoln Savings and Loan was another company that used relationships to commit fraud. In Lincoln's case, it structured sham transactions with certain straw buyers (related parties) to make its negative performance appear profitable. Related-party relationships are problematic because they allow for transactions other than arm's-length. The management of ESM Government Securities, for example, hid a \$400 million financial statement fraud by creating a large receivable from a nonconsolidated related entity.

Relationships with all parties should be examined to determine if they present fraud opportunities or exposures. Relationships with financial institutions and bondholders are particularly important because they provide an indication of the extent to which the company is leveraged.

Lack of knowledge or education. Sometimes people become fraud victims because perpetrators know that such individuals may not have the capacity or the knowledge to detect their illegal acts. Such vulnerable people are easy to deceive. For example, perpetrators often target older, less educated, or non-native-speaking people because they find them to be easier victims. When perpetrators believe that auditors and other monitoring bodies are not likely to catch them, perceived opportunity increases.

Rationalizations. Rationalizations are measures of the ability people have to defend, explain, or make excuses for their actions. An increased ability to rationalize increases the probability that people will commit fraud. When one is honest, there is no need to rationalize or make excuses. Regarding fraud, researchers have found that fraud can be greatly reduced by hiring honest people.

Level of personal ethics. A less ethical person will have greater propensity to commit fraud, given a constant level of opportunity and pressure. A mediating factor in personal ethics is the level of greed an individual has. Greed can decrease a person's ethics and

make fraud easier to rationalize. In the frauds researched for this article, there was a significant amount of greed by executives, investment banks, commercial banks, and investors. Each of these groups benefited from the strong economy, the high level of lucrative transactions, and apparently high profits. None of them wanted to accept bad news. As a result, they sometimes ignored negative news and entered into bad transactions. For example, in the Enron case, various commercial and investment banks made hundreds of millions from Enron's lucrative investment banking transactions, in addition to tens of millions in loan interest and fees.⁷ None of these firms alerted investors about derivatives or other underwriting problems at Enron. Similarly, in October 2001, after several executives had abandoned Enron and negative news about Enron began reaching the public, sixteen of seventeen security analysts covering Enron still rated the company a "strong buy" or "buy." Enron's outside law firms were also making high profits from its transactions. These firms also failed to correct or disclose any problem related to the derivatives and special-purpose entities but rather helped draft the requisite associated legal documentation. Finally, the three major credit rating agencies, Moody's, Standard & Poor's, and Fitch/IBC—each of which received substantial fees from Enron—did nothing to alert investors of impending problems. Amazingly, just weeks prior to Enron's bankruptcy filing—after most of the negative news became public and Enron's stock was trading for \$3 per share—all three agencies still gave investment-grade ratings to Enron's debt.⁸

Environmental ethics. Although some individuals may be honest or dishonest regardless of the circumstances, most people are influenced by the ethical values of their coworkers and organizations. Companies with strong codes of ethics that are supported by policies, ethical modeling at the top, and anonymous feedback measures provide strong ethical environments for their employees.⁹

Need to succeed. Psychology and behavioral research hold that people have different achievement needs. Researchers have found that people with higher achievement needs set higher goals and perform better than those with lower achievement needs.¹⁰ People who have a greater need to achieve consider their contribution and participation in success to be important¹¹ and find it enjoyable to work hard, be compared to a standard, and be challenged.¹² They feel the need to establish themselves as experts and excel above others.¹³

Individuals with a higher need to succeed will have greater ability to rationalize fraud if given adequate opportunity and overpowering pressure. These types of individuals rationalize cheating on exams more easily than others because they feel significant pressure to achieve high scores. In the financial world, individuals with a high need to succeed may rationalize fraud to make financial success appear possible.

Rule-based accounting standards. Rule-based accounting standards lead to financial statement fraud rationalizations. In contrast to principle-based accounting practices in Europe, US generally accepted accounting principles (GAAP) are much more rule-based.¹⁴ One of the effects of rule-based standards is that if a client chooses a particular questionable method of accounting that is not specifically prohibited by GAAP, it is hard for auditors or others to argue that the client can't use that method of accounting. When management teams and other advisors seek to create competitive advantages by identifying and exploiting possible loopholes, it is difficult to make a convincing case that a particular accounting treatment is prohibited when it technically isn't against the rules. The result is that rather than deferring to existing general rules, *specific* rules (or the *lack* of specific rules) can be exploited for new, often complex financial arrangements. For example, even if Andersen had argued that the accounting for Enron's special purpose entities wasn't appropriate, it would have been impossible for them to make the case that their accounting violated *specific* rules. This lack of specific rules has been seen as one of

the reasons it took so long to get plea bargains or indictments in the Enron case, since it wasn't immediately clear whether any laws had actually been violated.

In many ways, having rule-specific accounting methods makes it easier for accountants to rationalize fraud because they can argue that what they are doing is not wrong. In Europe, this issue does not have to be dealt with.

Concluding comments

Fraud and corruption are cancers that eat away at society's productivity. Their occurrence reduces the effectiveness and efficiency of countries' economies and costs individuals and corporations tremendous amounts of money. The proposed model provides insight into why financial statement fraud occurs, and it is a useful way for shareholders, board members, and others to think about incentive planning. By better understanding what caused such major ethical lapses to occur in the United States, Europe can prepare itself to avoid similar ethical breakdowns. In the end, we can learn from the mistakes of the United States, instead of follow in the footsteps of its errors.

[1](#)

The authors would like to thank the government of Catalonia and the European Social Fund for financially supporting this research.

[2](#)

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[3](#)

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The Securities and Exchange Commission has acknowledged that US standards may be too rule-based and plans on aligning PCAOB Auditing Standard No. 5 with the SEC's management guidance under Section 404 of the Sarbanes-Oxley Act.

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Chapter 7: Article Six

A Comment on Koerber and Neck's (2006) Religion in the Workplace: Implications for Financial Fraud and Organizational Decision Making

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¹A Comment on Koerber and Neck’s (2006) “Religion in the Workplace: Implications for Financial Fraud and Organizational Decision Making”

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Koerber and Neck (2006) have argued that the adoption of religion in the workplace can create an environment that leads to a greater possibility of financial fraud. This logic flows from the proposition that a culture embedded in religion allows the fraud triangle to develop by creating a greater opportunity for fraud to occur. Koerber and Neck have raised some interesting points. However, in the following commentary, I challenge their proposition that religion in the workplace will increase an organizations overall susceptibility to fraud. I base this proposition on two key elements of the fraud triangle—pressure and rationalization. In the following commentary, I propose that, by examining the entire fraud triangle—not just one element of the fraud triangle—organizations embedded in religion may have an overall minimized risk of financial fraud.

Keywords: Religion, Fraud, Fraud Triangle, Culture.

¹ The author would like to thank the Generalitat de Catalunya (Government of Catalonia) for financially supporting this research.

INTRODUCTION

In the article, “*Religion in the Workplace: Implications for Financial Fraud and Organizational Decision Making*” by Koerber and Neck (2006), it is argued that the likelihood of financial fraud increases in organizations that are embedded in a culture of religion. Koerber and Neck base their arguments upon the fraud triangle. The fraud triangle is composed of three basic elements—pressure, rationalization, and opportunity (Wells, 2001, Albrecht, 1981). The fraud triangle has gained considerable popularity in recent years and, in 2002, formed the basis for SAS 99, *Considerations of Fraud in a Financial Statement Audit*, which became the fraud auditing standard of the accounting profession within the United States (American Institute of Certified Public Accountants, 2002).

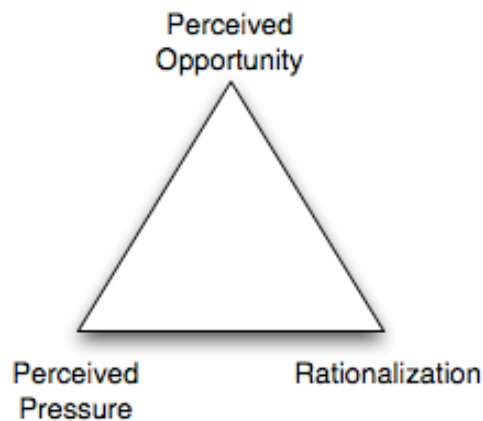
In their article, Koerber and Neck specifically focus on one dimension of the fraud triangle—that of opportunity. They assert that organizations embedded in religion will have a greater susceptibility to fraud as a result of two factors. These two factors include: (1) an increased overall forgiveness within the organization, and (2) an increased trust to members of the organization. Based on this assertion, Koerber and Neck argue that an organizational culture that places trust in its members will have fewer internal controls to prevent and/or detect theft and other forms of fraud and abuse, creating a greater opportunity for fraud to occur. Koerber and Neck present this idea from both the organizational and individual level. They also argue that workplaces embedded in religion will be more forgiving to members of the organization. Thus, when a member is found guilty of dishonesty, an organization embedded in religion will be more forgiving of that individual than those organizations that are not embedded in religion. As a result of these two factors, Koerber and Neck conclude that organizations embedded in religion are more likely

to be susceptible to fraud than organizations that are not embedded in religion. In the following commentary, it is proposed that—when the fraud triangle is viewed in its totality—organizations that are embedded in religion may have an overall minimized risk for financial fraud when compared to organizations that are not embedded in religion.

THE FRAUD TRIANGLE

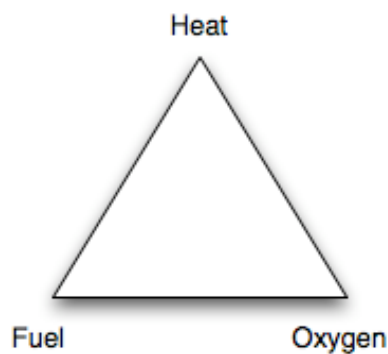
As discussed earlier, the fraud triangle is comprised of three elements: opportunity, pressure, and rationalization. These three elements are common to all frauds (Wells, 2001). A perceived opportunity to commit fraud, conceal it, and to avoid being punished is the first element of the fraud triangle. The Committee of Sponsoring Organizations (2002) identified five elements of an organization's internal control framework that must be taken into consideration in order to avoid fraudulent opportunities. These include the control environment, risk assessment, control activities, information and communication, and monitoring. The second element of the fraud triangle is pressure. These pressures don't have to be real, they only have to seem real to the perpetrator. Pressures usually involves a financial need—such as substantial debt, although non-financial pressures, such as the need to report results better than actual performance, work frustration, or even a challenge to beat the system can motivate fraud. The third element of the fraud triangle is rationalization. Perpetrators of fraud must find ways to rationalize their illegal acts as being acceptable and, in the process, rationalize away the dishonesty of their acts (Albrecht, Albrecht, & Albrecht, 2006). The fraud triangle is presented in Figure 1.

Figure 1: Fraud Triangle



The fraud triangle is often compared to the fire triangle. In order for fire to occur three elements are necessary—heat, fuel, and oxygen. When all three of these elements are present, fire occurs. When one factor is eliminated the fire goes out. Fire fighters are smart and know they can fight fires by working on any one of the three elements. Fires are extinguished by taking away oxygen (smothering, chemicals, etc.), by eliminating heat (water, etc.) and by eliminating fuel (turning off the gas, constructing fire breaks, etc.) Further, the more pure the oxygen, the less fuel and heat it takes to have a fire. The fire triangle is presented in Figure 2.

Figure 2: Fire Triangle



Koerber and Neck have argued that organizations with a religious culture may be more susceptible to the opportunity element of the fraud triangle. I agree with this proposition. Koerber and Neck (2006) have provided various examples to illustrate this point including the famous “Praise the Lord” scandal.

However, before making an assertion that an organization embedded in religion is at a higher overall risk for fraud abuse, it is necessary to take into account all three elements of the fraud triangle. Once the fraud triangle is viewed in its totality, it is possible to see that organizations embedded in religion may be at less risk for fraudulent behavior than organizations that are not embedded in religion. By considering the effects of religion on the elements of pressure and rationalization in addition to the element of opportunity, it is possible to do an accurate assessment of the effect that religion may have on organizations. In the following paragraphs, I discuss some of the positive effects that religion in the workplace will have on both the pressure and rationalization elements of the fraud triangle.

Research has suggested that religion is negatively related to values that emphasize self-indulgence (Schwartz & Huisman, 1995). Since, fraud is a self-indulging behavior, individuals with higher values are going to be less likely to participate in fraud than those who are not value oriented. Furthermore, individuals with values will find it harder to rationalize their illegal acts as acceptable.

Most people who commit fraud do so as a result of a financial pressure. However, once perpetrators meet their own financial needs, they often continue to steal, using the stolen funds to improve their lifestyle. Few, if any perpetrators, save what they steal. Many perpetrators buy new cars, take expensive vacations, buy new homes, buy expensive jewelry and spend the money in other extravagant ways (Albrecht & Albrecht, 2004). One of the best-known examples of this type of

behavior is that of Mickey Monus in the famous Phar-Mor case, who took extravagant trips to Las Vegas in a private jet, financed the world basketball league, and truly lived a lifestyle well beyond his means. This type of behavior, portrayed by many fraud perpetrators, is the near opposite of what research on spirituality suggest. Research on spirituality has suggested that spiritual and religious individuals are “...well adjusted and exhibit a sense of inner harmony. They have positive energy, are conscientious, and tend to be open to possibilities. Compassionate and altruistic, persons with spirit at work are self-transcendent and spiritually inclined. These spiritually inclined individuals seek deeper meaning and a purpose beyond self and, as such, see work as an act of service. They are filled with gratitude and harmony” (Kinjerski & Skrypnek, 2006, p. 234).

People who are truly religious generally adhere or believe in the golden rule. This rule, which encourages us to “do unto others as you would want others to do unto you,” is found in most religions. Those individuals who believe in treating others as they would want to be treated will be less likely to harm others through fraudulent or other abusive behavior. Below are a few examples of religious teachings throughout the world to support this statement:

· *Judaism: You shall love your neighbor as yourself (Bible, Leviticus, 19 – 18.*

· *Christianity: Do unto others as you would have them do unto you (Luke 6: 29 – 38).*

· *Islam: Not one of you is a believer until he loves for his brother what he loves for himself (Forty Hadith of a-Nawawi 13).*

· *Jainism: A man should wander about treating all creatures as he himself would be treated (Sutrakritanga 1.11.33).*

· *Confucianism: Try your best to treat others as you would wish to be treated yourself, and you will find that this is the shortest way to benevolence (Mencius VII.A.4).*

· *Hinduism: One should not behave towards others in a way that is disagreeable to oneself. This is the essence of morality. All other activities are due to selfish desire (Mahabharata, Anusana Parva 113.8).*

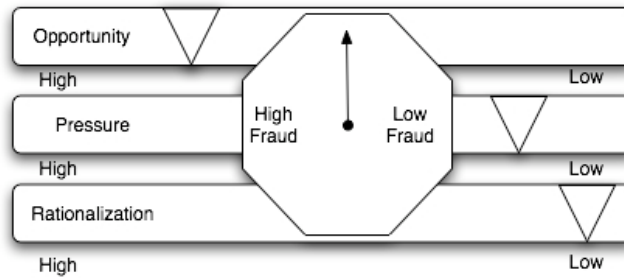
Furthermore, since individuals with stronger values are more altruistic, managements of organizations embedded in religion will be less greedy than those of organizations that are not embedded in religion. It has been suggested that individuals who are less greedy will not have the same pressures to commit and/or be conned by fraud as greedy individuals (Langenderfer & Shimp, 2001). Along this same line of reasoning, is the fact that, many individuals who practice religion have an increased ethical foundation to help guide them to make good decisions.

The act of labeling and modeling by management and others also has a tremendous influence on organizations. I assert that individuals with religious convictions will not only label good ethical behavior but will also “practice what they preach”. In other words, organizations embedded in religion will have individuals who both label and model good behavior. This in turn will have a positive influence on the organization as a whole and reduce the likely hood that individuals will be able to rationalize their illegal actions as justifiable.

Scholars have suggested that the fraud triangle is interactive, meaning that the three elements of the fraud triangle work together (Albrecht, Albrecht, & Albrecht, 2006). If more of one factor is present, less of the other factors need to exist for fraud to occur. In other words, the greater the perceived opportunity or the more intense the

pressure, the less rationalization it takes to motivate someone to commit fraud. Likewise, the more dishonest a perpetrator is, the less opportunity or pressure it takes to motivate fraud. This point is illustrated in figure 3 below.

Figure 3: The Fraud Scale



Hence, while it may be that organizations embedded in religion may have increased opportunities for fraud, the benefits of a culture embedded in religion on both rationalization and pressure may compensate and even outweigh this increased opportunity. The table below outlines the susceptibility of fraud to organizations embedded in religion compared to those organizations not embedded in religion.

Table 1: Susceptibility to Fraud of Organizations embedded with Religion compared to Organizations not embedded in Religion.

Fraud Triangle	Opportunity	Pressure	Rationalization
Effect on Organization	↑ Trust ↑ Forgiveness	↑ Humility ↓ Greed	↑ Values ↑ Integrity
Likelihood of Fraud	Higher	Lower	Lower

CONCLUSION

While Koerber and Neck have discussed the effects of religion in the workplace on one dimension of the fraud triangle, I have examined the effect of religion on all three aspects of the fraud triangle. Koerber and Neck have done a good job of identifying the possible increased risk on the dimension of opportunity as a result of a culture embedded with religion. However, when all three dimensions of the fraud triangle are taken into account, I suggest that the increased risk of fraud for organizations embedded in religion will generally be offset by the decrease in potential rationalization and pressure of fraud perpetrators. In the process, I have presented the fraud triangle and the fraud scale. I have also presented a table to show how all three dimensions of the fraud triangle—pressure, rationalization, and opportunity—are effected by organizations that are embedded with religion compared to organizations that are not embedded with religion.

If managers and executives understand the potential risks and benefits that are associated with religion in the workplace, they will better be able to prevent fraud and other forms of abuse from occurring within their respective organizations. This in turn, will create a positive effect on the organization as a whole. Our knowledge with regards to the relationship between fraud and religion is still in its infancy. As Koerber and Neck have stated, “Additional research is needed to empirically test the relationships between religion in the workplace and financial fraud (Koerber and Neck, 2006, p. 315). This additional research must include both qualitative and quantitative methodologies.

I would like to thank Koerber and Neck for their article and for bringing attention to the relationships between fraud and religion in the workplace.

Furthermore, I would like to thank Koerber and Neck for bringing attention to the idea that organizations embedded in religion will have different challenges when dealing with fraud than organizations that are not embedded in religion.

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Conclusion

Impact of the Research

In this dissertation, I have attempted to show the importance of studying fraud from a managerial perspective. I believe this research has had an impact on the real world, helping individuals and organizations to understand the phenomenon of fraud a little better. It is our hope that, as a result of the research presented in this dissertation, individuals will be able to educate potential victims and perpetrators to the risk and consequences of fraud.

A search on Google Scholar has shown that our fraud related research has been quoted 46 times in other publications (Google, 2008). While this number is somewhat arbitrary (and includes fraud related publications that we have had that are not included in the dissertation), we do believe it gives a good idea of the value that our peers give to this research. In the coming years, and as this research becomes more predominant in mainstream management fields, we believe that this research will have an even greater impact within the academic community.

We have recently learned that the editor of *Internal Auditing*, a peer review publication by Thomson, would like to re-publish our article that originally appeared in *Corporate Finance Review*. According to the editor of *Internal Auditing*, the article was so well received by the accounting field that they would like to publish it one more time to give the article even more exposure. *Internal Auditing* is a professional journal that is now in its 23rd year. Some of the most influence academics in the field are members of its editorial board.

Research Implications

In the introduction to the dissertation we identified information about the journal and the basic idea of each of the articles contained within the dissertation. In the following paragraphs, I will take this a step further, by going through each paper of the dissertation and discussing the implications and conclusions of each article.

Paper #1: Financial fraud: The How and Why

The idea that we tried to express to the management community with this article is the fact that when a fraud occurs – everyone loses. In other words, fraud is destructive to everyone involved. Fraud and corruption are cancers that eat away at societies productivity. They reduce the effectiveness and efficiency of economies, and have very high costs for individuals and companies throughout the world. In the paper, we propose a model that provides insight into why financial statement fraud occurs, and it is a useful way for shareholders, board members and others to think about issues such as incentives for executives. By better understanding what caused major ethical lapses to occur in the US, Europe can prepare itself to avoid similar ethical breakdowns. In the end, Europe can learn from the mistakes of the US.

Paper #2: Exploring the Recruitment of Individuals into Financial Statement Fraud Schemes

The main purpose of this paper has been to propose a model that explains the process by which individuals recruit other individuals to participate in unethical acts. We do this by demonstrating how individuals may use power to exert influence upon another person. Previous research shows that a key element of fraud prevention is educating employees and others about the

seriousness of fraud and informing them about what to do if fraud is suspected. Educating employees about fraud and providing fraud awareness training helps ensure that frauds that do occur are detected at early states, thus limiting financial exposure to the corporation and minimizing the negative impact of fraud on the work environment.

The model that we presented in this paper, has created another tool, in addition to the fraud triangle for individuals to use in the fight against corruption within organizations. Instead of simply explaining how one individual becomes involved in fraud, such as is the case with the fraud triangle, the model presented provides an explanation of how many individuals become involved in financial statement fraud. The model further explains how fraud is perpetrated throughout the various levels of the organization, giving insight into the important phenomenon of how entire organizations become involved in financial statement fraud. It is our hope that the model provided in this paper, will provide a background from which to create schemes and actions to limit organizations' susceptibility to financial statement fraud as well as other possible forms of organizational corruption.

Paper #3: The Role of Power and Negotiation in Online Deception

The purpose of this paper was to explain power as well as the primary tactics utilized to realize power within the online setting. The strength of the paper is that it explains the relationship that takes place between perpetrator and victim, specifically in an online environment. By understanding the techniques employed, and how potential fraud victims self-select themselves in response to these mechanisms will enable policy makers and consumers to

understand the overall process of online deception and decrease overall risk of current and future frauds.

It is our hope that this paper has been able to advance theoretical understanding of the specific power forms that perpetrators use when influencing victims in fraudulent transactions. The model combines the dimensions of power and negotiation from the management and psychological literature as well as Internet fraud research from the Information Systems field. The paper further examines the moderating effects of the Internet on communication and fraud processes between perpetrator and victim, as well as deception tactics employed to realize each power type in frequently occurring fraud forms.

Paper #4: Current Trends in Fraud and its Detection

As discussed in the introduction of the thesis the main implications from this article is the discussion that takes place regarding fraud audits. In addition, the article also helps practitioners and academics alike to better understand the basic nature of fraud, including the major accounting scandals of the last decade. The article further sheds light on the discussion of whether or not auditors should be held liable for detecting financial statement fraud. The article helps auditors and regulators alike to better understand the result of the recent standards, rules, and acts put in place after the major frauds of the 1990s and 2000s.

Paper #5: Financial Statement Fraud: Learn from the Mistakes of the U.S. or Follow in the Footsteps of its Errors

The greatest contribution and implications of this article is the

explanation that the article provides regarding financial statement fraud within the United States. More specifically, the article explains how the United States is attempting to curb financial statement fraud and what Europe can do to learn from the US's mistakes. The article also discusses the significant cost of fraud and corruption to companies and the economy as a whole. Finally, the article contributes to the existing literature by presenting our own expanded model of classic fraud theory and explaining how the model can help European firms.

Paper #6: A Comment on Koerber and Neck's (2006) "Religion in the Workplace: Implications for Financial Fraud and Organizational Decision Making"

This article's implication and contributions to the field include added insight into the debate on fraud in the workplace. While Koerber and Neck discuss the effects of religion in the workplace on one dimension of the fraud triangle, this article examines the effect of religion on all three aspects of the fraud triangle. Furthermore, in the commentary, I suggest that the increased risk of fraud for organizations embedded in religion will generally be offset by the decrease in potential rationalization and pressure of fraud perpetrators. In the process, I have presented the fraud triangle and the fraud scale. I have also presented a table to show how all three dimensions of the fraud triangle – pressure, rationalization, and opportunity – are effected by organizations that are embedded with religion compared to organizations that are not embedded with religion.

The article states that if managers and executives understand the potential risks and benefits that are associated with religion in the workplace, they will better be able to prevent fraud and other forms of abuse from occurring within their respective organizations. This in turn, will create a positive effect on

the organization as a whole.

General Conclusion

The study of fraud is an important aspect of business. Unfortunately, mainstream management has ignored many aspects of fraud examination. In this dissertation, I have attempted to bring more attention to the topic of fraud by publishing research in both academic and professional journals. I have also attempted to spur more attention and debate to the study of fraud by attending and presenting research at various academic conferences. In fact, while a doctoral student, the research that my colleagues and I have done on fraud has been presented at conferences in the United States, Spain, Vienna, Paris, Slovenia, Mexico, and Norway. Because of my interest in fraud, Simon Dolan asked me to submit a special track proposal on International Fraud and Corruption at the 2008 European Academy of Management held in Slovenia. The track was accepted and has resulted in many different papers on the subject of international fraud in the management field. Simon Dolan and myself are currently co-chairing this special track on international fraud and corruption.

It is my hope that the research presented in this dissertation will have a practical implication on businesses today. While much of the fraud research I have been involved in as a doctoral student has been presented in this dissertation, there are other papers and projects that have not been presented. In fact, my colleagues and I are currently working on several projects that should result in top tier publications. One of these projects provides empirical evidence to the relationship between accounting, as an institution, and corruption. Data used in our analysis has come from over 90 different countries. Another project I am currently working on has collected data from over 250 business ethics

academic professors. These professors have reported on the top ethical issues that our field will face in the coming decade. This same project has provided data that will help us to better understand the ethical values of college students today. Finally, a third project on fraud deals with the relationship between South Korean chaebols and fraud. This last article has resulted in a paper that is currently under “revise and resubmit” status for a special issue on fraud prevention at *Management Research News*, a management journal published by Emerald.

Preventing fraud is generally the most cost-effective way to reduce losses from fraud. Once a fraud has been committed, there are no winners. Perpetrators lose because they are usually first-time offenders who suffer humiliation and embarrassment as well as legal consequences. They usually must make tax and restitution payments, and there are often financial penalties and other consequences. Victims lose because not only are assets stolen, but they also incur legal fees, lost time, negative publicity, and other adverse consequences. Further, if organizations don’t deal harshly with the perpetrators, a signal is sent to others in the organization that nothing serious happens to fraud perpetrators in this organization, making fraud by others more likely. Organizations and individuals that have proactive fraud prevention measures usually find that their prevention efforts pay big dividends. On the other hand, the investigation of fraud can be very expensive.

The purpose of this dissertation has been to stress the importance of fraud prevention. Specifically, throughout the dissertation, I have stressed the importance of fraud education as a means to prevent fraud. If fraud can be eliminated, or at least reduced, organizations and societies will be much more

productive and efficient. To help aid in the education and prevention of fraud, the dissertation has presented five peer review papers and a sixth paper that is currently under review. Each of these papers has aided in fraud prevention by helping managers, practitioners, regulators, and academics understand the nature of fraud a little better. Several of the papers have also talked about how individuals use power to recruit other individuals within an organization to participate in unethical acts such as fraud.

In conclusion, fraud is a cancer that eats away at society's productivity. Fraud reduces the effectiveness and efficiency of economies, and creates very high cost for individuals and companies throughout the world. The papers presented in my dissertation provide insight into why fraud occurs. The papers also provide insight for shareholders, board members, and others to think about various fraud related issues. By better understanding what causes fraud to occur, we can better prevent fraud from occurring in our organizations and communities.