Perceived “Tone From The Top” During A Fraud Risk Assessment

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Abstract

In recent years, the focus on good governance and control mechanisms has increased significantly due to the number of high-profile corporate failures caused by top management fraudulent acts. Recent fraud cases reflect the deceptive “tone from the top”, even though the organisation had reported good governance and control systems. This research analysed the importance of the perceived management support and its effect on the organisation culture during a fraud risk assessment. The study used Action Research as the researcher intended to have a more in-depth study on the factors affecting organisational fraud.

Keywords: Fraud Risk Assessment; Internal Controls; Culture; Tone from the Top; Corporate Executive Fraud; Occupational Fraud.

1. Introduction

Fraud is an intentional act designed to deceive others, resulting in the victim suffering a loss after relying on the deceit and the perpetrator achieving a gain (AICPA, 2008). This research paper focuses on fraud committed by top managers (corporate executives), also known as white-collar crime. A white-collar crime is committed by a person of respectability and high social status; in the course of his occupation (Sutherland, 1949). Choo & Tan (2007) define Corporate Executive Fraud as an intentional financial misrepresentation by trusted executives of public companies.

It is vital to differentiate between the various classifications of white-collar crimes as each crime would reflect different red flag, motivations and circumstances. Clinard & Quinney (1973) differentiated occupational fraud from

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corporate crimes. They claim that occupational crimes reflect on the organisation as the victim, with the crimes being committed against the organisation for the benefit of the perpetrator. Wells (2007) agrees by defining Occupational Fraud as the misuse of one’s occupation in order to achieve personal enrichment through the deliberate misuse or misapplication of the employing organizations resources or assets. Corporate crimes, on the other hand are committed by the perpetrator for the benefit of the corporation (Clinard & Quinney, 1973). Zahra et al (2005) mention that white-collar crimes can also be classified according to the extent of individual involvement. The research cites the work of Daboub et al (1995), which distinguishes between active participation (individuals are actively involved in illegal activities) and passive acquiescence (managers are aware of illegality within the organisation, but are unwilling to take corrective action); Kelman & Hamilton (1989) which discuss about the “Crimes of Obedience” (Individual caught in the dilemma of either carrying out a directive that is wrong or disobeying an order and suffering the consequences) and Hamilton & Sanders (1999) “Second Face of Evil” (The result of actions of individuals who occupy positions and make routine decisions according to procedure, which eventually escalates into either cover ups or disasters). This research provides an overview of a fraud risk assessment and organizational culture of a selected case study.

2. Fraud Risk Assessment

Implementing anti-fraud controls appear to have helped reduce the cost and duration of fraud schemes (ACFE, 2014). However, the perceived mechanisms of a good governance and control system can be misleading. For example, Enron had all the mechanisms of a good governance and control system, however due to the management culture and decisions, the fraudulent activities took place. Gebler (2005) states that culture is the leading risk factor for compromising integrity and compliance in companies.

Too many controls could cause bureaucracy, causing additional cost and time. CIMA (2009) states that the Internal Control System consists of an organisation’s policies and procedures that when taken together, support an organisation’s effective and efficient operation. COSO (2012) defines an Internal Control System as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.

One of the risks that the organisation faces which may affect the achievement of the objectives set is the risk of fraud. CIMA and COSO recommend a fraud risk assessment to ensure proper focus, identification, and management of fraud risk in an organisation. O’Bell (2009) believes that the Fraud Risk Assessment helps to focus management’s attention on the significant fraud risks to be addressed and managed.

The researcher used a framework summarised by Rubasundram (2014) for the Fraud Risk Assessment:

a) Management to initiate the Fraud Risk Assessment & Management by setting up a Fraud Risk Assessment & Management Team (FRAM Team) to set goals, objectives and the fraud risk appetite of the organization.

b) FRAM Team to carry out brainstorming activities, process mapping, necessary checks, audits & tests and discussions / interviews with other personnel to understand:

i. The organizations environment, culture, management, business, departments, processes, functions and process owners.

ii. Potential fraud scenarios and schemes, taking into account red flag areas such as management overriding of controls and personnel who may exhibit the factors identified in the Fraud Triangle, Fraud Diamond, The New Fraud Triangle and the new Fraud Diamond. Heiman-Hoffman and Morgan (1996) ranked the most important warning signs (red flag) as management attitude.

iii. Categorise and assess the likelihood & impact of the fraud schemes.

iv. Review the current controls in place and identify the gap in terms of any additional or revised controls needed, in line with the organizations risk appetite and decided risk strategy.

v. Implement and monitor controls with periodic evaluation.

3. Development of Fraud Theories

The question arises on what would make management violate their position of trust. The writer agrees with Zahra et al (2005) that management fraud is often committed by highly successful people, who have everything to
lose if discovered. Cressey (1973) concluded that trusted persons become trust violators when they view themselves as having a non-shareable financial problem that is solvable using unethical means by violating their position of trust. Choo & Tan (2007) described the term “Broken Trust Theory”, in relation to the work of Albrecht et al (2004) to explain Corporate Executive Fraud. The research had linked the Agency Theory and Stewardship theory to the Fraud Triangle concept. The agency theory (Jensen & Meckling, 1976) describe the principal-agent relationship between owners and executives, with top executives acting as agents whose personal interests do not naturally align with shareholder interests. Stewardship theory views corporate executives as stewards of their companies who will choose the interests of the stockholders over the interests of self, regardless of personal motivations or incentives (Sundaramurthy & Lewis, 2003). These two theories seek to align the interests of corporate executives with the shareholders and question the complexity of corporate executives’ behaviour.

Over the years, Donald Cressey’s hypothesis, popularly known as the Fraud Triangle identified three variables representing pressures or motivation to carry out the fraud, the opportunity to carry out the fraud and the final variable being to rationalise the act as being inconsistent with one’s personal level of integrity. Albrecht et al (1984) states that it appears that the three elements (opportunity, pressure and rationalisation) must be present for a fraud to be committed. It is interesting to note Kassem & Higson (2012) expression of Cressey’s rationalisation concept, “most fraudsters are first time offenders with no criminal record” and that the trust violators knew the behaviour to be wrong and that they merely kidded themselves into thinking that it was not illegal”. ACFE’s, Report to the Nations 2014 reflects that 86% of perpetrators had never been charged or convicted. In Cressey’s theory, the pressure component initially reflected a non-shareable financial problem which was then developed to include non-financial components (Albrecht et al: 2008, 2010), political and social pressure and subsequently; personal pressure, corporate/employment pressure and external pressure (Kassem & Higson, 2012). CIMA (2009) describes opportunity for fraud takes place in companies where there is a weak internal control system, poor security over company property, little fear of exposure and likelihood of detection, or unclear policies to concerning acceptable behaviour.

Critics of the fraud triangle argued that it provides a limited perspective since it is difficult to observe the rationalisation and pressure effect, and it ignores important factors like the capabilities of the fraudster, culture etc. Wolfe & Hermanson (2004) introduced the Fraud Diamond, extending the Fraud Triangle to include fraudster capabilities. The capability component takes into account the fraudster’s position or function within the organisation which may furnish the ability to create or exploit an opportunity for fraud not available to others, which also includes the fraudster’s ability to exploit internal control weakness. The fraudsters’ personality also plays a role in this model. Wolfe & Hermanson (2004) identify ego and confidence of non-detection or non-penalisation as well as the ability to coerce others to commit or conceal fraud; which is in line with Kelman & Hamilton (1989) “Crimes of Obedience”.

Finally, Wolfe & Hermanson also believe that the fraudster has the ability to lie effectively and consistently; and to deal with stress accordingly. Kassem & Higson (2012) discuss the New Fraud Triangle Model in their paper, citing Dorminey et al (2010). In this model, they suggest to expand the motivation component of the original fraud triangle, to include Money, Ideology, Coercion and Ego (MICE). Ideological motivators are able to justify the fraud by believing that their action would bring greater benefits, consistent with their beliefs (ideology). The model includes a personal integrity scale instead of rationalisation, introduced by Albrecht et al (1984). Personal integrity is seen as the personal code of ethical behaviour each person adopts. It also includes the fraudster’s capability as the development of the Fraud Diamond. Gbegi & Adebisi (2013) “The New Fraud Diamond Model” includes the National Value Systems (NAVS+MICE) and Corporate Governance as additional elements.

4. Methodology

corporate culture review should include a review of employee turnover rates at all levels, reasons for turnover, average employee tenure, nature and magnitude of customer complaints, product quality and related warranty expense experiences, nature of legal battles, employee morale as noted via observation, grievances, attendance, newsletter comments, comparison of wages with industry averages, credit rating, better business bureau reports, employee benefits and investment in employees such as training and office support. Glover & Auno (1995) also assert that the auditor should assess management philosophy as documented in their policies and procedures manual, including an analysis of the corporate board minutes.

Each fraud risk assessment normally reflects different circumstances and evidences. Action Research enables research to take place in real life situations and to solve actual problems or issues. Therefore, the researcher needed to have access into an organisation process, policy, documents, employees etc.; and also to be involved with the decision-making process, policy setting, and implementation and monitoring. It was also crucial that the organisation reflected red flags (symptoms of fraud), especially by top management. The organisation selected also faced cash flow and financial issues due to fast paced growth, which was in line with the researchers criteria since the temptation to commit fraud would be higher in a financially troubled company. It also had a multi cultural employee base which added value for the cultural risk assessment. The red flags that were noted include limited communication channels between the board, executive management, and department heads. The Management Information Systems had performance issues led to incomplete accounting records and reports. This was aggravated by high turnover especially amongst accounting personnel.

5. Results

Based on the initial assessment, the possibility of fraud involving the top executives seemed high. However, the FRAM team concluded that the motive was more towards ego (not wanting to loose reputation) and the ideology of the betterment of the organisation i.e. towards the inclination of Corporate Executive Fraud. The top executives were extremely supportive of the overall FRA initially; in their attempt to be perceived as accountable and transparent. The second level managers (operational) were rather divided, and were passively acquiescence; following the Crimes of Obedience. During the assessment, it was interesting to note that the operational managers focused on lower level employee fraud as the issue, rather than on the top executives until prompted and trained.

The employees were from a variety of culture and background, and generally conformed to the organisational culture. The management and culture of the organisation reflected an ethical culture, with strong controls and procedures. However, the group of top-level executives dominated the organisation and demanded obedience. Most employees were of the opinion that their job security mattered most, which led them to carry out certain practises which they were not too comfortable with. Training the employees improved the culture and empowerment factor over the period of time. Although they were aware of the ethical standards and their roles in upholding these standards (vigilance), most employees did not engage themselves due to lack of credibility in the overall organisations commitment. Since it did not involve them directly, they felt they were not accountable beyond their work neither were they empowered to disclose the same. Since the employees felt divided, it was easy to note that they lacked the courage and initiative to rectify the culture, especially since they were not aware of any other options available to them.

6. Conclusion

Setting up Internal Controls to prevent fraudulent activities in an organization can only be effective when the tone from the top is strong. Until the committee was set up to oversee the management, there was a lot of conflict and attempts to override the controls set in place, even though the organisation had already set up some interim controls. The main issue that the team had to contend with was the perceived top executive attitude, the lack of commitment from the other employees and overriding of controls. However, with the gradual education and training of the employees, eventually this was minimised. The FRAM Team did note that without the support of the Directors, the successful implementation might not have been possible as the Executives would have eventually overridden the controls. Clear policies and the provision of options of whistleblowing, as well as access to Directors improved the overall perception of the culture and employees morale. This was noted during post implementation with managers and other employees taking a pro-active stand against unethical decisions.
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