

REVIEW ARTICLE

presents the state of research around a specific topic and identifies key themes for future research

Understanding the Theoretical Underpinnings of Corporate Fraud

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KEY WORDS

Fraud Triangle

M.I.C.E.

Fraud Diamond

Predators and Accidental Fraudsters

Financial crimes have existed since the advent of trade commerce. One of the key factors behind recurrent financial crimes in the corporate context is the separation of corporate ownership and management. Such a separation makes it difficult for the owners to effectively monitor the management, therefore allowing the management to act opportunistically or fraudulently (Jensen & Meckling, 1976). White-collar crime is the overarching term that encompasses a range of financial frauds which are committed in the corporate context. Sutherland (1940) describes white-collar crime as a violation of delegated trust. In the corporate context, management is entrusted with the responsibility of managing a corporation on behalf of its owners and stakeholders. A corporate fraud involves the violation of such trust where the management does not act in the best interests of the corporation's stakeholders but rather acts opportunistically to benefit certain specific stakeholders at the expense of others.

Given the potentially damaging consequences of corporate fraud, the auditing standards in various jurisdictions have attempted to define it. For instance, the Indian auditing standards describe corporate fraud as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage' (ICAI, 2007-SA 240). Similarly, the US standards describe fraud as 'an intentional act that results in a material misstatement in financial statements that are the subject of an audit' (AICPA, 2002). Both US and Indian standards categorize corporate fraud into two broad categories *fraudulent financial reporting* (FFR) and *misappropriation of assets* (MOA) (AICPA, 2002; ICAI, 2007-SA 240).

Misstatements arising from FFR typically involve 'intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be



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presented, in all material respects, in conformity with generally accepted accounting principles (GAAP)' (AICPA, 2002). FFR does not involve the actual theft or misappropriation of the company's assets, rather in such cases the management of a company tries to manipulate the company's financial results to benefit certain stakeholders of the company. Misstatements arising from MOA typically 'involve the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented, in all material respects, in conformity with GAAP)' (AICPA, 2002).

This paper discusses the various theoretical models explaining corporate fraud. The paper reviews both business and personal factors driving corporate fraud and highlights the relevant drivers of fraud applicable in the Indian context. The synthesis of fraud-related research in this paper is organized around the works of Hogan et al. (2008), Dorminey et al. (2012), Trompeter et al. (2013), and Trompeter et al. (2014). The remainder of the paper is organized as follows: In the next section, the prevalent models which explain the origin and perpetuation of corporate fraud are discussed. The last section discusses the factors which drive corporate fraud in the Indian context.

POPULAR MODELS EXPLAINING CORPORATE FRAUD

Fraud Triangle

This model is one of the earliest attempts to describe corporate fraud. The model was developed by Cressey (1950) to describe a white-collar crime in general; however, it has become one of the most prevalent models applied to describe corporate fraud and is widely cited in various standards globally (including AICPA, 2002; ICAI, 2007-SA 240). Based on interviews of white-collar criminals, Cressey (1950; 1953) identified three primary drivers of fraudulent behaviour: (a) a non-shareable financial problem (*pressure/incentives* to commit fraud); (b) knowledge of weaknesses in the structure and workings of a corporation which would allow the perpetrator to commit the fraud and escape detection (*opportunities*); (c) ability to justify to oneself that the fraudulent actions are not necessarily wrong (*rationalizations*).

Perceived pressures from a non-shareable financial need or problem create incentives or motivations for a fraud. Typically, a financial need or problem is deemed to be

non-shareable in a corporate context due to the social stigma associated with the issue. The perpetrators' strong sense of ego or pride further prevents him/her from sharing it with others and seeking help (Dorminey et al., 2012). For example, the chief financial officer (CFO) of a large publicly listed corporation could be potentially embarrassed to accept that his company is not going to meet its quarterly earnings target. Moreover, having risen to the rank of a CFO of a large corporation would have infused him/her with a great sense of pride and ego, as well as a fear associated with the risk of losing such a prestigious position. This, in turn, would motivate the CFO not to report a bad quarter and fraudulently manipulate earnings to ensure that the organization beats the quarterly targets.

Hogan et al. (2008) and Trompeter et al. (2013) list several studies which report how factors such as: need to meet financing requirements at lowest possible costs; need to comply with debt covenants especially for financially troubled firms; need to meet earnings targets to earn bonuses or to satisfy analyst expectations; need to reduce taxation; insider trading and back-dating of options to increase value of stock options. The results of Langton and Piquero (2007) employing general strain theory (Broidy, 2001) suggest that the social environment in which an individual resides induces certain stress to achieve material success, which in turn influences the individual to act criminally. Such social environments fuel the perceptions of a non-shareable financial problem which pressurizes individuals to act fraudulently. Langton and Piquero (2007) argue that securities violators were of high social status, but they appeared to have more unemployment and liability strains. As a result, they were more likely to feel the pressure to excel in the workplace—perhaps by any means necessary.

Perceived opportunities relate to the perceived presence of control and structural weaknesses in the corporation's governance mechanisms which allow the perpetrator to go undetected after committing the fraud. Prior literature cites several such weaknesses such as lack of independence of board of directors (BOD); lack of presence of audit committees or inappropriate composition and compensation structures of audit committees which weaken their independence and compromise their oversight abilities; CEO being the founder of the company and exerting undue control over it; CEOs power over the BOD; CEO and CFO positions being held by the same individual which in turn weakens oversight (Hogan et al., 2008; Trompeter et

al., 2013). All the factors listed above weaken oversight over top management and as a result embolden them to act fraudulently.

In a non-finance context, Engdahl (2008) develops a model to help understand how top management could circumvent the company's governance structure. Engdahl (2008) suggests that the senior management's social status and position creates opportunities in terms of access to authority, social contacts, and technical and administrative systems which allow them to commit fraud without being detected. Wedel (2001) suggests that management indulging in fraud creates informal communications systems to override lines of authority. Such systems are designed to address shortcomings in the existing organizational structure; but eventually they create new groups and institutional structures within the existing organizational structure, while at the same time obstructing institutional change and reform. Such informal systems enable collusion among top management, which is a key ingredient in any major corporate fraud. Van De Bunt (2010) suggests that lack of supervision, successful concealment efforts, and silence maintained in social environments further add to the opportunities available to commit fraud.

Rationalization refers to an individual's ability to explain away wrongful acts as not wrongful. At a broader level, rationalization involves reducing the cognitive dissonance experienced after indulging in an act that violates ethical, legal or social norms. It is very difficult to observe rationalization and therefore there is minimal research on this aspect of the fraud triangle. However, researchers understand the importance of psychological traits on individuals' actions. For example, Cohen et al. (2011), using content analysis of press articles, document a significant association between the attitude/rationalization component of the theory and fraud firms, as opposed to a control sample of firms. Hobson et al. (2011) reviewed earnings conference calls searching for vocal dissonance markers. They reported an association between such markers and financial misreporting.

As a result, researchers have started to conduct studies that examine how an individual's personal traits affect fraudulent behaviour in a corporate context. For example, Hartmann and Maas (2010) and Murphy (2012) report a positive link between Machiavellianism and opportunistic behaviour in organizational and financial reporting settings. Similarly, Agarwalla et al. (2017) document a significant relationship between

self-deception and managers' ethicality judgments related to earnings management. Olsen et al. (2013), Ham et al. (2017), and Al-Shammari et al. (2019) report a positive relationship between the level of CEO narcissism and opportunistic financial reporting.

Fraud Scale

The fraud scale was developed by Albrecht et al. (1984) based on an analysis of 212 frauds in the early 1908s. The researchers interviewed internal auditors of several fraud affected companies to analyse each case. Albrecht et al. (1984) propose a model which borrows two factors from the fraud triangle: pressures and opportunities, and replace the third factor (rationalization) with personal integrity (Dorminey et al. 2012, Figure 6). They argue that personal integrity could be judged based on past actions, whereas it is very difficult to operationalize rationalization. However, top management personnel who have failed in their previous positions or who have been accused of financial impropriety rarely get re-hired in senior managerial positions. Hence, this model has limited applicability in explaining corporate fraud beyond the Fraud triangle.

Fraud Diamond

Wolfe and Hermanson (2004) expand the fraud triangle and add another dimension to it. They argue that without the right capabilities, a potential fraudster cannot successfully commit a material fraud. Dorminey et al. (2012) further add that the essential traits thought necessary for committing fraud, especially for large sums over long periods of time, include a combination of intelligence, position, ego, and the ability to deal well with stress.

Dorminey et al. (2012) suggest that an individual's organizational position could provide the requisite ability to create or exploit opportunities to commit fraud. Additionally, the potential perpetrator must be educationally and technically qualified to identify and exploit internal control weaknesses and to utilize his organizational position and knowledge to his or her advantage. Large corporate frauds are typically committed by highly intelligent, experienced, and creative individuals who have an excellent understanding of the company's controls and vulnerabilities (Dorminey et al., 2012). Moreover, such individuals have a strong ego and overconfidence that they will go undetected and a strong belief that they can talk themselves out of

trouble if caught. The fraud diamond modifies the opportunity side of the fraud triangle and suggests that the triangle works only if the perpetrator has the appropriate capabilities.

MICE

The acronym MICE (Kranacher et al., 2011) stands for money, ideology, coercion, and ego. Not all corporate frauds are driven by a perceived non-shareable financial pressure or opportunities. MICE goes beyond financial pressures and provides an expanded set of motivations beyond a non-shareable financial pressure that could drive fraud. For example, research indicates that social status comparison (Ramamoorti, 2008; Ramamoorti et al., 2009) and a culture of competition (Coleman, 1987) are significant motivating factors for white-collar criminals. In a country like India, where a majority of the large corporations are controlled by their promoters, MICE provides a better framework to explain fraud.

In India and globally, several large frauds have been perpetrated by CEOs and CFOs because of their greed for money, a corrupt ideology, a sense of entitlement, inflated ego, and weak governance structures which enabled them to coerce lower-level employees to follow their lead. In cases such as Phar-Mor, Parmalat, HealthSouth, Madoff, Adelphia Communication Corporation, Satyam, Yes Bank, and Punjab National Bank (PNB) top management was under no specific business pressures to commit fraud. The fraud was primarily driven by greed, ideology, and ego which in many cases were fueled by social comparisons and a hyper-competitive culture which prevented them from backing out of their chosen course of action even if it meant defrauding the stakeholders of the company.

Predators Versus Accidental Fraudsters

As per the fraud triangle, typical corporate fraud perpetrators experience a non-shareable financial pressure such as the need to meet earnings target and obtaining financing at the lowest possible cost. Combined with pressures and rationalization, an otherwise good individual commits fraud. Such an individual is considered to be an accidental fraudster (Dorminey et al., 2012). Typical corporate fraudsters are middle-aged, intelligent, well-educated employees (ACFE, 2009; Ramamoorti et al., 2009) who feel

compelled to act fraudulently by a combination of factors discussed above. On the other hand, a predator is someone who acts opportunistically simple because he/she can. The predator does not need a perceived non-shareable financial pressure to act fraudulently, the presence of opportunities and high propensity to rationalize are sufficient to drive them to act fraudulently.

The actions of an accidental fraudster are driven more by the dimensions described in the fraud triangle; the MICE framework applies more appropriately to the actions of a predator. Through repeated fraudulent acts, an accidental fraudster gradually becomes desensitized to its moral and legal ramifications and finds it incrementally easier to commit such acts in the future (ACFE, 2014; Beasley et al., 1999; Beasley et al., 2010). As a result, it is highly possible that an accidental fraudster eventually becomes a predator. In the corporate context, management may initially start by temporarily managing earnings to buy time for the company to begin performing better but eventually earnings management leads to committing of flagrant fraud where existing legal and financial reporting rules are violated.

A-B-C Model

The A-B-C model proposed by Ramamoorti et al. (2009) categorizes fraud as follows: a bad Apple, a bad Bushel, and a bad Crop. The bad apple refers to an individual who commits fraud, the bad bushel refers to collusive fraud where collusion amongst management personnel allows the perpetration of fraud, and the bad crop refers to cultural and societal mechanisms that influence the propensity to commit fraud. The bad bushel refers to group dynamics and relationships amongst top management personnel which typically facilitate fraud. The bad crop refers to a lack of a strong 'tone at the top' which emphasizes the legality and ethicality of all actions, either at the organizational or societal level which eventually permeate through the organization and possibly culture and society (Ramamoorti et al., 2009).

The sub-prime mortgage crisis in 2007–2008, where banks as a group aggressively gave out loans to ensure higher earnings or the current non-performing assets (NPA) and bad loans crisis in Indian banks are prime examples of a 'bad crop' where a culture of greed and corruption permeated throughout the respective banking systems and led to a loss of billions of dollars.

Dorminey et al. (2012, p. 570) argue that 'once a practice, even an illegal one, becomes trendy, it may create pressure on companies competing for the same managerial talent, the same stock price appreciations, and the same customers to at least consider doing the same.' Thus, the inappropriate tone at the top could add to the pressures affecting the company which in turn could enable top management of companies to collude to circumvent existing controls and act fraudulently.

FRAUDS IN AN INDIAN CONTEXT

India has been plagued by several banking and corporate frauds in recent times. For example, bank frauds involving fake guarantees, and improper and aggressive lending without due diligence (PNB, Punjab & Maharashtra Co-operative Bank), have saddled banks with large amounts of NPAs and significantly eroded stakeholder wealth. Similarly, corporate frauds such as Manpasand Beverages, Kingfisher Airlines, United Distilleries, and Satyam involve top management using related party transactions to siphon off money for personal gains and large-scale loss of shareholder value. In each of the three cases mentioned above, the core business of the company was performing satisfactorily. However, the corrupt ideology of the promoters combined with their ability to coerce other members of top management and a relatively lax litigations regime allowed the fraud to be committed and go unchecked.

The majority of the corporate frauds in India are driven by personal greed, lack of morality, and a lax litigation regime rather than the factors mentioned in the fraud triangle. The MICE framework applies more to frauds in India than the fraud diamond or fraud triangle and a majority of the perpetrators can be classified as 'predators' rather than 'accidental fraudsters'. None of the perpetrators faced any specific non-shareable financial pressure to commit the fraud prior to the committing of the fraud. Their unethicity, combined with the availability of opportunities, drives the majority of Indian fraudsters. The frauds in India are more white-collar crimes rather than elaborate schemes employed to hide weak corporate performance. Unlike frauds in the US which typically involve FFR, frauds in India are largely MOA committed by the top management and promoters of the company where large amounts are stolen from the company through collusion and related party transactions. A report by Deloitte (2018) corroborates our arguments and

indicates that lack of appropriate controls, diminishing ethical values, and management override of controls are primary drivers of corporate fraud in India. Similarly, the report indicates that frauds classified as MOAs are significantly more prevalent in Indian organization than frauds classified as FFR (Deloitte, 2018).

CONCLUSIONS

This paper reviews various models explaining corporate fraud and white-collar crime. The paper also attempts to specifically highlight and understand the factors driving fraudulent actions in an Indian context. There are significant differences in drivers of frauds in corporate India compared to frauds examined in extant research, mostly in the US context. Therefore, by introducing various models explaining fraudulent actions to Indian researchers, the paper attempts to stimulate more research on frauds in India and factors driving these frauds.

Another avenue for future research in the Indian context is to explore governance mechanisms that could be specifically targeted to the Indian context to check corporate frauds. The Indian regulators have recently introduced several reforms to check fraudulent actions such as greater transparency in approval of related party transactions, and increased responsibilities and penalties on top management. Researchers can add to this effort and through a better understanding of factors driving corporate fraud provide additional guidance in developing anti-fraud measures.

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