ACCOUNTING EDUCATION & FRAUD PREVENTION

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ABSTRACT

Fraud is increasing with frequency and severity. In this paper, we explore the assertion of the fraud related to accounting practices and disclosure practices by taking a case of Lehman Brother. We also explore existing literature to find the reasons for such incidents of frauds. Further, we conclude by suggesting how accounting education can prevent it.

Introduction

Fraud is increasing with frequency and severity. In the last several years, the importance of preventing and detecting fraud has been brought home as never before. The financial crisis of 2001 witnessed an unprecedented level of corporate accounting frauds involving some of America’s largest corporations. Articles and papers on Enron, Tyco, WorldCom and other accounting-related scandals have appeared in the pages of many newspapers and journals as case studies. Top company executives have been tried and sent to jail for cooking the books of accounts.

Seven years later, in 2008, the global financial system was struck by a global financial crisis ("GFC") that changed the financial and economic landscape of the world (Sikka, 2010a). Immediately after the GFC, a litany of corporate accounting scandals began to make headlines. A
few examples of these scandals included that of Bernard Madoff’s (“Madoff”) scheme that broke out in 2008. Madoff was convicted and sentenced to 150 years in prison for an elaborate Ponzi scheme in which he swindled investors of over $50 billion (Henriques, 2009). There was also the case of a senior Hong Kong executive and partner at Ernst & Young (“EY”) who, in 2009, was detained for suspected forgery linked to the bankrupt electronics maker Akai Holdings Ltd. EY later entered an out of court settlement in the amount of $1 billion for a negligence claim with Akai Holdings Ltd (Ng, 2009). Similarly in 2009, a London-based accountancy chief from KPMG was sentenced to four years in jail for swindling over $900,000 of the firms funds for personal use (Moult, 2009).

In 2014 and there are reports alluding to the continued rise in accounting fraud. A Global Economic Crime Survey (“GECS”) conducted by PricewaterhouseCoopers (“PWC”) found that accounting fraud is on the rise and poses a serious threat to business (PWC, 2014). The GECS noted that unless fraud control and prevention measures are implemented, businesses will be at greater risk of irreparable damage from fraud.

While the exact statistics are not known, it is estimated that the number of fraud examiners and auditors trained to detect fraud has exploded since the GFC. The Association of Certified Fraud Examiners (“ACFE”), arguably the world’s largest anti-fraud organization and premier provider of anti-fraud training and education, now has over 70,000 members worldwide. To investigate accounting chicanery and other frauds, the ACFE advocates that auditors and other anti-fraud professionals use the fraud triangle as a standard investigative method to understand the factors that cause people to commit fraud.

The fraud triangle’s decomposition has its origin in Cressey’s (1953) book, Other People’s Money: A Study in the Social Psychology of Embezzlement. Cressey’s (1953) fraud triangle consists of three elements: pressure, opportunity and rationalization, all of which must be present in order for a crime to be committed (Cressey, 1953, p. 30). Support for the fraud triangle comes from audit professionals and standard setters who argue that investigators analyzing financial statements will be able to quantify the pressure (as in inflated revenue or overstated net income) that led to the fraud. They will also need to assess the opportunity to commit the fraud with
reference to weak or absent adequate internal controls and the rationalization techniques used to justify the fraud (see AICPA, 2002; Auditing Standards Board, 2002 emphasis added).

Concerned about the erosion of ethical standards within the accounting profession, the American Institute of Certified Public Accountants (“AICPA”) in 2002 and the International Federation of Accountants (“IFAC”) in 2006, followed the ACFE’s footsteps and turned to Cressey’s (1953) work on the fraud triangle for potential explanations of the frauds (Donegan & Ganon, 2008, p. 3; O’Connell, 2007, p. 733–784). The adoption of the fraud triangle is most evident in the Statement on Auditing Standards (SAS) No. 99: Consideration of Fraud in a Financial Statement Audit, which makes the concept the standard method for understanding fraudulent conduct (Auditing Standards Board, 2002).

Despite the efforts of the AICPA and the ACFE, it would appear that the present state of fraud prevention is one of abject failure (Cooper, Dacin, & Palmer, 2013; Free & Murphy, 2013; Morales, Gendron, & Guénin-Paracini, 2014; Neu, Everett, & Rahaman, 2013; Sikka, 2010a). Fraud continues to be a problem to the point where the standard setters do not have anything convincing to say about fraud prevention and prescribe policies to put in place to reduce fraud (Dorn, 2010; McBarnet, 2006; Power, 2013; PWC, 2014).

**Reasons for Fraud: Review from existing literature**

**1. Pressure to commit occupational fraud**

Cressey (1953) hypothesized that individuals commit fraud because of non-sharable financial pressure. Non-shareable financial pressure is a financial strain experienced by an individual, which he or she does not intend to share with others. The individual’s inability to communicate the financial strain serves as a motivation to transgress the law in order to solve the problem. The literature on the pressure to commit occupational fraud can be broadly classified into financial pressures and non-financial pressures (AIC & PwC, 2003; Albrecht, Albrecht, Albrecht, & Zimbelman, 2012; Fitzsimons, 2009).
A financial strain, such as a distressed business or failed market investment(s) is the catalyst that drives many offenders to commit fraud (Dellaportas, 2013, p. 30). In an organizational context, financial pressures stem from the company’s failure to meet Wall Street’s expectations (Dorn, 2010; Power, 2013; Sikka & Hampton, 2005; Sikka, 2010a). In other cases, financial pressure arises from the company’s inability to compete with other companies in similar industries (Albrecht, Albrecht, & Albrecht, 2004; Sikka & Hampton, 2005). Within these purviews, monetary incentives in the form of compensation bonuses are given to executives to improve the company’s financial performance (Brennan & McGrath, 2007). Financial incentives, coupled with the company’s interest in investors’ relations (i.e. to keep stock price high and maintain investors’ confidence), serve as added incentives for executives to manipulate financial statements (Mardjono, 2005).

2. Opportunity to commit occupational fraud

The opportunity to commit fraud is the next component of Cressey’s (1953) fraud triangle. A perceived opportunity to commit a fraudulent act arises when someone in a position of trust violates that trust to address a non-sharable financial pressure (Cressey, 1953, p. 30). In the accounting literature, opportunity has been examined within the context of weak internal controls which, according to KPMG (KPMG, 2006, 2008, 2010), is a major factor attributable to fraud (Albrecht & Albrecht, 2004; Alleyne & Howard, 2005; Dellaportas, 2013; Fleak, Harrison, & Turner, 2010; Kelly & Hartley, 2010; Rae & Subramaniam, 2008; Strand Norman, Rose & Rose, 2010). Such an opportunity arises when the individual has the technical skills and knowledge of “assets, people, information, and computer systems that enables him or her not only to commit the fraud but to conceal it” (Coenen, 2008, p. 12). Indeed, the opportunity to engage in fraud increases as the firm’s control structure weakens, its corporate governance becomes less effective, and the quality of its audit functions deteriorates (Free, Macintosh, & Stein, 2007; Neu, Everett, & Rahaman, 2013; Power, 2013; Rezaee, 2005).
3. The rationalization of occupational fraud

Rationalization is the lack of feelings and indifference expressed by offenders to justify any guilt arising from their misconduct (Dellaportas, 2013, p. 32). It is a mechanism by which an employee determines that the fraudulent behavior is “okay” in her or his mind. For those with deficient moral codes, the process of rationalization is easy. For those with higher moral standards, it may not be quite so easy; they may have to convince themselves that a fraud is okay by creating “excuses “in their minds (Coenen, 2008, p. 12).

Rationalization also involves the fraudster reconciling his/her actions with commonly accepted principles of decency and trust. Self-serving and “morally acceptable rationalization is necessary before the crime takes place” (Dorminey, Fleming, Kranacher, & Riley, 2010, p. 19).

The present discussion on the elements of the fraud triangle is structured around research that assume fraud is committed by dishonest individuals lacking morals and it is the duty of the organization to establish credible layers of controls to prevent their employees from committing fraud or at least to detect fraud in a timely manner (see Morales et al., 2013, p. 184). Other variants used different articulations to increase the explanatory potential of the fraud triangle as a modern fraud diagnostic tool (see Albrecht, Howe, & Romney, 1984; Choo & Tan, 2007; Kranacher, Riley, & Wells, 2010; Ramamoorti, Morrison, & Koletar, 2009; Rezaee, 2002, 2005; Wolfe & Hermanson, 2004). Albrecht et al. (1984) introduced the Fraud Scale Model, which suggests that the likelihood of fraud occurring can be assessed by examining the relative forces of pressure, opportunity and personal integrity. Rezaee (2002) provided an alternative referred to as the “3-C” model and consists of three components necessary to commit corporate fraud: “Conditions”, “Corporate structure”, and “Choice”. Wolfe and Hermanson (2004) proposed a fourth dimension, “capability”, to the fraud triangle and in so doing, transformed it into a “Fraud Diamond”.

Others prefer to combine the fraud triangle with psychology, sociology and criminology theories. Choo and Tan (2007) explain corporate fraud by relating the fraud triangle to Messner and Rosenfeld’s (1994) work on the American Dream Theory (“ADT”) of crime. Ramamoorti et al.
(2009) introduced the Bad Apple, Bad Bushel, or Bad Crop Syndrome, the so-called ABCsof fraud, to understand the incidence of fraud from an individual, group, and macro-oriented contextual perspective. In addition, Krancher et al. (2010) M-I-C-E (Money, Ideology, Coercion, and Ego/Entitlement) model modifies the pressure side of the fraud triangle, by providing an expanded set of motivations beyond a non-shareable financial pressure to commit fraud.

Methodology

We use case study approach for this paper to explore plausible reasons for accounting frauds. Cooper and Morgan (2008) advocate the case study approach to study accounting phenomena. According to Cooper and Morgan (2008), case studies can enhance research and help understand complex accounting issues (p. 165). Indeed, many have used the case study approach to study issues related to corporate fraud (Choo & Tan, 2007; Clikeman, 2009; Donegan & Ganon, 2008; Gabbioneta, Greenwood, Mazzola, & Minoja, 2013; Mardjono, 2005; Mitchell & Sikka, 2011; Mitchell et al., 1998; Neu, Everett, Rahaman, & Martinez, 2013; Sikka, 2008). The use of case studies allows these researchers to examine real world accounting problems in an intellectually rigorous manner (e.g. see Donegan & Ganon, 2008; Neu, Everett, Rahaman, & Martinez, 2013). A case study methodology facilitates holistic investigation and adds strength to the validity of previous research (see Mitchell & Sikka, 2011; Mitchell et al., 1998; Sikka, 2008). This epistemological approach allows for insights into the inquiry around a contemporary accounting phenomenon within a real-life context (Yin, 2003, p. 13).

In this paper, I used three illustrative cases to show where and how the fraud triangle is inadequate.

By reading various news outlets and the Securities and Exchange Commission’s (“SEC”) Accounting and Auditing Enforcement Releases, I was able to collate a shortlist of cases for which there was sufficient information to carry out a critical analysis of the discourses used to promote the fraud triangle. Secondary evidence from newspaper reports was also used in the research. The cases involved both individuals working for the corporate entity and the corporate entity themselves. This case selection approach will allow for an evaluation of the fraud
triangle’s concepts from both a solo-offending (individualized) and co-offending (collective) perspective in fraud (also see Free & Murphy, 2013).

Case Study of Lehman Brothers

Lehman Brothers (“Lehman”) was founded in 1850 by German immigrants Henry Lehman and his brothers, Emanuel and Mayer. While Lehman prospered over the intervening decades, it had to endure many challenges: the Great Depressions of the 1930s, two World Wars, and the Russian debt default of 1998, amongst others. However, despite Lehman’s ability to withstand these challenges, the subprime mortgage crisis brought the once largest investment bank hurling headlong to the ground. Lehman’s troubles started with its decision to enter the real estate business in 2003 during the U.S. housing bubble. At first, this decision under their Chief Executive Officer (“CEO”) Richard Fuld seems credible. Record growth from Lehman’s real estate business enabled revenues in the capital markets unit to surge to 56% between 2004 and 2006. In 2006, the Company securitized $156 billion of mortgages, which represented a 10% increase from 2005. For the full 2007 fiscal year, Lehman reported a record net income of $4.2 billion on revenues of $19.3 billion (from $17.6 billion for the 2006 fiscal year). In 2007, cracks began to surface in the U.S. housing markets with an increasing number of defaults. Lehman started to suffer losses and resorted to illegal techniques to mask its loss. To hide its unhealthy financial position, Lehman resorted to window dressing technique called Repurchase Agreement (Repo 105) (Jeffers, 2011). Repo has historically been used to allow companies to manage their short-term cash, but “in Lehman’s case, these transactions took on an unusual spin that were designed to make Lehman’s balance sheet appear to look healthier than they actually were” (p. 46). Repo 105 allowed Lehman to use arcane accounting techniques to sell toxic assets to banks in Cayman Islands with the understanding that they would eventually be bought back. With the help of its auditors, this accounting man oeuvre was engineered to allow Lehman to create an impression that it had $50 billion more in cash and $50 billion less in toxic assets on its books and artificially reduce its net debt level (Valukas, 2010, p. 42). It was no surprise therefore that Lehman declared bankruptcy with $615 billion in debt (Table 1.1).
Fraud categorized as “white-collar crime” has been the focus of a great deal of research in criminology and sociology (Cooper et al., 2013, p. 441; Lynch, McGurrin, & Fenwick, 2004, p. 390–391; Power, 2013, p. 526). To understand how the term ‘fraud’ has been conceptualized in the literature, it is necessary to begin with historical work on the definition of white-collar crime. Ever since Sutherland (1949) coined the term ‘white-collar crime’, the definitional problem of what constitutes “fraud” has proven to be an “intellectual nightmare” (Geis & Meier, 1977, p. 25; see also Berger, 2011). Despite the fact that in inaugurating the concept Sutherland went to great lengths to define white-collar crime both through elaboration and examples, debate continues as to the proper definition of the term (Coleman, 1985; Gottfredson & Hirschi, 1990; Lynch et al., 2004).

Psychological traits such as dishonesty, greed and self-interest are seen as the main motivations for fraud. This dominant perspective of fraud considers it to be an abnormal phenomenon, perpetuated by rational actors who make decisions that are not influenced by their situational context (Palmer, 2012).

Recent research has described the way in which institutional processes and practices influence fraud (Davis & Pesch, 2013; Gabbioneta et al., 2013; Née, Everett, Rahaman, & Martinez, 2013; Sikka, 2010a, 2010b). Sikka’s (2010b) work on tax evasion and avoidance is instructional here. He (2010b) notes that companies legitimise their social credentials by promising responsible and ethical conduct; however, organizational culture and practices are not necessarily aligned with these publicly espoused claims (p. 153). His work draws attention to the gap between corporate
talk, decisions and action culminating in organized hypocrisy in regard to what corporations say and do, particularly as they need external legitimacy whilst internal practices pursue profits at almost any cost (p. 165).

To illustrate how the discourse on the “opportunity” to commit fraud is constructed to privilege a particular situational context at the exclusion of others, let’s revisit the Lehman case. In this case, the main players were the executives, Lehman’s accountants and the Company’s auditors, Ernst & Young (“E&Y”). The bankruptcy examiner of the Lehman Brothers Case (Anton Valukas (2010) was critical of E&Y’s part in the collapse; according to Valukas (2010), E&Y took no steps to question the non-disclosure by Lehman’s executives of the $50 billion, off-balance sheet transactions that flattered the bank’s financial position. Rather, it seems that E&Y was encouraging participants to present Lehman’s low leverage as positive news to investors (Jeffers, 2011). Together, E&Y colluded with Lehman’s executives and in-house accountants to take advantage of accounting rules in order to present a favorable financial statement to stakeholders (Valukas, 2010). The misleading portrayal of Lehman’s true financial health appears to have been perpetrated through the actions of individuals working together either within the organization or across organizations; as opposed to being the actions of a single misguided individual (see Ashforth & Anand, 2003, p. 2). Fraudulent practices were disseminated throughout Lehman via an institutional process that allowed such practices to prosper (Gabbioneta et al., 2013). E&Y was co-opted by Lehman’s executives and tacit agreement was fostered to turn a blind eye to fraudulent practices (see also Ashforth & Anand, 2003, p. 11). This secret cooperation amongst individuals became more difficult to detect when one of the gatekeepers (in this case E&Y) responsible for monitoring such behavior became part of the problem (Coleman, 1985).

Come to think of it, it may be rather naïve to picture “opportunity” as something Lehman’s executives recently discovered and were seduced by to commit fraud (Brytting et al., 2011, p. 52). Rather, as the evidence suggests, fraud is less the result of solo-offending and more the result of collusion between senior managers and their vastly experienced inner circle of accountants and information technology experts (see also Coleman, 1985; Donegan & Ganon, 2008; Free et al., 2007; Lokanan, 2014; Mitchell et al., 1998; Morales et al., 2014). The fraud is
usually perpetrated by these individuals who cleverly camouflage and manipulate internal controls to carry out the fraudulent act (Free et al., 2007; Lokanan, 2014; Mitchell et al., 1998). It takes specialized knowledge to commit fraud, and to some extent it may seem as if the organization’s control system has been consciously re-designed into an opportunity for fraud (Brytting et al., 2011, p. 52). Accordingly, it is not always opportunity that leads to fraud and it could be the other way around, with the fraudsters creating the opportunity to commit the fraud (p. 52). The fraud triangle’s inability to explain the more collusive corporate frauds therefore presents parsimonious discourse of offending (Free & Murphy, 2013, p. 30). The collusion to commit fraud amongst individuals within the organization, as well as across organizations, does not appear to fit the fraud triangle’s framework.

### Conclusion

Going forward, it is important that anti-fraud research recognizes that predators do exist and provide professionals with the requisite skills for detecting the distinguishing characteristics for exposing the predatory fraudster (Dorminey et al., 2012). To assist in this cause, “a stronger understanding of the role of culture and institution in promotion, persistence and prevention of fraud would enable [anti-fraud professionals] to address some of the more systemic issues on a macro-level” (Cooper et al., 2013, p. 452). In the sociology and criminology literature on white-collar crime, there is a long standing concern to locate wrongdoing within wider societal influences (Braithwaite, 1985; Coleman, 1985; Colvin et al., 2002; Hirschi & Gottfredson, 1989; Hirschi, 1969; Wikström & Treiber, 2007). This social science understanding “starts from a position that morality and fraud are neither personal nor universal, but are situated in specific social and historical contexts” (Cooper et al., 2013, p. 445). Fraud is multifaceted and is a reflection of the perpetrator’s surrounding habitat. As such, a consideration of the wider macro social and economic dimensions are all critical for gaining an understanding of the unethical behavior that could eventually lead to fraud (Cohen et al., 2010; Coleman, 1985; Cooper et al., 2013; Donegan & Ganon, 2008; Gabbioneta et al., 2013; Misangyi, Weaver, & Elms, 2008; Morales et al., 2014). This integrated approach “highlights the value of a more situated view of
how fraud takes place” (Cooper et al., 2013, p. 451), and provides additional insights on its socio-political origins (Davis & Pesch, 2013; Morales et al., 2014).

References


