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Managerial Finance; 2000; 26, 11; ProQuest Central
pg. 33

Understanding Fraud in the Accounting Environment

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Abstract

The paper presents a general framework to be used for identifying those situations most conducive to fraud in the accounting environment. The framework relies on models and theories from criminology including the conflict and consensus approaches, the ecological theory, cultural transmission theory and anomie theory.

Fraud in the accounting environment is on the increase, causing enormous losses to firms, individuals, and society and creating a morale problem in the workplace [Levy, 1985; Gaines, 1988]. It takes place as corporate fraud [Merchant, 1987], white collar crimes [Bequai, 1978] and audit failures [St. Pierre and Anderson, 1988]. Fifty-nine percent of the respondents to a KPMG 1998 Fraud Survey believe that fraud will become more of a problem in the future, which is a seven percent increase from 1994. The fourteen types of fraud were medical/insurance claims fraud, false financial statements, credit card fraud, check fraud, inventory theft, bid rigging and/or price fixing, ATM theft, false invoices and phantom vendors, diversion of sales, expense account abuse, unnecessary purchases or purchases for personal use, conflict of interest, kickbacks, and payroll fraud. The leading reasons cited for the expected increase in fraud are: a) economic pressures, b) inadequate punishment of convicted animals, c) weakening of society's values, d) insufficient emphasis on prevention and detection, and e) more sophisticated criminals. Poor internal controls, management override of internal controls, and collusion between employees and third parties are also seen as factors contributing to fraud. One important issue is the determination of the causes and the provision of an explanation for the situation. One approach has been to rely on descriptive characteristics of the person or the situation that may lead to fraud in the accounting environments. The result has been a list of "red flag" characteristics to watch for in the course of an audit [Bologna, 1984, p.39; Merchant, 1987, p.12 and Elliot and Willingham, 1980]. For example, Elliot and Willingham [1980] distinguished between situational pressure red flags and personality red flags. Red flags identified by the KPMG 1998 Fraud Survey were: personal financial pressure, vices (e.g. abuse of drugs, alcohol, or gambling), extravagant purchases or lifestyle, real or imagined grievances against the company or management, ongoing transactions with related parties, increased stress, internal pressure (e.g. management pressure to meet budgets) and short vacations/unexplained hours. Although these descriptive characteristics may be useful in the detection of potential for fraud in the corporate environment, they do not provide an adequate explanation of what fraud occurs in the accounting environment (Akst and Berton, 1988; Berton, 1988). The field of criminology offers various models and theories that are very much applicable to fraud in the accounting environment and offers various alternative explanations for the phenomenon. They can also be integrated into a general framework to be used for identifying these situations most conducive to fraud in the accounting environment.

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1. **The Conflict and the Consensus Approaches**

The consensus and the conflict approaches are two major views that hypothesize about law and society [Carley, 1978, p.8]. Influenced by anthropological and sociological studies of primitive law, the consensus approach sees laws developing out of public opinion as a reflection of popular will. The conflict approach sees laws as originating in a political context in which influential interest groups pass laws that are beneficial to them.

Using the conflict approach to explain fraud in the accounting environment, it can be argued that accounting interest groups presented a favorable picture of their problematic situations by insisting that they can control for fraud and worked to get their view of the situation more widely recognized. The process led to less stringent regulation enacted for fraudulent reporting cases and white-collar crime. Basically, it fits with the notion that the criminal law that emerges after the creation of the state is designed to protect the interests of those who control the machinery of the state, including the accounting profession.

The consensus approach refers instead to the widespread consensus about the community's reaction to accounting fraud and to the legislation enacted. The consensus approach to accounting fraud may have resulted from either the ignorance or the general indifference of the general public to the situation. Another explanation is the idea of differential consensus related to the support of criminal laws [Gibbons, 1969]. While serious crimes receive strong support for vigorous actions, crimes relating to the conduct of business and professional activities generate an apathetic response.

Using again the conflict model of crime, the origin of the fraudulent practices in accounting may be linked to a society's political and economic development. As society's political and economic development reach higher stages, institutions are created to fulfil new needs and to check aggressive impulses. In the process, these monitoring institutions create a system of inequality and spur the aggressive and inquisitive impulses that the consensus model of crime mistakes for part of human nature. It is the powerful elite rather than the general will that arises to label the fraudulent practices of accounting as criminal because these crimes affect these elite as they are related to the possession and control of property. At the same time, members of the same elite constitute a major component of those participating in the fraudulent practices of accounting. Their motivation to engage in the practices remains the question. The conflict model of crime would attribute the practices to a system on inequality that values certain kinds of aggressive behavior. Basically, those engaging in fraudulent practices in accounting are reacting to life conditions of their own social class: acquisitive behavior of the powerful on one hand and the high-risk property crimes of the powerless on the other hand. One would conclude that the focus of the attack on fraud in accounting should be towards the societal institutions that led to the isolation of individuals. It implies a reorganization of those institutions to eliminate the illegal possession of rights, privileges, and position [Carey, 1978, pp.36-41].

2. **The Ecological Theory**

An examination of some of the notorious accounting frauds, white-collar crimes, and audit failures may suggest that some criminal types are attracted to business in general and accounting in particular [Earle, 1972]. Therefore, criminal cases are not indicative of a general phenomenon in the field, but the result of criminal actions of the minority of criminal types that have been attracted to the discipline of accounting. This approach is known as the

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"Lombrosian" view of criminology [Carey, 1978]. But with the Lombrosian theory of a physical "criminal type" losing its appeal, the ecological theory appears as a more viable and better alternative to an explanation of the fraud phenomenon in accounting. It adopts the concept of social disorganization as a basis of explanation of the fraud phenomena in accounting. By social disorganization, it is meant the decrease in influence of existing rules of behavior on individual members of the group. Criminal behavior in the accounting field is a result of a basic social disorganization. First, the weak social organization of the accounting discipline leads to criminal behavior. Second, with the social control of the discipline waning because of the general public indifference, more accountants are freed from moral sensitivities and are predisposed to corporate fraud, white-collar crime, and audit failure. It is the general public's failure to function effectively as an agency of social control that is the immediate cause of corporate fraud, white-collar crime, fraudulent financial reporting, and audit failure.

3. **The Cultural Transmission Theory**

Unlike the ecological theory, which assumes that criminal behavior is a product of common values incapable of realization because of social disorganization, the cultural transmission theory attempts to identify the mechanisms that relate social structure to criminal behavior. One mechanism is the conception of differential association, which maintains that a person commits a crime because he/she perceives more favorable than unfavorable definitions of law violation. A person learns to become a criminal. As explained by Sutherland [1945, p.240]

> "As part of the process of learning practical business, a young man with idealism and thoughtfulness for others is inducted into white-collar crime. In many cases, he is ordered by a manager to do things which he regards as unethical or illegal, while in other cases he learns from those who have the same rank as his own how they make a success. He learns specific techniques for violating the law, together with definitions of situations in which those techniques may be used. Also, he develops a general ideology."

This mechanism assumes, then, that delinquents have different values than non-delinquents. Criminal behavior is the result of values that condone crime. Criminals have been socialized to accept these values. They were transmitted into a culture of crime. Their behavior is an expression of specific values [Miller, 1958].

Basically, what is implied is that fraudulent behavior in accounting is learned; it is learned directly, or by indirect association with those who practice the illegal behavior. An accountant engaged in fraud because of the intimacy of his or her contact with fraudulent behavior. This is called the process of "differential association." Sutherland [1940, p.12] explains as follows:

> "It is a genetic explanation of both white collar criminals and lower class criminality. Those who become white-collar criminals generally start their careers in good neighborhoods and good homes, graduate from colleges with some idealism, and with little selection on their part, get particular business situations in which criminality is practically a folk way. The lower-class criminals generally start their careers in deteriorated neighborhoods and families, find delinquents at hand from whom they acquire the attitude toward, and the techniques of, crime through association with delin-

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> quents and through partial segregation from law-abiding people. The essentials of the process are the same for the classes of criminals."

4. Anomie Theories

Anomie, as introduced by Durkheim [1964], is a state of normlessness or lack of regulation, a disorderly relation between the individual and social order, which can explain various forms of deviant behavior. Merton's [1938] formulation of anomie focuses not on the discontinuity in the life experiences of an individual but on the lack of fit between values and norms that confuses the individual. For example, in achieving the American dream a person may find himself or herself in a dilemma between cultural goals and the means specified to achieve them. The solutions that can be adopted include conformity, innovation, ritualism, retreatism or rebellion [Merton, 1957, pp.131-60].

Conformity to the norms and use of legitimate means to attain success do not lead to deviance. Innovation refers to the use of illicit means to attain success and may explain white-collar crime in general and fraudulent accounting and auditing practice in particular. The use of innovation may erase the distinction between what is acceptable business mores and sharper practices beyond the mores [Merton, 1957, p.144]. Ritualism refers to the abandoning of the success goal but also to abiding compulsively to institutional norms [Merton, 1957, p.150]. Retreatism is basically a tacit withdrawal from the race, a way of escaping it all. Finally, a rebellion is a revolutionary rejection of the goals of success and the means of reaching it.

These adaptations are the results of the emphasis in our society on economic success and the difficulty of achieving it. Deviant behavior is an unexpected outcome.

> "It is only when a system of culture values extols, virtually above all else, certain common success goals for the population at large while the social structure rigorously restricts or completely closes access to approved modes of reaching these goals for a considerable part of the same population, that deviant behavior ensues on a large scale" [Merton, 1957, p.146].

Interestingly enough, Merton goes as far as to suggest that deviation develops among scientists because of their emphasis on originality. Given limited opportunity and short supply, scientists would resort to devices such as reporting data that support one's hypothesis, secrecy, stealing ideas, and fabricating data [Merton, 1957].

Unlike Durkheim, Merton believes that anomie is a permanent feature of all modern industrial societies. The emphasis on achievement and the pressures that result lead to deviance. The anomie thesis is further explored in the works of Cohen [1955] and Cloward and Ohlin [1960]. Cohen [1959] attributes the original criminal behavior to the impact of ambition across those social positions for which the possibilities of achievement are limited. What results is a nonutilatarian delinquent subculture. Individuals placed in low positions accept societal values of ambition but are unable to realize them because of lack of legitimate opportunities to do so. Cloward and Ohlin [160, p.72] suggest that the resulting delinquent behavior is, however, conditioned by the presence or absence of appropriate illegitimate means.

Corporate fraud, fraudulent reporting practices, white-collar crime, and audit failures are a direct result of anomie in modern societies. Basically, delinquent accountants emerge

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among those whose status, power and security of income are relatively low but whose level of aspiration is high, so that they strive to emerge from the bottom even using illegal ways. It results from the discrepancy between the generally accepted values of ambition and achievement and the inability to realize them, and the availability of appropriate illegitimate means.

A Framework for Fraud in Accounting

The various theories from the field of criminology offer alternative explanations for corporate fraud, white-collar crime, fraudulent financial reporting, and audit failures. They can be integrated in a framework to be used in identifying those situations most conducive to fraud (see Exhibit 1). Basically, the framework will postulate that corporate fraud, white-collar crime, fraudulent financial reporting and audit failures will occur most often in the following situations:

1. Situations in which accounting and business groups have presented a favorable picture of their problematic situation by insisting that they can control for fraud and worked to get their view of the situation more widely recognized. What may exist is a situation in which the accountants and/or businessmen have stated they are taking private actions to avoid public regulation of the phenomenon, where in fact their actions were mere cosmetic changes of camouflage of serious problems in the profession. There have been many examples of situations in which the accounting profession has argued for private regulation of various problems that affect the profession, the discipline, and standard setting, and has thwarted the actions of legislators who were trying to put a stop to the abuses [Collins, 1985; Connor, 1986; Earle, 1972; Minow, 1984; National Commission on Fraudulent Financial Reporting, 1987]. One has only to recall the failures of various congressional committees investigating the profession to illustrate the point. From a conflict approach, this is clearly a situation in which the interests of those who control the machinery of the state, including the power of the accounting profession, are protected from stringent regulation.

2. Situations in which societal institutions have accummulated power, privileges, and position, creating a perception of inequality in those who are not members of these institutions. Basically, the situation may lead to an isolation of individuals in a situation in which the acquisitive behavior of the powerful is evident in their daily lives. The lower-class accountant may react to this situation of powerlessness, inferiority and exclusion by resorting to fraudulent practices. It would be a mere reaction to a system of inequality that values aggressive behavior as explained by the conflict model.

3. Situations in which firms in general have attracted some criminal types. This Lombrosian view of the phenomenon applies to various cases of accounting frauds.

4. Situations in which social disorganization in general and failure to apply social control exist. Basically, weak social organization of the discipline and failure of the general public to be concerned creates a climate conducive to accounting fraud.

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5. Situations in which people are placed in a system of values that condones corporate fraud, white-collar crimes, fraudulent financial reporting, and audit failures.

6. Situations in which there is a lack of fit between values, and norms that confuses the individual.

Conclusion

Unethical or criminal acts by workers costs US businesses more than $400 billion a year. As a result a greater concern is being shown for business ethics. A log of companies got religion after the adoption of laws called the Federal Sentencing Guidelines where the government codified fines and penalties for corporate wrongdoing. The most serious wrongdoing arises from fraud in accounting. Accordingly, this paper presented a general framework that can be used for identifying those situations most conducive to fraud in the accounting environment. The framework relies on models and theories from the field of criminology including the conflict and consensus approaches, the ecological theory, cultural transmission theory and anomie theories. Each of those theories offers a description of the fraud environment, its sources and causes that can be used to categorize some of the fraud perpetrated in the accounting world. It calls for companies to identify these situations most conducive to fraud, reevaluate their ethics programs and strengthen their internal controls. It is interesting to notice that the Federal Sentencing Guidelines granted some leniency to companies with concrete internal programs to detect and prevent illegal acts.

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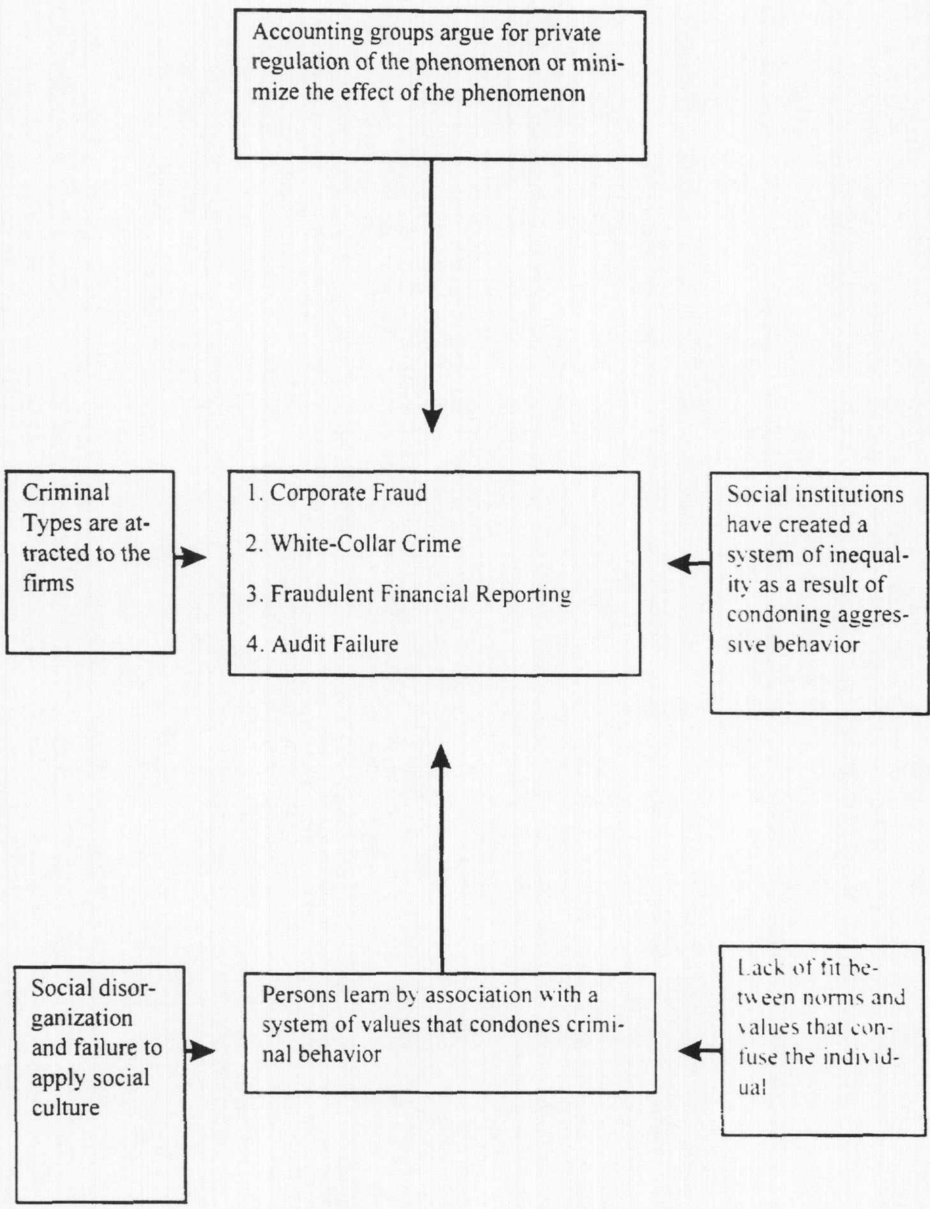

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