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Analyzing the Worst Corporate Accounting Scandals: Theoretical Framework Perspective

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Abstract

This paper offers additional worth insights and knowledge to enhance our understanding of the causes of fraud beyond fraud triangle framework by analyzing the worst current corporate scandals from various perspective of theories. These insights are synthesized from contemporary thinking and current research findings aimed to give significant contribution to practitioners in terms of the fighting against fraudulent financial statement and as well as academic environment in terms of developing theory. Undoubtedly, imperfect prevention mechanisms, for example, due to lack of adequate managing information systems, are categorized as a major factor that allows business organizations to become very vulnerable to be defrauded by perpetrators. Financial fraud can be perpetrated by organizational insiders or outsiders. However, the catastrophic threat comes from disgruntle workers, regardless level of positions in that company, who are authorized to access the company's systems. Insider threats become the most hazardous threat and a very complicated concern to solve because they typically have already known the firm's system weaknesses. In this case, greed and acquisitiveness from organizational insider threat may arise due to powerful belief that firm should pay for perceived inequities. Accordingly, this paper suggests recommendations in the form of plausible applicable measures to fight against this kind of crime.

Keywords: fraud triangle, fraudulent financial statement, fight against, corporate scandals, prevention, threat references

1. INTRODUCTION

Fraudulent financial statement is an intentional deception of the financial statement aimed to gain tangible or intangible assets, for example, reporting fictitious sales/revenues, reporting income or expense into the present year which essentially belongs in the following one. Financial statement fraud is defined by ACFE (2014), as "The intentional, deliberate, misstatement or omission of material facts, or accounting data which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision". Rezaee and Riley (2010) define it as deliberate misstatement or omission of amounts or disclosures of financial statement to deceive financial statement users, particularly investors and creditors.

Fraud comprising Corruption, asset misappropriation, and fraudulent financial statement is nondiscriminatory, nevertheless private sector entities are generally more at risk than other ones as evidenced by table 1 below. Because published audited financial reporting has crucial roles in capital market, internal and external auditors should carefully scrutinize and notice the information may be misstated by management and the red flag of the likelihood of fraud. Therefore, the aim of this paper is to address fraudulent financial statement scandals occurred in private sector organizations by analyzing why financial statement fraud become successful in that sector where it will be critically appraised from various perspectives such as agency theory, psychology theory

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and fraud triangle theory. Additionally, this paper will suggest possible best measures (recommendations), based on the cases presented in this paper, to mitigate those financial crimes. The implication of this paper is to give significant contribution of knowledge and insight to academic environment as well as practice world in terms of combating fraudulent financial statement scandals in private sector organizations.

Table 1: The worst corporate accounting scandals

Name of Scandal	**Key Description**
1. Enron Scandal (2001)	Company: Houston-based Commodities, Energy and Service Corporation. What happened: Shareholders lost $ 74 billion, Key players: CEO Jeff Skilling and former and CEO Ken Modus operandi: Kept huge debts off the balance sheets
2. American Insurance Group Scandal (2005)	Company: Multinational Insurance Corporation What happened: Massive accounting fraud to the tune of $3.9 billion, bid-rigging, manipulated stock price. Key player: CEO Hank Greenberg Modus operandi: Allegedly booked loans as revenue, steered clients to insurers
3. Lehman Brothers Scandal (2008)	Company: Lehman brothers; Global finance services firm What happened: Hid over $50 billion in loans disguised as sales Key players: Lehman executives and the company's auditors, Ernst & Young Modus operandi: Sold toxic assets; created the impression Lehaman had $50 billion more cash and $ 50 billion less in toxic assets that it really did.
4. Bernie Madoff Scandal (2008)	Company: Lehman brothers; Global finance services firm What happened: Hid over $50 billion in loans disguised as sales Key players: Lehman executives and the company's auditors, Ernst & Young Modus operandi: Sold toxic assets; created the impression Lehaman had $50 billion more cash and $ 50 billion less in toxic assets that it really did.
5. Saytam Scandal (2009)	Company: Indian IT services and back-office accounting firm What happened: falsely boosted revenue by $ 1.5 billion. Key player: Founder/Chairman Ramalinga Raju Modus operandi: falsified revenues, Margins and cash balances to the tune of 50 billion rupees.

Source: Conlen, (2015)

2. ANALYZING FRAUDULENT FINANCIAL STATEMENT SCANDAL

Before going further, it is very important to take into account prudently why the vast majority of white-collar classes are inclined to perpetrate fraudulent financial statement. In that concern, Rezaee (2005), claims that the opportunity of perpetrators to commit financial crimes arises when the company's internal control systems become weak, the quality of its internal audit roles deteriorates and its corporate governance be less operative. The common factors "*red flag*" affecting financial crimes are pressure, opportunity and rationalization, which are collectively known as fraud triangle (Cressey, 1986). In addition, there are some other factors and conditions, such as the understanding of the weaknesses of the entity's internal control systems, access to accounting records or assets, lack of supervision, unethical tone at the top and belief that it cannot be arrested, that enable person to abuse his (her) authority to mislead information including company's tangible or intangible assets motivated by self-interest, (Fraud Risk, 2009).

Ashforth and Anand (2003), state that a harmful or fraudulent activity generally occurs within firms when malevolent executives ask subordinates to commit wrongdoing. Gillett and Uddin (2005), find that CFOs' behavior of large firms is more likely to mislead stakeholders by presenting false financial statement. Similarly Cohen et al. (2010), find that a self-interested manner motivates some people to perpetrate income smoothing. Because of those concerns, therefore, the major responsibility of corporate governance participants is to establish and maintain the adequate and effective internal control activities, and to ensure that financial reporting disseminated to the public is free from potential risk of material misstatement due to mismanagement or fraud. There are many fraudulent financial reporting scandals involving the failure of the board of director composition to fulfill their primary responsibility for managing and controlling their company performance. For instance, the cases are presented in the table 1 above**.** Those cases are categorized as organized complex crimes, involving many people, companies and cross organizational borders.

The important lesson to be learned from real milestones in those cases is that fraud occurred because there is conflict of interest that arises due to imperfect contract between principals and agents where agent's performance is measured based on final outcome. As consequence, Information asymmetry to misrepresent information is one of undeniable facts in those workplace phenomena. This inherently mobilizes an encouragement of moral hazard where the principals will not know whether the agents have already run organization in accordance to principals' interest. If an inadequate control of moral hazard does take place, it becomes terrible situation that can lead to emerging risky effects as demonstrated in those case that are presented in the table. As a concrete evidence, it suggested by a study carried out by Pavel and Encontro (2012), outlined that Enron culture was heavily influenced by competition and since the employees were motivated by fat bonuses and scared of getting laid off if they did not perform well, and in effect resulted to an unhealthy competition between the co-workers. Basically, the primary responsibility of agents is to conduct the preservation of business's tangible and intangible assets and to operate firm's activities always in the greatest business of their principals.

Broadly, the proposed mechanism to minimize information asymmetry and moral hazard are through incentive and monitoring, where the board of directors should also takes role in that main monitoring mechanism (Jensen 1993, Daily et al. 2003). One of the common causes that tends to arise conflict between agents and principals is the dissimilarities of view (goal) as clearly showed in the table 2.

Table 2: Agency theory

Party	**Objective**
Principal	Safe investment
	Regular dividends
	Long-term capital growth
	Maintenance of value
Agent	Salary and benefits
	Maximum bonus
	Share options
	Personal success of successful business assessed by share price

Source: Taylor (2011)

According to table above, it can be accepted that the improper ownership separation regarding internal control structure and the uncontrolled emerging power of corporation will encourage managers to adopt aggressive accounting practices that may intentionally mislead figures (accounts) presented in financial reporting. Substantially evidenced by the recent fraudulent financial reporting cases in private sector organizations are showed at previous table. The managers in those organizations, including founder of organizations actively colluded in misleading potential investors or costumers to maintain enriching themselves in the process of their business even though their corporate situation in the real situation stands at unsustainable share price. To deal with that concern, agency theory constitutes one of best analysis tools to overcome the different interests between principals and agents because it provides important root map, for agents, of how to conduct and behave in the best interest of their participants and how to separate control system appropriately in the organization (Jensen and Meckling, 1976).

Furthermore, Taylor (2011), argues that agency theory contains “the structural framework on which principles of corporate governance are based and what follows it”. Therefore, it may be assumed that the cornerstone of that theory is to limit the interests of principals and agents by providing proper monitoring for agents' performance to ensure they act in the owner's interests. In addition, other factors affecting those cases became successful are pressure, opportunity, and rationalization. Those elements are generally known as fraud triangle (Cressey, 1986). All of fraudsters in those cases had a high level of authority (power) to control the company operation including assets and finally they misuse that authority (power) to perpetrate fraud motivated by self-interests and (or) their own parties. Many researchers conducted studies to find correlations between the existing of three components of the fraud triangle and financial statement fraud. Hogan et al. (2008), synthesize that another factor directly contribute to the likelihood of fraudulent financial reporting is pressure from higher position to satisfy analysts' forecast, rapid growth, poor performance, and need for financing. Because those fraudsters, in the previous table, have power and understand the whole of organization's internal control activities, they can easily study its weaknesses to ensure that their desire to do unethical and wrongful conducts is safe and success. All of cases mentioned in this paper are strongly contradict two published academic studies conducted by Burns and Kedia (2006) and Erickson et al. (2006). The former found that the responsiveness of other components of CEO compensation have little influence on the propensity to misstatement. Moreover, the latter reveal that there is no consistent evidence to support the judgment that the possibility of financial statement fraud has relation with the sensitivity of executive's total equity to change in stock prices.

Moreover, People who are very ambitious with power or having too much power proportion are more likely to get involved in risky behaviour that finally can lead to commit fraud by abusing their authority (Duffield and Grabosky, 2001). The last but not the least, the final component affecting perpetrators to conduct wrongdoing especially to misreport financial statement is moral justification. In other words, those exclusive activities of criminal syndicates occur successfully due to moral justification from perpetrators with low empathy on damages caused by their harmful acts related to the insidious nature of accounting system piracy. This effectively and directly enables their ideology and rationalization to legitimate wrongdoing or violence as divine ordination without any feelings of righteousness. Because fraud perpetrators commonly rationalize their acts, they always assume their harmful actions as not big problem or assume that their company should deserve that consequence because there is no fair proportion between rewards (salary) and their dedication (works). An empirical study carried out by Murphy and Dacin (2011), reveals that rationalization is a mechanism that allows people to justify inappropriate manner to commit fraudulent activities.

Psychological perspectives of the perpetrators

Psychology is the science of the functions, phenomena and nature of mental experience and human behavior (Colman 2003). Recently, behavior scientists had failed to identify a well-understood and well-defined psychology characteristic that are diagnostic about fraud perpetrator propensity (Samamoorti, 2008). The most common conceptual framework related to fraud is the so-called fraud triangle that broadly spread by Association of Certified Fraud Examiners (ACFE). An empirical research proved that most fraud schemes have already been perpetrated due to the existence of fraud triangle components in organization (Bell and Carcello 2000; Hogan et al. 2008). As a recent example, LaSalle (2007) finds that the three elements of fraud triangle tend to increase the possibilities of fraudulent financial statement risks. Nonetheless, white-collar crimes in the table 1 may not be fully influenced by fraud triangle components as the antecedent to fraud.

Even though the fraud triangle is known widely as great fraud concept, there are other factors that still have strong influence to encourage an individual to commit fraud such as greed and acquisitiveness that may arise because there is belief that organization should pay for perceived inequities. A study carried out by Al-Saggaf et al. (2015), reveals that one of the surprising findings from that research is that unethical behavior in the Australian Information and Communications Technology (ICT) workplace is triggered by greed factor. Because the cases presented in the Table 1 committed by the agents that work on behalf of organization, we should fully pay attention to their motivation (identifying supplementary psychological antecedents/or personality characteristics) and determine both why and how they commit fraud.

Moreover, it broadly accepted that the personality characteristics cannot be ignored in understanding of the root causes of fraud within organization because another study conducted by Samamoorti (2008), shows that fraud detection and deterrence should pay attention fully on how to overcome the interpersonal dynamics (the fraudsters psychology) because they have preliminary influence to fraud perpetrators. Hollin (1989) documented that uncontrolled human personality (psychology) and environment atmosphere have greater contribution to emerging criminal behaviours in society. Thus, employees who have unmanaged psychology characteristics undoubtedly incline to commit unlawful conduct because their mindset predominantly are constructed by moral justification and their palliative characteristics will directly mobilize to psychological mechanism. Those are very dangerous threat because their conducts and ways will be exceedingly perilous for others. From this situation, the organization should be able to establish proper anti-fraud program and control. For doing that, understanding of behavior and psychological aspects affecting fraud perpetration is the main factor for creating responsive detection and deterrence systems and proactively handling the financial fraud risk. Therefore, in looking at the elements that have relation to fraud in a general context, as well as specific categories of fraud, it should be understood that psychological factors may be viewed as the considerable causes that encourage person to conduct fraud.

3. HOW TO FIGHT AGAINST THOSE SCANDALS

Organization commitment nowadays is increasingly playing crucial roles in terms of promoting positive workplace culture that are free from fraudulent acts, because Mowday et al. (1979) claim that the commitment of organizational as the strength of people’s attributes to get involved in and behave the best manner to achieve organization objectives. If an individual has strong commitment to a company, he (she) will work hard on behalf of company’s values systems and objectives. Therefore, an individual who feel committed to his (her) employing organization, whether organization internal control system circumstances become less effective, is more likely to be consistent with organization objectives by fostering professionalism, than an individual who does not feel committed. In addition, it is very important for organization to strengthen the level of its employees’ commitment that is started from maintaining effective working relationship among organization members in order to stay comfortable in the organization. Moreover, that organization takes proper measure to enhance those ones’ commitment that it can generally be fostered by giving them positive experiences, including an understanding of anti-fraud programs. An empirical study finds that employees who have strong level of commitment to their company tend to be better corporate participants than those who have low level of commitment (Meyer et al.1993).

Alarmingly, people, nowadays, cannot control or fight their desires to do what should not to do. In other words, they are too weak to deal with the situations of temptation. Because of it, that situation is deduced that the inordinate desires may drive an individual to astray. In this context, rewards and punishment are better possible solution for organization to improve (at least maintain) employees’ commitment in order that they do their duties based on the company objectives and principals' interests with a high level of productivity and honesty ethics, and to address negative desires (greed). Due to the situations as discussed above, this article recommends some measures to prevent fraud scandals in order not to occur again in the future. Those measures include:

Applying code of conduct or ethical standards

The organization should apply and promote good moral and ethical standards and these must be equally implemented to workers, all level of managers, and even officers. Because the likelihood of fraud not only comes from internal factors, but it is also affected by external ones, these standards should be also applied to vendors, customers, and suppliers alike. All of these standards should provide pivotal guidance for people how to conduct their routine activities with clear directions. If stakeholders hold these ethics, they will strive to avoid deeds that could establish conflict of interest, corruption, collusion, fraudulent financial statement and put the interests of the company ahead of personal interests, clan or tribe. Apart from that, they always try to apply the principles of transparency, independence, accountability, and fairness in managing a company. Undoubtedly, one of the biggest security assets owned by an enterprise is its employees, but only if they have already understood and made commitment to comply with security policies ruled in that enterprise.

Encouraging effective board of director composition

The board of director composition is increasingly playing an important role of reducing the occurrences of fraudulent financial statement because it has a responsibility to supervise top managements' performance. An organization's board of director have not only an obligation to ensure that an organization have good controls to deal with the likelihood of frauds but also they have a duty to ensure that such controls run effectively to prevent and minimize potential misstatement due to fraud. Because the existence of fraud is strongly affected by an entity's environment conditions, both inside and outside operating systems, the directors and chief executives officers should create a culture of perfect ethics and integrity.

In addition, an unqualified financial report has direct links with the effectiveness of board of director structure as substantially demonstrated by qualified research findings. As examples, Romano and Guerrini (2012), find that firms committing fraud schemes have lowest percentage of independent boards and fewer non-executives than Non-fraud Corporation. Similarly, Farber (2005), finds that fraud company has weak corporate governance than non-fraud company. Therefore, organization's leaders should be able to encourage their employees' awareness to identify unusual things as many as possible that are potentially vulnerabilities to be attacked by perpetrators, and should evaluate them on continuous basis, and determine what types of appropriate actions/ controls are in place that can reduce those threats whether they come from organizational insider or outsider. A simultaneous independent review from high authority might highlight the areas in which internal controls are not designed adequately or are not being followed. Basically, the major objective of such an assessment in this section is to enhance the effectiveness of internal control environment within organization and mitigate the opportunity for fraudulent activities.

Encouraging an effective whistleblowing system

Whistleblowing in business world is usually assumed as morally unjustifiable actions because it impairs the duty of confidentiality and loyalty to the organization and fellow employees. However, it is generally accepted that encouraging a positive whistleblowing culture within company is good business practice to deter wrongdoing whether caused by error or fraud. In other words, fair complaint system can boost employees' loyalty to the organization by demonstrating a commitment to keep an ethical atmosphere in the workplace. Several academic studies have already proved that a fraud hotline for reporting of suspicious wrongdoings is the most effective way to prevent and detect fraud in early stage (Buckhoff, 2003; Newswire, 2005). By providing a confidential hotline service, whistleblowers will report potential wrongdoing, ethical issue, and other concerns with high level of confidence, because that service can minimize harassment, discrimination and retaliation from suspected wrongdoer (O'Rourke, 2012; Rolin, 2015). Therefore, to encourage employees and business's colleagues makes report of suspicions of malfeasance, organization should establish a whistleblowing policy especially governing whistleblower's identity protections, and then place an advertisement in the staff break room with a hotline number that employees and organization's clients can call to confidentially report suspicious fraudulent conducts in the workplace.

Implementing programs dealing with conflict of interest and information asymmetry

The first measure that should be considered to deal with conflict of interest and information asymmetry is that establishing strict policies and procedures that regulate specific proper act with trading clients and define consequences of violating that rules. The program regulating this concern must be consistently applied and stated that these kinds of wrongful behaviors cannot be tolerated, including violation by senior management. In addition, the conflict of interest and information asymmetry policy should be publicly disseminated to business colleagues, as well as directions that any deviations from that policy should be conveyed to proper authority within organization, for example a compliance officer. Furthermore, another step to deal with these concerns is that board of director and line managements must get involved with periodically main monitoring and encoraging employees to share their business activities information in order to remove the impediments of access to business information. In this point, if ingrained practices of sharing information do take place in that organization, there is no doubt to argue that it obviously can help to alleviate the likelihood of information asymmetry impeding business activities and the prosecution of potential financial crimes. In relation to this concern, corporate culture plays a special role. Because the various corporate governance participants are being required to greater levels of accountability to establish a positive business atmosphere where the possibility of material fraud risks is mitigated, the conflict of interest and information asymmetry policy which is encouraging information sharing among employees, whether it is horizontal and vertical communication, complimented by committed professionals is one of the possible best deterrence for preventing financial crimes within organization.

4. CONCLUSION

Fraudulent financial statement constitutes one of dangerous financial crimes. The result of this study confirms that the enterprises and auditors should notice and consider carefully at the internal control activities. The fraud triangle consisting of pressure, opportunity, and rationalization is famous theoretical structure to understand why people commit fraud. However, it will be helpful and complete if fraud deterrence and detection try to look at psychology of fraud perpetrator condition.

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