Management Fraud: A Dilemma of Today's Society

An Honors Thesis (HONRS 499)

by

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The discussion of fraud is limited to management type frauds committed for or against a company. Management frauds are perpetrated by those who are in an upper-level or supervisory position and consist of willful misrepresentation of financial information. The paper proceeds with suggested approaches used by accountants to discover potential fraudulent situations. A motivational study conducted by Michigan CPAs is included in the discussion of fraud criminals. Another study by two criminologists has been included as a source of characteristics of possible fraud perpetrators and compares them to normal individuals and property offenders. Another motivational study by Michigan CPAs is presented in the discussion of fraud criminals. Finally, a list of different types of management fraud is examined along with ways to prevent and detect their occurrence.
Ethical values of many United States citizens have greatly diminished since the beginning of society. The current decade has been labeled the "Me Generation" because people think of what is best for themselves when making decisions. One way to accomplish such selfishness is through the practice of fraud. Individuals as well as businesses participate in fraudulent acts to benefit themselves. Many reasons and ways are available to implement these deceptions and illegal events which will be examined throughout this paper.

The basic definition of fraud is the act of deceiving or misrepresenting the truth in order to induce another party into surrendering something of value or a legal right. However, an absolute meaning of fraud cannot be determined because of the constant changing environment. In essence, human nature establishes the possibility of fraud because of man's standards of truth and justice. As time passes, norms change and certain concepts such as fraud must be altered to allow for new conditions. People possess the ability to reason, but they also are capable of irrational behavior leading to false ideas and actions.

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An early example of deception relates back to the Hebrew Biblical story of Adam and Eve. Eve accepts the serpent's temptation to eat from the tree although she has been warned by God not to. All the elements of fraud are found in this story: a perpetrator (the serpent), the victim (Eve), and the misrepresented fact (that Eve will become godlike if she eats from the tree). As shown by this example, deception has existed for centuries but has not received much attention until now.

Fraud is the most common human misbehavior in the world. Everyone can admit to being a party to a fraudulent act whether as the victim or the perpetrator. Deception can be accomplished through lying and cheating of which most people have taken part one way or another whether intentionally or unintentionally. Lying and cheating are both intentional ways of deceiving another, but all untruths are not considered a fraud. Such untruths may occur because of mistakes, misinformation, miscalculation, or unintentional ignorance.

All fraud cases are based upon the concepts of what is fair and just. The judge decides a case according to the prudent man rule. The rule requires the judge to imagine what an ordinary and reasonable man would have done in a similar situation as the defendant. Previous cases heard on

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the same type of fraud are also considered by the judge in many common law cases.

Although all types of fraud are important, the focus of this paper will be based upon corporate or management fraud. This fraud can be defined as the willful misrepresentation of financial facts by management or nonmanagement personnel of business organizations. Business frauds are intended to benefit the organization itself, as in tax breaks, or its employees, as in thefts and embezzlements. Corporate frauds can be internally generated by agents, officers or employees, or externally generated by suppliers or customers.

The accounting profession has developed an approach called "Red Flags" to discover potential management fraud situations. Fraud perpetrators are hard to profile, but the Red Flags system presents types of situations that auditors should consider. Red Flags are descriptions of human and organizational behaviors that do not prove fraud but indicate its potential. Thus, a more extensive audit is required to either rule out fraud or document its existence.

The Red Flags help monitor personal pressures of employees, prevent opportunities for fraud, and indicate personality factors of employees. These three categories form a continuum ranging from low to high. A person falls along the continuum according to the particular situation.

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among themselves. Fraud is committed by all levels of employees and all types of people. Typically, fraud is influenced by dishonest people who are motivated by greed. These people should not be placed in a position of trust because they are driven by personal desires and selfishness.

Deciding whether a person has a strong desire for personal gain is a difficult task. All people want a certain amount of personal wealth, but most obtain it in an honest manner. The few who act dishonestly must be watched closely. In order to determine the integrity of a potential employee, personality profile tests have been implemented to measure a person's honesty. Not all fraud perpetrators fit into one profile, but it provides a guideline for companies to adhere.

Another method to measure a potential employee's honesty is a polygraph or a lie detector test. The stress created from lying is reflected by changes in pulse rate or elevated blood pressure which can be seen during the test. The effectiveness of the test has been relatively high in the past, but people do not look upon them favorably because they feel it is an invasion of their privacy. Nevertheless, a lie detector test is a reliable way to evaluate an employee's integrity.

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Edwin Sutherland and Donald Cressey are two criminologists who have examined the motivation of criminals and have provided insight on fraud perpetrators. Sutherland's "differential association" theory suggests that criminal behavior is linked to a person's association with a criminal environment. In other words, individuals who interact with people having criminal backgrounds tend to become criminals as a consequence of the interaction. Sutherland also says that criminal behavior is learned among intimate groups. Fraud will be committed if the rewards outweigh the possibility of being caught and the punishment that will follow. This theory explains that a company that creates a climate of honesty can reduce crime. Management must follow a defined code of ethics and encourage employees to obey the same code.

Donald Cressey's "nonshareable need" theory deals with motivation based upon financial gain. The person violates his position of financial trust by embezzlement. Three elements must exist: a nonshareable problem, an opportunity for trust violation, and a set of rationalizations that defines the behavior as appropriate. If the person is not

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convinced that his actions are acceptable, he will not defraud the corporation because he cannot rationalize the idea.

MDMM taxonomy is another classification system for employee-related crimes. The letters stand for Motivation, Opportunities, Means, and Methods. The motivational aspect consists of economic, ideological, egocentric, and psychotic reasons for people to commit fraud. Employees may steal from the corporation because their economic survival is threatened due to a financial loss. Others defraud a business because of spite or anger. Egocentric perpetrators are motivated by jealousy or excessive pride. These people want to prove they are knowledgeable or clever. The last category of psychotic persons are induced to commit fraud because of misperceptions or a distorted reality.

In order to be induced toward fraud, an opportunity for theft must exist within the corporate environment. Weakness in internal, management, accounting, and administrative controls provides easy access to material that is subject to fraudulent acts. Inadequate reward systems and ethical standards also need to be examined and redefined if a company desires an honest staff. The external environment can threaten a firm and induce fraud. High competition, political action, and governmental regulations are examples of outside behavior that can motivate businesses to resort to theft.
The means aspect of the MOMM taxonomy consists of the various ways to accomplish the employee-related crimes. Employees can overstate assets or revenues, understate liabilities or expenses, forge data, destroy records, or falsify performance data. Fraud cases are still being studied by auditors to add more "means" to the list.

The last part of MOMM is the methods used by perpetrators. Employees tend to compromise controls and personnel in order to defraud a corporation. They try to override or bypass internal and accounting controls to gain access to the information they want. They also resort to bribery and conspiracy. With others involved, people begin to believe their actions are not wrong and continue until the desired result is reached.

In addition to the theories of Sutherland and Cressey and the MOMM taxonomy, data has been collected from Certified Public Accountants on what they feel are the most prominent reasons for employees to steal from their employer. A survey of one hundred CPAs from Michigan reveals that the number one reason people commit fraud is because they feel they can get away with it and not be caught. C. J. Silas, CEO of Phillips Petroleum Company, agrees when he says "37% of all taxpayers cheat because the odds of getting away with it are

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People enjoy taking risks, but the possibility of being caught must be minimal before the fraudulent act will seem beneficial to the perpetrator.

The second most important reason employees defraud the firm is that they think, "Stealing a little from a big company won't hurt it." Much time may pass before the act is discovered, but once top management knows of the fraud the perpetrator will be punished no matter what size the corporation is. Larger firms are more susceptible to fraud because of the number of employees and the pressures placed upon them. Personnel controls and evaluations should be implemented in these companies in order to deter the possibility of theft.

Many of the Michigan CPAs surveyed agree that most employees who steal are caught by accident rather than by audit. Therefore, people are not scared of being caught. Other reasons relating to the corporation include weak internal controls, lenient punishments, and employee frustrations with their job or employer.

Personal reasons also cause employees to defraud a business. These are not as common as other reasons such as

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finances, but they should be examined because the consequences are just as serious. Some employees steal because they feel abused by their boss and seek revenge. Others commit fraud because they are dissatisfied with some aspect of their personal life such as finances or even love. They feel that by stealing from the company they are receiving compensation for the frustration they feel. Some employees simply lack morals or ethics which leads them to theft.

G. Nettler once stated, "There is, then, no one road to the violation of a vocational financial trust; there are many." Nettler's quote emphasizes the numerous reasons for the existence of fraud. Empirical research on fraud perpetrators is on-going because substantial evidence is not available. The lack of empirical studies influenced the authors of How to Detect and Prevent Business Fraud to conduct their own research on fraud perpetrators.

The study focuses on a sample of prisoners convicted of fraud and compares them to two other groups. One of the groups consists of prisoners incarcerated for property offenses. The other comparison group comprises college

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students. The purpose of the research is to discover whether fraud perpetrators, as a group, are different from the normal population and other criminals. For the study, perpetrators are defined as those who are in a managerial or professional position and who illegally apportion thousands of dollars from their employers. Twenty-three prisoners from the Utah State Prison serve as the subjects for the research. Incarcerated fraud perpetrators are not typical perpetrators because people who commit fraud usually are not caught and arrested. Therefore, incarcerated fraud perpetrators are those with the most serious crimes and most extensive criminal records.

Fraud perpetrators are compared with property offenders on demographics, criminal background, and personality variables to determine differences between the two groups. The study reveals that fraud perpetrators are considerably older. The older age is understandable because it generally takes a long time to obtain a managerial position or a position of trust. Women tend to become fraud perpetrators more than males. Since women have greater opportunities to obtain jobs that allow them to

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steal, they will become even more involved in fraud. The older age of fraud perpetrators helps explain why more of them are married, have children, and live a more stable family life.

Social differences are also found by this study. Fraud perpetrators are more likely to have a higher education than other criminals. They are less likely to use alcohol or drugs mainly because of the older age of perpetrators and their non-acceptance of drug use. Fraud criminals are shown to have a shorter arrest record, except for those who are incarcerated because of the severity of the crime committed. Property offenders are found to begin their criminal behavior at a younger age and are more likely to be sent to juvenile correction facilities.

Fraud perpetrators and property offenders also possess psychological differences with respect to personality traits. People involved in fraud seem to have more optimism, self-esteem, self-sufficiency, achievement motivation, and family harmony. Property offenders show more depression, self-degradation, dependence, lack of motivation, and family discord. Self-control and social conformity as opposed to


social isolation and hostility are expressed by fraud perpetrators. All these differences suggest that fraud perpetrators are similar to normal people with healthy personalities and socially acceptable characteristics. A study by Glick and Newsom support this by indicating that embezzlers appear like normal persons who are sincere, likeable, and socialable. 

Next, fraud perpetrators are compared to a group of college students. This part of the study shows that fraud perpetrators are more similar to college students than property offenders. Only six out of 15 traits were discovered as significant differences, thus supporting the idea that fraud perpetrators are quite normal. White-collar criminals are more dishonest, have more psychic pain, and are more independent, sexually mature, socially deviant, and empathetic when compared to college students. Despite these six differences, fraud perpetrators are considered very similar to normal college adults but quite different from other criminals.

Comparing fraud perpetrators to other criminals helps auditors predict what types of people may commit white-collar crimes. Not one single explanation can cover all kinds of  


fraud, but at least professionals have a place to begin their research and investigations. Studies on the motivation of perpetrators are not the only ones conducted with respect to fraud. Auditors have also developed different forms of fraud initiating from both internal and external sources.

Within the internal and external types of fraud are four divisions: larcenous, misrepresentative, manipulative, and extorsive. Larcenous frauds provide no concealment because the victim company's records will not disclose the theft, the records are insufficient to identify the perpetrator, the victim condones the fraud, or the thief does not have access to any concealment course of action. Falsification of a personal, commercial, or physical reality before, during, or after the theft either to assist its commission or conceal a loss refers to misrepresentative frauds. Manipulation refers to the falsification of accounting records before, during, or after a larcenous or a misrepresentative theft. This type of fraud is also intended to conceal the illegality or assist in its commission. Finally, the extorsive division consists of frauds that use force, blackmail, or coercion.

Internally generated frauds are committed by a corporation's own officers, agents, directors, or employees. These people have access to and control of accounting record,
ut have limited access to physical assets. Two types of
frauds originate internally: management and operational.
Both contain all four divisions discussed earlier which are
ever similar in each type. For example, the one difference
between internal larcenous management and internal larcenous
operational frauds is the type of assets at risk.
Management frauds involve conflicts of interest, misuse and
heft of office supplies and equipment, misuse of computer
data, and misuse of secretarial services. Stealing tools or
stocks are categorized as operational thefts. Another
operational fraud includes the use of machines, equipment, or
time to perform private or conflicting work.

Misrepresentative management and operations frauds also
have only one significant difference. Management type thefts
are restricted to a physical or commercial event to which the
thief is a party. An example involves a company that loaned
gambling machines to cafes and clubs whose sales manager
ampered with the cash meters on the machines. The fraud is
of a physical reality and the thief is a party to the event
because he was responsible for reading the cash meters and
recording the profits. However, misrepresentative operations
usually are restricted to a physical reality over which the
thief has control. These frauds include falsifying accident

claims for insurance or compensation, altering time clock cards, and misrepresenting inventory levels.

The most prevalent and costly corporate frauds are the manipulative management thefts committed internally. These frauds consist of embezzlements, computer crimes, false purchases, and false performance reports. Since the thief is in a management position, he has much access to accounting records which conflicts with the operational frauds. The latter type of frauds are performed by operations employees who only have access to source documents which are limited in information. Examples of manipulative operations theft include payroll padding, false cash purchases, and false expense claims.

The second source of frauds are externally generated and consists of business contacts, opportunities, and organized thefts. External frauds are committed by suppliers, vendors, or customers who have limited access to business premises, assets, and accounts. The first type of external theft is larcenous business contacts which are similar to internally generated larceny. The only difference is the source of risk which is outside the firm. The conversion of stolen goods into cash is a perfect example of an externally generated larceny as the goods are returned to the same company from which they were taken.

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Larcenous opportunist thefts differ from the other larcenies because they consist mainly of petty or high impact thefts. The opportunity to steal the assets must be created by the thief through trespassing or altering his business status. Robbery, burglary, hold-ups and factory thefts are classified as part of this category.

The last larcenous fraud is of an organized type that is preplanned and directed toward high-valued consumer goods. The thief often relies upon inside information from a collusive relationship with an employee of the victim company. Industrial espionage is an excellent example of an externally organized theft.

The next category of externally generated thefts are misrepresentative. Business contacts are frequently established with the main objective as fraud. The thief misrepresents an event over which he has control or to which he is a party. Examples include credit card frauds, insurance frauds, con games, and investment frauds. The external opportunists generally misrepresent a commercial reality that is directed toward a third party. Resulting from such an action is a loss of an intangible asset like market share by the victim company. Finally, an organized misrepresentation can also be employed by a perpetrator.

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These frauds involve a physical reality and result in a loss of a tangible asset by the victim company. Counterfeiting and forgery fall into this final type of misrepresentative fraud.

Next are the externally manipulative frauds. Business contacts can also be used to manipulate information found in documents that exist because of the business relationship between the victim and the perpetrator. False investment data and false credit applications are classified as manipulative frauds. The opportunist manipulates accounting records that are outside the ownership or control of the victim company. The thief has access to the information and can create a false record or destroy an existing one. Organized manipulation usually involves an employee of the victim company who has internal access to records. These employees are generally driven by greed and become a party to the conspiracy.

External extorsive thefts are similar to those that are internally generated. They are produced through force, blackmail, or coercion but the sources are found outside the firm. The threat may be directed toward the owners of the corporation or the employees depending on whether the loss is hidden among records or is obvious on the financial documents.

As can be seen, several categories of fraud have been formulated by auditors and other professionals. Understanding the different characteristics of each type
ases fraud detection and prevention. No matter which theft is committed, the perpetrator will try to utilize the best concealment course possible to limit the chance of being caught. From all the classes of frauds, extorsive and manipulative are the most dangerous and difficult to detect. Prevention techniques have been developed to help deter these two types of fraud as well as the many others.

The prevention methods incorporate the "Red Flags" that have previously been described. As a review, Red Flags consist of situational pressure, opportunities, and personality traits. A corporation does not desire to eliminate all pressures because individuals work well under a moderate level of stress. However, an overwhelming amount of pressure can lead an employee to commit fraud.

Avoiding unrealistic performance expectations is one way to reduce situational pressures. Companies with a "do it at any cost" attitude encourage employees to behave dishonestly. Involving people in setting performance goals is an excellent method for establishing realistic expectations. Personal counseling should be available to employees. People with alcohol, drug, and financial problems tend to commit fraud because of the intense pressures. A last way to reduce situational pressures is to implement fair and uniform

personnel policies. Resentment of superiors can be created through policies that reflect unfair treatment of employees; thus they seek revenge on the corporation.

Decreasing the opportunity for fraud requires tight internal controls. Corporations must monitor business transactions and interpersonal relationships of suppliers, purchasing agents, buyers, and sales representatives to insure honesty and subjectivity. Accurate accounting records must be maintained to produce effective reports. Separation and rotation of duties should also be implemented. Individuals with total control over an operation are capable of fraudulent acts because no one is available to monitor their performance. Separating duties allow corporations to discover illegalities easier. Group work is also an effective way to reduce opportunity to commit fraud because people enjoy being able to identify with a team.

Regardless of the situational pressures and the opportunities to commit fraud, the dishonest act is still performed by the individual. Society holds individuals responsible for their behavior, thus encouraging them to adopt a strong ethical code. Managers should teach honesty through lectures, group discussions, written materials, casual comments, and moral behaviors. Honest and dishonest

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behavior must be defined by top management. An explicit code of conduct should also be adopted and followed by all personnel. Keeping fraud and its consequences a secret from employees can influence perpetrators to continue their dishonest actions. If white-collar criminals are never prosecuted, employees perceive the act as not very severe. Penalties for fraudulent activities should be harsh in order for personnel to understand the intensity of the crime. Severe punishments will not eliminate fraud, but it does act as a deterrent.

Prevention techniques do not always work for every type of fraud, but they provide a starting point for auditors. Comparing previous fraud cases to current ones adds insight into what should be done to remedy the situation. To insure against crime, a corporation should constantly review policies and controls. Employees need to know what is expected of them and the consequences that follow if rules are disobeyed. Implementing the above procedures will help eliminate some of the thefts and create a more honest working environment.
Work Cited


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