



FORENSIC ACCOUNTING AND FRAUD RISK FACTORS: THE INFLUENCE OF FRAUD DIAMOND THEORY

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ABSTRACT

Background: Fraud has become a global phenomenon that attracts the attention of the world's business organizations towards using the services of forensic accountants to identify the fraud risk factors so as to detect and prevent fraud occurrences. **Objective:** This paper aimed to identify the fraud risk factors by forensic accountants with the effect of FDT. **Result:** It was found that the use of Fraud Diamond Theory (FDT) by forensic accountants will help to reduce if not to eliminate the phobia of fraud incidences in organizational settings and equally shaped the organization's thinking to develop a sound and effective detection and preventive measures. **Methodology:** The paper was designed to use conceptual approach. The information used for the study was obtained from journal articles, textbooks, and the Internet. **Conclusion:** The discussion of the fraud risk factors will immensely contribute to the understanding of FDT and fraud red flags especially by the government, forensic accountants, auditors, fraud examiners and other anti-fraud bodies as well as the private business owners. The study also serves as guidance for further fraud related research.

Keywords: Fraud, white collar crime theory, fraud triangle, fraud diamond, forensic accounting, red flags

1. INTRODUCTION

Fraud has become a global phenomenon as well as order of the day up to the extent that no single country at a federal, state or local government level as well as private and or public sector can proudly point finger on air to claim zero fraud. But the level of fraud varies from one country to another and from one organization to another. Consequently, this depends upon the measures taken by the organization to detect and prevent the menace. In order to effectively detect and prevent the occurrences of the fraudulent activities the forensic accountants need to have professional skills that will enable them to understand, synchronise, analyse, the financial information obtained so as to retrieve, identify, safeguard, report, and testify the result of their investigation in the court of law [1,2,3,4]. The National Public Procurement Integrity Baseline Survey in 2006 estimated that at local government level alone annually about 18-20 billion dollars used to be lost due to related fraud and other fraudulent activities [5]. Consequently, fraud has become a serious threat to the global economy, especially when taking into account the huge amount of money lost every year [6].

There is no controversy among the researchers, academicians, and practitioners on the importance of forensic accountants to understand the fraud triangle theory in particular which include opportunity, incentive, and rationalization [7,8]. Wolfe and Hermanson, reveal the importance of the FDT in identifying and assessing the risk of fraud occurrence [9]. The forensic accountant should be conversant with the four-sided fraud diamond that considered an individual's capability in addition to the process of discussing the fraud diamond theory that presents different ways to mitigate fraud risks [4]. Fraud examiners should not underrate the capability of fraudsters because the perpetrators are sufficiently keen to exploit the organizational weaknesses [9,10]. Understanding the accounting information systems and other regulatory factors within the organizational settings by the forensic accountants would help them to thoroughly investigate fraud and those of overriding organizational red flags [11,12]. Moreover, forensic accountant should be able to possess and demonstrate specialized knowledge and skills in preparing evidential reports to the court of law. Equally, he should be able to identify the pattern of abuse by having effective investigation skills and analytical thoughts and excellent communication skills [8-13].

This paper discussed the issues of forensic accountant's efforts to identifying the fraud risk factors with regard to FDT base in three sections as follows: Section 1 discusses the concept of fraud and forensic accounting and section 2 gives details of the classical theories as WCCT, FTT, and FDT. Lastly, Section 3 presents the likely fraud red flags as the key indicators of fraud risk in an organization. Furthermore, the conclusion is drawn as well as contributions and suggested areas for future research.

2. Literature review

2.1 Concept of fraud

The Institute of Turkish History explains the word fraud as "a deceptive trick, scam, game, artifice, cabal which is committed to cheat, mislead someone" and "contributing something useless to something in order to gain advantage"

[14]. Fraud is a deliberate act of misjudgement and misleading one party to take part in a contract without which he may not participate [15] it is a universal game that forms in different shapes as such courts are limited to a few general rules to investigate and alliviate fraud [16,17,18]. It was argued that fraud has involved deliberate misrepresentation and falsification of information that is reported by an entity so as to deceive the users. From the audit and other investigation viewpoints fraud poses a serious problem because it customarily involve the efforts of individuals to conceal, falsify, misdirect, manipulate and alter the true and fair view of the organizational reports to satisfy their selfish interest. In most cases, the issues of fraud become a challenging task to solve by the traditional auditors since they cannot provide absolute assurance of their responsibility [15,19,20]. The reason is that the auditors "use of judgment, sample testing and the fact that the evidence available to them are persuasive rather than conclusive in nature" [21]. Fraud is difficult to detect since it is very unusual to observe it but only its symptoms which may not necessarily means fraud is occurring [22,23,24,25]. Fraud is alsodefined as the deliberate action made by an individual or group of persons with the intention to take an unlawful advantage at the expense of the other party [26].

2.2 Types and Classification of Fraud

Association of Certified Fraud Examiners reported that fraud has been divided into three broad categories as follows: corruption, assets misappropriation, and financial statement fraud [27]. From the existing cases, there are many ways that fraud can be perpetrated from the simply misuse of trust to the sophisticated computer based offense. Scholars have classified fraud base on the methods used by the fraudsters even though the perpetrators are smart enough to use various devices in different cases. These include defalcation, overpowering, embezzlement, manipulation, power abuses and falsifications, illegal loan, establishing fake borrowers, impersonation, fake payment. They continue to mention fraudulent use of the organizational documents, establishing fictitious accounts, false proceeds of collection, manipulation and alteration of vouchers, dry posting, over or excessive invoicing, increasing the statistical data, manipulation of the organizational ledger accounts, creating and manipulating fictitious contracts, duplicating the cheque books, computer and cyber fraud, misuse and deliberate mismanagement of suspense accounts, and incorrect affirmation of deficit balance [26-28,29,30,31]. The various forms of fraud include bribery and extortion; embezzlement; Unlawful use of public assets for private advances; over- and under-invoicing; payment of salaries and other benefits to ghost (non-existent) workers and pensioners; payment for air supply (goods or services not supplied or rendered). Fraud can also be categorized into corporate, management fraud and fraud as a tort. Corporate fraud, on the other hand, is any fraud perpetrated by or against a business corporation [32].

2.3 Concept of forensic accounting

Forensic accounting involves the use of accounting concepts, procedures and skills to provide solutions to the egal problems [33]. Forensic accounting is the "integration of accounting, auditing, and investigative skills" [34]. Usually, it provides reports where the accountability of fraudulent activities is detected, and the report is reflected as proof in the court of law or the administrative proceedings [35-34]. Forensic accounting is described as the method of interpreting, summarizing and communicating complex financial and non-financial matters, succinctly and accurately in a court of law as an expert [36]. Forensic accounting is the specialty area of accountancy profession which describes engagements that result from actual or anticipated disputes or litigation. "Forensic" means "suitable for use in a court of law" and it is to that standard and potential outcome that forensic accountants generally have to work [37]. Nowadays, large accounting firms are reactively using the services forensic accountants rather than proactively. Forensic accounting should be used during the audit investigation to help identify key fraud risk areas, and communicate them to the management of the organization for further consideration. It was argued that the presence of deterrent to fraud in an organization is clearly signifying the perception and anticipation of the likelihood of an increase in the detection and prevention of illegal activities [38].

3.1 White Collar Crime Theory (Sutherland 1939)

Edwin H. Sutherland originally pioneered White collar crime theory during a Presidential talk to the American Sociological Society in 1939. The introduction of "The White Collar Criminal", has become contrary to the traditional theories of crime which blamed poverty, broken homes, and disturbed personalities as the source of committing white collar crime. Sutherland noted that most f the trust violators in the business settings were far from poor, they are from happy family backgrounds and having no mental problems. After ten years of further research, Sutherland published White Collar Crime in 1949 [39]. Henceforth, he published a revised version in 1983. White collar crime is defined as "a crime committed by a person of respectability and high social status in the course of his occupation." [40]. Sutherland called attention and place more emphases on to prove that criminal activities were not only the business of lower class people but including those of the upper class. Sutherland had faced so many challenges and critics especially in respect of the appeal made by social scientists to pay more attention and focus much on the criminal activities perpetrated by upper-class offenders. Furthermore, Sutherland was criticised on the method used to describe his study of white-collar crime. Scholars of social science and legal experts have galloped their criticism based on the following concerns. (i) conceptual

ambiguity, (ii) empirical ambiguity, (iii) methodological ambiguity, (iv) legal ambiguity, and (v) policy ambiguity. Despite the tremendous criticism faced by Sutherland on the proposition of WCCT, his work did not fall in vain. Two young scholars, as it was then, in persons of Marshall Clinard and Donald Cressey later became famous in criminology and quickly shouldered Sutherland's work. In 1952, Clinard authored a book on price control violations during World War II and Cressey (1953) wrote *Other People's Money*, a study of embezzlement [39].

3.2 Fraud Triangle Theory (Donald Cressey, 1950)

FTT was developed as an idea to investigate the causes of fraud. Donald Cressey in 1950 first coined it and published for the first time in 1953 in his journal title "other people's money" [41]. Cressey in 1950 was troubled with the question of why people commit a financial crime; this is what gives him the courage to examine 250 criminals in a period of 5 months. Cressey concludes that:

"Trust violators, when they conceive of themselves as having a financial problem that is non-shareable and have knowledge or awareness that this problem can be secretly resolved by a violation of the position of financial trust. Also they are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property" [41].

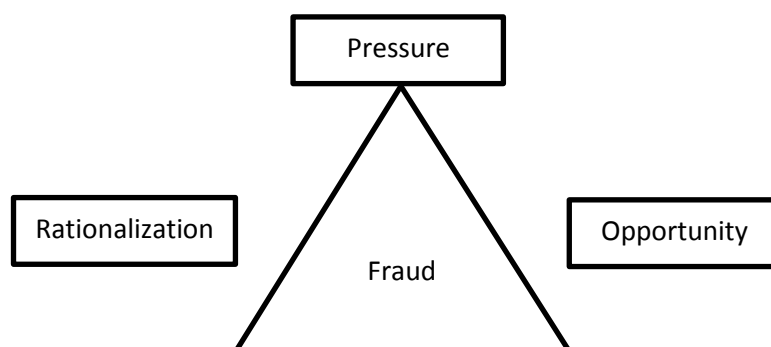


Figure 1: The figure above presents fraud triangle theory (Source: Manurung and Hadian 2013)

FTT describes three factors that are present in every situation of fraud as follows:

1. Perceived Pressure, Incentives/Motivation: This is the initial cause of committing fraud. Pressure can include almost anything (financial and non-financial) which will motivate individual to commit fraud (see, [41,42,43,44]). SAS No. 99 indicates that there are four common types of conditions on the pressure that can lead to cheating. The condition is financial stability, external pressure, personal financial need and financial targets [44].

2. Perceived Opportunity: This is the ability of a fraudster to discover and exploit organizational weaknesses to violate trust [41,45,46,47]. Opportunity to commit fraud can be created due to internal control weaknesses; poor corporate governance; lack of job rotation and poor supervision among others. According to SAS No. 99, the chances of financial statement fraud can occur in three categories of the following conditions: (i) the nature of the industry (ii) ineffective monitoring and (iii) organizational structure [44].

3. Rationalization: This is the attitude, set of ethical beliefs that enable certain party (ies) to commit fraud, or different people in an environment that makes them quite hit rationalize fraudulent actions [48,49]. Rationalization can also be a process through which a fraudster justifies his evil course of action. Cressey's findings reveal that all the three elements (perceived pressure, opportunity, and rationalization) must be present for a fraudster to be able to violate trust in an organization [41].

3.3 Fraud Diamond Theory (David T. Wolfe and Dana R. Hermanson 2004)

The FDT is an extension of FTT, which was made by David T. Wolfe and Dana R. Hermanson in 2004. They believed that the FTT could be enhanced to improve both fraud prevention and detection by considering an additional element "**capability**". In addition to addressing, perceived pressure, perceived opportunity, and rationalization, [46] Wolfe and Hermanson considered an individual's capability, which comprises the personal traits and abilities to commit fraud [50]. FDT can be illustrated using Figure 2.

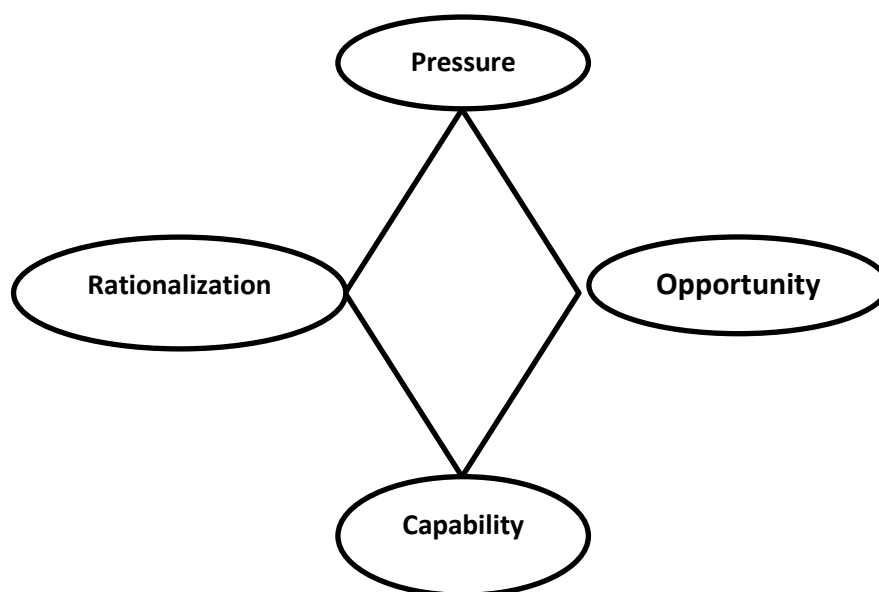


Figure 2: The figure above presents the fraud diamond theory (Source: Wolfe and Hermanson 2004).

The FDT was first published in CPA Magazine in December 2004. The recognition of the element of capability has involved the six factors expected to be achieved by the fraudsters as described by Wolfe and Hermanson as follows:

- (i) A fraudster must have **function or authority** for him to be able to commit fraud.
- (ii) The fraud perpetrator must be **intellectual** to the extent that he/she can be able to harness and exploit an organizational weakness to commit the fraudulent action.
- (iii) Fraudster must be *egoistic* and have strong, confident and courage as he will not be caught.
- (iv) The fraud perpetrator must be a person who can **coerce and pursued** others to commit fraud for him or alongside with him.
- (v) Fraudster must be a person who can be able to **deceive** others or look at people into their eyes to convincingly and comprehensively tell them **lie**.
- (vi) A fraudster must be able to conquer the **stress** by concealing the true face of the matter as well as frequent monitoring the issue to prevent detection.

"Opportunity opens the doorway to fraud, and incentive (i.e. pressure) and rationalization can draw a person toward it. However, the person must have the capability to recognize the open doorway as an opportunity and to take advantage of it by walking through, not just once, but repeatedly." [46].

4. RED FLAGS (SIGNS OF FRAUD RISK)

Red flag is a "set of circumstances that are unusual or deviated from the usual activity. It is a signal that something is out of the ordinary and may need to be investigated further" [51]. Red flags do not indicate fraud had occurred or not but merely provide possible warning signs of fraud. Red flags are symptoms or signs of fraud occurrence, [52] in the financial statements report. Red flags may be defined as a systematic way of detecting the symptoms or any signs of fraudulent activities within the organizational settings [53]. It has been realised that international accounting institutions reveal the utmost importance of fraud red flags in the process of regulating the occurrence of fraudulent activities [51]. The Statement of Auditing Standards (SAS) No. 82, superseded SAS No. 53, with regard to fraud in a financial statement audit, and it was one of the first statements that identified 25 fraud risk factors (red flags) for auditors. SAS No. 99 [54], requires auditors to use 42 red flags in financial statement audits to detect fraudulent financial reporting later which was established as a replacement for the later standard. The list of red flags found in SAS No. 99 is organized based on the fraud triangle concept, which involves the interaction of the following three factors: incentive, opportunity, and attitude and in the course of this study the red flags was extended to FDT.

Table 1: The table presents the situational Pressure Red Flags .

-
- Excessive personal debt
 - Material lifestyle with lower earning
 - Excessive gambling
 - Undue family, organization, and or community prospects
 - Alcohol or drugs addiction among the employees
 - Perceived differential and inequality treatment
 - Antipathy of superiors, intimidation and frustration with job
 - Pressures from the employee's peer group and clique
 - Greediness of the employee
 - Social, working and other environmental distresses
-

Table 2: The table presents the opportunity Red Flags.

-
- Close relationship between suppliers and other key people within and outside the organization
 - Organizational failure to orienting employees on the measures uses to eradicate fraudulent act
 - Frequent and excessive replacement of key employees due to retrenchment, firing and retiring
 - Lack of job rotation, regular vacation or transfer of key employees within the organization.
 - Inadequate personnel-screening policies when employing a new employee for the replacement
 - Lack of general and precise personnel policy
 - Improper record of commendation on personnel dishonest act and other disciplinary actions
 - Lack of executive disclosures and examinations
 - A dishonest or overlapping of duty by the dominant management
 - frequent operation in an unfavorable climate
 - Lack of supervision and attention paid to details of the job
 - Inadequate compensation scheme
 - Inadequate training programs
 - Related party transactions
 - A complex organizational structure
 - Lack of effective internal auditing staff
 - use of several auditing firms or changes auditors frequently
 - providing irrelevant data to the auditors and lack of required information
 - Use of various legal firms or changes legal counsels repeatedly
 - An organization that uses large number of different bank accounts
 - Continuous problems with various regulatory agencies
 - Large year-end and unusual transactions or unbalanced transactions
 - An inadequate internal control system or no enforcement of the existing internal controls
 - Lack of proper accounting records and inadequate accounting personnel
 - An organization that is inadequately disclosed questionable or unusual accounting practices
 - Too much familiarity with operations
-

Table3: The table presents the personal Characteristic (Rationalization) Red Flags.

-
- An employee's inconsistent behaviour
 - Lack of personal ethics and morality
 - A wheeler-dealer personality
 - A strong desire to beat the system
 - Employee's criminal or questionable historical background
 - A poorly recommended employee with poor financial status
-

Table 4: The table presents the capability Red Flags.

-
- Having exercising an excessive power
 - Job or work overlapping
 - Too much power to coerce other employees
 - Ability to pursued others
 - Too much resistance to stresses
 - Ability to convincingly deceive and tell lies
 - Too much egoism and over confidence
 - Specialization in one function for a long duration
 - Confidence of risk bearing
-

5. CONCLUSION AND RECOMMENDATION

Fraud investigation, detection, and prevention are some of the primary responsibilities of forensic accountants. Nowadays, the rate at which fraud is growing in the business organization has become an attractive issue worldwide as such it makes significant way to examines and identify the related fraud risk factors in this paper. The fraud risk factors have been a grim problem to address by the forensic accountants and to develop efficient red flags to curve the cases of fraud incidences in the world's business organization. This paper discusses the forensic accounting and fraud risk factors using one of the classical fraud theories (FDT). It clearly itemized some of the fraud red flags that will be helpful in preventing fraud after thoroughly discuss the concept of fraud and forensic accounting. Considering the nature of the fraud occurrences and the way the fraudsters perpetrates fraud through their power and capability to violate organizational trust this paper will be supportive to mitigates the occurrence of fraudulent activities in the organization. Based on the contribution made in this study it is recommended that organizations should carefully consider the a periodic job rotation in order to prevent employee from exploring the organizational weaknesses. Additionally, it is recommend that the organization should pay more attention to establish fraud red flags that will indicicate employee's capability to commit fraud. These include segregation of duty, clearly defined power, detect egoesm, coercion and employee's ability to deceive and tell lies.

Contribution and area for future research

The study contributes to the existing body of knowledge by identify the possible fraud risk factors through the influence of FDT and it will be serve as a source of academic literature. Furthermore, the study will help the government, private business owners, forensic accountants, auditors, fraud examiners and other anti-graft bodies to understand the fraud risk factors thoroughly and to develop suitable mechanisms for investigating, detecting and preventing fraud occurrence. The study may serve as guidance for future research in the subject matter where the study did not address. Therefore, the future researchers may intend to conduct a quantitative study in relation to the impact of red flags in preventing financial fraud. This is because red flags are the indicators of the symptoms or a sign of fraud in an organization even though it does not indicate the fraudster as a guilty or not but rather an alert of the fraud occurrence.

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