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Original Research Paper

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RECOGNIZING THE INDICATORS OF FRAUDS BY TRACING THE ELEMENTS OF FRAUD TRIANGLE AND ITS DETERRENCE

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ABSTRACT The present paper endeavors to throw light on the factors that stimulates an individual to commit fraud in the light of the fraud triangle theory. Based on the existing theories and literature, an attempt has been made to recognize the red-flags of fraud risk related to an individual's behavioral approach. The paper further suggests that of the other elements, a check on the Opportunity vertex of the triangle can control the intensity of the fraud. It also highlights the applicability of SAS-99 and COSO framework for deterring fraud constituents from the system.

KEYWORDS : SAS-99, COSO framework, Opportunity vertex, fraud triangle

INTRODUCTION

A rich and diverse base of research literature in has proven that the fraud perpetrators cannot be differentiated based on demographic or psychological characters. Most of the executives who commit fraud at workplace are not career criminals and often referred as trusted staff. According to one of the noted Criminologist Donald R. Cressey, there are three convincing factors that stimulate an ordinary person to commit fraud. They are perceived pressure, perceived opportunity and rationalization of acts, which is technically termed as the *Fraud Triangle*.

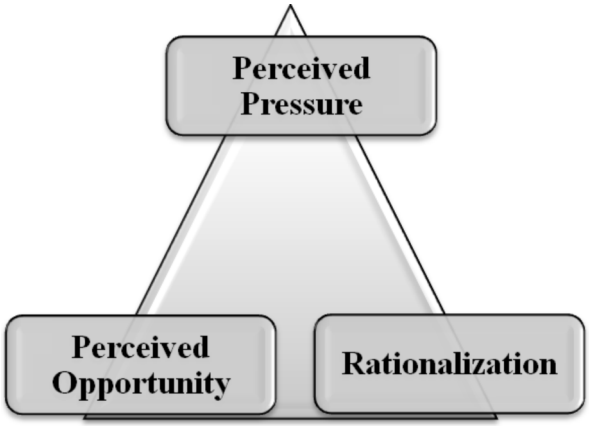

Figure 1 The Fraud Triangle

In general frauds are perpetrated with a view to benefit oneself or an organization. At micro level an executive misappropriates from his or her employer for individual benefit, at organizational level the management tends to deceive investors and creditors by manipulating the financial statements and at macro level administrative authorities uses public money for personal benefits instead of social well-being. A brief compilation of such instances in Indian context can be presented as follows:

Table 1 Compilation Of Scams In India

Scam	Amount of Fiscal Resources Involved
2G Spectrum	Rs. 175000 Crore
Satyam Scam	Rs. 8000 Crore
Harshad Mehta Scam	Rs. 4000 Crore
Ketan Parekh Scam	Rs. 1500 Crore
C.R. Bhansali Scam	Rs. 1200 Crore
Fodder Scam	Rs. 950 Crore

Source: Indian Stream Research Journal

The data table above shows an increasing trend both in terms of magnitude and volume of funds involved. The factors may be attributed to gradual depletion of ethical values and high propensity to deceive public at large for self-enrichment.

Forensic Accounting comes into the picture once the fraud has been actually committed i.e. the damage has been done. It tends to cure the inconsistencies that have crept in. On the other hand, anticipating the probable risk of fraud by identifying the elements of fraud triangle in advance is a preventive measure which keeps an eye on the entire course of action. However, they do not operate in isolation rather they are complementary to each other.

Analyzing The Elements Of Fraud Triangle

In order to delve deeper and understand the underlying causal factors that motivates one to commit a fraud, the elements of fraud triangle are elaborated as below:

The Determinants of Perceived Pressure

The experts believe that pressure can be segregated into four main classifications:

- *Financial Pressure:* Studies have suggested that 95% of the frauds are committed due to the financial pressures such as greed, living beyond one's means, poor credit, unexpected financial needs etc. Usually, when the management fraud occurs it is found that the financial position of the company is actually not sound, the assets and income statements are overstated in order to preserve the interests of present and potential investors.
- *Vice Pressure:* Closely related to financial pressures are motivations created by vices such as gambling, alcohol, drugs, expensive extramarital relationships etc.
- *Work*-Related Pressure: Factors such as getting less recognition for job-performance, having a feeling of job dissatisfaction, fear of losing job, being over-looked for promotion and feeling exploited by way of underpayment have motivated many frauds at organizational context.
- *Other Pressures:* A strong desire for an improved lifestyle or a challenge to beat the system also contributes to commit such unethical deeds.

The Determinants Of Perceived Opportunity

An opportunity is perceived when there are weaknesses in controls. Individuals think they won't get caught because nobody is looking, or reviewing, or performing reconciliations and reviews. At least six major factors increase opportunities for individuals to commit fraud within an organization they are:

- Lack of controls that detect fraudulent behavior.
- Inability to judge quality of performances delivered.
- Failure to discipline fraud perpetrators.
- Lack of access to information.
- Ignorance, apathy and incapacity

- Lack of audit trail

The Determinants of Rationalization

Rationalization involves a person reconciling his/her behavior with the commonly accepted notions of decency and trust. For those who are generally dishonest, it is probably easier to rationalize a fraud. For those with higher moral standards, it is probably not so easy. They have to convince themselves that fraud is OK with "excuses" for their behavior. Common rationalizations include making up for being underpaid or replacing a bonus that was deserved but not received. A guilt executive may convince himself that he is just "borrowing" money from the company and will pay it back one day. Some embezzlers tell themselves that the company doesn't need the money or won't miss the assets. Others believe that the company "deserves" to have money stolen because of bad acts against employees. Thus some of the common rationalizations are:

- The organization owes it to me.
- I am only borrowing the money and will pay it back.
- Nobody will get hurt.
- I deserve more.
- It's for a good purpose.

Finally, Organizations are implementing tighter controls and broader oversight. The auditing profession has adopted more rigorous auditing standards and procedures, and software developers are adding continuous monitoring features to back-office systems. It remains unclear whether these efforts are sufficient to mitigate the fraud problem.

Thus based on the assumptions of the theory, some of the characteristic feature of an individual prone to fraud-risk may be enumerated as follows:

- One who is reluctant to get his/her work reviewed by others
- Has a strong desire for personal well-being
- Have a "Beat the System" attitude
- Has a tendency to live "Beyond their Means"
- Outwardly appear to be trustworthy
- Often have "too good to be true" work performance
- Often displays some sort of drastic change in personality or behavior

Breaking The Fraud Triangle

Breaking the Fraud Triangle is the key to fraud deterrence. Breaking the Fraud Triangle implies that an organization must remove one of the elements in the fraud triangle in order to reduce the likelihood of fraudulent activities. "Of the three elements, removal of Opportunity is most directly affected by the system of internal controls and generally provides the most actionable route to deterrence of fraud" (Cendrowski, Martin, Petro, *The Handbook of Fraud Deterrence*).

Statement on Auditing Standards No. 99 (SAS 99):

Consideration of Fraud in a Financial Statement Audit was "the first major audit standard to be released since the passage of Sarbanes-Oxley" (AICPA, *Detection in a GAAS Audit: SAS No. 99 Implementation Guide*). While the standard was intended to assist auditors in detecting fraud during a financial statement audit, its application was more pervasive. "SAS No. 99 has the potential to significantly improve audit quality, not just in detecting fraud, but in detecting all material misstatements and improving the quality of the financial reporting process" (AICPA, *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide*).

The SAS 99 Practice Aid discusses fraud deterrence in addition to its primary focus of fraud detection, "Because fraud prevention, detection, deterrence are management's responsibility, the new fraud SAS now requires you to determine whether management has designed programs and controls that address identified risks of material misstatement due to fraud and whether those programs and controls have been placed in operation" (AICPA, *Detection in a GAAS Audit: SAS No. 99 Implementation Guide*). In essence, the AICPA has identified that fraud deterrence can be achieved through the implementation of controls and procedures that mitigate (Mitigating Controls) against areas already identified as risk areas.

The Committee of Sponsoring Organizations (COSO) Model:

The COSO "Internal Control – Integrated Framework," (COSO Model) describes five interrelated components of internal control that provide the foundation for fraud deterrence. These elements of internal control are the means for which the 'Opportunity' factors in the Fraud Triangle can be removed to most effectively limit instances of fraud. In fact, The Association of Certified Fraud Examiners (ACFE) 2002 Report to the Nation on Occupational Fraud and Abuse reveals that 46.2% of frauds occur because the victim lacked sufficient controls to prevent the fraud. The five COSO components are:

- *Control environment:* The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, management's operating style, delegation of authority systems, as well as the processes for managing and developing people in the organization.
- *Risk assessment:* Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives and thus risk assessment is the identification and analysis of relevant risks to the achievement of assigned objectives. Risk assessment is a prerequisite for determining how the risks should be managed.
- *Control activities:* Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address the risks that may hinder the achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
- *Information and communication:* Information systems play a key role in internal control systems as they produce reports, including operational, financial and compliance-related information that make it possible to run and control the business. In a broader sense, effective communication must ensure information flows down, across and up the organization. For example, formalized procedures exist for people to report suspected fraud. Effective communication should also be ensured with external parties, such as customers, suppliers, regulators and shareholders about related policy positions.
- *Monitoring:* Internal control systems need to be monitored—a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities or separate evaluations. Internal control deficiencies detected through these monitoring activities should be reported upstream and corrective actions should be taken to ensure continuous improvement of the system.
- However, internal control involves human action, which introduces the possibility of errors in processing or judgment. Internal control can also be overridden by collusion among employees or coercion by top management.

Concluding Thoughts And Future Prospect

In an emerging economy like India channelization of funds is inevitable for national growth and development. Funds flow from household sector to business as investments and to government as tax revenues for developmental expenditures,

any loophole in the process will paralyze the fiscal circulation resulting to a hindrance in societal development. Thus, business owners, executives and government agencies must take control of fraud by working on the portion of the fraud triangle over which they have the most control: the opportunity to commit fraud. It may be difficult for management to do anything about an employee's needs or rationalizations, but by limiting opportunities for fraud, the company can reduce it to some extent. Of the three elements, opportunity is the leg that organizations have the most control over. It is essential that organizations build processes, procedures and controls that don't needlessly put employees in a position to commit fraud and that effectively detect fraudulent activity if it occurs.

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