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Accounting 612: The Auditing Process

Does the failure of internal controls primarily promote management fraud?

"Why Management Fraud is Unstoppable" discusses the effectiveness of internal controls in preventing management fraud (Tipgos, 2002). The article covers the history of internal controls and how management was able to manipulate internal control models throughout history. It covers the internal control implementations the Committee of Sponsoring Organizations has recommended. The thesis of this article is that internal controls are owned by management and cannot prevent management fraud. The article concludes that due to management's overriding control of internal controls management is the only one that can stop fraud, not internal controls. It also concludes that management must practice the rules set fourth within the organization and be held accountable just as any employee would be. The article further concludes,

> The present system of corporate governance is seriously flawed and ineffective because it is based on the agency theory of classical economics, which promotes the adversarial relationship between stockholders and management but never recognizes the relationship between management and employees (Tipgos, 2002, p. 40).

The final conclusion the article draws is that management compensation methods should be reconsidered.

I think that internal controls can prevent fraud to a certain extent but cannot completely eliminate it. I think that management override has been a serious problem with internal controls since the inception of the concept and that this reflects ultimately that management's behavior is responsible for preventing fraud. Much focus has come on internal controls with the passage of the Sarbanes Oxley Act. With all of this focus one could wonder if the passage of the law has had an impact on the prevention of fraud and in particular the impact of internal control on the prevention of fraud. One thing that this article looks at is the vulnerability of internal controls effectiveness to management. With the author's conclusion that due to management's overriding control of internal controls management is the only one that can stop fraud, not internal controls, with this in mind I would like to propose the following research question: Does the failure of internal controls primarily promote management fraud?

From the perspective of an evaluation of management integrity in an audit, failure of internal controls contributes to management fraud. This perspective of auditor perception of management's ability to manipulate internal controls leads to the conclusion that the failure of internal controls will facilitate management fraud. Kaplan states, "When management can override controls, there is no obvious reason for auditors to revise their evaluation of integrity when controls are weak because managers can commit fraud regardless of control strength (1999, pp. 114)." This reminds us that management's power of internal controls is absolute and weak or strong internal controls can allow management fraud.

Silver, Flemming and Riley (2008) discuss that management, internal auditors and audit committees place too much reliance on segregation of duties to prevent collusive management fraud, which are not effective. In this case the internal controls, specifically traditional segregation of duties are the culprit that collusive management is overriding and committing management fraud. From this discussion one can conclude that the failure of traditional segregation controls is promoting management fraud. The heavy reliance on internal controls by management, internal auditors and audit committees responsible for mitigating fraud shows us that these individuals believe that internal controls can be the primary factor in eliminating management fraud. Although internal controls can be a very powerful deterrent of management fraud, there is plenty of discussion out there regarding other causes of management fraud besides the failure of internal controls.

Recession has been considered one of the primary causes of fraud. According to Pomeranz, “Recessions may trap executives who have made extravagant forecasts or even commitments based on hope. Such individuals have limited options; they can accept dismissal; seek mercy by accepting mitigating circumstances; or cook the books Pomeranz (1995).” Pomeranz (1995) has also alluded to an erosion of business ethics as a cause of fraud. He points to Roberta S. Karmel, a former commissioner of the securities and exchange commission and her characterization of the 1980s as a ‘decade of greed’. She points out the distinction between greed and market-based solutions to economic and social problems and how they have become synonymous by the end of the 1980s. This led to a change in SEC policies to curtail the infatuation with the markets, which can still be seen today by investor driven pressures that causes management to cook the books in order to meet Wall Street’s expectations.

One of the conclusions of the initial article also points to an alternative reason for management fraud occurring as a result of something other than the failure of internal controls. Tipgos (2002) refers to the adversarial relationship between stockholders and management and how this flawed relationship leads to pressures on management to cook the books. The adversarial relationship that exists consists of the high expectations of stockholders for management to produce positive results such as a profitable quarter that increase earnings per share and ultimately stockholder wealth. The adversarial nature of this relationship is simple; if you do not perform to our expectations you lose your job. This pressure to meet performance standards is one example of why management goes to such great lengths to cook the books and conceal their fraud. They ultimately hope that the business will turn around before anyone notices their shenanigans or that what they are doing is ok.

Saksena (2001) writes that there are various internal and external antecedents that are responsible for management fraud. Internal antecedent factors such as financial performance, threat of insolvency, insufficient resources that turn managers to illegal activities to procure resources and organization size that is so large that more opportunities for fraud to occur exist. External antecedents include a dynamic environment, hostile environment, number of competitors in the firm's industry and industry membership: the industries culture, the influence of observation of other firms that are committing illegal activity, industry structure such as ease of entry and exit, type of products and different vulnerabilities to regulation, monitoring and wrongdoing. The facts presented previously by Saksena regarding financial performance as an external antecedent support Tipogs's assertions about the adversarial relationship between stockholders and management and how the pressures related to this relationship result in management fraud. The fraud of Crazy Eddie consumer electronics chain is a perfect example of a fraud committed as a result of the internal antecedent; poor financial performance and the lack of proper internal controls. Rezaee and Riley state, "By falsifying its books, Antar convinced financial analysts that Crazy Eddie was growing when, in fact, it was falling apart" (2010, pg. 105). The prescience of internal controls in this instance is irrelevant. The failure of internal controls is not the primary variable which is driving the perpetration of management fraud. In this instance internal controls are irrelevant to management and are overridden due to other internal antecedents. An example of an external antecedent that drove the commission of fraud is the competitive market that AOL faced in the mid 90s. Schlit (2002) discusses how AOL had concerns on whether or not it would be able to survive against its larger and more formidable competitors of that era, CompuServe and Prodigy. As a result of this concern AOL began excluding marketing costs in calculating its profit, which is considered an aggressive accounting technique. In this instance a corruption in the application of GAAP is where the fraud takes place and internal controls are completely avoided. Thus, internal controls are not even capable of being a weakness in which management can primarily exploit. With this in mind we can conclude that failing internal controls are not the primary source of management fraud.

Wells (2008) discusses that internal controls are not the primary deterrent to fraud. If this is true than it doesn't matter whether or not they are failing but that internal controls may be ineffective all together and that there are other reasons that are promoting the occurrence of management fraud. Wells discusses that the perception that unlawful conduct will be detected is a primary deterrent to fraud. He writes about the installation of a camera on the school buses to stop fighting children and harassment of the drivers. After the installation of the camera the children quickly settled down. Fake cameras were installed on the rest of the buses, which produced the same effect. With Well's discussion in mind we can conclude that the failure of internal controls are not the reason that management fraud is occurring, that fraud will occur regardless of these controls and that the fear of getting caught is what prevents a fraud.

Zahra, Priem, Rasheed (2007) discuss various factors that cause top management to commit fraud. These factors do not include the failure of internal controls although the author does mention the recent attention that has been given to internal controls in the deterrence of fraud. They include Society, Industry and Organizational pressures. Societal factors include aspirations such as the need to obtain a certain level of wealth as a reason to commit fraud. Industry conditions such as cultures, norms and histories can contribute to management fraud. Organizational pressures such as lack of stockholder involvement that leads managers with the power to enrich themselves and their positions, lack of aggressive monitoring by the board of directors, senior leadership in areas such as corporate ethics is lacking and deviant organizational culture all contribute to fraudulent behavior of top management. The Saga of Chainsaw Al Dunlop is a good example of how organizational pressure can lead a manager into turning to fraud. Schlit (2002) discusses how Al Dunlop had a reputation for turning companies around. He was hired by Sunbeam to solve their financial woes. Schlit states, "The day Sunbeam announced that Dunlap would be the new CEO, the share price jumped 60 percent, the largest one-day jump in the company's history. A Wall Street analyst was so excited by the hiring of Dunlap that he said, "This is like the Lakers signing Shaquelle O'Neal.""(2002, pg. '64-165). With this type of reputation in place Al Dunlop was under the pressure to get things done at Sunbeam. Regardless of internal controls failing he was going to do what he and to get the job done.

Rizaee and Rily discuss antifraud applications for practice. In their discussion they mention the establishment of a proper internal control environment. However, this is not the only practice they recommend for the avoidance of fraud. They mention "Adequate training and supervision of personnel, effective monitoring of company management by auditors, audit committees, proactive antifraud programs, a strong ethical culture, anonymous hotlines and whistle-blower protections" (2010, pp. 90). Rizaee and Rily's antifraud applications monitoring of company management by auditors, audit committees, proactive antifraud programs and a strong ethical culture clearly show that internal controls do not stand alone in the prevention of management fraud and will not be the primary cause of management fraud if they fail.

Uhl-Bein discusses that besides the factors that influence management fraud mentioned by Zahra, Priem and Rasheed that ethics is a major proponent to the problem. She points out research done by Marshall Shminke, Anke Arnaud and Marabeth Kunzi on ethical climates in organizations. Uhl-Bein discusses that organizations need strong internal systems of ethics and values to ensure overall ethical well being of an organization. These systems are referred to as ethical climates. These climates include for specific elements: sensibility, judgment, motivation and character, which have been demonstrated to play a critical role in ethical organizations (2007, pg. 120). Weak internal controls are not going to be the only factor in management fraud as we can see in this discussion of ethics. A poor ethical climate will contribute to management fraud occurring if internal controls are weak. This can even occur if internal controls are strong within the organization. Sensibility, judgment, motivation and character are going to play an important role in whether or not a fraud occurs. If these elements are poor than there is a good chance that weak internal controls are not the primary culprit of management fraud.

A study in India concerning corruption also sheds light on some interesting facts concerning the causes of management fraud. The authors primarily discuss executive management's participation in corrupt practices with the government. In the article, Collins, Uhlenbruck and Rodriguez discuss executive's rationalization of corruption and social relationships and corruption. Regarding executive rationalization of corruption, Collins, Uhlenbruck and Rodriguez find that it is the executive's surroundings that are responsible for facilitating the management fraud. Things such as corrupt organizational culture have an influence on the top executives. This is similar to what Saksena has stated. With regards to corruption and social relationships, Collins, Uhlenbruck and Rodriguez find that, "Top management's personnel relationships are significant predictors of engagement in corruption and, more particularly, that these relationships promote a greater willingness to ignore legal proscription regarding corruption" (2009, pg. 101). These personnel relationships are the background for the commission of management fraud. Collins, Uhlenbruck and Rodriguez go on to narrow down particular causes of management fraud related to social relationships,

> "familial ties to government officials may lead top managers to be more willing to engage in illegal corrupt transactions because they receive favorable opportunities and terms, are more confident that their transactions will be effective and secreted, or out of a sense of obligation or reciprocity to their kin" (2009, pg. 101).

It is evident that the weakness of internal controls has no impact on these variables when it comes to the commission of management fraud. In this instance it is the social ties such as family that are spurring the commission of management fraud.

The amount of facts presented concerning the commission of management fraud while internal controls are failing is very limited. From the facts presented it is apparent that while internal controls may fail, there are so many other variables that contribute to the commission of management fraud. I think that weak internal controls are not the only factor that allows for the commission of management fraud. The facts provided by Saksena are just a few of the causes of management fraud that overshadow the failure of internal controls as a primary cause of management fraud.

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