

## THE DYNAMICS AND CONTROL OF CORPORATE FINANCIAL STATEMENT FRAUD

**Author's Name:** Subhan, Rika Syahadatina

**Affiliation:** Prodi Akuntansi Fakultas Ekonomi Universitas, Madura, Indonesia

**E-Mail:** [subhanunira511@gmail.com](mailto:subhanunira511@gmail.com)

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### *Abstract*

*This paper offers additional worth insight and knowledge that enhance our understanding of the causes of fraudulent financial statement. These insights are synthesised from contemporary thinking and prior empirical fraud studies. This paper isto give a significant contribution to practitioners in terms of fighting against fraudulent financial statement and academics in terms of developing fraud theory. We acknowledge, imperfect prevention mechanisms, for example, due to lack of adequate information system management, are categorised as a major factor that makes organisations very vulnerable defrauded by their employees. It is true that fraud can be perpetrated by organisational insiders or outsiders. However, the catastrophic threat comes from disgruntle organisational insiders, regardless the level of positions in the company. It is because they are legally authorised to access the company's systems and know the weaknesses of control systems. In relation to the psychological factors of perpetrators, greed, dignity, and acquisitiveness are highly likely adhered to fraud perpetrators coming from organisational insiders. Such factors arise because a powerful belief that organisation should pay for the perceived inequities.*

**Keywords:** *Fraudulent Financial Statement, Greed, Dignity, Acquisitiveness*

### **INTRODUCTION**

Fraudulent financial statement is an intentional deception on the financial statement. Broadly it is intended to deceive the users of financial statement. Financial statement fraud is “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” (ACFE 2018). In practice, fraud comprising corruption, asset misappropriation, and fraudulent financial statement is non-discriminatory, but private sector entities are generally more at risk than other entities as evidenced by table 1. According to the latest regular study carried out by ACFE (2018), the least common and most costly form of occupational fraud is financial statement fraud, which occurred in 10% of the cases and caused a median loss of USD 800,000. However, to date most of fraud studies exploring anti-fraud controls are lack of explanation on the reasoning behind a worker's decision to commit workplace fraud (ACFE, 2018, KPMG, 2018). Based on this finding, the aim of this paper is to offers an explanation on why fraudulent financial statement scandals occurred in private sector organisations. Importantly, this paper suggests possible best preventive measures, based on the cases presented in this paper, As such, this paper gives a 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 organisations.

**Table 1: The worst corporate accounting scandals**

Name of Scandal	Key Description	
1. Enron Scandal (2001)	Company: What happened: Key players: Modus operandi:	Houston-based Commodities, Energy and Service Corporation. Shareholders lost \$ 74 billion, CEO Jeff Skilling and former and CEO Ken Kept huge debts off the balance sheets
2. American Insurance Group Scandal (2005)	Company: What happened: Key players: Modus operandi:	Multinational Insurance Corporation Massive accounting fraud to the tune of \$3.9 billion, bid-rigging, manipulated stock price. CEO Hank Greenberg Allegedly booked loans as revenue, steered clients to insurers
3. Lehman Brothers Scandal (2008)	Company: What happened: Key players: Modus operandi:	Lehman brothers; Global finance services firm Hid over \$50 billion in loans disguised as sales Lehman executives and the company's auditors, Ernst & Young Sold toxic assets; creted the impression Lehman had \$50 billion less in toxic assets that it really did.
4. Bernie Madoff Scandal (2008)	Company: What happened: Key players: Modus operandi:	Bernard L. Madoff Investment Security LLC, a wall street investment firm founded by Madoff Ticket investors out of \$64.8 billion through the largest Ponzi scheme ever. Bernie Madoff, his accountant, David Friehling, and Frank Dispascalli. Investors were paid returns out of their own money
5. Saytam Scandal (2009)	Company: What happened: Key players: Modus operandi:	Indian IT services and back-office accounting firm falsely boosted revenue by \$ 1.5 billion. Founder/Chairman Ramalinga Raju falsified revenues, Margins and cash balances to the tune of 50 billion rupees.

**WHY FRAUDULENT FINANCIAL STATEMENT HAPPENS?**

***Internal control weaknesses***

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 (FFS). Some scholars, (e.g. Rezaee 2005; Wolfe and Hermanson 2004), claim, it is because of control system weaknesses. Specifically, the opportunity of perpetrators to commit FFS arises when the company's internal control systems become weak, the quality of its internal audit roles deteriorates, and its corporate governance is less operative. 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' behaviour 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. It suggests the failure of the board of director composition to fulfil the primary responsibility for managing and controlling their company performance. To support such claims, let's have a look for instance, the cases presented in the table 1. There are categorised as organized complex crimes, involving many people, companies, and cross organisational borders.

The important lesson to be learned from the 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. It arises due to the agent's performance measured based on an outcome. As consequence, information asymmetry is one of undeniable facts. If it does happen, this inherently mobilizes an encouragement of moral hazard where the principals will not know whether the agents have already run organisation in accordance with principals' interests. Then it becomes terrible situation that can lead to emerging risky effects as demonstrated in the cases that are shown in the table 1. As concrete evidence, it suggested by a study carried out by Li (2010), 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 in 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.

Generally speaking, the proposed mechanisms to minimise information asymmetry and moral hazard are through the appropriate implementations of incentive and monitoring programs. Importantly, the board of directors should take role in the monitoring activities (Jensen 1993, Daily et al. 2003). Some people argue, one of the common causes that tend to arise conflict between agents and principals is the dissimilarities of view (goal) as clearly showed in table 2.

**TABLE 2: AGENCY THEORY**

PARTY	OBJECTIVES
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 2, it can be accepted that the improper ownership separation will encourage managers to adopt aggressive accounting practices that may potentially mislead the figures (or accounts) presented in financial reporting. It issue statically evidenced by the cases of fraudulent financial reporting showed in table 1. As we can see, in general the managers in those organisations including founder of organisations colluded in misleading the potential investors or costumers. We think, agency theory is the one of best analysis tools to study the different interests between principals and agents because it provides an important root map of how to conduct and behave in the best interest of the principals and how to separate control system appropriately in the organisation (Jensen and Meckling, 1976). And, Taylor (2011), argues that agency theory contains the structural framework that limits the interests of principals and agents.

Hogan et al. (2008), find another factor that directly contributes to the likelihood of fraudulent financial reporting. It is “pressure” coming from the higher authority. They said, due to poor performance the higher authority gives a great pressure to increase the company performance. Moreover, People who are very ambitious with social status, are more likely to get involved in risky behaviour and even commit fraud by abusing their authority (Duffield and Grabosky, 2001). The last but not the least, the final component affecting perpetrators to conduct wrongdoing specially to misreport financial statement is moral justification. This effectively and directly enables the ideology and rationalisation to legitimate wrongdoing or violence as divine ordination without any feelings of righteousness. At some situations, the perpetrators assume their harmful actions as not big problem or assume that their company deserve those consequence because there is no fair contract 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 a science for studying the social phenomena, nature of mental experience and human behaviour (Colman 2003). The most common conceptual framework for studying people motivation to commit fraud is fraud triangle. It is broadly spread by Association of Certified Fraud Examiners (ACFE). Prior empirical research proved that the existences of fraudare strongly related to the fraud triangle components (Bell and Carcello 2000; Hogan et al. 2008).

Even though the fraud triangle is known widely as great fraud concept, there are other factors that also have strong influence to encourage an individual to commit fraud such as greed and acquisitiveness that arise because there is belief that organisation should pay for perceived inequities. A study carried out by Al-Saggaf et al. (2015), reveals that one of the surprising findings from their research is that unethical behaviour in the Australian Information and Communications Technology (ICT) workplace is triggered by greedy.

Moreover, it is broadly accepted that the individual personality cannot be ignored in studying the root causes of fraud within organisation because another study conducted by Ramamoorti(2008), shows that fraud detection and deterrence should fully pay attention on how to overcome the interpersonal dynamics (the fraudsters psychology) because they have preliminary influence to fraud perpetrators. Hollin (1989) documents 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 is constructed by moral justification and their palliative characteristics that will directly mobilise to the psychological mechanism. Those are very dangerous threat because their conducts and ways will be exceedingly perilous for others. If we look at the cases presented in the table 1, generally, people who get involved in fraudulent activities are not necessarily individuals for whom a life of crime is predestined, nor are people forced into it by poverty or desperation. But those individuals are with nice houses, and good job. From this situation, the organisation should be able to establish proper anti-fraud program and control. For doing it, the understanding of behaviour and psychological aspects affecting fraud perpetration is the main factor for creating responsive detection and deterrence systems.

Furthermore, the last possible psychological point that forces offenders to deceive their employers and fellow workers are human dignity. Dignity closely refers to a matter of status and honour, and it might be a core contributor to moral hazard. If employers treat their staff in an undignified manner, they unconsciously put themselves in vulnerability to be defrauded. Even though, from a normative point of view, individuals may manage their emotional interactions well, although in place they are undeserved, this does not necessarily mean they are honest/good people. The notion of 'dignitary' is seen as something worth in human being.

It is both a highly personal concern and a matter of social standing. Through these psychological pressures, they try to commit fraud, by manufacturing an assumption, for example "everyone's getting wealth, so I do deserve the special acknowledgement of my standing, and also, it's fine for me if I manipulate small figures as compensation because I have already dedicated my life for growing up this company". These kinds of people, thus, to pursue their malicious desires, in human characteristic point of view, will start with a small misstatement of earnings periodically.

The concept of the unconscious power coming from inner malevolent desires by which people deal with self-satisfaction are central to the construction and maintenance of painful emotion and ambition, even though they know that this leads to destructive aspects for both their organisation and colleagues. It is because this concept presses thought and motivations.

### **HOW TO FIGHT AGAINST THEM**

Alarmingly, people 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. Due to the situations as discussed above, this article recommends some measures to prevent fraud risks. Those measures may include:

#### ***Strengthening employees' commitment***

Employee commitment can take different forms. Organisation commitment nowadays is increasingly playing crucial roles in terms of promoting positive workplace culture, because Mowday et al. (1979) claim that the commitment of organisational as the strength of people's attributes to get involved in and behave the best manner in achieving organisation objectives. If an individual has strong commitment to a company, s/he will work hard on behalf of company's values and objectives. Therefore, an individual who feel committed to his/her employing organisation, even though organisation internal control system circumstances become less effective, is more likely to be consistent with organisation objectives by fostering professionalism, than an individual who does not feel committed. Subordinate behaviour is reflection of the behaviour of the leader. If leaders promote that behaviour well then the subordinates will imitate. We believe, leadership commitment is required as an effort to prevent fraud. Commitment can be expressed in exemplary forms. This commitment should be represented in organization implicit rules. Generally speaking it is a bunch of rules which is generally composed for representatives of an organisation, which secures the business and educates the workers regarding the organization's desires.

Therefore, it is very important for organisation to strengthen the level of its employees' commitment. It can be achieved, for example by maintaining effective working relationship among organisation members in order to stay comfortable in the organisation. In addition, organisation provides the employees positive experiences, including an understanding of anti-fraud programs. An empirical study suggests 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).

#### ***Conducting integrity tests in recruitment process***

There is no doubt to argue that the integrity or honesty tests has positive effects on organisation's accountability and transparency because personality variables are influential in job performance. An honesty test is a particular kind of character test intended to evaluate a candidate's propensity frankly, reliable, and trustworthy. An absence of trustworthiness is related with such counterproductive practices as burglary, brutality, harm, disciplinary issues, and non-attendance. Honesty tests have been found to gauge a portion of similar elements as standard character tests, especially uprightness, and maybe a few parts of enthusiastic solidness and suitability.

This test is primarily assessment of the conscientiousness personality factor. Commonly

dishonest individuals have greater tendencies towards disregard of rules and social norms, lack of dependability or irresponsibility. The interview process remains one of the most employed methods for a workforce selection. Through extensive research, psychologists acknowledge that many factors can affect the result of an interview. Integrity tests can likewise be substantial proportions of by and large work execution. This is not astounding in light of the fact that uprightness is emphatically identified with scruples. It is a solid indicator of by and large work execution. Like different proportions of character qualities, uprightness tests can add a lot of legitimacy to a determination cycle when managed in blend with a psychological capacity test. John (2010) synthesizes and reviews many literatures on interviews and finds a dozen factors that influence an interviewer's decision. So, it will look good if the interviewer directly asks questions about the applicant's own involvement in illegal behaviours or wrongdoings (e.g., theft, illicit drug use). To measure the applicants' answers whether they are honest, the interview can use letters of reference and records of past work.

### ***Applying code of conduct or ethical standards***

The organisation should apply and promote good moral and ethical standards, and these must be equally implemented to workers, all level of managers. 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.

One of the biggest security assets owned by an enterprise is its employees, if they have already understood and made commitment to comply with security policies ruled in the enterprise. In this context, managers play a major role in determining whether employees embrace a company's values. If managers and top leaders do not model ethical behaviour or enforce rules in a fair manner, employees lose trust. They must influence their subordinates to behave ethically. Influence means that the relationship between top management and other employees is not passive; and that influence is not coercive.

As the board creates and actualizes parts of its program, the association must screen the program's work and convenience. Cycle checks are suitable to screen hotline action, controls, and warnings. Fast activity even with suspected false action can significantly cut misfortunes. Internal forensic experts, or an external team, ought to explore all presumed deceitful exercises. In this regard, interchanges and change the board are basic to the checking stage since workers must utilize the new projects before the association can evaluate their viability. Making individuals mindful of the new projects and getting them to transform from the natural requires a complete program of progress the board. So, conveying the association's messages requires reliable informing subjects and an assortment of media.

### ***Encouraging effective board of director composition***

The connection between fraud and the "tone at the top" of an organization has received

international attention over the last few years. Tone at the top refers to the ethical atmosphere that is created in the workplace by the organization's leadership. In this context, 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 organisation's board of director does not only have an obligation to ensure that an organisation 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 minimise the 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 officers should create a culture promoting good ethics and integrity.

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. This means, organisation'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 determines what types of appropriate actions/ controls are in place that can reduce those threats whether they come from organisational 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 organisation 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 organisation 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. A fair complaint system can boost employees' loyalty to the organisation by demonstrating a commitment to keep an ethical atmosphere in the workplace. Several academic studies have already proved that a fraud hotline for reporting suspicious wrongdoings is the most effective way to prevent and detect fraud in early stage (Buckhoff, 2003). By providing a confidential hotline service, whistle-blowers 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 reports of suspicions of malfeasance, organisation 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 organisation's clients can make a call to report suspicious fraudulent conducts happening in the workplace.

#### ***Implementing clear 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 the strict policies and procedures that regulate specific proper act and define consequences of violating those rules. The program regulating this concern must consistently

state that any kind of wrongful behaviours cannot be tolerated. In addition, the conflict of interest and information asymmetry policies should be publicly disseminated to business colleagues, as well as directions that any deviations from those policies should be conveyed to proper authority within organisation, for example a compliance officer. Such policies serve as a guide to moral daily living and helps us judge whether our behaviours can be justified.

Regardless of scale, organisations rely on their management personnel to set a level of ethical behaviour for all personnel to adopt. When managers adhere to the code of ethics, it sends a message that every worker is supposed to have universal compliance. So, by developing a code of ethics, an organization makes it clear that employees and members cannot claim ignorance as a defence for unethical conduct.

Furthermore, another step to deal with these concerns is that board of director and line managements must get involved with periodically main monitoring and encouraging 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 organisation, 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 organisation.

## CONCLUSION

Fraudulent financial statement is the one of dangerous financial crimes. We see the fraud triangle consisting of pressure, opportunity, and rationalisation is a helpful theoretical framework to understand why people commit fraud. However, it will be better if it is combined by the psychological factors of fraud perpetrator in explaining the motivation behind individual intention. Surprisingly enough, we identified the existence of fraud risk becomes greater when fraud perpetrators are people who have power in the top. It is mainly because their subordinates are afraid to come forward with any suspicions. The offenders often rationalise their fraudulent behaviour, by trying to make it more acceptable in the eyes of the social group to which they belong.

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