MINORITY SHAREHOLDERS WATCH GROUP
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(Incorporated in Malaysia – Registration No.: 200001022382 (524989-M)

New Straits Times, Business Times – Thursday, 29 September 2022 **(A)**

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MORALITY, HONESTY AND INTEGRITY

THE ANATOMY OF FRAUD

FRAUD happens. And sometimes it happens a lot. It would be interesting to analyse the anatomy of fraud. Hopefully, understanding these elements may enable the mitigation of the risk of fraud.

Fraud refers to a deception that is intentional and caused by a leader, an employee or organisation for personal gain. In other words, fraud is a deceitful activity used to gain an advantage or generate illegal gains. Also, the illegal act benefits the perpetrator and harms other parties involved.

For example, an employee who pockets cash which belongs to the company is committing fraud. The employee would benefit from getting additional cash at the expense of the company. Sometimes, it is the employer who commits the fraud.

FRAUD TRIANGLE

The fraud triangle, developed by Cressey in 1953, is a framework commonly used to explain the anatomy of fraud. The fraud triangle comprises three components: incentive, opportunity and rationalisation. These components feed off each other when fraud happens.

INCENTIVE

Incentive, alternatively called pressure or motivation, refers to the fraudsters' mindset. Fraud just does not happen. There must be an incentive to commit fraud.

At the corporate level, examples of incentives for committing fraud include bonuses and employee share option scheme (Esos) based on a financial metric, e.g. revenue or profit. Thus, bonuses and Esos based on a financial metric create pressure for employees to meet targets, which, in turn, may incentivise them to commit fraud to achieve the objective.

Investor and analyst expectations can be another incentive for fraud. There may be an incentive to meet or exceed investor and analyst expectations to ensure stock prices are maintained or increased.

There may also be an incentive to inflate revenue by creating fictitious sales and earnings to meet or beat analysts' forecasts to maintain the company's "buy" rating to avoid being downgraded to a "sell" call which will have an impact on the share price.

The incentive is greater when major shareholders have pledged their shares. In such instances, a drop in the share price may result in a margin call. This can create pressure (incentive) to commit financial fraud by painting a rosy picture to maintain the share price.

Finally, there are the personal incentives. These may include wanting to earn more money, the need to pay bills or a gambling addiction, etc. Sometimes it is a need to put food on the table.

We hear of people stealing milk from grocery stores to feed the children at home. As noble as the end sounds, the means is fraudulent. Sometimes, it is not a need but a want. Greed and avarice come to mind. There is not much a company can do to manage the "incentive" aspect.

OPPORTUNITY

Opportunity refers to circumstances that allow fraud to occur.

In the fraud triangle, it is the only component that a company exercises complete control over.

Examples that provide opportunities for committing fraud include weak corporate governance and internal controls.

Internal controls are processes and procedures implemented to mitigate risks (including the risk of fraud). They also ensure the integrity of accounting and financial information. Weak internal controls, such as poor separation of duties, lack of supervision and poor documentation of processes give rise to opportunities for fraud. The best of controls will collapse when there is a deliberate override of these controls or when collusion is involved.

Poor tone at the top provides another opportunity to commit fraud. Tone at the top refers to upper management and the board of directors' commitment to being ethical, showing integrity and being honest.

A poor tone at the top results in a company that is more susceptible to fraud. After all, an army is only as good as the general who leads it. Where the top is compromised, the top loses its moral right to hold others accountable.

Adopting the best corporate governance practices are well and good but they comprise structures and processes only. You may have the best structures and processes in place, but they are of no use if not accompanied by leadership with morality and integrity.

RATIONALISATION

Rationalisation refers to an individual's justification for committing fraud. An example of a common rationalisation used by fraudsters is that "they treated me wrong", perhaps a perceived unfair bonus. For that staff member, it is their way of getting back. And coming back to the tone at the top, the fraudster may rationalise that "upper management is doing it as well. So, what's wrong if I take a bit?"

The same rationalisation will filter down to every level of the organisation and there goes the fabric of corporate culture.

When it comes to mitigating the risk of fraud, the challenge for companies is to remove any and every opportunity to commit fraud.

It will be naive to think that good corporate governance practices and a system of internal control in themselves are sufficient to prevent fraud from happening. There has been, and can be, no substitute for morality, honesty and integrity.

When it comes to mitigating the risk of fraud, the challenge for companies is to remove any and every opportunity to commit fraud.

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