

Beyond the Fraud Diamond

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Abstract

Fraud is a debilitating factor that affects business growth and continues to be a major problem for many organizations. Fraud schemes today have become more sophisticated and complex with technological advancements. Numerous types of fraud schemes such as asset misappropriation, corruption, and financial statement fraud have been perpetrated against organizations, resulting in loss of consumer confidence, shareholder investments, and collapse of otherwise thriving businesses. In order to effectively combat fraud, businesses need to understand its risk factors and elements. The fraud triangle theory is well-known and is often discussed in the literature. However, later an expanded version of the fraud triangle theory, the fraud diamond theory, was introduced. The fraud diamond theory offers insightful information regarding the various factors that have an impact on an individual's decision to commit fraud.

Keywords: Fraud, Fraud Triangle, Fraud Diamond

1. INTRODUCTION

Any organization is prone to fraud, which is an act of deception performed to gain something of value from others illegally, either by physical force or by trickery (Albrecht, Albrecht, & Albrecht 2006). Research literature indicated that both private and public organizations have experienced being victims of this behavior. Business organizations continue to face issues of fraud, and combating this issue is a challenge. According to the Association of Certified Fraud Examiners (ACFE, 2014), it is estimated that the typical organization loses about 5% of revenues each year to fraud, and, if the data is applied to the 2013 estimated gross world product, this translates to a potential projected global fraud loss of nearly \$3.7 trillion. Additionally, the median loss caused by fraud, according to the ACFE report, was estimated at \$145,000, where 22% of the cases involved losses of at least \$1 million. With the severity of fraud, it is important that organizational leaders understand the root causes of this behavior in terms of who commits fraud and why in order to proactively manage the risks (Ramamoorti, 2008).

2. BACKGROUND

A well-known theory, which is discussed quite often in the literature, is the fraud triangle. This theory identifies the elements that lead perpetrators to commit fraud. Dorminey, Fleming, Kranacher, and Riley (2010) pointed out that the originality of this theory dates to the work of Sutherland who coined the term "white collar crime," and Cressey, one of Sutherland's former students. Cressey focused his research on the circumstances that lead individuals to engage in fraudulent and unethical activity; later, his research became known as the fraud triangle theory.

The fraud triangle theory consists of three elements that are necessary for theft or fraud to occur: (a) perceived pressure, (b) opportunity, and (c) rationalization. Based on this theory, fraud is unlikely to exist in the absence of these three elements, and the severity of fraud depends on the strength of each element (Howe & Malgwi, 2006). In basic terms, for an individual to make unethical decisions, perceived pressure, an opportunity, and a way to rationalize the behaviors must exist. Despite the popularity of the fraud triangle theory, many scholars, however, have tried to identify more factors that may have an impact on this behavior. In December 2004, an expanded version of the fraud triangle theory was introduced by Wolfe and Hermanson in the *CPA Journal*: the fraud diamond theory. The main difference between the fraud diamond and fraud triangle theories is that the fraud diamond includes an additional element: capacity. This article will further explore the expanded version of the fraud triangle theory or the fraud diamond theory. Various element of the fraud diamond theory will be discussed.

3. ELEMENTS OF FRAUD DIAMOND

Wolfe and Hermanson (2004) argued in their research that, although perceived pressure or incentive might exist along with an opportunity and a rationalization to commit fraud, fraud is unlikely to take place unless the fourth element is present: capacity. In other words, the potential perpetrator must have the skills and ability to actually commit fraud. Figure 1 below presents the complete elements of the fraud diamond theory.

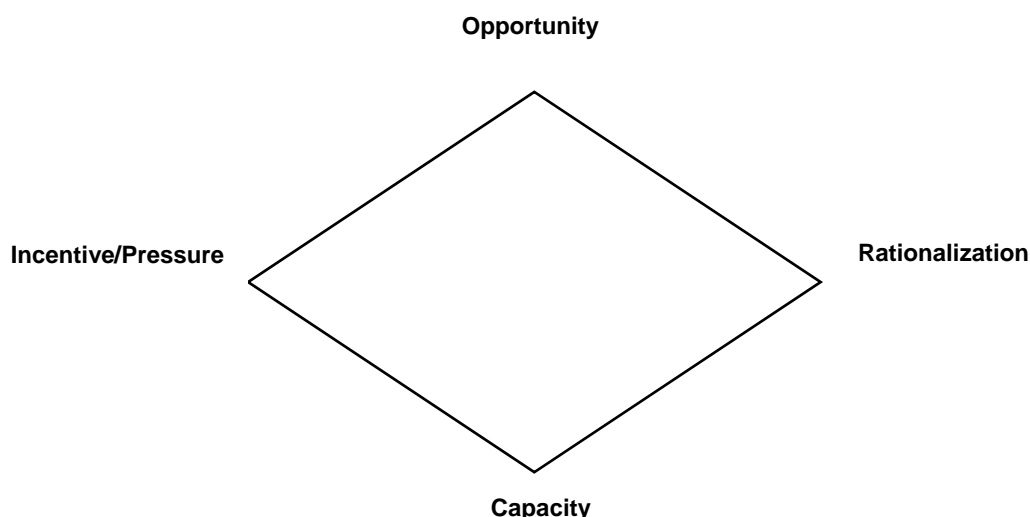


Figure 1: Elements of Fraud Diamond

3.1. Incentive/Pressure

Every perpetrator must face some type of pressure to commit fraud. Perceived pressure is defined as the motivation that leads the perpetrator to engage in unethical behaviors. It is important to point out that perceived pressures can occur with all employees at any level of the organization and can occur for various reasons. Such pressure does not have to be real, if the perpetrators believe they are being pressured, it can lead to fraudulent behavior (Albrecht, Hill, & Albrecht, 2006). Although an individual may demonstrate different motives, research has shown that fraud often occurs as a response to economic pressures, and most pressures involve a financial need such as greed, living beyond one's means, large expenses or personal debt, poor credit, personal financial losses, and an inability to meet a financial forecast (Albrecht, Hill, et al., 2006; Albrecht, Turnbull, Zhang, & Skousen, 2010; Howe & Malgwi, 2006). Specifically, about 95% of all fraud cases were influenced by financial pressure, according to Albrecht, Hill, et al. (2006).

3.2. Opportunity

This is the second element necessary for fraud to occur. Opportunity that exists in organizations has a major impact on an individual's decision to commit fraud. Rae and Subramaniam (2008) suggested that, if a susceptible individual perceives opportunities due to a lack of or inefficient internal controls and has the ability or power to exploit these opportunities, that individual may perpetrate a fraud. Perceived opportunity is similar to perceived pressure; the opportunity does not have to be real, the perpetrators simply have to believe or perceive that the opportunity exists in order to take fraudulent action (Albrecht, Hill, et al., 2006; Zikmund, 2008). Individual factors such as financial need and personal issues are variables that businesses cannot control; therefore, they can only decide how to react to these factors through the use of internal controls (McClurg & Butler, 2006). Holtfreter (2004) suggested two mechanisms that organizations can use to prevent fraud. The first is to implement pre-employment screening; the second is to implement mechanisms (internal controls) during the course of employment. The system of internal controls is clearly necessary for businesses' success, which is critical for businesses to have some types of controls in place to eliminate the opportunity element.

3.3. Rationalization

An attitude or morally acceptable rationalization needs to occur before fraudulent behavior emerges. It is important to acknowledge that fraud perpetrators sometimes do not view their actions as unethical; they merely justify their actions as ethical before fraud takes place (Dorminey et al., 2010). In other words, rationalization allows the fraudster to view his or her illegal actions as acceptable. Jackson, Holland, Albrecht, and Woolstenhulme (2010) concluded that, if a person cannot justify unethical actions, it is unlikely he or she will engage in fraud. That person, however, may rationalize those actions in different ways using various justifications. These are some examples: "I am only borrowing," "The organization can afford it," "I deserve a bonus or a raise but did not get one," "Everyone's getting rich, so why shouldn't I?" and "It is not really a serious matter" (Ramamoorti, 2008; Zikmund, 2008).

3.4. Capacity

A person's position or function within a company may give him or her the ability to create or exploit an opportunity for fraud not available to others. According to Wolfe and Hermanson (2004), the fraudster also has the necessary traits and abilities to be the right person to pull it off, and that this person has recognized this particular fraud opportunity and can turn it into reality. Wolfe and Hermanson identified important observable traits related to individuals' capacity to commit fraud. Those threats include: (a) authoritative position or function within the organization; for example, a CEO might have the ability to influence and perpetuate frauds due to his or her position within the organization; (b) intelligence to exploit the accounting and internal control systems' weaknesses to the greatest advantage and have the ability to understand how the system works; (c) ego and confidence that fraudulent behaviors will not be detected, which will have an impact on their decision-making process; thus, the more confident they are, the greater chance that they will commit fraud; and (d) capability to effectively deal with stress due to the risk of getting caught and manage the fraud over a long period of time. That person also must effectively and consistently lie to avoid detection and may even have to persuade others to believe that fraud does not take place.

4. CONCLUSION

Opportunity opens the doorway to fraud, and incentive and rationalization can draw the person toward it. However, based on the fraud diamond theory, the person also must have the capability to recognize the open doorway as an opportunity and to take advantage of it. While various factors may have an impact on an individual's decision to commit fraud, the discussion related to the fraud diamond theory can add value to the fraud detection/prevention discipline. The fraud diamond theory has provided valuable framework, in addition to the fraud triangle theory, which can assist business leaders and practitioners to find solutions to minimize and/or prevent this behavior. Because any organization can be a victim of fraud, and this issue is on the rise, fraud theory is therefore an important topic of study that may provide businesses better understanding of root causes of this behavior before it becomes too late.

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