

## FRAUD RISK MANAGEMENT – HUMAN RATIONALIZATION ASSESSMENT

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### Abstract

More and more organizations are now concerned with the implementation of risk management processes as a proactive function in maintaining economic and financial balance. Losses registered by both companies and employees or managers may become pressure pillars of fraud triangle, increasing the existing fraud risk within the organization. Legislative and information environment changes speed creates an opportunity for fraud and rationalization is easy to find even for people with an average degree of morality, because of the present financial instability. Fraud risk assessment on human resources is made relatively easy in terms of opportunities (lack of internal controls) and pressures (identification management style), but when it comes to the level of an individual's morality the things become complicated. This paper presents an interdisciplinary manner, based on economic sociology and behavioral sciences, factors for the assessment of individual justification that can lead to unethical behavior. Conclusions focus on the importance of building an ethical environment and continuous anti-fraud education, issues that may change the individual justification given the proven adaptability of people to different situations or environments, whether positive or negative, and rapid behavioral copying. This paper is supported by the Sectoral Operational Programme Human Resources Development (SOP HRD), financed from the European Social Fund and by the Romanian Government under the contract number POSDRU ID POSDRU/89/1.5/S/56815.

**Keywords:** HR ethics, fraudster philosophy, fraud risk management, culture of integrity, ethics assessment

### 1. INTRODUCTION

More and more organizations are now concerned with the implementation of risk management processes as a proactive function in maintaining economic and financial balance. Losses registered by both companies and employees or managers may become pressure pillars of fraud triangle, increasing the existing fraud risk within the organization.

Legislative and information environment changes speed creates an opportunity for fraud and rationalization is easy to find even for people with an average degree of morality, because of the present financial instability. Fraud risk assessment on human resources is made relatively easy in terms of opportunities (lack of internal controls) and pressures (identification management style), but when it comes to the level of an individual's morality the things become complicated.

Assessment of individual justification can be made according to the environment in which the person activates, constraints and values of that environment, and according to all efforts to improve the ethical climate at work.

## 2. FRAUD TRIANGLE – RATIONALIZATION PILAR

An effective fraud risk management process should start from understanding why a person might commit a fraud act and involves implementing the fraud triangle within the organization. Because fraudulent acts are committed by humans, the risk is directly affected by human component, so the procedure for identifying fraud generating events should be structured by types of functions and disciplines of others with the organization. Another aspect to be taken into account in the analysis of these reasons relates to the type of fraud allegedly committed (fraudulent financial reporting or misappropriation of assets, corruption).

History of "fraud triangle" theory begins in 1950 with Donald Cressey research. One of the major findings was that every fraud had three things in common: (1) pressure (sometimes referred to as motivation), (2) rationalization (personal ethics), and (3) knowledge and opportunity to commit the crime (opportunity). These three points have become parts of the fraud triangle.



FIGURE 1 - FRAUD TRIANGLE  
Source: Cressey, 1973

- a. **Pressure** (or incentive, or motivation) refers to something that happened in the life of the perpetrator which creates a need that motivates him to steal. Usually, this motivation is centered on financial constraints, but may also be symptoms of other pressures.
- b. **Opportunity** - criminals always have the knowledge and opportunity to commit fraud. The explanation lies in the fact that employees and managers who have been employed at their current job for many years know very well the weaknesses in internal controls and have sufficient knowledge about how to successfully commit fraud. The main factor influencing the opportunity to commit fraud refers to the internal controls of the organization. An internal control weakness or lack offers the opportunity for criminals to commit financial crimes.
- c. **Justification** - most of those who commit fraud do not have prior history as criminal fraudsters. In Report to the Nation (RTTN) issued by the ACFE in 2010 shows that 85.7% of reported

perpetrators have no criminal record. In fact, fraudulent people or white collars have a personal code of ethics to justify their murder case. For example, many will steal from employers, but mentally they are convinced that over time they will reimburse those funds (e.g. "just a loan"). Others believe that theft is benign due to the size of the organization (case often in multinational organizations), while others believe that they are entitled to benefit from the fraud act and solve their own personal problems (e.g. they deserve a raise or a best treatment). Many other excuses could serve as a justification, including some kind, if the offender does not keep stolen funds or assets for itself, but it uses social purposes (e.g. to fund an animal clinic for stray animals, donations to orphanages).

Justify committing fraud in the *financial reporting* can be based on a desire to encourage investment in the company through the sale of shares or to demonstrate an increase in earnings per share, to hide the inability to generate cash flow, removing certain negative market perceptions to obtain funding or concessional funding, to achieve the goals set by the company, to receive performance bonuses.

Justification for *fraudulent financial reporting* may have personal points on the situation at work: lack of or poor communication company policies related to ethical issues, excessive participation of non-financial management in accounting policies selection processes, history of fraudulent acts at fiscal, operational or financial level; excessive personal interest in maintaining or increasing the company's share price; achieving personal market forecasts, aggressive or unrealistic repeated attempts to justify creative accounting policies or extent of the law; damaged relationships with former or current auditors.

Justification for *asset misappropriation* fraud type has many forms, depending on personal human reasoning of those who commit fraud: damaged relationships with management staff, working in an industry that does not recognize and compensate the overtime hours worked, work in a company which has a monopoly or market success, internal attitude of the company to fraud risks, legal compliance, other personal explanations which are difficult to detect or quantify.

Plausible justification for *corruption* that have criminals can be personal (desire to help people and hence the feeling and belief that nothing has been done wrong), or social (social environment in which the employee lives and works allows corruption) or behavioral (wish to take advantage of the victim organization, or to share with others the benefits of victim organization).

### 3. FRAUDSTER PROFILE – FACTS AND FIGURES

A key issue in fraud prevention and detection is to understand the typical profile of fraudsters, depending on the type of fraud committed. In terms of asset misappropriation, the person is usually someone who was never suspected. White-collar criminals profile is very different from that of blue-collar criminals or the street criminals. Economic criminals are more difficult to detect.

People who have a conscience (fear of being caught and punished) are more resistant to the temptation to cheat. Intelligent people tend to be more honest than ignorant people. Social persons at the top or middle classes tend to be more honest than those in lower classes. At the same time, individuals have different needs and therefore different levels that they will be sufficiently motivated to lie, steal, and the committed fraud will be consistent with the capital and hence needs and pressures related.

Singleton (2010) presents a radiography of fraud variables:

Personal Variables	Organizational Variables	External Variables
<ul style="list-style-type: none"> <li>•Skills</li> <li>•Attitude</li> <li>•Personal needs / wishes</li> <li>•Values</li> </ul>	<ul style="list-style-type: none"> <li>•Nature of work</li> <li>•education tools</li> <li>•Incentive tools</li> <li>•Management quality</li> <li>•Clarity of duties</li> <li>•Clarity of work objectives</li> <li>•Interpersonal trust</li> <li>•Ethic work climate</li> </ul>	<ul style="list-style-type: none"> <li>•Degree of competition in the industry</li> <li>•General economic conditions</li> <li>•Existing social values (ethics competitors and political and social models)</li> </ul>

FIGURE 2 - VARIABLES IN FRAUD ACTS

According to information collected from anti-fraud examiners (CFE), ACFE<sup>1</sup> has developed a profile of offenders, presented in his studies. Thus, fraud acts leading high costs or losses for companies are committed, particularly by so-called „high-level criminals " who: (a) have a significant experience in the company, (b) earn an above average income (c) male, (d) are over 60 years old, (e) have a high level of education (the higher the level of education is higher, the fraud is greater), (f) operate in groups rather than alone, and (g) have no criminal record.

The most common frauds that generate small and medium costs and losses are committed by offenders with a different profile. They: (a) were employed for about the same time like high-level criminals, (b)

<sup>1</sup> ACFE – Association of Certified Fraud Examiners <www.acfe.com>.

gain little or average, (c) could be male or female, (d) are between the ages of 41 and 50 (e) have completed secondary education, (f) operate alone, (g) have not usually a criminal record.

The analysis of RTTN<sup>2</sup> the ACFE in 2010, reveals that in 2010 there is a close correlation between the position and level of authority held within the organization and the losses incurred as a result of fraud. The report shows that 17% of fraud cases were committed by shareholders with an average loss of 723.000 USD, 41% by managers with an average loss of \$ 200,000, and 43% by employees with an average loss of 80.000 USD. Because of the influence factors, level of education, position held in the company, the level of authority and trust, access to information, it was found that the average fraud detection is 24 months for fraud committed by ownership, 18 months for committed by managers and employees for 13 months for fraud.

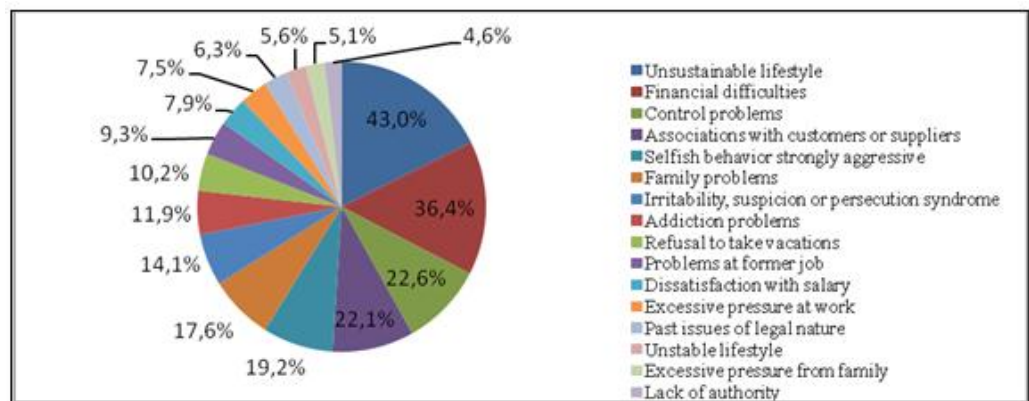


FIGURE 3 - REASONS FOR FRAUD ACTS

Analysis of the level of education of the fraudster was performed on structure: studies of high school, higher education in course, higher education completed, postgraduate studies. The study shows that the largest share in the structure of fraudsters in the level of education people have completed higher education (38.0%) resulting in an average loss for these companies hit by 234.000 USD. Share the smallest in number fraudsters have people with postgraduate studies (probably due to the high level of awareness of the risks, benefits and penalties), but they cause the greatest losses affected companies an average of USD 300,000.

In conclusion, the study conducted by ACFE on fraudster profile presents and analyzes the reasons which led fraudsters to commit fraud. The most common reason was unsustainable lifestyle (43%), and financial difficulties (36.4%), and problems holding the control (22.6%). This structure should be

<sup>2</sup> RTTN – Report to the nations issued by ACFE every year.

included in the plan for internal controls development, meaning that each exposed ground should be a wake-up call "red flag" - generating increased timing controls for susceptible fraudster.

#### 4. HR ETHICS ASSESSMENT

Assessing the internal environment of the organization is the first step in the process of fraud risk management.

Internal environment of the organization is defined by elements such as moral integrity, ethical values, organizational competence of employees and managers, management philosophy and style of work, how are management operations authorised, delegating responsibilities and organizing the entity, attention to organization Board's members, attitude towards fraud and against business risks.

Internal environment assessment process is carried out continuously on verifying the existence of structured policies and procedures as well as their qualitative evaluation.

Human component will be divided into internal (management, employees) and external (customers, suppliers, employees of banks, social parties).

For each human component related to organization is built a rating system for the three aspects of the fraud triangle, thus presenting the event description and the associated risk. The rating system will thus generate fraud risk profile of each human component that relate to the organization.

##### **4.1. Internal Human Component (management and employees)**

The identification of fraud risk should include an assessment of justification, pressures and opportunities to commit fraud.

Aspects of the opportunity to commit fraud are directly related to the existing internal control system. Thus, the opportunities are greater where there is no internal control, or there are deficiencies or there is no function segregation.

Factors related to the pressure to commit fraud can be separated for analysis in factors of the working environment and personal factors. Work environment factors are related to the company incentive programs, the pressure on employees to obtain specific performance, to achieve certain goals or to provide jobs.

Company's incentive programs should be valued to determine how they may affect employees' behavior and their professional judgment in carrying out business processes. Incentives and key indicators that are based may provide a "map" of places where it is most likely to occur fraud.

It will also consider the financial indicators and operational status which must be maintained within certain limits, because maintaining the status quo is sometimes pressure to commit fraud.

Pressure on employees to achieve performance or to achieve certain targets (sales, procurement, research results) is something difficult to quantify. If the organization has established clear standards for personnel evaluation and performance indicators, showing transparency in assessment procedures and help in establishing procedures where indicators are not met, the risk of fraud is lower because the pressure the staff is not very high. In multinational companies, the approach is not transparent, but rather subtle and indirect, and thus the risk of fraud is higher, achieving performance and achieve certain indicators are absolute requirements for job retention or promotion of employees and companies leaving behavior pressure on them to be influenced by so-called "corporate culture".

Personal factors that can cause the pressure to commit fraud are difficult to identify because of privacy issues for employees or managers are not known to the company. Disclosure of these factors would bring in most cases a public opprobrium, so will try hiding them (huge debt, loan rates exceeding at times personal budget, issues of drug addiction, alcohol, or gambling or desire to have a lifestyle beyond the real possibilities). The emergence of these factors can not be prevented or controlled, new control procedures can be implemented only after they have been identified in the behavior of employees or managers.

Justifications for committing fraud is also a psychological factor own by every person, factor that can not be identified and quantified in a credible way before committing fraud, unless the person concerned has a clear and public beliefs about a particular issue .

These factors, mainly psychological, associated to personal pressures and justifications to commit fraud, are usually assessed through indicators of personality. Personality indicators require an individual psychological evaluation to determine its behavior on fraud. They are determined on psychological and active behavioral level depending on individual behavior in the workplace. Evaluation procedures for indicators will be made respecting risk rating system, thus ensuring comparability of information. Determination of psychological level indicators involves giving a grade or values for:

- Ethical sense and perception of fraud.
- Willingness to take risks.

- Refusing to take time off.
- Unjustified extension of the work program.
- Addiction or abuse of drugs, alcohol or gambling.
- Rapid and unexpected changes of mood.
- Major life changes (appearance of a child, divorce, becoming parents and taking new family responsibilities, change of residence).
- Life style appearance unable for a justification.
- Strong social convictions.

There are other variables that can be considered to determine a risk profile, variables that can be obtained from the ACFE Report to the Nation, "fraudulent profile", such as age, sex, ethnicity, education level, but their inclusion in the analysis of risk and assigning values to determine a specific fraud risk personal profile, may be regarded, in certain countries or organizational culture, as discrimination.

Indicators at behavioral level are based on facts which can be proved, and being specific to the work environment, they will be personalized for each employee based on his work requirements. As synthetic elements they relate to employee focus on his work, on environmental compliance and procedures, on the errors committed at on any preferences for other employees or third parties.

#### **4.2. External Human Component (customers, suppliers, employees of banks, social parties)**

Application of the fraud triangle to external human component is possible, in a lesser extent, because it cannot be determined reliably and completely pressure issues and justifications. Evaluating opportunities, however, can be quantified, the rating system having a clear part judged on internal controls in place to prevent external fraud.

Internal controls should aim segregation of duties, clear procedures for delegating tasks, systems, data protection, contract monitoring procedures, quality assessment systems for goods and services sold and purchased. In opportunities category should be included legal regulations applicable, in a less controlled environment, where there is a lack of regulation of fraud and consequences of the fraud, the occurrence is higher.

Pressures to commit fraud must be identified in the economic status of the country or region and they can not be evaluated because there are no known individual aspirations or financial problems of others.



Declining purchasing power, unemployment and other negative effects of economic recessions lead to increased economic crime.

Also, psychological justification for fraud is related to these issues. Psychological justification can only be assessed globally, taking into account factors that could cause fraudulent behaviors related to culture, civilization and religion.

The first factors considered are those of the entity level, because it is considered that the probability of fraud, theft or embezzlement in the company's work is directly related to personality and behavior of management, staff and employees (working conditions, effectiveness of internal controls, and the level of honesty and loyalty in the company - ethical organizational culture.

#### **4.3. Factors for business sector**

The fraud risk assessment should take into account the current economic situation of the country in which the company operates. The current state of the economy is a determining factor "pressure" pillar, and is related to the financial stress, people are more inclined to commit fraud during periods of economic recession.

#### **4.4. Factors for internal work environment**

Internal environment of the company can increase or decrease the likelihood of fraud, embezzlement or theft. An ignorant internal environment to fraud or a vitiated one by certain procedures, which betrays a lack of accountability of those charged with the management, is characterized by:

- Lack or misapplication of a culture of honesty in business.
- Lack of or poor communication for the performance minimum standards for employees and those on ethical behaviour.
- Lack of or insufficient anti-fraud training policies for employees.
- The existence of inappropriate policies for fraud deterrence, in terms of quantity, quality and mode of implementation.
- Lack of communication or lack of administrative measures where there is low level of performance and professional behavior under internal company standards or ethics violations or business.
- Ambiguities in separation of duties, obligations, responsibilities of employees.

- Lack of regular audit missions or any mission control and review that aimed reasonable assurance that business and management processes undertaken by the company are in line with business objectives, priorities, policies, procedures approved by the board of directors and the regulations laws.

Research on anti-fraud examinations and economic investigations revealed that a corporate environment based on a culture "success at any cost" is more vulnerable to fraud than one based on a rational and balanced education. Features two corporate environments that result in lower or higher vulnerability to acts of fraud are: management style and orientation, management structure and control type, characteristics executive management, leadership, planning, performance reporting, the main concerns of management, reward system, ethical values and business principles, internal relational environment, external relational environment, success formula, human resources, financial, loyalty to the company.

#### **4.5. Determinants of ethical behavior in the organization**

Determinants of ethical behavior in the organization are represented by superiors' behaviour, peers behavior, ethical practices in the industry or sector of activity, the moral climate of society, the official policy of the company, the employees' loyalty to the company. All these factors need to be addressed in the building code of ethics of the organization.

According to studies conducted by the Ethics Resource Center in 2009, the managers' actions and attitude towards fraud and unethical behavior in the workplace, significantly influence employee behavior. Thus, employees who feel that managers act in an ethical manner at work and have a positive attitude towards moral values (talking about the importance of business ethics, inform employees, keep their promises, are examples of behavior), presents a less probability to commit fraud than employees who feel that managers only have ethical principles at the information level, without actually apply and exemplify in their own behavior. The study examines the variation of four criteria: a) pressure on employees, b) the rate of unethical behavior at work, c) failure reporting unethical situations and d) retaliation against whistleblowers in two contexts: that of a strong culture of ethics, and of a weak or nonexistent culture of ethics.

The results demonstrate that an organization with a high degree of ethics, the pressure on employees (representing an important aspect of the fraud triangle) decreases by 75%, the rate of unethical behavior in the workplace decreases with 48% reporting failure situations decreases by 38% and

unethical behavior on whistleblower retaliation are reduced 5 times (from 1 case of retaliation in 4 cases reported from 1 to 20).

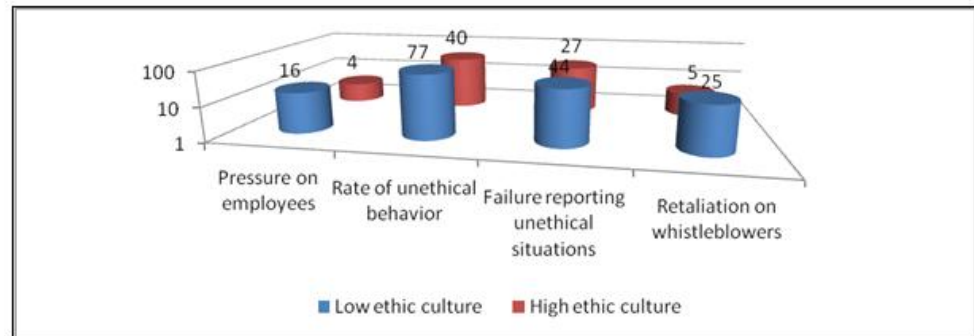


FIGURE 4 - INFLUENCE OF MANAGERS ETHIC CULTURE ON WORKING VARIABLES  
 Source: Ethic Resource Center, 2009

Workmates behavior influence the ethical conduct of a person, so that if in the workplace is tolerated an unethical behavior, all new employees will certainly quickly adopt the same behavior, if contrary, employees who observe ethical behavior from their peers will be less inclined to commit offenses.

Ethical practices in the industry or sector of activity are used by employees every day at work. If in a particular industry is grounded some unethical practice but works like an unwritten law, employees will adapt to it, as a standard or as an essential requirement in order to achieve goals that market. Anti-fraud policy of the company should provide clear descriptions about possible unethical practices to be encountered by employees and state the delimitation of the company from such behavior. If the company does not accept forms of fraud as bribery, influence peddling or illegal gratuities, and explicitly dealt reporting forms and combat all acts of fraud of this kind, it is unlikely that an employee be influenced by practices market.

*Moral climate* of society affects two aspects of a person's ethical behavior in the *form of personal attitude and appearance as moral*.

The first aspect, *personal attitude of committing an act of fraud*, comes from the ethical culture of that country. If acts of fraud or corruption are widespread and not suffer consequences, the person will adapt to this environment and find in it a justification for his actions ("everybody steals"). The second issue *concerns the moral appearances* and assume that a person would not want to be convicted of committing an act of fraud and suffer public hub of family, friends or acquaintances. But if society is tolerant of acts of fraud or corruption, this aspect is neglected because it would be possible that the offender commit without regret and fear any moral deviations.

Official policy of the company is also a factor influencing the ethical behavior of employees. A proper anti-fraud official policy means that the organization will publicly condemn unethical behavior and will declare that moral violations will not be tolerated, regardless of their potential opportunity cost. This policy should be applied in practice and exemplified by the daily behavior of persons in leadership so that employees are aware that anti-fraud policy is not only apparent format adopted for maintaining the company's reputation, but an active mindset in the workplace.

Another factor influencing the likelihood of an employee committing fraud for or against the employing organization is its loyalty to the company. Creating a work environment where employee loyalty to the company supplies overlaps with obtaining a positive work environment as defined by the AICPA in "Management Guidelines anti-fraud programs and controls: guidelines for prevention and deterrence of fraud." In a negative work environment, employees' level of moral integrity and loyalty to the company is small or nonexistent. This creates prerequisites for employees to commit fraud against the company regardless of its consequences, because they consider no obligation to protect the employing organization. In a positive work environment, employees will be more reluctant to commit acts of fraud that could affect the organization, having a higher level of morality and loyalty to the employing company.

## 5. CONCLUSIONS

The first step in developing an effective system to prevent fraud within the organization and an efficient risk management process is to create a prevention environment with a strong culture of ethics and integrity throughout the organization.

Whatever the organizational structure of a company, managers and those charged with governance sets the tone, a trend level of integrity and ethics in the organization. Known in anti-fraud literature as "*tone at the top*", the expression defines the managers' *involvement and attitude, regarding the fraud acts within the organization*.

Without managers' strong example and intensive support is hard to believe that the organization can develop a culture of integrity. Development of codes of ethics in the organization, providing values and principles of integrity is a symbol of the company's attitude towards fraud and must be adopted by all employees or third parties relational thereof.

Employees are paying an increased attention to the managers behavior and actions, tending to follow their example. Whatever manifested behavior management principles, they will propagate down with the

effect on company employees. If the standard set of principles and behaviors by managers, are supporting ideas of ethics and integrity, employees will be more inclined to support themselves these values. If senior management is not concerned with ethics, employees will be more likely to commit fraud because they feel that integrity and ethical conduct is not basic principles and priorities of the organization.

Developing an ethical culture and a working environment with a high level of integrity is a quality parameter against which potential investors assess the organization in making business decisions or future employees look forward to the company or not.

Each person has their own set of moral values and a code of ethics that you apply daily life, including employment relationships, whether employee or manager. Individual behaviors differ in terms of pressure, opportunity and rationalization. Work ethic and anti-fraud training climates can change rationalization aspect for the possible fraudster, given people proven adaptability to different situations or environments, whether positive or negative, and rapid behavioral patterns copying.

The training and antifraud education must be done both for new and existing employees, in order to reconfirm the ethical values of the organization. Trainings should include elements of fraud warning and its impact on the organization. Following antifraud courses must give the insurance that employees understood: a) duty to communicate certain matters, b) the list of problems or doubts that may damage the organization, will also consider how an example, and c) how to communicate these issues. It also will consider the specific level training to employees, responsibilities and locations where they are employed.

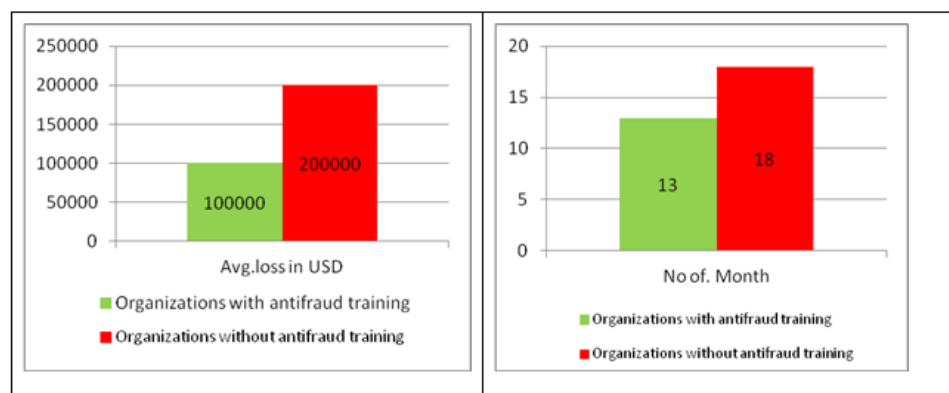


FIGURE 5 - NET LOSS FROM FRAUD AND THE AVG. TIME OF FRAUD DETECTION PROGRAMS DEPENDING ON WHETHER ANTI-FRAUD EDUCATION AND TRAINING FOR EMPLOYEES AND MANAGERS

Impact of antifraud education and training programs to prevent and detect fraud, it is not insignificant. Companies that have organized courses of anti-fraud education and training for employees and their

managers, decreased by 27.8% the fraud detection time (18 months to 13 months), and a decrease of 50% in the net loss due to acts of fraud 200.000 USD to 100,000 USD, as can be seen in Figure 5.

In addition to anti-fraud training, an organization can adopt a number of measures of employment and promotion, proactive for fraud prevention. These include:

- Carrying out investigations on who is at the stage of being hired or promoted (references to others).
- Checking job summary rigorous on education, employment history and any data held by the candidate himself (check documents, supporting knowledge evaluation tests, physical verification was hired, human resources phone checks from former employers).
- Performance assessment for employment and promotion, and depending on how the candidate's behavior contributed to creating a working environment in accordance with the ethical values of the organization.
- Continuous objective assessment of compliance with the organization's values and immediate punishment of any violations of the code of ethics, or violations of internal regulations.

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