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Corporate Culture and the Occurrence of Financial Statement Fraud: A Review of Literature

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Abstract

The complexity of financial statement fraud has received considerable attention over the past few years and will continue to cause concern. Financial statement fraud can surface in many different forms such as overstating assets, sales and profit, understating liabilities and expenses. Although once deceptive accounting practices are initiated, various systems of manipulation will be utilized to maintain the appearance of sustainability. Financial statements are used by shareholders to measure the performance of the firm versus expectations. However, it is sometimes manipulated to meet own greed. Lots of studies have been done in detecting and predicting the occurrence of financial statement fraud. This study explores the significant impact of corporate culture in the occurrence of financial statement fraud. Culture has been widely accepted as a pattern of behavior which influences the character of society. In studying the occurrence of financial statement fraud, an element of corporate culture needs to be considered together with other factors. This paper provides a holistic view of the concept of culture and its effect on organization and behavior. The second purpose is to discuss the effect of the corporate culture within the perspective of financial statement fraud. The findings of the study provide the suggestion for improvement in corporate culture.

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1. Introduction

In today's world, companies are operating in a multidimensional global business environment. They are managing huge amounts of digital data, adapting to the threats of doing business in new markets, struggling to comply with increased regulations and trying to avoid costly enforcement actions and litigation. Dealing with the risk of fraud and misconduct has never been more challenging and such risk has captured the attention of corporate boardrooms today. Many business leaders recognize the potential for significant reputational harm from financial fraud scandals, an economic cost in the form of investigations, fines and penalties and individual cost in the form of criminal prosecution.

The complexity of financial statement fraud has received considerable attention over the past few years and will continue to cause concern. Financial statement fraud can surface in many different forms although once deceptive

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accounting practices are initiated, various systems of manipulation will be utilized to maintain the appearance of sustainability. Common approaches to artificially improve the appearance of financials include overstating revenues by recording future expected sales, understating expenses through such means as capitalizing operating expenses, inflating assets by knowingly failing to apply an appropriate depreciation schedule, hiding obligations off the company's balance sheet and incorrect disclosure of related party transactions and structured finance deals. Another alternative to financial statement fraud involves cookie jar accounting practices, a procedure by which a firm understate revenues in one accounting period and maintain them as a reserve for future periods especially those in which they are expecting a lackluster performance. Such procedures remove the appearance of volatility from their operations.

According to the study by ACFE (2014); PWC (2014); PWC Malaysia (2014), financial statement fraud accounts for the lower number of incidents concerning financial fraud. Asset misappropriation and corruption tend to occur at a greater frequency, yet the financial impact of these latter crimes is much less severe compared to financial statement fraud which by far has greater impact with a median loss of $1 million (ACFE, 2014). Therefore, this study takes the initiative to cover only the discussions pertaining to the financial statement fraud. The rationale behind this is that the fallout from the financial statement fraud can be significant, including punitive damages, tainted corporate and brand image, lost revenue, dipping shareholder value, and inability to attract and retain human capital (KPMG Malaysia, 2014).

Previous studies focused on factors concerning the motive or pressure, opportunity and rationalization associated with financial statement fraud (e.g. profit trend, inventory turnover, total asset turnover, weak governance structure) (Skousen, 2004); (Skousen and Wright, 2006); (Skousen, Smith, and Wright, 2009); (Lou and Wang, 2011); (Dellaportas, 2013); (Schuchter and Levi, 2013); (Sabău, 2013). However, the interesting aspect of this study is that to the best of the researcher's knowledge, there is a minimal study on the relationship between corporate culture and the occurrence of financial statement fraud. Recent cases provide insight into the role that an unethical corporate culture plays in financial statement fraud. The case of financial statement fraud in Olympus Corporation, a Japanese organization provides the opportunity to examine how corporate culture plays a role in corporate governance and fraud detection (Morgan & Burnside, 2014). Not only in Olympus, famous fraud scandals, such as Enron, WorldCom, Parmalat and Satyam have issues of unethical cultures which surround them. Hence, it is important to understand the concept of corporate culture and how it influences the decision on involving in fraud activities. Besides, this study will help to fill the gap in the current literature in advancing corporate culture as one of the factors associated with the occurrences of financial statement fraud.

This study will explore the corporate culture and the occurrence of financial statement fraud using previous literature review. This is to help to explain how these two factors relate to each other.

2. Literature Review

The term "culture" originally comes from social anthropology. The concept of culture was thus coined to represent, in a very broad and holistic sense, the qualities of any specific human group that are passed from one generation to the next. It is the totality of socially transmitted behavior patterns, arts, beliefs, institutions, and all other products of human work and thought characteristics of a community or population (Kotter, 2008). At the deeper and less visible level, culture refers to values that are shared by the people in a group and that tend to persist over time even when group membership changes. These notions about what is important in life can vary greatly in different companies; in some settings people care deeply about money, in others about technological innovation or employee well-being. At this level, culture can be extremely difficult to change because group members are often unaware of the many values that bind them together (Kotter, 2008). Meanwhile, corporate culture itself is a behavior of humans within an organization and the meaning that people attach to those behaviors.

In each of these cases, despite differences in initial research focus, terminology, and methodology, the fundamental conclusions are very similar and very dramatic: all firms have corporate cultures, although some have much "stronger" cultures than others. These cultures can exert a powerful effect on individuals and on performance, especially in a competitive environment. This influence may be even greater than factors that have been discussed most often in the organizational and business literature; strategy, organizational structure, management systems, financial analysis tools and leadership. American and Japanese executives often devote time and energy expressly to creating, shaping, or maintaining strong corporate cultures (Kotter, 2008). According to Hofstede, (2010), there are two aspects that

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