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Understanding the Causes and Effects of Top Management Fraud

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Fraud by top managers has become a worldwide problem. Major scandals have rocked the U.S. (e.g., Enron Corp., Fannie Mae, Global Crossing and WorldCom Inc.), drawing attention to the serious consequences of fraud, not only for companies but also for their employees, communities and society at large. But fraud by top management is not just a U.S. problem; Asian, European, Latin American, African and Australian companies also have been afflicted. Revelations of such fraud have been alarming across the political and ideological divide. After all, how can well paid and highly respected senior executives develop such elaborate schemes to defraud the very people who invested in their companies? What would lead successful and accomplished senior executives to lie for money and jeopardize their honor, reputations and careers? Moreover, revelations of fraud by senior executives have made many wonder: How can these crimes be committed and persist for years in spite of external audits by professional companies and monitoring by boards of directors? What can be done to reform corporate governance and to instill a strong ethical perspective among top managers?

In this paper, we discuss different types of fraud by top managers and link them to various classes of white-collar crime. We then identify key societal, industry, organizational and individual characteristics that contribute to such behaviors. Next, we highlight the various societal, industry and organizational effects of top management fraud.

WHAT IS TOP MANAGEMENT FRAUD?

Fraud refers to the deliberate actions taken by management at any level to deceive, con, swindle or cheat investors or other key stakeholders. Fraud can take many forms that include embezzlement, insider trading, self-dealing, lying about facts, failure to disclose facts, corruption, and cover-ups. Top management fraud may also involve intentional misrepresentations in financial statements. Managers might also create schemes to hide or misrepresent what the firm does or how the firm does it. Intentionality is the key; senior managers committing fraud willfully undertake actions that mislead others.

Some fraud schemes are limited to just one or a few transactions (e.g., falsifying a document). Others might encompass multiple, ongoing activities across several organizational functions or units. For instance, Adelphia Communications Corp.'s founding family was accused of fraud when it collected $3.1 billion in off-balance-sheet loans that were backed by the company. The family also was accused of overstating the company's financial results by inflating capital expenditures and hiding debt. Enron's top managers, on the other hand, are accused of developing an elaborate pyramid-like scheme of "new businesses" that did not actually exist but supposedly generated new revenues and profits.

The schemes that senior managers devise to commit fraud also vary in their magnitude. Some affect only particular units or divisions, while others permeate the entire firms' operations, as in the case of Enron. Some of these acts were committed in one part of the company to cover up acts that occurred in other parts of the operations. Fraud schemes also vary in their duration; the Enron and WorldCom frauds each persisted over a decade.

Some fraud schemes (e.g., falsifying financial statements to overstate earnings) are common among companies across different industries. Other schemes are industry-specific, however. For example, the Savings and Loan (S&L) crisis of the 1980s included various S&L industry specific frauds, such as ''hot'' deals involving land flips, nominee loans, reciprocal lending, or linked financing, as well as more universal fraudulent activities such as ''looting'' by siphoning off funds and covering up to hide insolvency.

TOP MANAGEMENT FRAUD AS A WHITE-COLLAR CRIME

Wrongdoing in and by corporations has been the subject of considerable concern, study and analysis. Researchers have used numerous labels to describe this phenomenon, such as white-collar crime, corporate wrongdoing, management fraud, managerial vice, and corporate illegal behavior. White-collar crimes have distinctive characteristics that include: the absence of physical violence, the existence of strong financial motivations, and the involvement of individuals who are otherwise considered respectable members of society.

White-collar crimes include a wide variety of managerial actions. *Occupational* crimes are those committed against a firm for the benefit of the individual perpetrator, and might include embezzlement or padding expense reports. *Corporate* crimes are committed by the perpetrator for the benefit of the corporation, and might include bribery or pollution control violations. Corporate crimes ''help'' the firm – for example, to obtain a contract or reduce costs – but these crimes may also lead to indirect benefits for the perpetrator such as receiving promotions or bonuses. Further, there are some white-collar crimes in which an individual perpetrator is the sole beneficiary and the firm is the victim, in which the firm is the beneficiary and others in society are the victims, and finally in which both the firm and the individual acting on behalf of the firm are beneficiaries and others in society are the victims.

White-collar crimes also can be classified according to the extent of an individual's involvement in the crime. This requires us to distinguish *active participation* from *passive acquiescence.* In the first case, individuals are actively involved in an illegal activity, whereas in the latter case managers are aware of illegality within the organization but are unwilling to take corrective action. In *crimes of obedience,* the individual is caught in the dilemma of either carrying out a directive that is wrong or disobeying an order and suffering the consequences. Finally, there are *errors* of negligence or omission that result in harm.

Management fraud can occur as part of either occupational or corporate crimes perpetrated by those at the very top or the very bottom of the managerial hierarchy, and can result from active participation or passive acquiescence. Chief executive officers (CEOs), for example, might actively divert corporate funds for their own use, or might knowingly stand aside while others in their firm market unsafe products. First-line supervisors, similarly, may steal from cash registers, or fail to discipline subordinates who lie about unnecessary repairs and inflate customer bills. These crimes can be committed by executives of business firms, managers of public sector companies, civil servants, or elected officials. While all types of management fraud can harm companies, individuals and society, the most serious effects become evident when these actions are committed by senior managers.

Fraud by top managers, which is a subset of white-collar crime, is a particularly serious issue for several reasons. This type of fraud has devastating effects on a company's shareholders and employees, and can ruin the reputation and credibility of a firm. Just the