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Exploring the impact of organizational investment on occupational fraud: Mediating effects of ethical culture and monitoring control

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ABSTRACT

There has been no clear evidence about whether organizational investment works for countering occupational fraud, and where to focus the investment if it works. In this regard, the present study explored the mediating roles of ethical culture and monitoring control in the 'organizational investment-occupational fraud' linkage. Using a sample of 392 Korean banking employees, a series of structural equation models were estimated. The results showed that the perception of increased investment in anti-occupational fraud enhanced two mediating variables, ethical culture and monitoring control. However, only the perception of an improved ethical culture was negatively related to the perceived frequency of occupational fraud with statistical significance. These findings imply that investing in ethical culture is more effective in preventing occupational fraud.

1. Introduction

The financial system of a country is the lifeblood of the economy. Commercial banking is a significant part of the financial system, providing core financial services such as savings accounts, investments, loans, mortgages and other services to ordinary people (Saunders and Cornett, 2008). The employees who serve these banking institutions are exposed to a range of opportunities to commit financial crimes and related acts (Hollow, 2014; Mitchell et al., 1992). White-collar crimes in the banking sector breach public trust in the financial system and can have a very detrimental effect on the whole economy. For example, the Savings and Loan (hereafter, S&L) scandal in the 1980s in the US had a significant impact on the economy. This debacle is regarded as the worst archetype of white-collar crime because fraud and illegal activities involving executives and managers of S&L institutions were so prevalent that they led to financial catastrophe (Friedrich, 2010). The directors and managers of S&L institutions threw extravagant parties and purchased luxury villas or yachts from embezzled money, which represented acute moral hazard. The debacle led some to conclude that "the best way to rob a bank is to own one" and the term 'collective embezzlement' was coined to explain the failure of the financial institutions (Black, 2013; Calavita and Pontell, 1991).

South Korea (hereafter, Korea) is also not immune from white-collar crime within its banking institutions. In 2011, more than 20 savings banks went bankrupt or were suspended by the financial authority due to occupational fraud and illegal activities (Min, 2012). The number of victims reached 100,000 people with losses estimated at around $26 billion. The crisis ended with many working-class families losing their life-long savings and in some cases tragic loss of life, by some committing suicide (The Kyunghyang Shinmun, 2012). The collapse of the financial institutions was attributed to internal fraud and corruption. For instance, the elder brother of the then Korean President and a leading congressman were arrested for receiving bribes from the director of a savings bank

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(KBS News, 2012). Aside from the savings bank scandal, official statistics recorded 147 embezzlement cases by bank employees in Korea, amounting to £30.6 million between 2011 and 2015. The average loss to embezzlement by bank employees was estimated at £210,000 per case (Kim, 2015).

Despite the very serious and significant impacts on society, empirical studies on occupational fraud in the financial sector have been very limited. To bridge the paucity of information, this study surveyed 392 Korean banking sector employees with respect to their perception and experience of occupational fraud in their organization. Although previous studies attempted to discover what control mechanisms (e.g., background checks, hotline, risk assessment, audit, etc.) are effective in preventing and detecting fraud (Holtfreter, 2005a, 2005b, 2008; Johansson and Carey, 2016; Kummer et al., 2015; Tunley et al., 2017), few studies have tried to investigate the impact of 'organizational investment' on occupational fraud. Furthermore, Murphy and Free (2016) called for more research on the relationship between 'ethical culture/climate' and 'fraud.' They argued that the current framework, the Fraud Triangle, has a limited scope of analysis by just diagnosing fraud as the problem committed by immoral individuals who should be 'monitored' through control mechanisms; this has led to assess fraud risk in a narrow approach focusing only on monitoring aspects. Therefore, the current study not only attempts to fill the gap of research on 'organizational investment,' but also to contribute to anti-fraud community by simultaneously exploring the effects of 'ethical culture' and 'monitoring effectiveness' on occupational fraud, in which lies the novelty and significance of the study. Following an explanation of the background, method and findings of the study, its implications and limitations are considered.

2. Literature review

2.1. Occupational fraud and the Fraud Triangle

Occupational fraud is sometimes called 'internal,' 'insider,' or 'employee' fraud (Bonny et al., 2015; Edge, 2016; Gunduz and Onder, 2013; Rossi, 2012) or just referred to as fraud (Holtfreter, 2005a, 2005b, 2008; Murphy and Free, 2016). The Association of Certified Fraud Examiners (ACFE), the world's biggest anti-fraud organization defines 'occupational fraud' as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets" (ACFE, 2012: 6–7). Therefore, 'occupational fraud' is fraud against an organization committed by members of an organization, which range from ordinary employees through to managers to executives. It entails three categories: (1) asset misappropriation, which includes the theft or misuse of an organization's asset; (2) corruption, where employees use their influence in business transaction to obtain unauthorized benefits contrary to their duties to employers; (3) fraudulent financial statements, which normally involve making reported financial statements look better than they really are (ACFE, 2012; Albrecht et al., 2015; Holtfreter, 2005b; Wells, 1997).

Holtfreter (2005b) found that the individuals who committed 'fraudulent statements' were more likely to be older, educated males with managerial positions conforming to the high status image of 'white-collar crime' (Sutherland, 1961), whereas those perpetrated 'asset misappropriation' or 'corruption' more closely resembled 'middle-class' offenders (Weisburd et al., 1991); in terms of organizational characteristics, 'asset misappropriation' was committed significantly more often in smaller organizations, whereas 'corruption' occurred in larger organizations more frequently. The definition and typology of 'occupational fraud' developed by the ACFE has provided an especially powerful way of analyzing white-collar crime at a workplace level and many previous studies adopted the ACFE's definition and typology for their analysis of fraud (Greenlee et al., 2007; Holtfreter, 2005a, 2005b, 2008; Johansson and Carey, 2016; Timofeyev, 2015). When fraud is commonly referred in this paper, the authors also adopt the concept of 'occupational fraud' by the ACFE.

According to the ACFE's biennial reports, almost every organization is a victim of occupational fraud and the typical organization loses approximately 5 percent of its annual revenue with the median loss of one case estimated at around $150,000 (ACFE, 2012, 2014, 2016). Therefore, studying what works for countering it is very important. Cressey's Fraud Triangle Theory depicts that there is a high probability of fraud when pressure (incentive), opportunity, and rationalization (attitude) intermingle at the same time (Cressey, 1953; Wells, 1997). However, some imply that all three elements only apply to 'first time' or 'accidental' offenders and not to repeat offenders, who are known as 'predators.' In the case of the latter, only one condition is necessary to commit fraud, which is opportunity (Dorminey et al., 2010, 2012). Although challenges and caveats have been made to the Fraud Triangle (Lokanan, 2015; Schuchter and Levi, 2016), the theory is established as a useful framework not only for assessing the risk of fraud but also for presenting ways of countering fraud (AICPA, 2002). For example, 'opportunity' can be reduced by strengthening control mechanisms to increase the probability of detection and punishment in organizations (ACFE, 2015; Albrecht et al., 2015; Dorminey et al., 2010, 2012).

Furthermore, having an ethical culture/climate is suggested as a solution to eliminate the other elements of the Triangle, 'rationalization' and 'pressure' (Dorminey et al., 2010; Murphy and Free, 2016; Rodgers et al., 2015). The individual level 'rationalization' and 'pressure' have been hard to observe because both are happening in a subjective human mind. Moreover, only occupational offenders actually experience the concurrence of the three elements by actually committing fraud, whilst normal employees do not often encounter them simultaneously. This hence made empirical studies of all three elements very complicated (Schuchter and Levi, 2016). However, if the unit of analysis is converted to the organizational level, 'ethical corporate culture' can be a proxy measure which is negatively associated with the strength of 'rationalization' and 'pressure' in a company (Dorminey et al., 2010; Murphy and Free, 2016). Despite the suggested link between the ethical culture and the two elements, empirical analysis for this expanded solution cannot be found in the extant literature. In this regard, the present study endeavours to enlarge Fraud Triangle Theory by measuring 'monitoring effectiveness' and 'ethical culture' in organizations rather than directly assessing individual