Fighting Against Financial Crimes: Tone At the Top

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ABSTRACT

Corporate fraud can be classified into asset misappropriation and fraudulent financial reporting. But corporate fraud significantly harms the transparency of financial reporting, regardless of types of fraud. Even a single incident of corporate fraud can shake the public's confidence in the credibility of financial reporting, which may ultimately dismantle effective functioning of the financial market. The loss of public's confidence will, in turn, increase the cost of capital even to those companies not involved in the fraud. In economic downturn, many companies face challenges to meet the target revenue or income, loan covenants, or analyst's expectations. Personal greed, pay cuts, diminished morale, and inadequate internal control aggravate the situation for corporate fraud. Most of fraud occurrences go undetected and their magnitude cannot be determined for certain. A preventive measure to lessen the tempting opportunities is regarded as the best approach to manage risks arising from fraud. ACFE (2008) reports the lack of internal controls as the main cause for corporate fraud. Internal control purports to provide reasonable assurance about safeguarding assets and reliable financial information along with other features. But the organization's tone at the top provides the ground upon which internal control system can be built and operated as planned.

Key Words : corporate fraud, financial crime, fraudulent financial reporting, audit committee

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Ⅰ. Introduction

In economic downturn, many companies face challenges as pressures to meet various analysts' expectations and loan covenants are mounted. Those companies may blur lines on revenue recognition, tinker stock options, abuse loan reserves, or evade loan covenants. Pay cuts, layoffs, diminished morale, and inadequate internal controls aggravate situations that open the door for fraud commitment in tough times. According to the survey conducted by the Association of Certified Fraud Examiners (ACFE), more than half (55.4 percent) of 500 randomly selected Certified Fraud Examiners (CFEs) said that the level of fraud has slightly or significantly increased in the past 12 months compared with those of prior years. In addition, about half (49.1 percent) of respondents cited increased financial pressure as the biggest factor contributing to the increase in fraud incidents, compared to increased opportunity (27.1 percent) and increased rationalization (23.7percent) (ACFE 2009). ACFE President James D. Ratley says, "The message to Corporate America is simple: Desperate people do desperate things. Loyal employees have bills to pay and families to feed. In a good economy, they would never think of committing fraud against their employers. But especially now, organizations must be vigilant during these turbulent times by ensuring proper fraud prevention procedures are in place (ACFE 2009)." Dan Ariely says that "Fraud perpetrators are frequently those you would least suspect. Repeated behavioral testing shows that people cheat if they can get away with it." He further says, "The moment you have a fuzzy environment, the more this (fraud) can happen (Ariely 2008)."

For every fraud case that makes news headlines and ends with prosecutions, most frauds drain corporate assets, which cause companies to be crippled. Some fraud is obviously flagrant crime, while others can be thought of as good intentions gone badly awry. When the business has turned downward and that is not what outsiders expected, temptations to meet expectations through accounting adjustment are doubled. According to the ACFE (2008), fraud can be classified into three broad categories: asset misappropriation (such as bogus invoice, payroll fraud, or skimming), corruption (such as bribes or extortion), and fraudulent financial reporting, often called management fraud, through earnings manipulation to inflate earnings or to deflate debts.

Asset misappropriation is the most common, but the least costly form of fraud (average amount of $150,000 per incident). On the other hand, management fraud is the least common, but the most costly form of fraud (average amount of $2,000,000 per incident). In 2005, Waste Management Corporation paid $26.8 million fine with other penalties for fraudulently manipulating the company's financial results to meet predetermined earning target. Nowadays any company obsessed to meet analyst's expectations need to have its head examined. But in economic deteriorating era, the temptation is not to try to maximize earnings or meet expectations, but to avoid impairments or other asset write-downs that drive companies in a downward spiral toward bankruptcy.

Nancy Schapiro, Chairperson of Securities and Exchange Commission (SEC) warned that "… those who break the law and take advantage of investors need to know that they would face an unrelenting law-enforcement agency in the SEC (Mintz 2009)." She promises her agency will pursue lawbreakers "until the full force of the law is the sure, certain, and sole reward of their wrongdoing (Mintz 2009)." ACFE (2009) reports that occupational fraudsters are generally first-time offenders and only 7 percent of perpetrators had prior convictions and only 12 percent were fired because of fraud. Most first-time embezzlers do not cover their tracks well. Many flaunt their bogus gains. ACFE (2009) further found that 39 percent of perpetrators lived beyond their means. A 33 percent had financial difficulties when they committed fraud. Because of such flagrant signals, whistle-blowers could tip authorities for suspicious activities.

But the companies cannot afford to simply wait for anonymous tips from whistle-blowers for fraud perpetrated. Monitoring peculiar activities and enforcing internal control procedures play an important role in preventing fraud. The right controls in place and stamping down the desire for fraud are the best ways to deter fraud. But the prerequisite condition for the internal controls and curbing desire for fraud must be set up from the tone at the top. The National Commission on Fraudulent Financial Reporting (The Treadway Report 1987) reports that the tone set by top management is the most important factor contributing to the integrity of the financial reporting process. The tone at the top can be thought of as a beacon that helps prevent employees in gray area from crossing over to the dark side. Nothing will eradicate fraud caused by human greed, but the top management can help keep fraud risk environment in check through the suitable working environment, the adequate internal control procedures, and watchful eyes across the entire organization.

The current study purports to provide the system-wide framework to deter or prevent fraud rather than ways to detect the fraud. The remainder of paper is organized as follows: Financial crimes within or against organization are discussed in section II, followed by occupational fraud in section III. Section IV will discuss the entity's tone at the top to prevent or fight fraud, followed by conclusion in section V.

II. Financial Crimes Within or Against Organization

Financial crimes are matters related to fraud, theft, or embezzlement occurring within or against business entities. These crimes are perpetrated by individuals or organization to obtain personal gain, business advantages, or to avoid the hardship the entities may encounter.

Financial crimes are characterized by deceit, concealment, or violation of mutual trust. The Financial Crimes Section (FCS) of the Federal Bureau of Investigation (FBI) investigates such financial crimes as corporate fraud, securities and commodities fraud, health care fraud, insurance fraud, and others (FBI 2008). The mission of the FCS is to monitor financial fraud, launch investigations, and forfeit assets gained from financial crimes. Each fraud is briefly discussed next.

1. Corporate Fraud

Corporate fraud involves accounting schemes and self-dealing by corporate executives. The majority of corporate fraud cases investigated by the FBI include accounting schemes designed to deceive investors, auditors, and stock analysts. By falsifying financial data, the stock price of a corporation is mostly inflated. Those falsifications bring not only financial losses to investors, but cause immeasurable damage to the nation's economy by providing distorted financial information to the securities market. The FBI has recently observed the sudden increase in the number of fraud among sub-prime mortgage lending companies. The FBI (2008) reports that the sub-prime market has grown from 2 percent share of the total mortgage market in 1998 to 20 percent share in 2006 with the total outstanding value of sub-prime loans reaching $1.3 trillion, compared with $4.5 trillion in overall mortgage market.

As the housing market deteriorates, sub-prime mortgage companies experience financial difficulties due to rising defaults. The FBI identified false accounting entries and fraudulently inflated assets and revenues upon investigation. Those investigations further revealed many instances of manipulation in accounting to inflate their financial reports. As those companies' stock prices have declined, executives rapidly sold their equities and profited illegally by using insider information.

Corporate fraud also includes the backdating of stock options. Stock options are incentives that a corporation allows the holder to purchase stock at a fixed price in future, regardless of the market price. The option holder is benefited the difference between exercise price and later market price. But when stock options are backdated, the date that the holder can exercise the options is set to a time in the past. The market price at then was lower than the market price on the date when the option was granted. Backdating stock options benefits the option holder at the expense of existing stockholders. In addition, corporate fraud also includes insider trading, kickbacks, misuse of corporate property for personal gains. Through fiscal year 2007, the FBI indicted 183 cases, and 173 of those indicted were convicted. It also restituted $12.6 billion and fined $38.6 million from corporate criminals (FBI 2008).

Examples of the recent corporate fraud cases include Brocade Communications Systems and Qwest Communications. Brocade Communications Systems was charged in connection with a backdating stock option scheme. Former Chief Executive Officer (CEO) Gregory L. Reyes and former Vice President of Human Resources Stephanie Jensen fraudulently falsified Brocade's financial information, made false statements to auditors, and filed false financial statements with the SEC. After reinstating earnings for the years 1999 through 2004, the cost to Brocade exceeded $400 million. On August 7, 2007, a jury convicted the former CEO of 10 counts of conspiracy and securities fraud, and was sentenced to 21 months in prison. On December 5, 2007, a jury also convicted Jensen of conspiracy to commit securities fraud and falsifying corporate records.

Qwest communications, one of the largest providers of telecommunication services in the U.S., fraudulently reported sales revenue of $16 billion in 2000 and $19 billion in 2001, which led the FBI to investigate the criminal activities. Five top managements were indicted and convicted of securities fraud or insider trading. The former CEO Joseph Nacchio was sentenced to 6 years in prison and ordered to pay $52 million gained illegally with $19 million fine.

2. Securities and Commodities Fraud

These scams are committed by artificially inflating buying volumes of a target company controlled by the fraudsters. The artificially inflated volume tends to increase the stock price of the target company. The fraudsters then rapidly sell their stocks in the market, resulting in gains to them and losses to innocent investors. High yield investment fund fraud scheme is another form of securities fraud. This scheme is characterized by offers that guarantee unusually high rate of return. Most common type includes the Ponzi scheme, the pyramid scheme, advance fee fraud, and commodities fraud. The Ponzi scheme, named after Charles Ponzi, distributes money collected from innocent investors to pay high rates of return promised to previous investors. The pyramid scheme is similar to the Ponzi scheme in nature, but the victims are induced or forced to recruit other victims to receive recruitment commissions. The advance fee fraud is the scheme that is designed to lure the victims to pay fees up-front in exchange for the promise of goods, services, or prizes. Commodities fraud includes the deceptive sale of commodities investments, in which fraudulent sales are advertised to solicit victims.

The FBI investigated Pinnacle Development Partners LLC. for soliciting innocent investors with promise of 25 percent return in 2 months through investing in foreclosed properties (FBI 2008). In October, 2006, the SEC filed fraud charges against Pinnacle and its founder for the operation of Ponzi scheme. The founder was sentenced to 12 years in prison with $22 million restitution charges. The FBI has investigated 1217 cases of securities and commodities fraud throughout 2007, indicted 320 cases, and convicted 289 of them (FBI 2008).

3. Health Care Fraud

Health care fraud is committed by individuals and organizations with purpose of defrauding the public and private health care systems. Most prevalent forms of fraud are as follows.

i. Billings for services not rendered, which include any of the following:
   - No medical service was provided.
   - The service mentioned in the claim form was not rendered at all.
   - Previously paid claims were billed again in slightly different formats.

ii. Services were inflated than actually performed.
   - This type of scheme inflates a bill to receive a higher payment than the service conducted.

iii. Unbundling is a scheme to bill claims in fragmented fashion to maximize the reimbursements.

iv. Excessive services are schemes that provided medical services than patient's needs.

v. Kickbacks occur when a health care provider offers or accepts money in return for the referral of a patient for health care services that may have been paid by a benefit plan.

vi. Unnecessary medical services may give rise to a fraudulent scheme when service is not justified by the patient's medical condition.

Fraudulent billings to both public and private health care programs are estimated between 3 and 10 percent of total health care expenditures. For 2007, the total health care expenditures were $2.26 trillion, representing 16.2 percent of the U.S. Gross Domestic Product (GDP), and is estimated to exceed $4.14 trillion by 2016 (FBI 2008).

Health care fraud is expected to continue to rise as people live longer. Health care fraud is prevalent worldwide. The side effects of the health care fraud include willingness of medical professionals to risk patients harm by conducting unnecessary services, prescribing dangerous drugs without medical necessity, and/or engaging in abusive care practices. Throughout 2007, the FBI investigated 2493 health care fraud cases, indicted 839 cases, and convicted 635 of those indictments (FBI 2008). Health care fraud increases health care cost for everyone.

4. Insurance Fraud

The U.S. insurance industry collects nearly $1 trillion as premiums every year. The Coalition Against Insurance Fraud (CAIF 2008) estimates that the cost of fraud in the insurance fraud is about $80 billion each year, and this cost is passed to consumers in the form of higher premiums. The National Insurance Crime Bureau (NICB) estimates insurance fraud raises $300 in yearly premium fro average household (FBI 2008). The temptation for insurance fraud is especially higher during the periods of economic downturn. The most common type of fraud involves insurance agents and brokers diverting policyholder premiums for their own benefit. In addition, unauthorized agents are growing in number. Financial crimes within organization, so called occupational fraud, are discussed in the next section.

III. Occupational Fraud

1. Occupational Fraud

Occupational fraud, depending on who commits fraud, can be categorized as management fraud or employee fraud. Management fraud, often called fraudulent financial reporting, is committed by management for the purpose of window-dressing financial statements. Two most common techniques used by management involve improper revenue recognition and overstatement of assets.

According to the study done by Committee of Sponsoring Organizations of the Treadway Commission (COSO 1999), 50 percent of U.S. companies which committed financial statements fraud between 1987 and 1997 recorded revenues prematurely or created fictitious revenue transactions. In addition, 50 percent of the fraud companies overstated assets by means of overvaluing existing assets, recording nonexistent assets, or capitalizing items that should have been expensed. Typically overstated assets include inventory, net accounts receivable due to understated allowance for doubtful accounts, and fixed assets. The COSO reports that the median fraud amounted to $4.1 million, which is relatively large considering total asset of $15.7 million of the median company. The chief executive officer (CEO) and/or the chief financial officer (CFO) committed 83 percent of the fraud cases.[1] Motivations behind management fraud were to avoid loss, to increase stock price, or to meet stock analysts' expectations. The officers and members of the board of directors were also financially motivated to commit fraud, because they owned 32 percent of the company stocks. Payoffs of the management fraud were significant in that more than a half of the companies filed bankruptcies or were under substantially different ownerships.

On the other hand, employee fraud, often called misappropriation of assets, embezzlement or defalcation, is to misuse or misappropriate the company's assets. Employee fraud can be either direct or indirect. Direct fraud occurs when as employee steals company properties, such as cash, inventory, supplies, or other assets. Indirect fraud occurs when employees take kickbacks or bribes from vendors, customers, or any one outside the organization. Types of employee fraud include skimming, cash larceny, billing schemes, payroll schemes, expense reimbursement and misappropriation of non-cash assets. Employee fraud usually benefits the individual perpetrator, while management fraud benefits his/her company and officers by deceiving investors and creditors through fraudulently reporting financial statements. But management fraud is more difficult to detect than employee fraud, because management is in a position to alter, falsify, or create source documents by collusion with employees or third parties.

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1) Refer to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) 1999 analysis of cases of fraudulent financial statements investigated by the U.S. Securities and Exchange Commission (SEC).

2. Fraud Environment

Three elements to fraud environment are perceived pressure, perceived opportunity, and rationalization. Albrecht et al. (2009) identified perceived pressure as the one that motivates individuals to commit fraud such as financial pressure, vices, or work pressures. Individual financial pressure may come from personal greed, living beyond one's means, extreme personal debts, or unexpected financial needs. Corporate financial pressure, such as poor cash position, uncollectible receivables, loss of customers, obsolete inventory, or declining market condition, often motivates management to fraudulently report financial statements. Vice pressures, such as gambling, drugs, and alcohol, may also induce individuals to perpetrate fraud. But other factors, such as little recognition for job performance, job dissatisfaction, being overlooked for promotion or being unpaid, also entice individuals to commit fraud.

The second element is a perceived opportunity to commit fraud. For example, factors such as lack of effectiveness of internal control, inability to judge quality of performance, failure to discipline fraud perpetrators, and lack of audit trail, contribute fraud opportunities. Establishing an effective internal control system is the crucial step to deter and detect employees' wrongdoings. Many frauds were perpetrated in environments in which control system was supposed to be in place, but it was not. Section IV will discuss further details of the internal control system. An ordinary person is unable to evaluate the quality of the professionals' job performance. When those professionals were faced with the pressure to cheat and believed that their customers would not know what they have done, they would commit fraud. If the fraud perpetrators were not punished or marginally sanctioned for what they had done, they might resume those behaviors again.

As for the third element, human beings have tended to rationalize their behavior, such as rationalization for not exercising enough, for being overweight, and for spending more than they earned. Unfortunately, people rationalize their dishonest behaviors for them not to feel guilty. Common rationalization that perpetrators use includes the following:

- The company owes it to me.
- I only borrow money and will pay it back.
- Nobody gets hurt.
- It's for good purpose.

Albrecht et al. (2009) suggests that three common fraud elements must be present for fraud to be committed: a situational pressure (non-shareable financial pressure), a perceived opportunity to commit and conceal the dishonest act (a way to secretly resolve the dishonest act), and some ways to rationalize the act contrary to a perpetrator's conscience level. According to the survey by ACFE, the biggest factor contributing to increase in fraud was increased pressure (49.1 percent), followed by increased opportunity (27.1 percent) and increased rationalization (23.7 percent (ACFE 2009).

IV. Tone at the Top

Purposes of internal control are to safeguard assets by preventing theft, fraud, misuse, or misplacement, to provide accurate accounting information, and help employees to comply with laws, rules, and regulations. The safeguarding of assets and accurate accounting information often go hand in hand, because employees attempting to misappropriate assets or embezzle cash will also need to adjust accounting records to hide the fraud. In addition, business must comply with applicable laws and regulations and reporting standards. Examples of such laws and standards include environmental regulations, contract terms, and generally accepted accounting principles (GAAP).

To that end, the entity's tone at the top is important for the control procedures to operate at its purported level. This tone includes control environment and personnel policy.

1. Control Environment

The control environment is the overall attitude of directors and top management about the importance of internal control to the entity. That is why the control environment is often referred to as the entity's tone at the top. If top management keeps telling about the importance of internal control, subordinates will tend to follow the established control. Without a solid control environment as a foundation, the other elements of internal control are not likely to function at its intended level. The following subcomponents are the factors that influence the control environment.

(1) Management's Philosophy, Operating Style, and Code of Ethics

One of the factors that influence the control environment is management's philosophy and operating style. A management who often overrides control policies may indirectly encourage employees to ignore controls. Also, the management that overemphasizes operating goals and deviates from control policies may indirectly encourage employees to ignore controls. At the same token, the management who emphasizes the achievement of target revenue may create undue pressures to employees to fraudulently record fictitious sales. Management cannot act one way and expect others to behave differently. On the other hand, the management that emphasizes the importance of controls and encourage adherence to control policies will create an effective control environment. Corporate code of ethics is designed to provide guidance on employees' behavioral standards that must be observed while performing their duties. The code may reflect the management's attitude to remove or alleviate temptations that might induce employees to engage in fraudulent or unethical behavior.

(2) Board of Directors

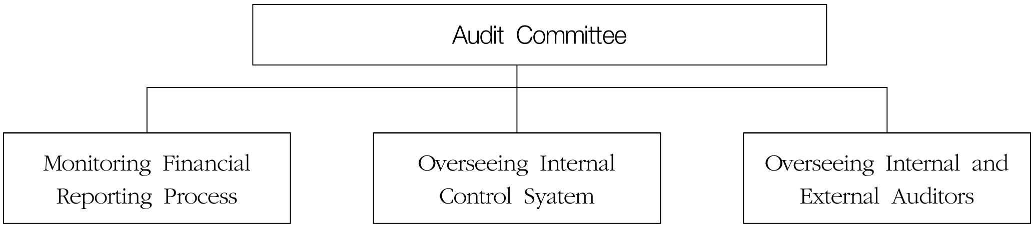
Shareholders of a company normally do not exercise direct control over the operations of the company. Instead, they indirectly control the company through the election of a board of directors. The board was entrusted with authorities from shareholders to oversee management's activities for the protection of their wealth. The board advises and approves strategies and operation of business as well as monitoring them. This system of authoritative directions is called corporate governance, which has a profound impact on the performance of business.

The board of directors sets and governs the directions, strategies, operation, and financial reporting. But the board delegates responsibilities for establishing and maintaining internal control procedures to management and, in turn, assesses its effectiveness. The board also monitors the possibility that the management overrides control policies. Since shareholders are not directly involved in day-to-day operations, they must rely on financial reports in evaluating management's performance. To get help for its oversight function over management performance and financial reporting, the board establishes an audit committee. An audit committee is a selected number of the board of directors whose responsibilities include overall oversight function on financial reporting and internal control processes. In fulfilling these responsibilities, the audit committee considers the potential for management's override of internal controls and oversees management's fraud risk assessment. Audit committee's oversight function also serves as a deterrent to fraud. For example, audit committee's frequent contacts and open line of communication with auditors and all lines of management may assist the committee to identify fraud attempts and to assess the strength and weakness of the internal control and the potential for the fraudulent financial reporting. The committee also helps the board discharge its fiduciary duties to shareholders satisfactorily by delivering information that it has acquired through the monitoring process to the board. The audit committee's involvements in the financial reporting process and frequent contacts with auditors are important determinants in evaluating proper functioning of internal control system and financial reporting.

(3) Audit Committee

Association of Corporate Directors' Blue Ribbon Commission on Audit Committee describes audit committee as "a vital role in corporate governance. The audit committee can be a critical component in ensuring quality reporting and controls, as well as the proper identification and management of risk."(NACD, 2000, p.1) The three key roles of the audit committee are shown in the [Figure 1].

[Figure 1] Major Roles of Audit committee



The audit committee is responsible for monitoring the financial reporting process, overseeing the internal control system and the works of internal and external auditors. The Treadway Commission(1987) reports that "the mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent and probing in fulfilling its oversight responsibilities."(p.41) For the audit committee to discharge its duties properly, the board of directors must adopt a charter which clearly describes the membership requirement and terms of office, duties and responsibilities, relationship with management, internal and external auditors, and frequency and timing of meetings. A written charter helps the member clearly understand his role. In addition, it provides the board of directors, management, and internal and external auditors with clear understanding of the committee's role. A written charter usually includes the followings: monitoring internal control system, overseeing internal and external audit function, relationship with management, reviewing interim financial statements, checking compliance with the code of corporate conduct, applicable laws and regulations, and reporting the committee's activities to the board of directors and shareholders.

1) Monitoring Internal Control System

Well designed and implemented internal control structure reduces the risk of financial statements being materially misstated. In addition, it promotes operational efficiency, reduces risk of asset loss, helps ensure the reliability of financial statements, and compliance with laws and regulations. But for the internal control system to function properly as designed, the top management's philosophy and operating style are important factors. Management must provide clear signals to employees about the importance of internal control. In other words, the tone set by top management, such as the corporate environment within which financial reporting occurs, is the most critical factor to the integrity of financial reporting.

The Treadway Commission (1987) reports that audit committee must review the internal control system periodically as a part of ongoing assessment regarding its effectiveness. In addition, the audit committee should occasionally discuss with internal and external auditors regarding their assessments of deficiencies in internal control. The audit committee should also monitor management's operating style to check whether management follows internal control system.

2) Overseeing Internal Audit Function

Internal auditors play watchdog role for the corporate environment. But for internal auditors to discharge their duties, management and board of directors must fully support its staffing, activities, and independence. Management must provide internal audit department with adequate resources and personnel to help them perform audits with moderate frequency at all organizational levels, areas, and activities. Management and board of directors should ensure that internal audit director and staffs must be free of undue influence in performing their assignments. The audit committee should open a line of communication with internal auditors and allow them to access to the committee without limitation. A good relationship with internal auditors helps the audit committee in fulfilling its duties for the board of directors and shareholders. To ensure that internal auditors carry out their assignments, the audit committee should approve and periodically review the internal audit charter in which objectives, goals, internal audit schedules, staffing plans, and budgets.

The director of internal audit must inform audit committee of audit results, significant findings, and recommendations. To help assure independence, the audit committee should have the director talk directly to the committee and attend all the audit committee's meetings. Internal auditors' independence can further be enhanced when audit committee approves for appointment, replacement, reassignment, or dismissal of the director of internal audits. When the director is being replaced or reassigned, the audit committee must make sure that the reassignment does not represent management's attempts to cover up internal auditor's findings. The audit committee must also evaluate the adequacy of the size, staffing, and qualification. In addition, the audit committee must follow up to ensure that management has taken appropriate steps for the internal auditor's recommendations.

3) Relationship with External Auditors

Since the audit committee's primary interest is in the reliability of financial reporting, the audit committee should communicate with external auditors on ongoing basis to discuss the proposed audit scope and approach, restrictions encountered during the audit, disagreements with management regarding accounting principles, and audit findings and suggestions. In addition, the audit committee and management must assist external auditors to preserve independence. On the other hand, auditors must discuss with the audit committee regarding any irregularities or illegal acts they become aware of during the audit process.

The audit committee should be involved in the process of selecting and reappointing external auditors. The audit committee reviews the management's recommendation on the appointment of external auditors and recommends them to the board of directors, which asks shareholders for approval. In reviewing management's recommendation, the audit committee must meet privately with management and internal auditors to discuss quality of the audit services and other appropriate matters.

4) Relationship with Management

Because management influences the integrity of financial reporting, the audit committee should continually assess the management's competence and integrity. Management, in turn, should provide the audit committee with various issues related to the corporate environment, such as business risks the company is facing, planned responses to them, status of any pending lawsuits, current issues affecting the company's operations, and any other major difficulties the company is experiencing. Management may have different opinions on significant accounting issues from external auditors, especially when transactions are complex or GAAP is not clearly defined on a particular issue. In those cases, management may seek a second opinion from the other accounting firms. The management's decision to do so may be a legitimate attempt to obtain the proper opinion on a disputed issue. But management may be viewed to others as trying to obtain an opinion that coincides with management's interest. In either case, the management may put undue pressure to external auditors. When such a case arises, management should discuss the matter with the audit committee and explain reasons for shopping a second opinion.

5) Reviewing Interim Financial Statements

Users of financial information rely heavily on interim reports ,such as quarterly reports, which were not audited but reviewed with limited scope. Most audit committees overlook the interim financial reporting process, even though that information is an integral part of the annual financial reports. The audit committee must review the process that interim financial reports are prepared to assess the reliability of those reports indirectly. In other words, the audit committee must review the internal control system that management has established to preserve integrity of the interim reporting process. In addition, the audit committee must be informed the extent of internal and external auditors' degree of involvement in interim reports.

Audit committee should also check compliance with applicable laws and regulations. To carry out those functions, the audit committee should review the effectiveness of internal control system. Audit committee must report its activities to the board of directors, which helps outside directors of the board gain financial information, and, thereby, discharge their duties properly.

Outside directors have less information than inside directors on the company's operating activities and its financial information, which hinders the outside directors' monitoring activities. By transferring the information that audit committee has obtained to the outside directors, the audit committee act as an efficient means to reduce information asymmetries between outside and inside directors. The Treadway Commission (1987) recommended the SEC to require all public companies to include a letter signed by the chairperson of audit committee regarding the committee's role and responsibilities in financial reporting process in annual report. The Commission believed that such an inclusion would clarify the role of audit committee and encourage its members to fulfill its responsibilities diligently.

2. Personnel Policy

The most important factor for the control system to function at the level it was planned is personnel. Competent and trustworthy personnel enhance effectiveness of internal control, while incompetent or dishonest people may nullify the system to a shambles. Personnel policy should be established to provide the entity with reasonable assurance that

- All new personnel should be qualified to perform their work competently and honestly.
- Work is assigned to personnel with adequate technical training and proficiency.
- Personnel selected for promotion has qualifications necessary to fulfill the assigned responsibilities.

Ⅴ. Conclusion

Fraud is any intentional wrongdoing aimed at deceiving others for the sake of personal enrichment. Fraud causes serious financial problems not only to those organizations victimized, but also to creditors and other stakeholders. In addition, many instances of fraud went undetected because of ineffectiveness of internal control system and inherent limitations of internal and external audits. That is the reason that the occupational fraud is more likely to be detected by tips from various sources. Even for those detected, the full amount defrauded may not be ascertainable. Determining the true breadth and depth of the fraud is extremely difficult, if not impossible. ACFE (2008) estimates that 7 percent of the U.S. Gross Domestic Product (GDP), which amounts to $994 billion, might be vanished due to fraud. Corporate fraud can be classified into three broad categories: asset misappropriation, corruption, and fraudulent financial reporting. Regardless of which type of fraud occurs, it has detrimental impact on the fair presentation of financial statements. Even a single incident of fraud can shake public's confidence in the credibility of financial reporting, which is essential for the effective functioning of the securities market. But the loss of public confidence will increase the cost of capital even to those companies not involved in fraud, which eventually leads the capital market to erode.

As many companies have faced numerous challenges in economic downturn period to meet target earnings, loan covenants, or stock analysts' expectations, the number of fraud incidents has increased significantly. During this turbulent period, organizations must be vigilant to prevent fraud by placing proper fraud prevention procedures in place. Past research cites lack of adequate internal control as the main cause for corporate fraud. The objectives of internal control are to provide reasonable assurance thatassets are safeguarded and used for business purposes, that financial information is accurate, and that employees comply with applicable laws and regulations. But the entity's tone at the top provides the foundation upon which internal control procedures can be effectively operated at its purported level. The right controls in place and suitable environment to stamp down wrongful desire are the best ingredients to deter corporate fraud. In addition, well defined ethical standards and written guidelines for acceptable behavior help establish atmosphere that encourages reliable financial reporting and fiduciary duties among employees.

A company must establish a written code of corporate conducts for all employees. A code of conduct promotes the appropriate control environment when management shows clear signs for enforcement of the code. For the code of conduct to function properly as designed, management should establish procedures to monitor compliance with the code, and the audit committee must oversee the entire program.

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Fighting Against Financial Crimes: Tone At the Top

이 기 열*

요 약

기업의 부패는 크게 자산의 착복, 횡령, 허위재무보고로 구분될 수 있다. 그러나 부패의 행태에 관계없이 기업의 부패는 재무보고서의 공정성에 심각한 위해를 가한다. 단 한 건의 부패일지라도, 증권시장의 효과적인 작용에 필수적인 재무보고의 진실성에 대한 공공의 신뢰 파괴를 야기하며, 이는 부패에 연루되지 않은 기업에게도 자본비용을 증가시키며 궁극적으로 자본 금융시장을 잠식시키는 심각한 결과를 가져온다. 경제적 침체시기에 많은 기업들이 목표이익, 채무조건의 이행, 증권분석가의 기대치 등을 충족하기 위한 도전을 받고 있으며 동시에 개인적인 욕심을 충족시키기 위한 기업자산의 착복 횡령등에 의한 부패건수가 심각하게 증가하고 있는 추세이다. 이러한 격변기에 기업들은 적절한 부패방지책을 설치, 적용 함으로서 기업에 대한 또는 기업내부의 부패예방에 촉각을 기울여야 한다. 과거연구는 적절한 내부통제의 결핍이 기업부패의 주된 원인으로 보고 있다. 내부통제의 목적은 자산이 안전하게 보호되고 기업목적을 위해서만 사용되며, 재무정보가 정확하고, 종업원이 관련법과 규정을 준수하게끔 하는데 있다. 그러나 내부통제가 원래 의도된 목적대로 실효성을 거두기 위해서는 이사회와 최고 경영자의 투명경영에 대한 의지가 필수적이며 또한 감사위원회의 재무보고 전 과정에 대한 적절한 감시가 이루어져야 한다. 적절한 통제장치가 되어있고 그릇된 욕망을 억제시킬 수 있는 적절한 기업환경이 기업부패를 예방할 수 있는 최선책이다.

핵심주제어 : 기업부패, 재무범죄, 허위재무보고, 감사위원회

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