# FRAUD, ETHICS AND PSYCHOLOGY: UNDERSTANDING WAYS OF MITIGATING FRAUD IN ORGANISATIONS

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***ABSTRACT***

Fraud can be understood as an ugly word representing an ugly act. Fraud is said to encompass any crime for gain that uses deception as its principal modus operandi. Deceive implies imposing a false idea or belief that causes ignorance, bewilderment or helplessness. The legal definition of fraud remains the same whether the offense is criminal or civil. The research explores the interconnection between frauds, ethics and psychology. In doing so, fraud triangle and diamond, ethics and psychological pathways to fraud were assessed in order to understand the fraudster behaviour. The history and evolution of fraud activities were highlighted to conclude that the findings by most surveys are correct i.e. most fraudster are usually first-time offenders with high authority levels and had been employed for long enough. Statistics were also gathered to prove that fraud does have significant impact (financial and non-financial) to the business and society. Understanding the reasoning behind fraud activities may assist organisation in preventing the occurrence of such unethical behaviour.

***Keywords:*** *fraud, ethics, psychology, fraudster, fraud triangle and diamond, unethical*

## 1.0 INTRODUCTION

Whenever someone saw news on fraud, the question would be, "why do they commit fraud, it is so unethical." And the next thing you would hear, "it's the money..money..!" Fraud and unethical behaviour is considered as "hot" and an upswing topic of discussion. The challenge is to mitigate the fraud effect by taking preventative action so that frauds occurrence reduces.

Fraud in a simple word means deceive or scam. In the world which is full with technology advancement, fraud cases seem to be enormous. Fraud has been described and elaborated in many different ways, the most simplistic being that fraud is any crime for gain that uses deception (Wells, 2011). It has been agreed by most scholars that fraud can be defined as '*the intentional act of misleading or committing harm to others with the aim of securing an unfair or unlawful advantage*' (Albrecht, 2004; Hopwood, 2008; Rezaee, 2010; Kranacher, 2011; KPMG, 2011).

Ethics is based on the recognition of certain human rights. It can be defined as a guide of moral conduct by which an individual is able to distinguish between rights and wrong (Beekun, 1996). It is the compass by which one is guided through life, in terms of actions, thoughts and emotions. Ethical means conforming to accepted standards of social or professional behaviour. Hence, unethical behaviour is a complete reversal of ethical and may include deliberate deception, violation of conscience, failure to honour commitments, unlawful conduct, and disregard of company policy.

Psychological explanation for fraud seems to be simplify by greed and dishonesty (Duffield & Grabosky, 2001). However, the reality may differ as not all dishonest people commit fraud. Many scientists are interested in identifying psychological characteristics of fraudster which is valid and reliable. However to date no one had successfully developed the idea. The attempts had only been so far in distinguishing people who will commit fraud from those that will not. These attempts include honesty and integrity testing with the aim of measuring trustworthiness of potential employees (Sacket & Harris, 1984; Ones, Viswesvaran & Schmidt, 1993).

As the need to mitigate the fraud risk increases, understanding the fraudster is seem to be crucial. They are educated as they hold good/high rank position, they are well trusted by the shareholders and they could be regarded as the gatekeeper of the organisation. And yet, why do they commit such offence? Thus, this paper looks at the ethical and the psychological aspect of fraud offender.

The paper is structured as follows. Section two discusses the definition, classification and cost of fraud to enlighten readers understanding. This is followed by assessment on fraud triangle or diamond, ethics and psychological pathways to fraud. Next section lay down the fraud effect to organisations and ways employed to reduce the consequences. Finally, the section concludes.

## 2.0 LITERATURE REVIEW

### *2.1 Definition of fraud*

Fraud is deception. Fraud is the intentional use of deceit, a trick or some dishonest means to deprive another of money, property or legal right' (Ernst & Young). In a fraudulent action, there is an element of intentional false representation, which is acted upon the victim to the victim's damage (Albrecht et al. 2006). However, most authors conclude fraud as involving the use of intentional deception or harm to obtain an unjust or illegal advantage (ISA 240; Albrecht, 2004; Rezaee, 2010; Hopwood, 2008; Kranacher, 2011; KPMG, 2011). Thus, an act that is legal but unjust, for example, not giving full disclosure of a takeover with the intention of concealing significant information from the shareholders that may jeopardise their interests, can be considered as a fraudulent act.

### *2.2 Classification of Fraud*

Nahariah (2009) classify fraud into two; fraudulent financial reporting (management fraud) and misappropriation of assets (employee fraud). Other authors such as Albrecht (2004) gave two different classifications, firstly fraud committed towards an organization (occupational fraud), and secondly fraud committed on behalf of an organization (fraudulent financial statements). ACFE (2012) then take a stand in defining occupational fraud as "*The use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets."* These are then being further classified into three categories as follows:

1. Asset misappropriation – theft or misuse of organization's assets
2. Corruption – wrongful use of influence in a business transaction in order to procure some benefits for themselves contrary to their duty to their employer or the rights of another
3. Fraudulent statement – falsifications of an organization's financial statements. Involves intentional misstatement of certain financial values to enhance the appearance of profitability and financial position of a company to deceive shareholders or creditors. The terms financial statement fraud and management fraud have been used interchangeably primarily because (i) Management is responsible for producing reliable financial reports; (ii) The fair presentation, integrity and quality of the financial reporting process is the responsibility of management (Rezaee, 2002).

### *2.3 Cost of Fraud*

Fraud is a million dollar business. There is empirical evidence for fraud occurrences. Statistics have shown variety of figures that give insight into the characteristics of fraud crimes and also of the fraudsters themselves. These facts can be useful to organizations as well as to individuals in preparing themselves against fraud. The ACFE Fraud report (2012) highlighted several findings that may give us a better idea of the fraud occurrence.

1. Typically, organization loses 5% of its revenues to fraud every year, indicating that fraud is a very serious problem to organizations and individuals everywhere.
2. The fraud cases reported to the ACFE lasted on average of 18 months before being detected. Occupational fraud was more likely to be detected through a tip by an employee of the organization than by any other way, thus exemplifying the importance of an ethical work environment in companies and easily accessible means for employees to report fraud, such as a dedicated fraud hotline.
3. Corruption and billing schemes also seem to pose the greatest risks to companies, as together they comprise more than 50% of the fraud reported to the ACFE.
4. Asset misappropriation schemes proved to be the most common type of occupational fraud, comprising 87% of the cases reported, while although financial statement fraud schemes made up a mere 8% of the cases in the study, they had the largest median loss of $1 million.

The report also included the most commonly targeted industries were banking and financial services, government and public administration, and manufacturing sectors. 77% of all frauds in the report were committed by people working in the accounting, operations, sales, executive/upper management, customer service or purchasing department. Most occupational fraudsters are first-time offenders, as 87% of them have never been charged or convicted of a fraud-related offense, and 84% had never been punished or fired for fraud-related conduct.

These types of figures are essential in making organizations and individuals aware and prepared for the possibility of fraud occurring, indicating the most likely suspects and red flags of fraudulent activity, and helping entities prevent recurrence.

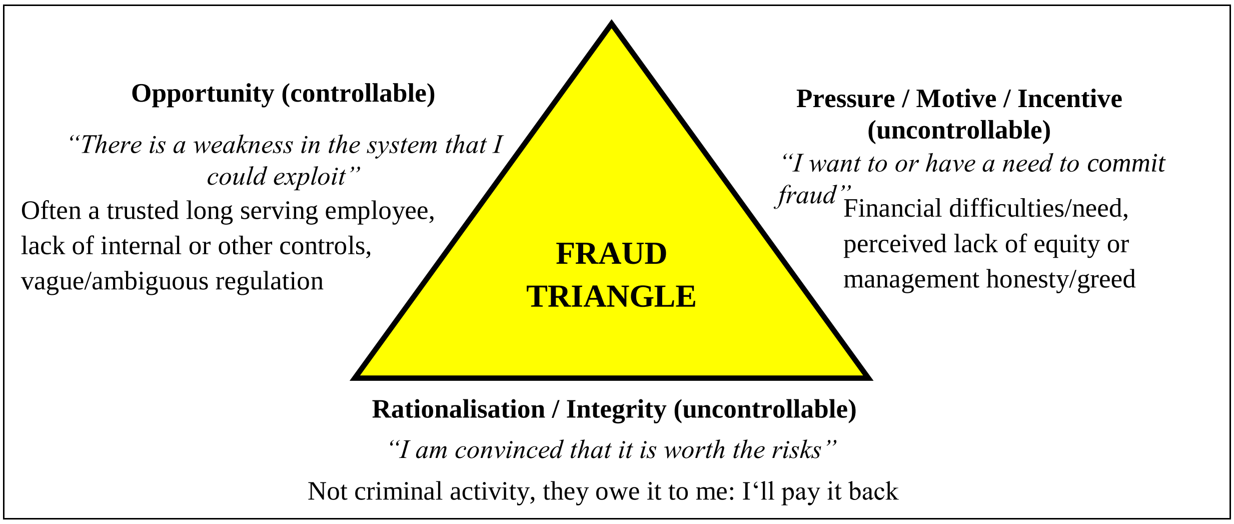
## 3.0 FRAUD TRIANGLE/DIAMOND, ETHICS AND PSYCHOLOGICAL PATHWAYS

Fraud as mentioned is deception done by a person in order to gain something. Thus it could be related to behaviour. As people think, act and response in a different manner, ethics and psychology affected very much an individual behaviour. Whether it is ethical or unethical, the border line could be vague and thus, using rationalisation one may say something bad is acceptable according to the situation. In order to understand why people commit fraud, we decided to enlighten the topic by discussing the three important subjects which is the famous fraud triangle or fraud diamond, ethics and psychological pathway to fraud.

### *3.1 Fraud Triangle/Diamond*

Traditional fraud theory states that there are three conditions that must exist if fraud is to occur (Cressey, 1953), which are popularly known as the Fraud Triangle (Albrecht et al. 2006; Kapp and Heslop, 2011) as shown below. The conditions are pressure (or motivation); opportunity to commit fraud; and rationalisation. This was then developed to include the fourth condition, which is the individual's capability (Wolf and Hermanson, 2004) and being known as the fraud diamond.

Illustration 1: The fraud triangle




The first condition is pressure (or motivation) to commit fraud, where a fraud perpetrator may have pressure to commit fraud, such as pressure to attract external financing at a low cost (Dechow et al., 1996); or firms are constrained by debt covenants; or firms raising new debt; or equity capital (Efendi et al. 2007).

The second condition is the existence of an opportunity to commit fraud, for example, a poor corporate governance structure. Corporate governance has been recognised as one of the controls to address the risk of management override, where a higher incidence of fraud is partly due to greater opportunities associated with a poor governance structure (Hogan et al. 2008). Studies on corporate governance find an association between corporate governance practices and occurrences of fraudulent acts in firms. Prior research discovers that firms with manipulated earnings are those that have less independent boards (Beasley 1996; Dechow et al. 1996; Farber 2005; McMullen and Raghunandan 1996), have the same person as chairman and CEO (Dechow et al. 1996), and where the CEO is the founder or chairman (Dechow et al. 1996; Farber 2005) and dominant management (Loebbecke et al. 1989).

The third condition is rationalisation by the perpetrator of the fraud. Fraud will not be committed if the perpetrator is unable to justify his fraudulent act. Fraudster may rationalise that any behaviour that creates advantage for him in a competitive environment is tolerable and encouraged even though the act may create a disadvantage for the competition. Some of the common rationalisations for smaller business concerns are: owners to bend the rules a little in order to be successful; or they are unfairly disadvantaged due to their size and thus, compromising ethical standards is considered acceptable behaviour; or an unethical decision is taken as a short-term solution to develop the business (Jackson et al. 2010).

The fourth condition is individual's capability, which consists of personal traits and abilities that play a major role in whether fraud may actually occur even with the presence of the other three elements. Many frauds, especially some of the multibillion-dollar ones, would not have occurred without the right person with the right capabilities in place. The person must have the capability to recognize the open doorway as an opportunity, and to take advantage of it by walking through, not just once, but time and time again. An Analysis of U.S. Public Companies on fraudulent financial reporting 1987-1997 (Beasley et al. 1999) found that corporate CEOs were implicated in over 70% of public-company accounting frauds, indicating that many organizations do not implement sufficient checks and balances to mitigate the CEO's capabilities to influence and perpetuate fraud.

### *3.2 Ethics and Fraud*

Ethics is a guide of moral conduct in terms of actions, thoughts and emotions by which an individual is able to distinguish between rights and wrong (Beekun, 1996). The objective of ethics is to assess and study human acts and behaviour in terms of moral standards, then is able to advise the individual on how they themselves should behave morally at any given situation (Azmi, 2005). The factors that determine individual ethics are legal interpretations, organizational factors, and individual factors such as the stages of moral development in the individual, his or her personal values and personality, family and peer influences, life experiences, and situational factors (Beekun, 1996). It is interesting to note that situational last factor as it is apparent that individuals may commit unethical acts or behave in ways that one might classify under a morally grey zone if they feel like they are caught in a situation with no way out (Beekun, 1996).

It is easy to imagine that when a person is caught in what they perceive as a desperate situation, the scruples they might have had in everyday life before would quite likely go right out the window. History has shown that under extreme circumstances, even the most decent and civilized of people can revert to the most evil of deeds (Hartemink, 2000). As exemplified by the famous Fraud Triangle, fraud can occur at the hands of practically anyone, given the right environment, situational pressures, and the personal ability of the individual to rationalize the unethical act (Bhattacharjee, 2007).

Another concept that is closely related to ethics is values, which is the personality traits or criteria a person possesses that influence their choices, such as family, friends, peer groups, nationality, culture, and economic and social classes (Kranacher, 2010; Cohen, Ding, Lesage & Stolowy, 2010). This concept is acutely related to the key elements of ethics stated before, and is really the driving force, together with personal ethics, in making the decisions of an individual's everyday life. Therefore, it is suggested that ethics of management should be evaluated through the assessment of attitude, subjective norms, perceived behavioural control and moral obligation (Cohen et al., 2010).

From a secular perspective, scientists and theorists have argued that the origin or root of a human being's ethical and moral life stems from nature (Ramamoorti, 2008). It is the way that life influences and moulds a person that shapes, as well, his moral principles. Similarly, scholars of Islam have also emphasized the importance of an ethical environment in creating a morally sound individual. However, the difference between the two is that while the secular view limits accountability to solely law, Islam makes the individual accountable to Allah above anything else. Islam does not recognize the division between spiritual and temporal affairs, and considers business in terms of moral matters that are subject to the teachings of *Shari'ah* (Kasim, 2010). Islam's principle of vicegerency of man on earth increases the believer's responsibility for all his actions, and as such, makes him follow the set of moral codes that Islam has laid down, in the belief that he would be punish not just in this world but in the hereafter as well, should he fail to observe them (Yunanda & Abd. Majid, 2011).

It is essential to look into the psychological and behavioural motives of fraud to truly understand why some people commit it and why others don't. The question of ethics plays a leading role in this as it is what one can say might push an individual into actually committing the crime instead of just thinking about it. As fraud includes psychological factors such as deception, intent, desire, the risk of getting caught, the violation of trust, and rationalisation, it is vital that they are studied to try to understand what exactly might have influenced fraudsters into breaking the law (Ramamoorti, 2008).

### *3.3 Psychological pathways to fraud*

Mere greed is an overly simplistic view of the motives of fraudsters. People who are normally trustworthy can turn into "trust violators" when first, they perceive themselves as having financial issues that cannot be shared with others, when they realize that the problem can be resolved in secret by abusing their position of trust, and finally when they can rationalize their actions (Ramamoorti, 2008). This concept is what helped in the creation of the "Fraud Triangle", in which ethics plays a starring role in its three elements – motivation, rationalisation, and opportunity (Turner, 2009).

An interesting concept to note is one outlined by Cotton (2005), called the "10-80-10" Rule. According to this guide, out of the total number of people there are, 10% would never do anything dishonest under any circumstances, another 10% is always on the lookout for something to steal, while the remaining 80% might commit fraud given the right motivation, opportunity, and rationalization.

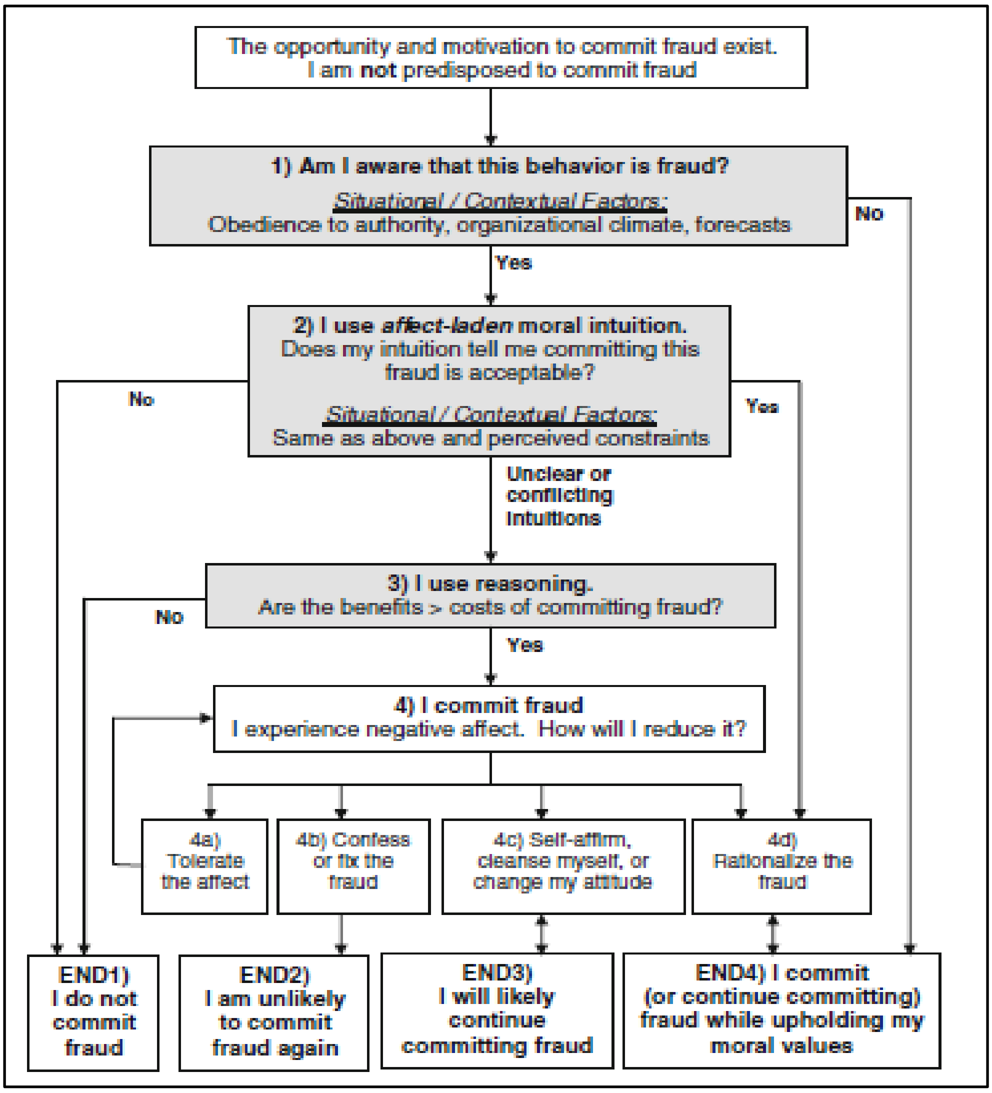
An individual's defences against fraud can be described as the battle between the financial need of the person against sufficient sources of income plus a strong ethical and moral foundation (Cotton, 2005). If the financial need outweighs the individual's income and ethical foundation, then it is reasonable to presume that the individual is more likely than to commit fraud.

Murphy & Dacin (2011) have developed framework on psychological pathways to fraud as shown in illustration 2. Fraud occurs when all the elements such as opportunity, pressure and rationalization are all together. Therefore, ethical decisions are important to distinguish a person to commit fraud. However, if a person is aware that the behaviour is fraudulent, they will process it within an ethical or moral context.

It is also interesting to note that the situations leading to fraud deal with, one way or another, activities that are either "status-seeking" or "status-maintaining". It was also found that it was important to the fraudster to resolve their financial problem secretly, without jeopardizing their status and approval by society (Kranacher, 2010). Thus showing that social pressure does go in play in an individual's motives to commit fraud, while at the same time helps in justifying or rationalizing breaking the law. Although, arguably this would ironically also threaten their standing in society should the individual get caught, hence creating a very viscous cycle of pressure. Therefore, ethics plays a key role in the psychological workings of a fraudster. The reasons and motivations for committing such a crime can only be divulged through the individual's personal concepts of what is ethical and what isn't, and what can be rationalised and what cannot, and if in their eyes the ends justify the means.

The two key observations of the pathway are on normalisation and rationalisation. Normalisation requires series of factors to work in tandem (Palmer, 2008) and interaction between situational factors and three different pathways should be closely monitored. Rationalisation ideologies as delivered by Ashforth and Anand (2003) are crucial in reducing ambiguities between mean-ends dilemma. These ideologies allow individuals to negate negative attributions and expand the boundaries of legitimate action in a given situation. Hence making fraud acceptable both normatively and cognitively (Murphy & Dacin, 2011).

Illustration 2: The psychological pathways to fraud framework




*Note: The grayed boxes indicate key decision or process points. Interventions can be designed to prevent fraud at each of these points.*

## 4.0 FRAUD OFFENDER AND MITIGATING WAYS

### *4.1 Fraud offender*

Looking into the history of fraud from the first recorded con to the numerous examples of fraudulent activities committed today, one could discern a distinct pattern in the ways these acts were committed. It is quite apparent that the three common tools that were often used were trust, ignorance, a manipulation of the system, and corruption.

Trust was a big factor in many of these cases, as in the case of the man named Ward, who used his friendship with the son of former American president Ulysses S. Grant, to trick people into investing in his firm on false pretexts. Trust was also a factor in the phony health cures and agricultural land schemes that were committed in early America. Ignorance played a big part in this as well, as in those days people were not as educated in medicine and science, and the American frontier was still quite unchartered territory. Thus, it was quite easy for conmen to use these factors to their advantage, preying on early settlers' desperation and gullibility to make a quick buck. Also, in the cases of stock manipulation, as people were ignorant of the mechanics of the stock trade in the early days of its invention, it was easy for conmen to create schemes such as stock pools to make a big profit for themselves at the expense of their targets.

This was the same for William Duer, who used insider trading to manipulate the system. Other examples are those of Frank Abagnale Jr. and Michael Sabo, who both used forgery and impersonation, to manipulate the system as well.

Corruption also played quite a big part in some of these cons. The Tweed Ring, for example, being the most notorious, was a group so corrupt within the government that the consequences greatly affected the entire city of New York, which suffered under their reign, as in the case of Ramón Baez Figueros, whose actions brought the Dominican Republic into an economic crisis in 2003.

Studying these various events in the history of fraud, one can definitely see how conmen use the vulnerability of others to their advantage, manipulating whatever they see fit, to mesh together with the lies they perpetuate in their schemes. However, fraud also can be related to the mindfulness which is showed by the relationship between ethical decision making and mindfulness. The constructs of mindfulness include cognitive load, self-regulation, and moral attentiveness. As highlighted by Ruedy & Schweitzer (2010) mindfulness promotes higher ethical intentions and lesser ethical infractions. Individuals higher in trait mindfulness reported higher ethical standards in a negotiations context.

### *4.2 Mitigating Fraud*

There is a need for organisations around the world to continue their attention on fraud and ethics for coming years. Strong ethics programme ultimately help the bottom line, improve fraud prevention and mitigate risk of reputational damages for any organisations. In doing so, current policy and procedures need to be reviewed and updated accordingly which among others include whistleblower programme, refresher marketing program and updating ethical training for employee as well as performing fraud risk assessment (COMPASS, 2013).

According to leading criminologists, there are three general categories of crime prevention - punitive, defense and interventionist methods (Sutherland et al., 1992). Punitive crime prevention methods use increasing punishment to make individuals too fearful to commit crime. Defense methods concentrate on limiting the opportunity for committing a crime. Interventionist methods, which assumed to be the most effective prevention system, are based on observation that the first two methods are not effective. This method assumes that crime rates can be reduced significantly only by determining the conditions that produce them and then changing those conditions (Sutherland et al., 1992).

Personality based integrity test capture a range of undesirable workplace behaviours however it seems to be measuring the broader concept of "conscientiousness' rather than the fraud risk per se. Aggressive prosecution and severe sentencing may help sending message to the potential fraudster in rationalise or excusing their intended acts.

Fraud prevention is very crucial as it protects the organisation's assets and most importantly the lives of people. Fraud tragically affects not just the perpetrator but everyone around the situation. Colleagues and family members may feel betrayed and hurt and the perpetrator himself will need to gain the trust of people in future. Thus destroying heart and lives of many.

## 5.0 CONCLUSION

Evidently, fraud is hazardous to many organisation especially the small businesses. As fraud is costly, it may harm not only the organisation, but as well impact the society and economy. Thus, it is a need to tackle the issue from ethical point of view since the perpetrator is human who is greedy and demand luxurious way of life at the expense of others. Thorough understanding of the fraudster may provide organisation ways in fraud prevention and detection efforts.

Fraud risk could be a product of both personality and environmental or situational variables (Duffield & Grabosky, 2001). This understanding will provide organisation with two implications – first, individual will vary in their propensity to commit fraud and secondly, situations will vary in their impact to individuals according to the inherent risk factors at any given time. The key to understanding and eventually controlling fraud is to consider both the individual and the environment in which they operate.

The repercussions of the public visibility of fraud - such as open discussions of fraudulent cases, the creation of oversight agencies and strengthening the internal control policies —might be useful in regaining public trust towards business firms. Strengthening organisation's internal control procedures to ensure such fraud will be minimise and if possible disappear in their diary

**Acknowledgement**

The team would like to express their gratitude to Accounting Research Institute (ARI), Universiti Teknologi MARA (UiTM) for providing the financial means and facilities. This article would not have been possible without the support of the grant provider, family members, and friends.

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