Taking Away Rationalization: *One Way to Fight Fraud in Your Organization*

by Paul Feltman

Fraud is a topic many people study to determine why individuals commit the frauds they do. Looking at the fraud triangle after the fraud occurs, we can see that the individual fits all of the factors – motive, opportunity, and rationalization. These three factors are present in all cases of fraud. In this discussion, we will look at the rationalization piece and discuss how we can possibly prevent employees from being able to rationalize their behaviors

Conflicts of interest in business are those situations where a person who is in a decision-making capacity can derive personal gain for themselves or their family if they make certain decisions. If an organization has a culture of doing these things, all employees may feel they too can do this, which would help them rationalize their behavior. One example would be through the purchasing process. If your purchasing department is running a request for proposal (RFP) for services, and the executive over the area intervenes to have a family business chosen, the purchasing department may feel this is wrong, but when nobody in the company questions the executive, they begin to see what is "acceptable" in the organization. If this happens enough, the employees in purchasing may begin to choose vendors that are willing to "take care" of them. The employee may believe this is wrong, however, rationalizes their decision to take the kickback, "my executive does it, so why shouldn't I?" This type of behavior, if not stopped, could cost the organization not only financially, but their reputation can be damaged. Those vendors that are willing to do business honestly, if they find out an executive is intervening for family, or purchasing is accepting kickbacks, will no longer participate in the bid process, and usually in these instances the vendor is not the lowest bidder or highest quality and the organization will suffer.

Sometimes an organization is managed by fear and intimidation. This is very difficult for employees to deal with and can go hand in hand with an organization that runs with conflicts of interest. There are some executives who believe the employees should be grateful they are working, and should never be comfortable in their positions. Consider the hypothetical example where a CFO tells their finance director one of the other executives or board of directors is upset with them in order to put fear in them. Later on, the CFO makes the finance director feel better by telling them that they intervened on their behalf, and although the other executives or board may still be upset, things should be good, for now. This tactic puts fear in the finance director, while also making them feel indebted to the executive who stepped in on their behalf. One may ask, how does this relate to fraud? This helps the executive feel they can get away with things with this employee, as they "saved" their job. Looking at this going hand in hand with a company that runs with conflicts of interest, if we look at the RFP example, the executive may not want to directly tell purchasing whom to choose, so they will use the finance director to choose the vendor of choice, leaving them distanced from the decision. The finance director will feel obligated to select the vendor the executive told them to, due to the executive's loyalty in saving their job. Most finance directors would not knowingly want to work in this environment. The dilemma for the finance director in this instance is the CFO makes these types of decisions regularly. And if the CEO or board members know about the management style, conflicts of interest and complaints regarding this CFO may be ignored, and the finance director would come to believe that this is acceptable behavior within the organization and could potentially help them rationalize other unethical behaviors in the organization.

When an organization is run by an individual executive or multiple executives who engage in dictating how, when, and what items are booked into the company's financial statements, this could lead to fraudulent behavior and a rationalization mentality by the staff. Certainly not in all cases does there need to be fraud. An executive may be reviewing and explaining to their controller or finance director things such as: the terms of a deal, which may not be immediately clear, or may be giving them information that is not yet public knowledge (companywide knowledge). An example of this would be an incentive payment that the executive knows will be paid out, that needs to be accrued. The executive should share with the finance department the calculation or rationale for the incentive, as this will need to be included with the monthly reconciliation. Where this can turn into fraud is when the executive has the staff book the incentive payment, lowering earnings before interest, tax, depreciation and amortization (EBITDA) and increasing liabilities with no back up or information. The executive just gives a verbal order or a sticky note with a dollar amount and account number. Another example, the executive does not affect EBITDA at all, just has an asset and liability booked to hide something from the board. These are examples of the executive trying to show something with the numbers that is not true. When the staff asks what the entry is for or why it is being booked, they are not given an answer and are told to book the entry. This behavior by executive management shows the employees the company has no problem not following rules, or is ok posting fraudulent information. This will make the employees potentially not care about the accuracy of the entire financial statements or take the entire month end process serious because they will feel anything that is wrong is no big deal.

In all three of these instances, a company is setting a bad tone and the employees are seeing what the corporate culture is. If the employees find themselves in a position where they feel they have the motive to commit fraud and the opportunity arises, the corporate culture has allowed them to rationalize their actions. There is no condoning of the employees fraudulent activities, but leaders of an organization should always be striving to create an environment where all employees understand the tone from the top is one of ethical behavior, fairness, and honesty. A place where you allow your staff to complete their duties without interference or fear of retribution if a specific business is not selected. Policies and procedures should be in place to protect the organization and employees from dealing with these unethical issues. For instance, in the RFP example, several departments should be involved and the criteria for selecting a vendor needs to be documented in advance. This will make it easy for the committee to choose and one person cannot influence. For other situations, such as the executive who manages by fear, or dictates which journal entries are booked in order to skew the numbers, the staff needs to feel they can communicate with other executives or the board. It is always important for all executives to make themselves available to all directors or managers so employees will feel comfortable going to them. If they do not make themselves available, the executive who is doing any or all of the things mentioned will continue with their behaviors.

In conclusion, it is important to look at how your organization is being managed and how the employees view the organization as being managed in order to ensure you are not giving employees rationalization to commit fraud. ♣

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