International Small Business Fraud:

Risk Mitigation Strategies

Abstract

Small international business owners face the challenge of designing fraud risk mitigation frameworks. One method for mitigating fraud risk is through the creation of managerial accounting system that includes internal controls. A managerial accounting system that includes internal controls may decrease the risk of financial loss due to fraud. Small international business managers may utilize the COSO Framework and the fraud triangle to plan, implement, and analyze the company's internal control system. Even with limited financial resources and staff internal control expertise, small businesses can improve their efforts to prevent and detect fraud through the adoption of proven fraud prevention frameworks.

Key Words

Fraud, Small Business, International, Fraud Triangle, COSO Framework, Risk Mitigation

Background of the Problem

Smaller international business owners and managers are responsible for designing and implementing a managerial accounting system that includes control. One specific internal control consideration is fraud risk mitigation. Fraud encompasses a variety of methods, affects organizations of all sizes and types and knows no geographical boundaries (Kramer, 2015). Small international businesses often need strategies to mitigate fraud risk. Recent research suggests that fraud is a significant contributing factor to worldwide small business failure (Hess & Cottrell, 2016).

Small businesses are less likely than larger organizations to have sufficient resources to allow absorption of a fraud loss and continuation as a going concern (Kramer, 2015). Antifraud experts say formal controls can help small businesses prevent and detect instances of fraud, which left undiscovered, could lead to costly losses and possibly bankruptcy (Tysiac, 2012). Internal control policies and procedures can save organizations a substantial amount of money if used for establishing detective and preventative controls compared to the costs associated with fraud (Teplitsky & Harris, 2015). Managers of small international businesses should pursue the design of a managerial accounting system that considers control including the mitigation of fraud risk.

Implementation of precautionary fraud prevention measures is crucial (Aris, Arif, Othman, & Zain, 2015). It may be useful for managers to understand the fraud risk mitigation strategies other small international business managers have implemented. Small international organizations may utilize the information regarding antifraud controls, which may aid small international business managers with fraud risk mitigation strategy development and assist with minimization of financial loss due to fraud incidents.

Smaller companies experience many challenges associated with internal control over financial reporting. These concerns increase the risk of material misstatement and potential financial loss due to fraud. Some of the most prominent issues include the following:

- Shortage of resources to maintain appropriate segregation of duties. The absence of separation of duties increases the opportunity for individuals to act unethically without anyone else knowing (Jackson, Holland, Albrecht, & Woolstenhulme, 2010).
- Absence of financial expertise at the Board of Director level.
- Employee inadequacy with accounting and financial reporting proficiency. Small business owners and their employees may lack the knowledge and training necessary

> to fully understand their firm's potential vulnerability to fraud and take the precautionary measures required to deter it (Jackson et al., 2010).

Substantial guidance is available concerning fraud risk mitigation. Yet, small organizations frequently do not employ internal controls to mitigate fraud risk. Empirical evidence suggests that the perpetrators in many unethical and illegal acts are, unfortunately, often the employees of small businesses (Jackson et al., 2010). Small businesses are especially susceptible to theft as they often lack the resources necessary to establish formalized control systems intended to deter unscrupulous behavior and prevent fraud (Jackson et al., 2010). Therefore, many fraud incidents occur in smaller organizations. Small businesses suffer a disproportionately larger number of frauds than bigger businesses (Kramer, 2015).

This section contains documentation regarding the issues associated with small international business fraud, internal control deficiency and related financial loss. The following section includes documentation of the specific business problem.

Problem Statement

International fraud surveys consistently find that small businesses are vulnerable to fraud. (Kramer, 2015). In 2012, the Association of Certified Fraud Examiners reported the worldwide median fraud loss for businesses with less than 100 employees was approximately $140,000. (Kramer, 2015). The general business problem is some small international organizations are negatively affected by fraud, which results in financial loss. The specific business problem is managers in some small international organizations lack the strategies to mitigate fraud risk.

Purpose Statement

The purpose of this study is to explore the strategies managers in some small international organizations implement to successfully mitigate fraud risk based on industry guidance. The target population for the study will be a small international organization. Study results may aid small international business managers with the design and implementation of fraud risk mitigation strategies, which may aid with the prevention of loss due to fraud.

Research Question

The research question is: What strategies do managers in some small international organizations implement to mitigate fraud risk?

Conceptual Framework

The researcher will use the Committee of Sponsoring Organizations (COSO) Framework and the Fraud Triangle in this study. One of the most authoritative references on the theme of internal control is the COSO Report (Rubino & Vitolla, 2014). The COSO Framework was introduced in 1992 and it is the most widely used framework (Rubino & Vitolla, 2014). Small international business managers may utilize the COSO Framework to acquire strategic guidance regarding the design, implementation and analysis of an internal control system. In an effective internal control system, the COSO Framework's five components work together, providing reasonable assurance to management and the board of directors regarding the achievement of the organization's strategies and objectives including fraud risk mitigation (Ionesco, 2011). Assessment a small company's risk mitigation strategies should incorporate consideration of the intelligence contained in the COSO Framework including fraud risk specifications.

In 1953, Cressey developed the fraud triangle model. In accordance with Cressey's theory, pressure, opportunity and rationalization exist when fraud occurs (Aghghaleh, Iskandar, & Mohamed, 2014). The fraud triangle is particularly important as a model for assessing the risk of fraud (Dorminey, Fleming, Kranacher, & Riley, 2012). Small international business managers should evaluate the existence of opportunity to commit fraud within the organization. The more lax a small business leaders' internal controls, the greater the opportunity for those internal controls to be circumvented and for possible fraud to occur (Buckholz, 2012).

The analysis of an internal control system should include consideration of the COSO Framework including fraud risk specifications and the fraud triangle. The researcher will utilize principles and guidance contained in the COSO Framework, and the fraud triangle to identify and document the existing strategies related to internal controls in the organization chosen for study.

Significance of the Study

Contribution to Business Practice

Proactive fraud prevention and detection methods are critical in minimizing fraud losses (Verschoor, 2014). Small international business managers may benefit from the study of existing fraud risk mitigation strategies. These strategies may provide guidance and insight to small international business managers that lack fraud risk mitigation strategies. Small international business owners and managers, associated Board of Directors, and related external auditors may find the research related to fraud risk mitigation strategies valuable. Research results may permit small international business managers to concentrate on minimizing fraud risk by implementing anti-fraud strategies. The study may increase fraud risk awareness amongst small international business Board of Directors and may help the board members with the understanding and execution of oversight responsibilities when analyzing management's strategies. External auditors may use the research results to conduct fraud risk assessments for small international business clients.

Implications for Social Change

Information regarding the strategies small international business managers have applied to minimize fraud risk may aid similar organizations to design and implement improved fraud risk mitigation strategies. Positive social change may result from small international business fraud risk mitigation. Small international business owners, managers and, employees may be adversely affected by a substantial financial loss or bankruptcy within a small organization. Employment of fraud risk mitigation strategies may help to reduce theft, financial loss, and failure in small international business organizations, which may result in a move toward less fraudulent activity within small companies. Fewer small organizations and associated employees may experience the adverse effects of fraud.

Review of the Literature

The purpose of the study will be to identify the strategies managers of small international businesses implement to mitigate fraud risk. The researcher focused on an examination of professional and academic literature related to internal control and fraud risk management aligned with the documented research question: What strategies do managers in some small international organizations implement to mitigate fraud risk?

The review included a majority of scholarly peer reviewed content from 2010 to 2016 as well as an evaluation of historical writings pertinent to the proposed study. The researcher obtained information via searches of numerous databases including ProQuest, Emerald Management and, industry publications. Key search terms included COSO framework, fraud triangle, small international business fraud studies and, fraud risk. The objective of the literature review is to provide an overview of the extensive literature on the COSO framework and the fraud triangle. Use of the COSO framework and consideration of the elements and concepts in the fraud triangle theory are critical to small international business manager's ability to mitigate fraud risk.

The Association of Certified Fraud Examiners defines 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 (Jackson et al., 2010). Small businesses need internal control in order to mitigate fraud risk (Tysiac, 2012). Research indicates that the presence of anti-fraud controls is associated with reduced fraud losses and shorter fraud duration (Association of Certified Fraud Examiners, 2014). Professional literature indicates opportunities arise because of the nature of the client's internal controls (Buchholtz, 2012).

The components of the COSO framework and fraud triangle concepts are included in the conceptual framework for the research study. The elements outlined in peer-reviewed literature encapsulate the key concepts of fraud risk mitigation. It is important to examine the history and advancement of these theories and frameworks.

COSO Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private sector organization that provides executive management with guidance regarding effective, efficient and ethical business practices as well as internal control (Scannell, Curkovic, Wagner & Vitek, 2013). Accounting professionals consider the COSO framework authoritative accounting industry guidance for the design, implementation and analysis of an internal control system. The framework provides direction to any business that wishes to establish an effective internal control system (Frazer, 2012). The Securities and Exchange Commission has provided guidance that suggests management should utilize the COSO framework when designing, building, and/or analyzing internal control (Marchetti, 2012).

The COSO framework sets forth guidance important for the achievement of an organization's objectives including fraud risk mitigation (Rubino & Vitolla, 2014). The COSO framework states internal control encompasses the policies, rules, and procedures enacted by management to provide reasonable assurance that financial reporting is reliable, the operations are effective and efficient, and the activities comply with applicable laws and regulations (Frazer, 2012). Small international business organizations may use the COSO Framework as a structure for conducting a complete assessment of its control systems.

The COSO framework and the five components are pertinent to best practices in the accounting industry (Frazer, 2012). The five integrated components of internal control are Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring (Rubino & Vitolla, 2014). These five major components are part of a holistic framework, which includes a variety of activities and steps designed to ensure that organizations do not provide opportunities for the manifestation of fraudulent behavior by employees (Frazer, 2012). Small international business managers should take into account all of the principles contained in each of the five COSO Framework components in order to obtain reasonable assurance an adequate system of internal control to mitigate the risk of fraud has been developed and implemented. When the five components are present and are all functioning management may have reasonable assurance that the internal control is effective (Rubino & Vitolla, 2014).

According to COSO (1992), the control environment sets the tone for the organization by influencing the control consciousness of its people. The control environment is a set of standards, processes, and structures that provide the basis for carrying out internal control across the organization (Rubino & Vitolla, 2014). These internal controls are universal throughout the company. The control environment is the foundation for all of the other components of internal control because it provides discipline, structure, integrity, ethical values, employee competence, management's philosophy and operating style, and leadership provided by senior management and the board of directors (Frazer, 2012).

Risk Assessment is the identification and analysis of risks relevant to the achievement of the entity's objectives (COSO, 1992). A precondition of risk assessment is the establishment of objectives that link at different levels and are internally consistent (Frazer, 2012). Small international business managers should record the organization's financial reporting objectives. Many smaller organizations do not have explicitly stated financial reporting objectives. The COSO Framework (COSO, 1992) principle suggests that in order for management to effectively evaluate the risk to reliable financial reporting and ultimately effectively mitigate risk the entity must clearly outline and communicate these objectives. Without management assessing the risks that an organization faces, putting the proper controls in place would almost be impossible (Nolan & Metrejean, 2013).

Control activities are the policies and procedures management develops that reduce risks to an acceptably low level (Rubino & Vitolla, 2014). These management directives ensure activities including approvals, authorizations, verifications, reconciliations, reviews of operating performance, safeguarding of assets, and segregation of duties are executed (Frazer, 2012). These practices minimize fraudulent activity. Small international business managers should implement control activities at the entity and process level.

Information and communication concerning the company's internal control system including identification of procedures and accountabilities is critical to the strength of the control environment. Information and communication is necessary for any entity to carry out internal control responsibilities to support the achievement of the entity's objectives (Rubino & Vitolla, 2014). Small international business managers should distribute information to individuals in all company levels.

Monitoring is a process that assesses the quality of the internal control system's performance over time and it includes regular management and supervisory activities as well as other actions that personnel undertake while performing their duties (Frazer, 2012). Small international business managers should periodically review and/or test the effectiveness of internal controls. Management must evaluate and communicate internal control deficiencies in a timely manner to those parties responsible for them to take any corrective action (Rubino & Vitolla, 2014).

Fraud Triangle

Inspection of fraud triangle history and theory is significant in consideration of fraud risk mitigation. An understanding of the fraud triangle can assist employers in fraud prevention (Kramer, 2015). The most widely accepted theory as to why people perpetrate fraud is the fraud triangle established by Dr. Donald Cressey in 1953 (Kramer, 2015). Cressey focused his research on the circumstances that lead individuals to engage in fraudulent and unethical activity (Ruankaew, 2013). Over the years, Cressey's research findings defined the fraud triangle, which became an integral part of industry guidance and standards (Soltani, 2014).

The fraud triangle consists of three fundamental observations, and it forms the basis for most discussions of white-collar crime (Dorminey et al., 2012). Cressey discovered three elements must exist simultaneously for an otherwise honest person to commit fraud – the fraud triangle (Kramer, 2015). In 2002, the American Institute of Certified Public Accountants established the Statement of Auditing Standards (SAS) No. 99, which includes fraud risk factors based on the fraud triangle model developed by Cressey (Aghghaleh, Iskandar & Mohamed, 2014). One of the major components of SAS 99 was the fraud triangle (Buchholz, 2012).

Traditional fraud theory explains the motivation for fraud as having three key elements: pressure, opportunity, and rationalization (Jackson et al., 2010). AU Section 316 - *Consideration of Fraud in a Financial Statement Audit* (formerly SAS 99) provides significant guidance when performing a fraud risk assessment (Marchetti, 2012). The guidance includes examples of incentives and pressures, attitudes and rationalizations as well as opportunities to commit fraud in both categories of fraud - fraudulent financial reporting and misappropriation of assets.

Every fraud perpetrator faces some type of pressure to commit unethical behavior (Ruankaew, 2013). Fraud motivation manifests itself in the form of an unshareable pressure, which may or may not be financial (Kramer, 2015). Financial pressure has a major impact on an employee's motivation and is considered the most common type of pressure (Ruankaew, 2013).

Rationalization suggests that the justification of unethical behavior is something other than criminal activity (Ruankaew, 2013). SAS 99 AU Section 316, recognizes that attitudes/rationalizations are most common to those employees with "behavior" indicating displeasure or dissatisfaction with the company or its treatment of the employee (Buchholz, 2012). These employees believe that the deceptive actions they perform are not really considered fraudulent because they are entitled since management really owed them for all of the years of hard work and service (Buchholz, 2012). Many individuals who perpetrate fraud attempt to justify their actions. If the potential fraud perpetrator cannot find a way to justify his actions, it is unlikely that fraud will ever take place (Jackson e al., 2010).

All sources of fraud risk have one element in common – exploiting opportunity (Hess & Cotrell, 2016). Poor internal controls can significantly increase the opportunity for fraud (Laufer, 2011). In other words, the fraud perpetrator concludes an opportunity exists. Weak or missing internal controls are enabling factors (Kramer, 2015). Financial strain, rapid growth, and lack of resources and expertise create ample opportunity for motivated fraudsters to take advantage of small businesses (Hess & Cottrell, 2016). Laufer (2011) cited that having a good internal control system in place is paramount in minimizing the opportunity for fraud.

Fraud is unlikely to exist in the absence of the three elements mentioned in the fraud triangle theory (Ruankaew, 2013). For an individual to make unethical decisions, perceived pressure, and opportunity, and a way to rationalize the behaviors must exist (Ruankaew, 2013). In order to successfully and proactively address and manage fraud risk, small international business managers should understand the root causes of fraud and design controls to eliminate those origins.

Fraud theory is an important topic of study that will provide businesses with a better understanding of the important factors involved as well as how to minimize or prevent this behavior (Ruankaew, 2013). Prior study proposes that opportunity must exist for fraud perpetration. Internal control deficiency presents an individual with opportunity to commit fraud. Printed authoritative guidance provides small international business managers with a framework for the design and implementation of an effective internal control system to mitigate fraud risk and minimize opportunity. It is essential to study writings related to the history and development of the internal control framework and fraud risk in order to understand the internal controls small business managers implement to mitigate fraud risk.

Conclusion

Small international business managers may mitigate fraud risk by creating a managerial accounting system that includes internal controls. A managerial accounting system that includes internal controls may decrease the risk of financial loss due to fraud. Research analysis indicates that despite major differences in the political institutions, laws and regulations, and managerial practices in different countries, there are significant similarities in all identified fraud incidents (Soltani, 2014). In addition, Soltani (2014) cited that significant similarities were also observed, in the analysis of fraud cases worldwide, from the fraud triangle perspective. Therefore, small international business managers may utilize the COSO Framework and the fraud triangle to plan, implement, and analyze the company's internal control system. Simple internal control procedures can go a long way toward preventing employee theft and detecting schemes already in place (Hess & Cottrell, 2016). Small business leaders should view the development of a fraud risk management plan as an important investment in the business's future (Hess & Cottrell, 2016). Even with limited financial resources, small businesses can improve their efforts to prevent and detect fraud, and in doing so, unleash the full potential of their business according to Hess & Cottrell (2016).

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