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An Experiment on Fraudulent Reporting: Internal Control versus Framing, Which one More Influencing?

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Abstract
This research examines fraudulent reporting behavior in accounting context. It evaluates the impacts of internal control strength toward fraudulent reporting with the involvement of internal control framing. Internal control has been widely accepted as framework of fraud prevention. Nevertheless, internal control strength has inconsistently created unfavorable result in preventing fraud. Strengthened internal control is not always associated with lower fraud. This inconsistency addressed the existance of another variable that might mediate the relationship between internal control and fraudulent reporting. Internal control framing is predicted as a variable that may influence fraudulent reporting. Therefore, this research is aimed to observe the effect of internal control framing as the factor that comes from company towards the employee's tendency of committing fraud. The 2 x 2 x 10 design experiment consists of 49 participants in experiment group and 11 participants in control group. A laboratory experiment with real rewards was conducted and analyzed using repeated measures ANOVA. Inconsistent with the previous research which mentioned the influence of interaction between internal control strength and framing towards fraudulent reporting, this research found the significant influence of framing toward fraudulent reporting is more than the influence of weak or strong internal control.
Keywords: Fraudulent reporting, Internal control strength, Framing coordinating, Framing monitoring

1. Background

Fraudulent reporting is believed as one of the most major cause of accounting scandal. In these couple of years, the issues identified with misrepresentation in money related reporting still get to be a standout among the most attentiveness toward numerous organizations (PricewaterhouseCoopers, 2011). In view of Carpenter and Reimers (2005), fraudulent reporting is a deliberate demonstration to beguile others by intentionally distorting occasions, exchanges, and/or other imperative data for individual and/or hierarchical additions. In this way as the anticipating activities to relieve the likelihood of false reporting, associations are concentrating on internal controls. According to several auditing literature, regulatory actions, and professional auditing standards, stronger controls reduce fraudulent reporting (AICPA, 2002; Bell and Carcello, 2000; COSO, 1999; Loebbecke et al., 1989; PCAOB, 2007). It concentrates on how internal control turns into the quality to compel the misrepresentation. By and by, a few inquiries about clarify that internal control alone is insufficient to avoid misrepresentation.

Internal Control has been undoubtedly admitted to be the predictive factor for fraudulent reporting. Companies keep focusing on how to establish better Internal Control because it has been in mind that Internal Control is significantly related on the tendency of people committing fraud. However, the recent research found that Internal Control could also result in unwanted actions, precisely fraudulent reporting. One of the examples is the fraudulent financial reporting found at Royal Ahold and New Century Financial Corporation in response strong internal control reflected in the budget pressure (Knapp, 2010). On the contrary to auditing standards, strengthening controls could create unintended consequences that even encourage employees to do actions that result in negative effects to the firm (Falk and Kosfeld, 2006; Hannan et al. 2006; Rankin et al., 2008; Tayler and Bloomfield, 2011). It is a dilemma where the existence Internal Control cannot be compromised as the power to fight against the fraud.

Research done by Liu, et al. (2014) became the first in explaining a new factor that influences on how Internal Control could be well implemented yet without resulting in negative side effect to the company. The research investigated fraud prevention and business ethics by examining the interactive effects of Internal Control and the firm's communicated control purpose / control frame on managers' propensity to engage in unethical fraudulent reporting. This research found that framing influenced the way control strength brings impact to fraudulent reporting. As internal control is framed for monitoring purpose, stronger internal control results in less fraudulent reporting than weaker internal control. Conversely, when internal control is framed for coordinating purposes, stronger internal controls result in more fraudulent reporting than weaker controls (Liu, et al., 2014). Framing mediates the relationship between internal control and fraudulent reporting. The research also emphasized on how the company should not only focus on preparing the control strength, but also on how to deliver it to employee trough framing.

2. Literature Review

2.1 Framing

Yates (1990) portrays the term encircling as alluding to "varieties in the presentation of a choice circumstance such that the decision making develops notably diverse representations of that circumstance." In easier words, framing is a varied communication of information to create a certain mindset to the audience. Tversky and Kahneman (1986) reported a distinction in choices made when the circumstance was displayed to decision makers in various frames (loss versus gain) which is upheld by the Prospect Theory (Tversky and Kahneman, 1992). Simon and Hayes (1976) discovered comparative impacts in problem (Kahneman, 2003). Framing impacts are not restricted to decision making. What makes a particular framing unique to another is "the way in which the choice problem is presented in accordance with the norms, propensities, and desires of the decision making" (Tversky and Kahneman, 1986).

The way in which information is framed affecting individual perceptions and judgments (Christ et al. 2012; Emby 1994; Emby and Finley 1997; Frisch 1993; Levin et al. 1998; Loroz 2007). Based on the objective, there are two ways framing being communicated, which are for monitoring purposes and for coordinating purposes. Monitoring and coordination have been viewed as two distinct and independent mechanisms companies may employ to direct employee behaviors toward achieving organizational goals (Roth and Nigh 1992; Marsden et al. 1994). Internal control with coordinating purposes frame the control's objective as to to improve coordination among functional departments or managers to achieve positive results for both the firm and managers (Christ 2012; Edmunds et al. 2010; Garrison et al. 2011; Nicolaou et al. 2011; Roth and Nigh 1992). While in monitoring framing, the existance of internal control is to monitor behavior or outcomes. Monitoring framing might result in less fraudulent reporting since the manager is awared of being monitored

Firm implement a budgetary control that establishes limits for various cost items for each department. Costs exceeding the maximum limits cannot be reimbursed to the department without additional approvals. This budgetary limit can be framed as a monitoring control mechanism in that it assists the firm in evaluating the actions of the department in terms of its spending and ensuring that departmental spending are within acceptable limits (Barrett and Fraser, 1977). Alternatively, the same budgetary limit can be framed as a coordinating control mechanism in that it provides relevant information to top management regarding potential areas in which corporate resources can be better allocated to improve overall firm performance and to coordinate functional managers' activities to achieve a target profit (Barrett and Fraser, 1977).

2.2 Fraudulent Financial Reporting

Fraudulent reporting is defined as the disclosure of financial statements involving accounting irregularities to the public so as to deceive them into perceiving the firm's financial health in a more positive light than it actually is (Brief et al., 1996; Carpenter and Reimers 2005; Kaplan et al. 2009). Accounting irregularities, such as to ''generate an inflated earnings report,'' involve ''hidden action'' (Crocker and Slemrod 2007). The public is unaware of the fraudulent accounting until the time they are exposed.

According to (AICPA 2002), fraud is a deliberate intentional act that outcomes in a material misstatement in financial statements. Misappropriation of asset and fraudulent financial reporting are types of fraud in private sector. According to Shana (2014), there are two parties who could trigger in committing fraud. It could be employee committing the unauthorized use of company assets for personal benefit (Wells 2008) or the corporate fraudulent financial reporting by manipulating financial performance to appear better. In contrast, employee fraud benefits the individual at the expense of the organization (Albrecht 2011. Accounting researchers have primarily focused their efforts on corporate understanding fraudulent financial reporting rather than employee fraud (Coram 2008; Mustafa and Meier 2006) yet survey evidence over the last decade indicates that employee fraud is the most common (Albrecht et al. 2011; ACFE 2012; KPMG 2009; PwC 2011).

2.3 Internal Control

According to ISA 315 (2012), Internal Control is extensively characterized as a procedure, designed to provide reasonable assurance regarding the accomplishment of operation's effectiveness and efficiency, financial reporting reliability, and compliance with appropriate laws and regulations. It addresses an entity's business objectives, which are performance, profitability goals, and safeguarding of resources. In addition, internal control supports the preparation of reliable financial statements. Internal control also deals with company's complience with laws and regulations. These particular yet overlapping objectives address diverse needs and permit a guided center to meet the different needs.

ISA 315 (2012) requires external auditors to make inquiries of the internal audit function to evaluate and assess risks of material misstatement. Auditors may refer to the management's responses of the identified deficiencies of the internal controls and determine appropriately. Besides inquiries of the internal audit function, auditors may collect audit evidence of the control environment through observation on how the employees perform their duties, inspection of the documents, and analytical procedures. After obtaining the audit evidence of the control environment, auditors may then assess the risks of material misstatement. Other factors that influence internal control are the risk assessment, information and communication, control activities, control monitoring, and control to fraudulent reporting.whether the management has taken appropriate actions to tackle the problems

The effect of internal controls on managers' propensity to engage in fraudulent reporting is dependent upon control strength (Hannan et al. 2006; Tayler and Bloomfield 2011). Ceteris paribus, weaker controls are less likely to prevent managers' fraudulent reporting behavior than stronger controls. However, prior economics, management, and management accounting literatures provide evidence challenging the notion that stronger controls necessarily lead to a lower likelihood of fraudulent reporting (Christ et al. 2008; Falk and Kosfeld 2006). This stream of literature finds that implementing formal controls has unintended consequences that may not reduce or even may induce managers' self-interested behavior that is detrimental to the firm (Falk and Kosfeld 2006; Hannan 2006; Rankin 2008).

The effectiveness of implementing stronger controls increases when the firm communicates that controls are implemented for coordinative (monitoring) purposes. Furthermore, a mediated moderation analysis suggests that rationalization mediates the interactive effect of control strength and control framing on fraudulent reporting. Inconsistency between the firm's choice in the strength of controls and control frame reduces the efficacy of the implemented control to curb fraudulent reporting. Specifically, stronger control communicated for coordinating purposes increases managers' propensity to engage in fraudulent reporting. Consistent with prior literature (e.g., Kramer 1999; Rowe 2004; Tayler and Bloomfield 2011), the inconsistent signals between a firm's actions and communicated message focuses managers' attention on their own self-interest, thus resulting in greater fraudulent reporting.

H1 : Coordinating (Monitoring) framing positively (negatively) impact the Fraudulent Reporting.

3. Research Methodology

The respondents are undergraduates Accounting students who will be treated as the experiment design. This primary data will be in the form of financial report showing the level of fraudulent reporting. Sixty business students are playing role as managers of division who will give their reports to the corporate headquarter. The instructor will be the corporate headquarter. One more independent person will be finance division who is charge in money inflow and outflow. Payroll division should be the one who don't know the purpose of the experiment. The division manager and the headquarter know that the reality that the cost is uncertain. The job flow is that corporate headquarter will announce that each division manager should report the cost of each product sold. The selling price of the product is $6 each. The term "$" here means experimental dollar. While the cost ranges from $4 until $6. After the manager submits the budget request to the payroll, he will receive money as much as the budget. Then the money would be exchanged into gifts proved based on the point they get during the experiment.

Two-way Repeated Measures ANOVA is appropriate for measuring the relationship between two independent variables to the dependent experiment in repeated periods (Field, 2012). The two independents variables will be manipulated to the respondents to see the result of dependent variables. The 2 x 2 x 10 ANOVA model is used with Internal Control and Framing as the between-subjects variables and Periods as the within subjects (repeated measures) variable. Internal Control itself will be divided into two categories, the weak Internal Control and the strong Internal Control.

The experiment is set to the managers that they face a dilemma whether they want to maximize their own wealth or to focus for company profit. They can easily keep the excess from the difference between the actual cost and the fake cost set by them. To apply the Internal Control, for the strong Internal Control, the minimum income is $2 while for weaker Internal Control is $2.5. In the monitoring frame condition, participants were told to help the firm more closely monitor project managers' reports in order to prevent project managers from gaining at the expense of the firm. This control procedure limits project managers from overstating project costs and thereby maximizes firm profits.

In the coordinating frame conditions, participants are told that the firm's newly implemented control procedure is to help the firm better allocate resources among projects to achieve corporate strategies which benefits both the firm and project managers. The benefits are received by project managers as reflected in a profit sharing arrangement based on firm profits. Managers are faced with dilemma to maximize wealth for themselves by causing loss to company or to report honestly. That is, the more the manager lies, the more he earns, and the less he lies, the less he earns. Thus, the experiment provides a direct test of the relation between monetary incentives to lie and reporting behavior. Because the manager knows the actual cost for certain when making his cost report.

4. Results

Table 1. Descriptive Statistics of Variable

Variable	N	Min	Max	Mean	Std. Deviation	Variance
Fraud	49	.30	1.00	.8478	.21452	.046
Valid N (list wise)	49					

Fraudulent reporting across the 10 period of reporting. The experiment was participated by 60 students where each students have 10 periods of reporting, meaning there are 600 possibilities of committing fraudulent reporting. There are 170 out of 600 reports were fraudulently reported. The level of fraudulent reporting is therefore 28% from the experiment.

Table 2. Result of Experiment

Group	Members (N)	Reports Collected	Dishonest Reports
Coordinating High	13	130	53
Coordinating Low	13	130	37
Monitoring High	11	110	8
Monitoring Low	12	120	25
Control	11	110	46

The table 2 shows the list of respondents based on their group. First group consist of 13 members where each of them collect 10 reports therefore the total reports are 130. There are 53 dishonest reports out of 130 reports. Second group consist of 13 members where each of them collect 10 reports therefore the total reports are 130. There are 37 dishonest reports out of 130 reports. Third group consist of 11 members where each of them collect 10 reports therefore the total reports are 110. There are 8 dishonest reports out of 110 reports. Fourth group consist of 12 members where each of them collect 25 reports therefore the total reports are 120. There are 25 dishonest reports out of 120 reports. Fifth group consist of 11 members where each of them collect 10 reports therefore the total reports are 110. There are 46 dishonest reports out of 130 reports.

Figure 1. Results of Experiments

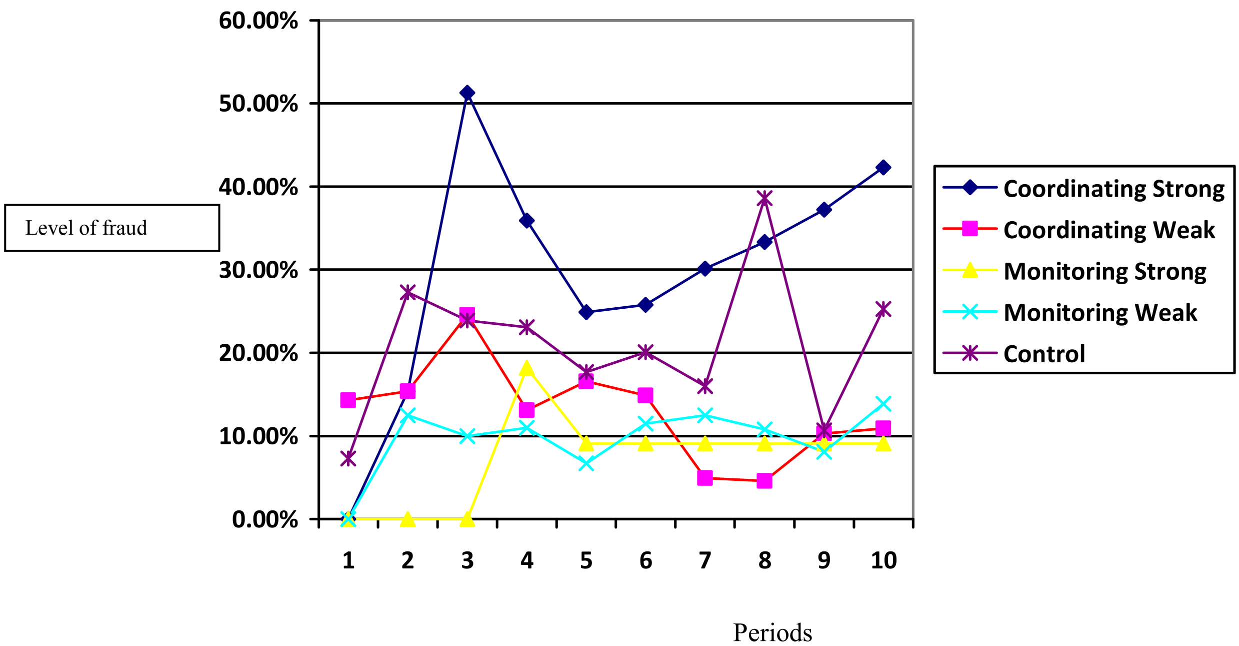

Table 3. Each Group Average Level of Fraud

Group	1	2	3	4	5	6	7	8	9	10	Average*
Coordinating Strong	0.0%	15.4%	51.3%	35.9%	24.9%	25.8%	30.1%	33.3%	37.2%	42.3%	30%
Coordinating Weak	14.3%	15.4%	24.6%	13.1%	16.6%	14.9%	4.95%	4.6%	10.3%	10.9%	13%
Monitoring Strong	0.0%	0.0%	0.0%	18.2%	9.1%	9.1%	9.09%	9.1%	9.1%	9.1%	7%
Monitoring Weak	0.0%	12.5%	10.0%	11.0%	6.7%	11.5%	12.5%	10.8%	8.1%	13.9%	10%
Control	7.3%	27.3%	23.9%	23.1%	17.7%	20.1%	16.0%	38.6%	10.7%	25.3%	21%

Table 3 explains the detail number of Figure 1. The figure shows interesting result where during first periods, the tendency of committing fraud is still low for each group. Then, the fraudulent level is getting higher and diversifies in the next periods. However, in the last periods, the level of fraudulent reporting tends to be low again. This may be caused by the tendency of people where they tend to learn the condition of company and try to look good at the first impression. Then, their real intentions will appear in the next time. Finally as the last time they are about to leave, the will try to look good again. This gap can be consideration for the next research.

Figure 2. Interaction between Fraud and Internal Control

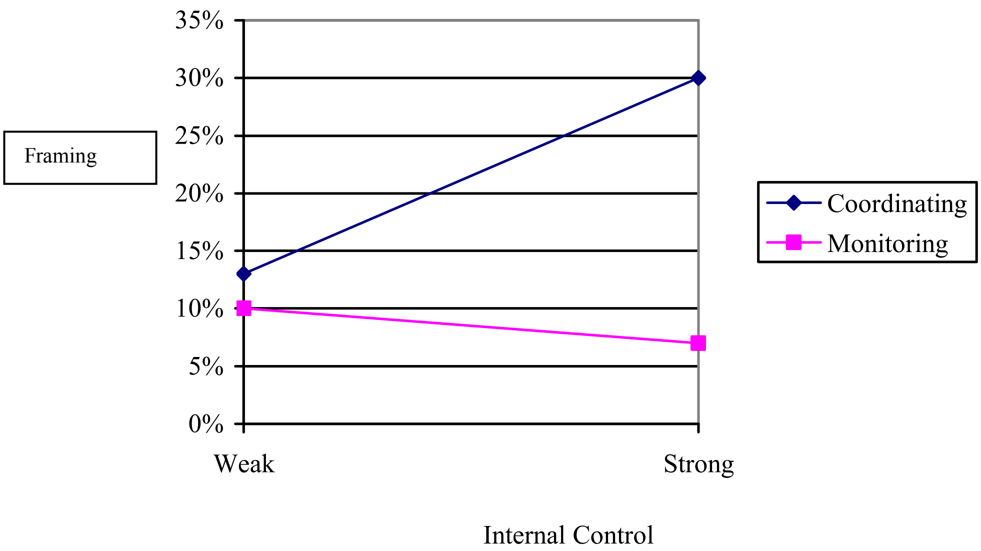

Figure 2 shows the interaction between the framing used in the company and the Internal Control of the company to the level of fraudulent within the company. The coordinating purpose (blue line) shows positive interaction with the level of the Internal Control. The level of fraudulent reporting is 13% when the Internal Control is weak. Then, the level of fraudulent reporting is 30% when the Internal Control is strong. Here we can conclude that as the level of Internal Control is stronger, the level of fraudulent reporting will also increase as well. Conversely, the monitoring purpose (purple line) shows negative interaction with the level of the Internal Control. The level of fraudulent reporting is 10 % when the Internal Control is weak. Then, the level of fraudulent reporting is 7% when the Internal Control is strong. Here we can conclude that as the level of Internal Control is stronger, the level of fraudulent reporting will decrease.

Figure 2 gave an insight that the level of internal control strength is not influencing fraudulent reporting. In fact, framing on internal control is more influencing. When the employee to be framed as internal control is directed for coordinating purposes, it will not be as effective as even weak internal control framed by monotoring framing purposes. Framing is more influencing since it give a mental blocked towards the employee on how they perceive on the sistem. To reduce fraudulent reporting, the entity is better to use monitoring framing on internal control.

4. Hypothesis Testing

4.1 Two-way Repeated Measures ANOVA

Table 4. Tests of Between-Subjects Effects

Measure: Fraud

Source	Type III Sum of Squares	Df	Mean Square	F	Sig.
Intercept	10.920	1	10.920	26.615	.000
Strength	.593	1	.593	1.446	.236
Framing	2.049	1	2.049	4.994	.030
Strength * Framing	1.076	1	1.076	2.622	.112
Error	18.463	45	.410		

Table 4 shows the result of testing for the first hypothesis (H1) which states that Framing has a significant effect on fraudulent reporting is partially accepted. Table shows that the P value of framing is 0.03, it means the effect of framing significantly influences over the fraudulent reporting. However, the relationship between Framing and Internal Control is not significant toward Fraudulent Reporting. The result also gives additional information where in fact, the Internal Control itself does not impact significantly toward fraud.

Table 5. Tests of Within-Subjects Effects for Fraud Measurement

Source		Type III Sum of Squares	Df	Mean Square	F	Sig.
Periods	Sphericity Assumed	1.177	9	0.131	2.268	0.017
	Greenhouse-Geisser	1.177	6.001	0.196	2.268	0.037
	Huynh-Feldt	1.177	7.489	0.157	2.268	0.026
	Lower-bound	1.177	1	1.177	2.268	0.139
Periods * Strength	Sphericity Assumed	0.723	9	0.08	1.393	0.189
	Greenhouse-Geisser	0.723	6.001	0.121	1.393	0.217
	Huynh-Feldt	0.723	7.489	0.097	1.393	0.203
	Lower-bound	0.723	1	0.723	1.393	0.244
Periods * Framing	Sphericity Assumed	0.726	9	0.081	1.398	0.187
	Greenhouse-Geisser	0.726	6.001	0.121	1.398	0.216
	Huynh-Feldt	0.726	7.489	0.097	1.398	0.201
	Lower-bound	0.726	1	0.726	1.398	0.243
Periods * Strength * Framing	Sphericity Assumed	0.652	9	0.072	1.257	0.259
	Greenhouse-Geisser	0.652	6.001	0.109	1.257	0.278
	Huynh-Feldt	0.652	7.489	0.087	1.257	0.268
	Lower-bound	0.652	1	0.652	1.257	0.268
Error(Periods)	Sphericity Assumed	23.362	405	0.058		
	Greenhouse-Geisser	23.362	270.061	0.087		
	Huynh-Feldt	23.362	337.011	0.069		
	Lower-bound	23.362	45	0.519		

Table 5 indicates that Period significantly impact toward the Fraud. It can be interpreted where the duration or length in periodicity of Financial Report impact the tendency in doing fraud. However, the interaction between Period, Framing, and Strength does not significantly impact toward fraud.

5. Conclusions and Recommendations

The result of the research gave a new perceptive to companies in preventing unwanted actions. Internal Control that is primarily and broadly accepted as preventive actions towards fraudulent reporting, in fact cannot stand alone. Internal Control acts as the rules and regulations that technically control the operations within companies to prevent any fraud and misappropriation of assets. However, the technical alone is not enough. The research shows that how companies deliver the Internal Control to the companies is the next big thing to consider regardless how well the Internal Control within that company. Managers should also emphasize on how they deliver the messages related on why rules and regulations are set so in order to establish the perceptions between the employees and the managers the same. The research even shows that impact of framing is bigger than the level of Internal Control regardless how weak or strong the Internal Control, the existence of Framing should be focused.

The second result shown in the research is that Love of Money initially observed to see the impact of internal factor from the employees is not significant toward the tendency in committing fraud. Here we could say that the impact of Framing that comes from the companies has bigger influence that the internal factor from the employees. Previous research done by Tang (1992) used questionnaires based in measuring the interaction between Love of Money towards unethical behaviors. The result shows that there is positive correlation between Love of Money and unethical behaviors. However, in this research that uses experimental based or in the other words, actions based shows that how people may commit in unethical behaviors are caused by the situations within companies. The factor from internal does not give much impact in encouraging people to do.

For the future improvement, the next researchers may concern on other factor that influence the level of fraudulent reporting. Framing is the significant factor that comes from the company. Other aspects that come from the individuals may be consideration. Secondly, the next researcher may use employees that already have working experiences to be the respondents in order to give more clear explanations. More samples used will be better. Thirdly, interesting result could be shown when the researchers use respondents across nations to see how each individual coming from totally different backgrounds perceive the Internal Control. This research was done to Indonesian students. In order to add the possible variables that could impact the tendency in committing fraud would give better explanation, even more if those variables related to culture or moral reasoning that are different in across nations.

The management should not only focus on how to implement control strength to reduce the fraudulent financial reports. Management should also the framing, so the message will be properly received by the employees. The lecturers of business students can concern to emphasize the importance in teaching ethics to the students. Educating is not just about the intelligence and skill but also the character development. The framing can be taught since in college to, so that the students will understand the importance of ethics and the reason why rules and regulations are strictly made.

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