The Disposition-Based Fraud Cycle

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ABSTRACT

This paper reviews the disposition-based fraud cycle (DFC) primarily from the perspective of financial frauds. It suggests that fraud as a human act represents an interaction between organism’s disposition and the circumstances he faces. The DFC model which maps financial fraud as a cycle driven by desire-belief connection is contrasted with the widely accepted paradigm called the Fraud Triangle (FT). A purpose of the analysis is to identify unique fraud-risk factors visible in the DFC model. Empirical evidence from the past studies is discussed to show relevance of the DFC model, and its potential role in preventing and detecting financial fraud. Although the model is applicable to all kinds of fraudulent acts, the focus of this study is on the powerful chief executive with considerable influence within the organization she leads.

Keywords: Disposition, Disposition-Based Fraud Cycle (DFC), Fraud, Fraud Risk-Factors, Fraud Triangle, Temptation

INTRODUCTION

Whereas considerable research on fraudulent financial reporting has been anchored on the fraud triangle, it is now recognized that the triangle’s rationalization condition offers limited insights to our understanding of the financial fraud as a human act (Ramamoorti, 2008). This in turn has spurred interest among researchers to further our knowledge of the human side of fraud. As Cohen et al (2011, p. 287) put it, “The psychological aspects of the individual manager ... play an important role in explaining the fraud.” Raval (2013) proposes an entirely new paradigm, the Disposition-Based Fraud Cycle (hereafter DFC) that in theory, distinguishes between potential actors and non-actors of fraud and explains the cycle of fraud. Chances are, a new way of looking at an exasperating challenge of executive incursions will improve our comprehension of fraud and will offer ways to prevent, not just detect, it.

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It would therefore help to review the DFC and examine, in light of current understanding, its potential contribution to new knowledge in the critical domain of executive financial fraud. Additionally, although the model is generally applicable across all levels in organizations, we focus on the highest level of management, for the most reported cases of fraud have a hand of the chief executive (Beasley et al., 2010). Moreover, we take a comparative view of both the groups, actors and non-actors, as we define dispositionally the non-actors as those who have neither committed nor are likely to commit a fraudulent act. A look at both universes at the same time while using the same model should provide deeper insights into the nature of fraudulent financial reporting (hereafter FFR) acts and perhaps reveal not just pertinent “red” flags, but also “white” flags.

This paper is organized into four main sections. First, we provide an overview of the DFC and benchmark its characteristics and components against what we already know. This exercise will also offer a litmus test of the model’s potential legitimacy as we frame our extant empirical knowledge using the proposed DFC. Simultaneously, such an exercise may raise new questions or contribute additional comfort in the DFC model. Second, we review the case of actors of fraud not in isolation, but rather as an active comparison between those who have, or are likely to, and those who haven’t, or are unlikely to, commit fraud. It is often remarked that not everyone commits fraud, even in light of glaring opportunities and huge incentives or pressures. The question is: where lies the difference? We attempt to systematically propose an answer to this long lasting mystery. Next, we compare the DFC with the fraud triangle to highlight differences and their significance in the identification of fraud risk factors. Finally, we offer additional insights on risk factors that would have greater impact on preventing or detecting FFR and conclude with implications of the DFC and suggestions for further research.

DISPOSITION-BASED FRAUD CYCLE (DFC)

A detailed account of the DFC is beyond the scope of this paper (see Raval, 2013), only a brief summary is presented here. An overview diagram of the DFC is shown in Figure 1. The DFC model includes two major components rooted in Eastern metaphysics, human disposition and the fraud cycle. Human disposition provides the basis for human behavior, including virtuous behavior. Dispositional differences among individuals lead to differences in desires – an evaluative dimension of the behavior. The second component, the fraud cycle, focuses on the situational differences, circumstances that tempt a person of certain disposition to seek temptations to which she is attached, and what follows from seeking such temptations. The fraud cycle postulates that the entanglement of a person into the cycle is contingent upon certain disposition of the person who would be tempted to commit an indiscretion. Once attachment to the temptation takes hold, the person is trapped in the cycle and ultimately commits an act of fraud. Hybrid in nature, the model’s two components integrate a “moral philosopher” with a “social scientist;” the former belongs to the domain of virtue ethics and the latter, social psychology. Broadly, one might categorize the two components, each necessary but not sufficient, as a representation of “organism” and “environment,” respectively; the interaction between the two produces the act. The nature of interaction between disposition and the cycle, implicit in the Eastern religious scriptures has been adapted to develop the model.

The Disposition Component

In articulating disposition, our inquiry is into capacities, skills, habits, liabilities, bents, and proneness; we are considering the powers and propensities of which their actions are exercises (Ryle, 1949). According to Ryle (1949, p. 124), “dispositional statements about particular things or persons... apply to, or are satisfied by, the actions, reactions and states of the object; they...
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