

## Factors Affecting the Risk of Fraudulent Financial Reporting in Iraq and Iran

Farqad Faisal Salla , Mohammad Ali bagherpour Velashani, Mohammad Javad Saei  
Ferdowsi University of Mashhad, Mashhad, Iran

Corresponding Author: Mohammad Ali bagherpour Velashani

Email: [bagherpour@um.ac.ir](mailto:bagherpour@um.ac.ir)

**Abstract :** *The purpose of this study is to investigate the factors affecting fraud risk assessment in financial reporting as well as the management ability to commit fraud in Iraq and Iran. The research method is descriptive-survey and its statistical population consists of independent auditors in both countries. The data was collected using field surveys and questionnaires. The results of this study reveal that in the view of independent auditors, the most important factor in fraud risk assessment in financial reporting is "management motivations" and the least important is "rationalization". In addition, the results suggest that the ability to exploit internal control weaknesses is a major factor affecting management's ability to commit financial reporting fraud. Therefore, the auditor needs to have sufficient knowledge of the internal control system to detect and assess significant risks and perform effective planning. Hence, it is recommended that relevant authorities provide the necessary training and skills to independent auditors in order to improve the risk assessment of fraud and consequently the detection and assessment of fraud factors.*

**Keywords:** *Fraud risk factors, Management ability, Fraudulent Financial reporting, Iraq, Iran.*

**INTRODUCTION:** Today, with the increasing growth of financial markets and the need to attract domestic and foreign investors, the detection of fraud in financial reporting has brought to the fore, drawing the attention of institutions, local and international organizations and the community (Vona, 2008). Fraud is divided into three categories, fraud in financial reporting, embezzlement, and corruption (Wells, 2005). Bankruptcy, collapse, and financial crises are attributed to a set of factors, most notably the adoption of specific accounting policies by the management to keep appearances, present an unrealistic image and to manipulate corporate accounting (Neuman, 2005) and utilization of alternative accounting policies used in preparing financial statements (Kachouri & Jarboui, 2017) Thus, there is a pressing need to provide appropriate mechanisms for the prevention of fraud, and great efforts have been made to identify ways to prevent fraud in financial reporting (Deepika & Senthil, 2019). In this regard, the International Auditing and Assurance Standards Board (IAASB) issued International Standards on Auditing (ISA) 200 and 240, which describe the responsibility of independent auditors for fraud in detail. ISA 200 states that independent auditors are accountable for identifying important distortion of the financial statements, either deliberately and fraudulently. ISA 240 assumes that the auditor's responsibility to detect fraud in financial statements compels independent auditors to assess and respond to fraud risk in financial reporting by taking into account the management's integrity and the three sides of the fraud triangle. With the expansion of capital markets, and the increasing complexity of economic and financial events, and raised awareness of accounting information users, there has been a call for greater focus on the role of the auditors in detecting fraud (Izzalqurny et al., 2019). Accordingly, auditors need to be aware of the importance of their role in detecting fraud (Kassem, 2018). Given the above-discussed points, the purpose of this study is to investigate the factors affecting the assessment of financial reporting fraud in Iraq and Iran. We also investigate the management's ability to commit fraud in the view of independent auditors in both countries. There are many studies on fraud, but the main innovation of this study is focusing on different risk factors of fraud in Iraq and Iran and the comparison of results in the two countries. Few studies have looked into factors that may affect management's ability to conduct financial reporting fraud. Further, this ability has not been addressed in auditing standards. Based on the above, the following questions are raised:

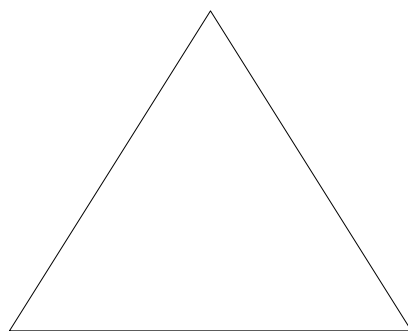
1. What is the relative importance and priority of fraud risk factors in assessing fraud risk in financial reporting in Iraq and Iran?
2. What are the factors affecting the management's ability to commit fraud in financial reporting from the standpoint of independent auditors?

### 2. Theoretical foundations and research background

Cressey, as a criminologist, in an attempt to identify motivations and incentives that drive people to fraudulent acts, discovered three key factors that the interaction of them would lead to fraudulent actions (Gray et al., 2006). Over the years, the Cressey's model came to be recognized as the "Fraud Triangle Model". The first side of the fraud triangle deals with the pressures or incentives to commit fraud. The second side is concerned with opportunities and the third side discusses rationalizations (Wells, 2011). However, Wolfe & Hermanson (2004) argue that the fraud triangle could be supplemented by another factor (capacity or ability) to improve the detection and prevention of fraud. This fourth fraud side is recognized as the contributing fraud factor, which delineates personality traits and

abilities that can play a crucial role in fraud in collaboration with other factors. Chart (1) illustrates factors in the triangle and diamond of contributing fraud factor. According to elements of the fraud triangle, financial reporting fraud requires incentives to commit fraud, opportunities to perpetrate fraud, and rationalization of fraud commitment. The auditor needs to be adequately aware of these factors to detect and prevent fraud.

Pressure/Motive

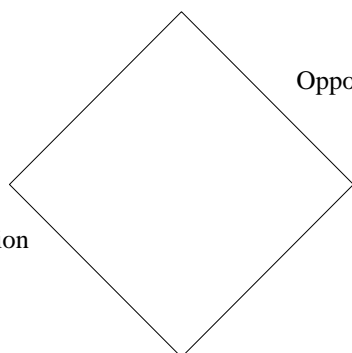


Opportunity

Rationalization

The fraud triangle

Source (Wells, 2011:4)



Opportunity

Pressure/Motive

Rationalization

capabilities

The fraud Diamond

Source (Tugas , 2012: 118)

Figure 1. Triangle and Diamond of fraud

• Pressure/Motive

Pressures / incentives or motivations are factor that stimulate a person to commit an act of fraud (Kassem & Higson, 2015). The incentive or pressure to perpetrate fraud in financial reporting when executives are pressured to obtain the expected profits or financial outcomes internal or external sources, especially when the consequences of failure to meet the expected financial goals are grave for executives (ISA 240). Bikiaris and Papachristo (2017) divide pressure or motivations into two types: financial incentives and non-financial incentives. Financial pressures may include personal financial losses, inability to compete with other companies, greed, living beyond personal means, life beyond individual possibilities, personal debt, distrust, the need to handle short-term credit crises, unexpected financial needs, insufficient income, inability to borrow, loss-making investments and tax evasion. A sharp fall in the value of a company's stock, a decline in sales or instable financial position of management due to deterioration of an entity's financial performance can also be the source of pressure (Davia et al., 2011). As regards non-financial pressures, factors such as the need to present positive outcomes, frustration with work, greed, weak performance, thirst for power and control, ambition or conceit, revenge, job dissatisfaction, fear of losing a job, and envy can be mentioned (Romney & Steinbart, 2006). Also, comparisons of social status (Robertson & Louwers, 2002), pressure on management to retain a company's reputation and its position on the stock exchange in compliance with the terms and conditions of ownership or mergers (Gordon et al. Et al., 2007) can also contribute to this pressure.

**Opportunities**

Opportunities originate from weaknesses of the internal control system. The manager or employees misuse the opportunity to gain personal gain under special circumstances, believing that they would not be held accountable for their actions. In other words, they are assured that after committing this act, they would remain anonymous or if caught, can work their way out of the predicament (Ruankaew, 2013). Opportunity does not stem solely from a weakness in organization or ineffective governance (Choo & Tan, 2007), but includes manager's search to find ways of committing acts of fraud. It means that even if such opportunities do not exist, managers will find a way to create them (Wuerge & Borba, 2011). Examples of opportunities that can be exploited by fraudsters include lack of management oversight or audit committees, weaknesses or absence of management supervision or accounting committee, weakness or lack of internal control systems, complexity of accounting guidelines and complexity of organizational structure, among other things (Nguyen, 2008). Lister (2007) believes that even if a person is adequately motivated for committing fraud, in the absence of appropriate conditions, s/he will not be able to commit any fraudulent acts. Fraud is conceivable when a trusted person becomes cognizant of specific flaws in internal controls.

#### Attitudes / rationalization

Attitudes are meant to rationalize deceptive behaviors rooted in the employee's lack of integrity and integrity. Some individuals have a kind of attitude, personality, or set of ethical standards that apparently give them permission to deliberately engage in fraudulent acts. In some cases, it helps them justify their fraudulent acts (Rae & Subramaniam, 2008). In other words, it describes a situation where the fraudster paves the way for an individual or a group of people to act unjustifiably or disseminate an attitude that advocates the commitment of frauds (Dorminey et al., 2012). Rationalization is a form of self-defense mechanism that a fraudster uses to justify his actions. For instance, statements like "I just borrowed some money with the intention of its repayment, I did not know it was a crime" (Özkul & Pamukcu, 2012); "Competitors do the same. This is not a criminal act as we protect shareholder value", are some of the excuses that fraudsters use to rationalize their wrongdoings (Nguyen, 2008).

Wolfe and Hermanson (2004) presented a different view of the fraud factors by adding another element called the ability or capacity to the fraud triangle. They believed that fraud is perpetrated only by a person with actual abilities and capacities for fraudulent acts. They presented four features for an act of fraud: a high-ranked position or great responsibility in the organization, the ability to understand and work with accounting and internal control systems, assurance that they would remain anonymous or be able to handle the situation in case they are caught and the ability to cope with any pressure and force in the case of engaging in illegal behaviors (Gbegi & Adebisi, 2013).

In this regard, previous studies (Lou & Wang, 2009; Okoye et al., 2009; Abbas, 2013; Ali, 2013) have stated that fraud is the outcome of three factors, including motivation, opportunities, and rationalization, and the combination of these factors is not a prerequisite for any fraudulent act. Yazdani Fazl abadi (2016) and Kassem (2016) postulated that management motivation is the most important factor in assessing fraud risk in financial reporting. However, Dellaportas (2013) and Mohammadi Moghaddam (2018) looked into the association between three components of fraud triangle, finding that a greater weight should be assigned to "opportunity" factor among other elements of fraud triangle (motivations and rationalization). Albrecht et al. (2008) introduced three sets of factors as the underlying causes of fraud. Incentives, which include huge debts and greed of executives. Opportunities, which contain arbitrary interpretation of generally accepted accounting principles, and finally rationalization (justification), including moral corruption of the society and the spread of immorality. Despite the importance of the fraud triangle model, some studies have mentioned limitations that may not fully explain the cause of fraudulent or deceitful behavior and therefore undermining its credibility as an effective model for identifying fraud in financial reporting. For example, as noted by Dorminey et al. (2011), two sides of "pressure (motivation) and rationalization" are not clearly defined in the fraud triangle. Others (such as, Ramos, 2003; Wilks & Zimbelman, 2004; Favere-Marchesi, 2009; Desai et al., 2010) have pointed that a fourth element (fraud capacity) should be added to the current fraud triangle model. They demonstrated that fraud does not necessarily stem from a mixture of three fraud factors, so that the absence of a fraud factor does not imply that no fraudulent action has been committed. They also posit that auditors should analyze all three fraud risk factors, as it gives them leverage in concentrating on the subject. Another criticism leveled at the current fraud triangle model is that some potentially important factors in assessing fraud risk in financial reports including the management's integrity and the ability of fraud perpetrators have been ignored. For example, Albrecht et al. (1984) developed a model called fraud scale in which rationalization in the fraud triangle model had been replaced with integrity. Lou and Wang (2009) and Albrecht et al. (2016) point out that the lack of integrity and dignity opens the gates for fraud.

Other researchers asserted that fraud perpetrators' ability represent a key factor in the current fraud triangle model. Wolfe and Hermanson (2004) expanded the fraud triangle model by adding fraud perpetrators ability to the model, calling it the "fraud diamond". In this regard, (Kassem & Higson, 2012; Gepp, 2015 & Yusof, 2016) developed a new framework (fraud detection triangle) to improve the selection of variables in financial statement fraud detection models. It comprises. It comprises four factors that explain any fraudulent acts. The first is incentive, which includes both financial and non-financial incentives. The second is opportunity and the third is integrity, which has been swapped with rationalization in the "fraud scale" model (Cressey's model). The fourth factor that lies at the heart of fraud triangle is the fraud perpetrators ability, which describe fraudsters' ability to justify and explain fraudulent behaviors. The results of previous studies (Rad, 2012; Kassem, 2018; Nwanyanwu, 2018; Singal, 2019) have introduced management's integrity as an important factor in assessing fraud risk in financial reports. The fraud rationalization must be assessed as part of the management's integrity not a separate risk factor of fraud. They also found that fraud perpetrators ability and fraud opportunities are of equal importance and should be taken into account.

**3. Research Method**

This is a descriptive-survey research in terms of its purpose. The data collected by questionnaires were analyzed using SPSS software.

**4. Statistical population and sampling method**

The statistical population of this study consisted of independent auditors including, partners, managers, senior supervisors, and supervisors in Iran as well as partners, first-ranked independent auditors and second-ranked independent auditors in Iraq. Sample size was determined by NCSS software (PASS). Based on the data obtained from this sample and using the chi-square test method, the final sample size was determined in Iran (n=194) in Iraq (n=140). The research was conducted during 2018- 2019 period.

**5. Data analysis method**

Descriptive and inferential statistics are used for data analysis. The descriptive analysis consisted of percentages and chi-square test, which is used to examine the difference between frequencies of a variable with more than two levels. Then, data analysis is conducted by Friedman test to compare the mean ratings of different groups.

**6. Research data analysis**

6.1 Descriptive statistics results

This section gives a summary of the demographic information of respondents. including gender, age, level of education, audit experience, and professional grade, as shown in Table 1. According to the data, 85% of respondents are male (Iraq 90.7% and Iran 80.9%) and 15% are female (Iraq 9.3% and Iran 19.1%). The majority of the participants were aged 41-50 years, which accounts for 32.2% of the sample (32.8% Iraq and 32.4% Iran). 51.5% of respondents (Iraq 43.6% and Iran 57.5%) have master's degree, 18.6% (Iraq 41.4% and Iran 2.6%) have doctoral degree, 6.3% have High diploma degree in Iraq, and 23.7% have a bachelor's degree in Iran. As for the work experience, the highest frequency belongs to 11 to 20 years of work experience that account for about 37.7% (Iraq 35.7% and Iran 39.2%). Of all respondents, 24.9% in both countries (23.6% in Iran, 25.8% in Iraq) are partner. In Iran, 14.9% are managers, 13.4% are senior supervisors and 45.9% are supervisor and in Iraq, 13.4% are first-ranked independent auditors and 13.4% are second-ranked independent auditors.

Table 1. Demographic information of respondents

Demographic information of respondents		Iraq		Iran		The whole sample	
		Frequency	Percent	Frequency	Percent	Frequency	Percent
Gender	Male	127	90.7	157	80.9	284	85.0
	Female	13	9.3	37	19.1	50	15.0
Age	20-30 years old	0.0	0.0	20	10.3	20	6.0
	31-40 years old	44	31.4	50	25.8	94	28.1
	41-50 years old	46	32.8	63	32.4	109	32.7
	Above 51 years old	50	35.7	61	31.4	111	33.23
Level of education	Bachelor's degree	0.0	0.0	79	40.7	79	23.7

Demographic information of respondents	Iraq		Iran		The whole sample		
	Frequency	Percent	Frequency	Percent	Frequency	Percent	
	High diploma	21	15.0	0.0	0.0	21	6.3
	Master's degree	60	43.6	112	57.2	172	51.5
	Doctoral degree	58	41.4	4	2.06	62	18.6
Audit experience	More than 10 years	36	25.7	70	36.1	106	31.7
	11-20 years	50	35.7	76	39.2	126	37.7
	More than 21 years	54	38.6	48	24.7	102	30.6
Professional grade	Partner	32	23.6	50	25.8	82	24.9
	Manager	0.0	0.0	30	14.9	30	8.7
	Senior supervisors	0.0	0.0	25	13.4	25	7.9
	Supervisor	0.0	0.0	90	45.9	90	26.6
	First-ranked independent auditors	58	42.1	0.0	0.0	58	17.7
	Second-ranked independent auditors	49	34.3	0.0	0.0	49	14.4
	Total	140	100.0	194	100.0	334	100.0

## 6.2 Research test results

### 6.2.1 fraud risk factors

To determine the significance of fraud risk factors in financial reporting from the standpoint of independent auditors in the two countries (Iraq and Iran), the chi-square test was used. As noted in Table 2, p-value of the chi-square test was less than 0.001 for the significance of fraud risk factors in financial reporting in Iran and Iraq. As such, it can be concluded that independent auditors' views about the significance of each factor in both countries is considerably different in general and the reported frequencies for each risk factor in order of importance are as follows: management motivations (96%), management uprightness and integrity (86%), fraud perpetrators ability (77%), opportunities (74%) and rationalizations (63%). In the view of independent auditors in Iraq and Iran, management motivations (95%, 96%), management uprightness and integrity (82%, 89%), fraud perpetrators ability (74%, 79%), opportunities (62%, 85%) and rationalizations 63% (65% and 60%) were the main important factors, respectively.

Table 2. The importance of fraud risk factors in financial reporting

Country	Factors	Significant & Most Significant	Rarely Significant & Least	chi -square	Value P
Iraq	Management motives	95%	5%	220.50	<0.001
	Management's integrity	82%	18%	129.64	<0.001
	Rationalization	65%	35%	147.64	<0.001
	Opportunity	62%	38%	45.86	<0.001
	Fraud perpetrators' capabilities	74%	26%	70.77	<0.001
Iran	Management motives	96%	4%	346.67	<0.001
	Management's integrity	89%	11%	188.371	<0.001
	Rationalization	60%	40%	168.01	<0.001
	Opportunity	85%	15%	199.454	<0.001
	Fraud perpetrators' capabilities	79%	21%	154.196	<0.001
The whole sample	Management motives	96%	4%	565.82	<0.001
	Management's integrity	86%	14%	302.018	<0.001
	Rationalization	63%	37%	313.874	<0.001
	Opportunity	74%	26%	223.695	<0.001
	Fraud perpetrators' capabilities	77%	23%	209.295	<0.001

In this section, the results of the Friedman test to evaluate the importance of fraud risk factors in financial reporting are presented. As shown in Table 3, from the standpoint of auditors in general, management motivations (3.92), management uprightness and integrity (3.20), fraud perpetrators capacities (2.85), opportunities (2.76), and rationalizations (2.27) are the most important factors, respectively. Furthermore, in the view of independent auditors in Iraq and Iran, management incentives (3.82, 3.98) and management integrity (3.38, 3.08) were ranked as the first and second important factors. Also, the factor of fraud perpetrators' capacities was assessed as the third (2.85) by Iraqi and the fourth (2.86) important factor by Iranian independent auditors. Similarly, opportunity was assessed as the fifth (2.42) by Iraqi and the third (2.092) important factor by Iranian independent auditors. Finally, rationalization was assessed as the fifth (2.16) by Iranian and the fourth (2.54) factor by Iraqi independent auditors.

Table 3: Mean ranking and prioritization of fraud risk factors in financial reporting

	Iraq		Iran		The whole sample	
	Factors	Average rating	Factors	Average rating	Factors	Average rank
1	Management	3.82	Management motives	3.98	Management motives	3.92

	motives					
2	Management's integrity	3.38	Management's integrity	3.08	Management's integrity	3.20
3	Fraud perpetrators' capabilities	2.85	Opportunity	2.92	Fraud perpetrators' capabilities	2.85
4	Rationalization	2.54	Fraud perpetrators' capabilities	2.86	Opportunity	2.76
5	Opportunity	2.42	Rationalization	2.16	Rationalization	2.27

### 6.2.2 Factors affecting management ability

This section looks into the factors affecting management ability to commit fraud in financial reporting in the view of independent auditors in Iraq and Iran using the chi-square and goodness of fit tests. The results of this study are presented in Table 4. The estimated p-value for management’s capacity to commit financial reporting fraud in both countries is less than 0.001. Table 4 shows that from the standpoint of auditors in general, management ability to exploit internal control weaknesses (39%), ability to understand accounting systems (24%), assurance that fraud will not be disclosed or if caught, they can work their way out of predicament (18%), a reputable position (power and authorities) in the organization (18%), and ability to cope with stress (1%) are the main factors affecting the management ability to perpetrate fraud.

According to Iraqi and Iranian auditors, using the internal control weaknesses was ranked first (46%, 34%), ability to understand accounting systems was ranked second and third (31%, 19%), and assurance that fraud will never be detected, and if caught, they could work their way out of the predicament were ranked third and fourth (22%, 14%) among factors affecting fraud, respectively.

In contrast, the factor of a reputable position and status (the power and authority) in the organization was ranked second (31%) and ability to cope with stress was ranked fifth (2%) in the opinion of Iranian auditors.

Table 4: Factors affecting management ability to commit fraud in financial reporting

Country	Abilities	Frequency	Percent	Rank	Chi square	P-Value
Iraq	Capacity to understand accounting systems	44	0.31	2	114.357	<0.001
	Capacity to exploit internal Control weaknesses	65	0.46	1		
	Ability to deal with stress	0	0.0	-		
	Authoritative position within the organization	0	0.0	-		
	Confidence that the fraud perpetrator will not be detected or if caught he/she will get out of it	31	0.16	3		
Iran	Capacity to understand accounting systems	36	0.19	3	68.010	<0.001
	Capacity to exploit internal control weaknesses	66	0.34	1		
	Ability to deal with stress	3	0.02	5		
	Authoritative position within the organization	61	0.31	2		
	Confidence that the fraud perpetrator will not be detected or if caught he/she will get out of it	28	0.14	4		

Country	Abilities	Frequency	Percent	Rank	Chi square	P-Value
The whole sample	Capacity to understand accounting systems	80	0.24	2	126.659	<0.001
	Capacity to exploit internal control weaknesses	131	0.39	1		
	Ability to deal with stress	3	0.01	4		
	Authoritative position within the organization	61	0.18	3		
	Confidence that the fraud perpetrator will not be detected or if caught he/she will get out of it	59	0.18	3		

## 7. Conclusion

The study findings suggest that independent auditors in both countries considered fraud factors in assessing the risk of financial reporting, but the most important factor was management motivations. This result consistent with those reported by Yazdani Fazlabadi (2016), Kassem and Higson (2012) and at inconsistent with the findings of Mohammadi Moghaddam et al. (2018) and Kassem (2016). However, the factor of opportunity in Iraq and the factor of rationalization in Iran were less important than the other factors, which may be due to different economic and social conditions in the two countries. The results also suggested that the ability to use internal control weaknesses is one of the major management's capacities for perpetrating financial reporting fraud, which should be considered by independent auditors when evaluating fraud risk factors. When the internal control system is weak and ineffective, the probability of fraud and manipulation rises. Therefore, the auditor needs to have sufficient knowledge of the internal control system to detect and assess significant risks and perform effective planning. This result is consistent with those reported by Vona (2008), Omar and Dean (2010) and Kassem & Higson (2012). Based on, it is recommended that relevant authorities provide the necessary training and skills to the independent auditors in order to improve the risk assessment of fraud and consequently the detection and assessment of fraud factors.

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