

CORPORATE FRAUD MITIGATION USING FRAUD DIAMOND THEORY

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Abstract - *The Enron scandal remains one of the most prominent cases of large-scale corporate fraud, reshaping global business regulation and accountability. This study adopted a qualitative descriptive case study approach and analysed publicly available secondary documents, including court rulings, journal literature, and investigative reports. Guided by the Fraud Diamond Theory (FDT), the analysis demonstrated that Enron's collapse stemmed from the interaction of pressure, opportunity, rationalization, and executive capability. Fraudulent accounting schemes—particularly the inappropriate use of Mark-to-Market valuation and the creation of Special Purpose Entities—were intentionally designed to obscure debt, inflate earnings, and maintain a fabricated image of financial strength.*

The collapse generated severe consequences for stakeholders including massive losses to investors, employee displacement, and the dissolution of Arthur Andersen. The findings further revealed that the scandal accelerated major corporate governance reforms, most notably the passage of the Sarbanes-Oxley Act, which strengthened reporting accountability and auditor oversight. Key insights emphasize the necessity of ethical governance, auditor independence, transparency in reporting, and avoidance of complex financial structures used for concealment. The study also proposes preventive measures applicable to Philippine corporations, including improved segregation of duties, strengthened internal audit mechanisms, performance-aligned compensation systems, mandatory auditor rotation, and stricter legal sanctions for corporate misconduct.

This case reinforces the critical role of ethical leadership and effective governance structures in preventing fraud and safeguarding public trust.

Keywords: *Corporate fraud mitigation, Corporate Governance Reforms, Enron Scandal, Ethical Leadership and Accountability, Fraud Diamond Theory*

INTRODUCTION

The Enron scandal stands as one of the most widely cited and ravaging corporate frauds in international business history. This corporate collapse caused over \$100 billion in stockholder losses and

catalysed major legislative reform globally, including the Sarbanes-Oxley Act. Despite the numerous studies conducted on this event, an academic gap remains regarding the analysis of the Enron case through the specific and robust framework of the Fraud

Diamond Theory (FDT). The FDT, introduced by Wolfe and Hermanson in 2004, is a progression from Cressey's (1953) Fraud Triangle, incorporating four required elements for fraud: pressure, opportunity, rationalization, and capability. This addition of capability emphasizes that successful large-scale fraud requires perpetrators—such as the high-ranking executives at Enron—to possess the authority, intelligence, and skills needed to penetrate internal controls and execute sophisticated schemes. Corporate fraud itself is defined generally as any illegal or unethical activity used for deception to gain a competitive advantage or stage a desirable company identity for investors. In Enron's case, this deceptive practice manifested primarily through the strategic misuse of Special Purpose Entities (SPEs) to conceal massive debt off the balance sheet and the aggressive application of Mark-to-Market (MTM) accounting to instantly recognize unrealized future profits. Given that studies concerning corporate fraud in the Philippines still require further insight and the country maintains a high incidence of economic crime, the objective of this research is established: to utilize the FDT as a powerful lens to thoroughly investigate the internal governance failures (including the failures of the Board of Directors, top

executive officers, and auditors) of the Enron case, thereby extracting crucial, applicable lessons and safeguards essential for corporate fraud mitigation within the Philippine business environment

OBJECTIVES OF THE STUDY

This study aims to address the main research question: “how does the Fraud Diamond Theory be used in unveiling the flaws of Enron?”

Specifically, this study sought to answer the following questions:

- 1.How fraudulent activities committed by Enron contributed to the demise of the company?
- 2.What are the impacts of fraudulent activities on the stakeholders?
- 3.What are the key takeaways in the case of Enron?
- 4.What safeguards could have been done to mitigate corporate fraud in terms of internal and external control?

METHODOLOGY

The research investigates the Enron scandal, characterized as a remarkable event in history and the most enormous and ravaging corporate fraud in the international market [i, 7], with the goal of

analyzing its failures to establish learning factors for the Philippine corporate business set up [i, 8, 52]. The methodology employs a qualitative research method through a descriptive case study approach, providing an in-depth understanding of events rather than focusing on numerical data. The total population of data used consists solely of verifiable secondary sources, including court documents, published journals, articles, and research studies concerning the defunct Enron Corporation. The entire analysis is processed using the framework of the Fraud Diamond Theory (FDT), which scrutinizes the elements of pressure, opportunity, rationalization, and capability. Results confirmed that Enron's fall was marked by severe weaknesses in corporate governance and internal control systems. Fraudulent schemes, driven by financial pressure, utilized the exceptional capability (authority, skills, and intelligence) of top executives like Jeffrey Skilling and Andrew Fastow]. These schemes included the manipulation of financial statements using Mark-to-Market (MTM) accounting to prematurely recognize profits and the deceptive use of Special Purpose Entities (SPEs) to hide vast amounts of debt

The findings highlight the necessity of strict safeguards for mitigating corporate

fraud, with the implementation of FDT-derived internal controls predicted to be a great game changer for Philippine corporate governance.

RESULT AND DISCUSSION

SOP 1: How fraudulent activities committed by Enron contributed to the demise of the company?

The demise of Enron was directly caused by fraudulent schemes employed to achieve financial reporting objectives, which were assessed to contain all four elements of the Fraud Diamond Theory: pressure, opportunity, rationalization, and capability.

Financial Schemes and Opportunity:
The primary fraudulent schemes included the misuse of two accounting mechanisms, both representing opportunity:

- Mark-to-Market (MTM) Accounting: Enron used MTM accounting to record the estimated present value of all future profits from a contract the moment it was signed. This gave the "illusion of higher current profits" rather than recognizing actual revenue over the contract's life. The application of MTM was found to be inappropriate for Enron's business and violated GAAP and relevant accounting standards.

- Special Purpose Entities (SPEs): These entities, dubbed "Raptors," were

fraudulently created and used by CFO Andrew Fastow to act as off-balance sheet vehicles. The purpose of certain transactions with LJM entities (controlled by Fastow) was to manipulate financial statements by hiding Enron's vast debt and losses and generating improper earnings and cash flow, thereby protecting the company from MTM losses and maintaining a fraudulent credit rating.

- **Pressure and Capability:** The schemes were driven by intense financial pressure originating from executive and employee bonus packages tied solely to reported figures, creating an incentive to attain high profits by any means. The perpetration required high capability; executives like Andrew Fastow, the Chief Financial Officer, possessed the necessary authority, skills, and intelligence to execute the complex fraudulent plan, turning the opportunity into reality.

- **Corporate Governance Failure:** The fraud was enabled by the failure of "gatekeepers," including the Board of Directors and external auditors, demonstrating weaknesses such as fiduciary failure, high-risk accounting, conflicts of interest, and lack of independence. Enron conspired with its external auditor, Arthur Andersen, which allegedly neglected or approved

accounting frauds due to the lucrative consulting fees it received

SOP 2: What are the impacts of fraudulent activities to the stakeholders?

The fraudulent activities led to catastrophic consequences for stakeholders.

- **Stockholder Losses and Economic Impact:** The scandal resulted in over \$100 billion in stockholder losses and caused a significant disruption in the U.S. economy.

- **Employee Losses:** Many employees lost their jobs and their retirement funds, which primarily consisted of Enron stock and represented their total life savings.

- **Demise of Arthur Andersen:** The subsequent investigation resulted in the demise of Arthur Andersen, one of the oldest international accounting firms.

- **Regulatory Change:** The collapse of Enron (and others) served as a pivotal result leading the U.S. government to enact new regulations, most notably the Sarbanes-Oxley Act (SOX) in 2002, intended to increase financial reporting accuracy and improve the performance of gatekeepers.

SOP 3: What are the key takeaways in the case of Enron?

The Enron case offers crucial lessons regarding business ethics, oversight, and accounting practices. Key takeaways include:

"Strategic Innovations Across Learning, Technology, and Business for Development and Growth"

- **The Power of Ethical Standards:** The scandal highlighted the necessity of ensuring corporate governance is aligned with high standards of business ethics and integrity.
 - **The Independent Role of External Auditors:** The failure of Arthur Andersen emphasized the need for external auditors to be truly independent, performing tests of internal controls and providing unbiased reports free of material misstatement.
 - **Limitations of Accounting Methods:** The misuse of Mark-to-Market accounting demonstrated that while a method might be legal (approved by GAAP), its fraudulent application through false assumptions can create serious misrepresentation of profits.
 - **Avoiding Structural Complexity:** The improper use of SPEs illustrated the danger of complex organizational structures designed to hide debt and manipulate financial appearances.
 - **Regulatory Improvement:** The collapse resulted in the U.S. government creating the Public Company Accounting Oversight Board (PCAOB) and implementing provisions like a mandatory 5-year rotation period for accounting firms to enhance oversight and transparency
- SOP 4: What safeguards could have been done to mitigate corporate fraud in terms of internal and external control?

The study proposed several internal and external control safeguards derived from the FDT analysis of the Enron case, particularly for the Philippine corporate business set up.

Internal Control Safeguards (Management Aspect):

These measures directly mitigate the elements of the Fraud Diamond.

1. **Segregation of Duties:** This is necessary to prevent one person or department from holding responsibility for multiple workflow roles, thus ensuring checks and balances.
2. **Internal Audit Committee:** Companies should establish an internal audit committee equipped to provide oversight, understand risks, and approve internal audit plans [i, 86].
3. **Reviewing Compensation:** Incentives should be based on performance rather than figures alone to remove the pressure that encourages fraudulent activities.
4. **Employee Morale and Behavior Check:** This is an effective tool for determining how people in the organization perceive things and approach fraud prevention.
5. **Using Irrational Ratios:** Tools such as Days Sales in Receivables Index and Gross Margin Index should be utilized to detect manipulation in financial statements that is difficult to conceal through simple analysis .

External Control Safeguards (Legal and Regulatory Aspect):

1. Independent External Auditor: Entities must engage external auditors who possess integrity and objectivity, avoiding conflicts of interest. The mandated 5-year rotation period for accounting firms should be followed.
2. Legal Deterrence: The Philippine Congress should pass laws that subject corporate officers proven guilty of fraud to imprisonment and fines, preventing them from invoking non-liability based on acting solely in their corporate capacity. This is expected to be a "great game changer" for corporate governance in the Philippines.

CONCLUSION AND RECOMMENDATION

1. Enron's Fraudulent Scheme Employed the FDT Elements: The study definitively concludes that the fraudulent activities leading to Enron's demise contained all four elements of the Fraud Diamond Theory.

- Pressure: The fraudulent scheme was driven by pressure]. This pressure stemmed from accounting tricks used to misinterpret debt as revenue. Every fraud perpetrator encounters pressure, which can be financial or non-financial, though financial pressure is the most common factor leading to unethical conduct.

- Opportunity: Opportunity was present due to ineffective control or governance, specifically identified as internal control weaknesses. Individuals holding positions of trust exploited these weaknesses to successfully commit fraud.

- Rationalization: The presence of rationalization occurred when the perpetrators convinced themselves that the fraudulent activities they committed were acceptable under specific circumstances, believing their actions were just and moral.

- Capability: The execution of large-scale fraud necessitated high capability . Capability refers to an individual possessing the authority, position, skills, and intelligence needed to turn the opportunity into reality. Individuals with high capability are "mugged with confidence" that they can smoothly execute the fraudulent plan and influence others to conceal the crime.

2. Corporate Governance Failure was Central to the Collapse: The study concludes that the core cause of the disaster was the profoundly poor corporate governance system The Board of Directors, top executive officers, internal auditor, and external auditors all "contributed to the fall of Enron" . The finding confirms the initial assumption that Enron's corporate governance employed fraudulent schemes

to achieve its corrupt objectives, making a significant contribution to the company's collapse and bankruptcy. The "gatekeepers failed against corporate fraud" as assessed within the FDT lens.

3. Fraud Detection and Prevention are Mitigated by Internal Control: Consistent with related research, the study concludes that effective and efficient use of internal controls mitigates fraud. Internal control is a process designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance.

4. Need for Philippine Regulatory Action: The study establishes that the lessons from the Enron case are highly applicable to the Philippines. The effective implementation of FDT-derived internal controls is expected to be a "great game changer" for corporate businesses in the Philippines, leading to the development of stronger internal control for each corporate governance structure. The Philippine Congress is encouraged to pass legislation imposing imprisonment and fines on corporate officers proven guilty of fraud, to prevent them from using their corporate capacity as a shield against liability

Recommendations

Based on the result of the study, recommendations are hereby proposed to be used by any corporation of any industry to mitigate corporate fraud aligned with the elements of Fraud Diamond Theory namely, pressure, opportunity, rationalization and capability

A. Management Aspect (Internal Controls)

This aspect focuses on internal control safeguards aligned with mitigating the elements of the Fraud Diamond Theory (pressure, opportunity, rationalization, and capability).

1. Developing the Right Corporate Culture: This should be the starting point for any corporation. A healthy organizational culture helps to maintain integrity, attract valuable talent, and establish appropriate expectations that align with core company values, thereby removing undue pressure on personnel.

2. Revisiting Compensation and Incentives Policy: Corporations must review and update their compensation and benefits packages. This ensures that salaries are aligned with industry standards, keeping employees satisfied and eliminating the pressure that encourages fraudulent activities for extra income. Furthermore,

incentives should be based on genuine performance rather than solely on financial figures, countering the pressure seen in the Enron case.

3. Employee Morale and Behavior Check: This tool is effective for determining how employees perceive things, approach difficult situations, and assess the intactness of their integrity.

4. Hiring Industry-Skilled Consultants: Engaging consultants with the right skills and knowledge can provide valuable insights to help the company achieve its goals and objectives and set appropriate and attainable expectations.

5. Segregation of Duties: This is essential to prevent one person or department from holding responsibility for multiple workflow roles, ensuring checks and balances across the entire entity. This mitigates the element of opportunity.

6. Independent External Auditor: Entities must hire an external auditor characterized by integrity and objectivity to provide unbiased assessments of financial statements and disclosures. This practice helps ensure financial statements are free from material misstatements, errors, omissions, or fraudulent activity.

7. Adherence to Government Regulations: Knowing that government regulations are in place serves as an external gatekeeper

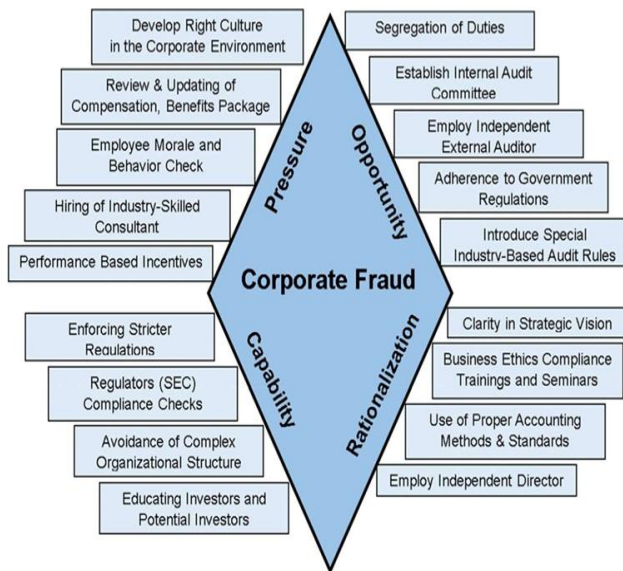
against attempts to commit fraud within the organization.

8. Setting a Clear Strategic Vision: Establishing a clear vision provides a meaningful context for the management and employee.

Further safeguards highlighted in the analysis that management can implement include:

- Establishing an Audit Committee: The committee should oversee compliance, operational audit, monitor the maintenance of sound internal controls, and strict compliance with laws and regulations to mitigate fraud.
- Employing Independent Director: It would be better if the concept of independent directors—individuals not employed by the company who bring an unbiased perspective to board decisions—could be applied to all entities, not just public companies [i, 72].
- Using Irrational Ratios: Analytical tools like Days Sales in Receivables Index and Gross Margin Index should be used in financial statement analysis to detect manipulation that fraudsters might attempt to conceal.
- Educating Investors and Potential Investors: Investors should be educated not only on investing money but also on the potential risks of their investments and

transactions within a given industry.



B. Legal Aspect (Government/Regulatory Action)

The legal recommendations focus on strengthening the law and punishment for committing corporate fraud in the Philippines.

1. Enact Stronger Penalty Laws for Corporate Fraud: The Philippine Congress (Senate or House of Representatives) should propose and enact a law strengthening legal provisions and promulgating higher penalties for corporations and officers who commit or participate in corporate fraud.
2. Preventing Corporate Liability Shield: The law enacted should prevent corporate officers proven guilty of fraud from invoking non-liability based on acting solely in their

corporate capacity. Convicted officers should face imprisonment and fines based on the nomenclature of penalties in the Revised Penal Code.

3. Reinforcement of Regulatory Bodies: The Securities and Exchange Commission (SEC) and other regulatory bodies should be reinforced by law to provide them with the necessary "claws" to strictly enforce rules and regulations.

4. Enacting Specific Industry-Based Audit Laws: Congress should pass a law mandating specific industry-based audits. This would help gatekeepers focus on relevant transactions within that industry [i, 93]. An audit committee for each jurisdiction should present yearly audit reports to the SEC for compliance review and determine if there is probable cause relevant to corporate fraud.

5. Preventive Suspension during Investigation: In cases of determined irregularities and non-compliance, the SEC should be empowered to issue preventive suspension to corporate officers involved in fraud, preventing them from interfering with criminal investigations. An external committee should then be assigned to ensure the corporation's operation is not affected.

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