

Inside the mind of the white collar criminal

There are red flags that can help you identify perpetrators of fraud on non-audit engagements.

BY BILL BARRETT, CPA/ABV/CFF



I once was a glorified bookkeeper, working my way through college with a family, before I became a *true* controller. Back in the day of paper ledgers and journals, I worked for a leather goods manufacturer. They made purses, wallets and pad holders (for regular old paper yellow pads, not iPads).

I had become increasingly concerned that while sales remained stable, the Cost of Goods Sold (COGS) was rising and negatively affecting the bottom line. I usually reported to the vice president, but something was nagging me about going to him with this problem. Maybe it was the new gull-wing DeLorean or the \$10,000 ultra-thin Piguet Jules watch that he recently bought. So off I went to the president instead.

After explaining the matrix of the income statement and its relation to inventory on the balance sheet, he was completely confused. However, he asked me to keep my analysis to myself.

A week later, I was being toasted with a raise and a three-day family weekend at the beach. Turns out the vice president was taking work-in-process from the locked-down holding areas, after hours, to a plant he had set up. His crew (the foreman also worked in collusion) would finish the goods and sell them to the various distributors and department stores.

The fraud was caught by the president, who had a trusted employee spend the night in his car outside the shop.

And the vice president, needless to say, went to jail. But the real satisfaction came when he bent the face of his Piguet and couldn't use it anymore.

What I learned is that sometimes the

first sign of fraud is just a feeling that something is not quite right. Numbers may not totally add up or internal controls may be sloppy. A gut instinct can be very helpful when trying to catch white collar criminals. But there are certainly red flags to look for.

DEFINING THE CRIME

The term "white collar" crime originated to distinguish the nonviolent nature of fraud from violent street crimes, such as armed robbery. It was used because most people in a position to commit fraud were "white collar" clerical, managerial or executive employees within a business organization rather than "blue collar" laborers. The term should not be taken too literally — a "blue collar" truck driver or receiving dock employee who steals the inventory to which he has access is also committing white collar crime.

Fraud that is visible on financial statements, however, is usually committed by higher levels of management. The perpetrators are typically well-educated, have a high social standing and are respected members of the community. They use their social and cultural background as well as their specialized knowledge and skills to their advantage.

In addition, they are usually experienced

and adept at bending others to their will. An organization in which management is dominated by a single person or small group may be a perfect breeding ground for fraud. Intimidation, domineering behavior and pressure from top management are often part of the psychological deception to conceal a fraud.

The fraud accountant's weapon to counter psychological deception is a well-developed professional skepticism. Professional skepticism is often described as a "show me" attitude that requires management to prove representations rather than present them to be accepted at face value.

FRAUD, RATIONALIZED

Once a corporate fraud perpetrator is identified, it won't take long for you to wonder: Why? You may not believe it, but criminals often believe they are doing the right thing (or at least close to it).

From the 2002 Enron fraud scandal and forward, one of the most interesting behavioral beliefs held by perpetrators is their belief that they were acting in a legitimate manner. Prosecutors say these criminals, even after they enter a guilty plea, often take months or more to fully accept their guilt. All of the convicted criminals had spent most of their ►

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lives viewing themselves as law-abiding citizens. Each believed that they were performing acceptable business practices within their organization — that the operational practices, while aggressive, were legal and even necessary for the survival of the organization.

This phenomenon of rationalization has been studied by the sociologist Robert K. Merton. In 1993, he first theorized that social structures provide motivation for misconduct because they focus individuals on competition, the importance of money in society and the erosion of norms that encourage legitimate money-making behavior (goal orientation). When individual goal orientation receives more emphasis than the norm of the social structure, the norms will lose their power to regulate behavior. This produces a state of “anomie,” or normlessness — an important concept in sociology that is said to lead to lawlessness.

Merton also defines competitive economic activity — the production,

exchange, distribution and consumption of goods, with wealth assuming a “highly symbolic cast”

— as “culturally legitimated success-goals.” This definition fits closely to the behavior of most profit-seeking organizations.

For a business, economic success means not only cultural approval, but survival. Regardless of the cultural emphasis on profits, an organization must seek profits, and profits will be a prime indicator of prestige within a society, as well as the key to social mobility within hierarchies of organizations. In short, money talks in the business world.

Merton states that to obtain financial success, individuals must compete, both for the means toward the goal and the goal itself. The availability of both the tools to compete and the profits themselves is limited by insufficient supply and demand. When these limits threaten a competitor with losses, innovation may result in the endless

quest for strategic resources.

And that innovation, often necessary to obtain the holy grail of financial success, can sometimes be found on the wrong side of the law.

IT'S ABOUT THE THRILL

Yep, committing crimes does give its perpetrators a thrill. High-dollar criminals describe their machinations as having a “kick.” They feel like they’re playing a game, and it’s the game of their lives. Behaviorists agree. Money is a “generalized reinforcer,” linked with many positive factors directly, and often taking on a symbolic power of its own, yielding a condition of strength.

Game-playing exerts something similar on its participants; someone who manipulates a chess board or a deck of cards successfully gains a sense of strength over external events. We can play the game “for its own sake” because it yields the impression of strength.



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Imagine the emotional charge to the “player” when the game’s power is combined with money as a generalized reinforcer, and both of these factors are played out with real people and settings. This dealmaker is racing through a thicket of reinforcements, and the greater the risk — financial, legal, personal — the greater the thrill.

Now, with a generation growing up playing action video games and living with cloud realities, isn’t it realistic to foresee some professionals wanting to duplicate these thrills in their real lives?

**IT’S ALSO ABOUT THE WHY:
THE FRAUD TRIANGLE**

Research focusing on fraud has been performed in the fields of criminology, psychology, accounting, auditing and management. Among those fields, three key factors have emerged that determine whether a person will commit fraud. The factors, which comprise the three points of the so-called fraud triangle, are: 1.) a perceived pressure facing the person; 2.) a perceived opportunity to commit fraud; and 3.) the person’s rationalization or integrity.

PERCEIVED PRESSURES

Knowing these three factors can help determine who is committing fraud in an organization. For example, several employees in a department may have the opportunity to commit fraud. However, by investigating the employees’ personal lives, you might find that only one is facing pressures that would motivate him to commit fraud. Keep in mind that while it is beneficial to consider a perpetrator’s opportunities and pressures, it is very

difficult to determine and understand a fraudster’s rationalizations. (See Table 1.)

OPPORTUNITIES

There are often opportunities inside corporations that make them vulnerable to fraud, particularly if an employee has both the pressures and the rationalizations to commit such an act. A few areas that provide opportunity for fraud are:

- An inadequate separation of duties.
- Failure of management to adequately inform employees about company rules and the consequences of violations
- Rapid employee turnover
- Crisis conditions
- A “workaholic” environment, with things such as the absence of mandatory vacations
- The failure to uniformly and consistently enforce standards and policies or to punish perpetrators.

RATIONALIZATIONS

As mentioned earlier, fraud can definitely be rationalized in the perpetrator’s mind. This is the ability to convince yourself that something you know is wrong is really okay. Fraudsters may often think: “I am only borrowing the money and will pay it back.” “Nobody will get hurt.” “The organization treats me unfairly, so they owe me.” “It’s for a good purpose.”

The research of Pamela Murphy, a professor at the Queen’s School of Business in Kingston, Ontario, Canada, demonstrates that just about anyone can convince themselves that what they are doing is right. Scan the QR code with your smartphone to read more from the Queen’s School of Business magazine on Murphy’s fascinating research. ►



TABLE 1: A FRAUDSTER’S POTENTIAL PRESSURES			
While certainly not all fraudsters are facing one or more of these perceived pressures, many white-collar criminals are dealing with some of these issues:		PERSONAL HABITS Addictions (alcohol, drug, gambling, etc.) An expensive extramarital affair	
FINANCIAL PRESSURES High personal debt levels Overuse of credit cards Divorce Investment losses Sheer greed Family or peer group expectations		WORK-RELATED FACTORS Feelings of resentment stemming from being overworked, underpaid or passed over for promotion	

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Rationalization takes place in the mind and is usually overlooked, but the observant accountant will be able to detect mannerisms and word-choice that typifies a fraud suspect's behavior.

ON THE LOOKOUT

Though the dollar amounts (and the audacity) of some white collar crimes boggle the average observer's mind, the crime remains an act of behavior and so should be approached using the same method used to analyze a \$3,200 credit card fraud. The perpetrator may be described as "obsessive" and "megalomaniacal," but she or he is still behaving in a network of actions, where behavior is subject to operant conditioning.

The specific measures will be particular to the crime. The actions dictate the response.

But whether we're dealing with a clerical worker's credit card fraud or the

"business expense" of Tyco CEO Dennis Kozlowski's \$2.1 million toga party, our methods can be behavioral. Fraud examiners may never eradicate crime completely, but approaching criminal acts scientifically, we can become more successful in anticipating and preventing the acts.

There are many ways an accountant may become suspicious that fraud is occurring in their company or their client's company (see Table 2). Despite these warning signs, the Association of Certified Fraud Examiners (ACFE) has found that much of financial fraud is still detected by chance — even in the face of improved corporate governance.

In fact, the annual Global Fraud Surveys conducted by PricewaterhouseCoopers have revealed a 22 percent increase in the last two years in the number of companies reporting financial fraud. Corroborating the ACFE assertions, fraud was detected by chance in more than a third of cases, and internal audit found the issues only 26 percent of

the time. Almost one quarter of the perpetrators were senior managers — the very people signing off on financial statements. Furthermore, the types of fraud are changing, with cybercrime as the next wave.

BREAKING THE CYCLE

There are many ways to make an organization more impervious to fraud, but it is important that management tries to "break" the fraud triangle by implementing specific policies and procedures in addition to developing fraud deterrence controls (see Table 3).

Most important is creating an ethical environment starting with a positive tone at the top and corporate-wide core values and policies to which all employees have buy-in. Secondly, organizations must reduce employees' opportunities to commit fraud. Surveillance procedure and timely preparation and review of monthly financial statements help ensure

TABLE 2: WATCHER BEWARE OF INITIAL RED FLAGS

The savvy accountant may catch wind of corporate shadiness if these warning signs begin to appear:

- | | |
|---------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------|
| 1. Problems detected by internal controls | 6. Accusations from anonymous sources |
| 2. Employee complaints | 7. Unusual or unexplained financial statement trends |
| 3. Problems detected by an internal auditor's review of controls | 8. Changes in an employee's lifestyle that are not consistent with the employee's salary or wages or other known sources of income |
| 4. Customer or vendor complaints, such as payments not being credited to the customer's account or contracts not received | 9. Abrupt changes in an employee's behavior that can't be explained by other factors |
| 5. Accidental discovery of something that warrants follow up, such as two expense reports that contain receipts for the same airline ticket | 10. Problems detected in the course of an external audit, review or compilation |

that finances are well-controlled. Policies like periodic job rotation and mandatory vacations can help boost morale. And finally, management can monitor the pressures on employees that could push them to commit fraud and develop appropriate responses. Adopting appropriate personnel policies and swiftly enforcing violations, performing drug tests and providing counseling and dispute resolution services can all help reduce and mitigate employee pressures.

There are many areas in which the talents of CPAs are useful to detecting fraud. Once you know what to look for — and how the mind of a white collar criminal works — you could become

an indispensable forensic accountant to your company or your client. ■

This article was developed from Bill Barrett's course, "Forensic Accounting in Non-Audit Engagements."



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TABLE 3: FIVE STEPS TO DESIGNING FRAUD DETERRENCE CONTROLS

While developing a suitable fraud deterrence program is an in-depth process, there are five basic steps to those controls:

STEP 1: Review the organization-level components of internal control and identify weak or nonexistent controls.

STEP 2: Identify assets (and related transactions) susceptible to misappropriation.

STEP 3: Review the organization's systems and procedures relating to the vulnerable areas and identify weak or missing systems and procedures.

STEP 4: Develop controls to reduce the risk of misappropriation in the vulnerable areas.

STEP 5: Consider the cost/benefit relationship of the controls developed.

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