Avoiding the Fraud Mind-set

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Following the high-profile fraud cases such as Enron, Tyco, and WorldCom around the early 2000s, lawmakers, regulators, and the accounting profession took unprecedented actions toward preventing and detecting future fraudulent conduct. This included passage of the Sarbanes-Oxley Act of 2002 (SOX), formation of the Public Company Accounting Oversight Board (PCAOB), and the issuance in 2002 of *Statement on Auditing Standards 99* (SAS 99), "Consideration of Fraud in a Financial Statement Audit" (now AU Sec. 316 (AU 316)). Yet despite these significant and costly undertakings, fraud continues unabated.

Research studies and reports reveal a common theme in which organizational fraud continues at a rate that should be of societal concern and that the fraud typically involves key insiders, often those at the C-suite level. In their article, "Detect Fraud Before Catastrophe," Chih-Chen Lee, Natalie Tatiana Churyk, and B. Douglas Clinton cited data from the Association of Certified Fraud Examiners (ACFE) that indicated fraud levels aren't declining, which they called "especially troubling given that we now have tougher laws, more aggressive enforcement, and steeper penalties" (*Strategic Finance*, March 2013).

They also noted that internal personnel typically are responsible for approximately 80% of an organization's fraud losses. This is consistent with findings reported by Curt Verschoor, who discussed the 2012-2013 *Kroll Global Fraud Report* in his article, "New Report Shows Changing Fraud Environment" (*Strategic Finance*, March 2013). The Kroll report also indicated that the rate of fraud involving company insiders is actually accelerating.

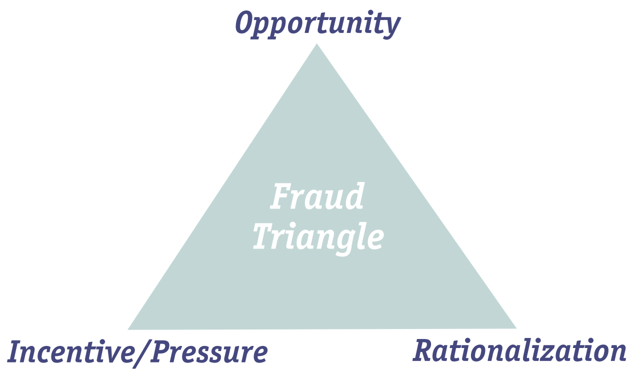
A study from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), "Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies," also showed indications that certain types of fraud mainly involve company management. Written by Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, the study noted that the vast majority (89%) of financial statement frauds involved the CEO and/or CFO.

Given these and other examples, you might reason that future fraud-prevention efforts should focus on ways in which such insiders can more effectively be dissuaded from fraud complicity. The regulatory approaches to fraud prevention offer ways of mitigating the opportunity to commit fraud, but this seems to be insufficient—especially since the usual perpetrators of financial statement fraud (i.e., C-suite-level insiders) have the position and authority to circumvent and override fraud-prevention controls.

Key questions that financial managers and company boards of directors looking to deter fraud should consider are: (1) What innovative approaches can be taken within the organization to deter fraud, particularly fraudulent accounting manipulation that involves senior financial managers? (2) What specific actions can be taken by financial managers to avoid becoming complicit in potentially fraudulent conduct?

To gain insights into these questions, we identified eight practical learning objectives that could help financial managers (and others responsible for corporate governance) avoid the common pitfalls of fraud. Based on circumstances that are commonly found in fraud cases, these learning objectives were developed by examining the "pressure" and "rationalization" elements of Donald Cressey's fraud triangle. If individuals recognize and understand the types of thinking and mind-sets that might lead someone to commit fraud, they will become less susceptible to the kinds of pressures and rationalizations that often result in fraud.

Figure 1: The Fraud Triangle



Source: Adapted from *Statement on Auditing Standards 99*, "Consideration of Fraud in a Financial Statement Audit," currently referred to as AU Sec. 316 (AU 316).

The Fraud Triangle

The fraud triangle (Figure 1) originates from the research of Donald Cressey, a renowned criminologist. His 1953 book, *Other People's Money: A Study in the Social Psychology of Embezzlement*, has been used extensively as the foundation for the study of fraud. In fact, it serves as a significant underlying principle for SAS 99 (AU 316), the primary source of guidance to auditors in fulfilling their fraud-detection responsibilities. Any fraudulent act can be analyzed vis-à-vis the fraud triangle's three components: opportunity, incentive, and rationalization. According to SAS 99, each side of the fraud triangle represents a condition that is generally present when fraud occurs:

1. Opportunity represents the absence of internal controls or the use of ineffective controls or controls that may be overridden by management;
2. Incentive, or pressure, represents the motivation to commit fraud; and
3. Rationalization represents an individual's internal justification for committing the fraud.

Opportunity

The opportunity to commit fraud is seemingly ever-present for financial managers, especially among those serving in senior-level positions. Given their broad understanding of the inner workings of the organization, they often have the ability to override even the most effectively designed controls. Indeed, the vulnerability of internal controls to the power of high-level employees is made clear in SAS 99: "Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information."

An organization's internal controls primarily attempt to address the opportunity component of the fraud triangle. That's why many of the efforts of regulators seeking to limit fraud have focused efforts on internal controls, as we noted earlier. When designed and implemented properly, internal controls may help prevent fraud and also identify actual occurrences.

But individuals at high levels of an organization are positioned to circumvent such controls. While internal controls are a necessary component of fraud prevention, they are insufficient on their own. Accordingly, additional efforts must be undertaken, particularly with respect to preventing fraud on the part of top-level management.

Pressure

There are two key incentives or pressures that can make senior executives more disposed to fraudulent conduct. The first is to meet the financial performance expectations of investors. In many instances in which a CEO is forced to depart, his/her C-suite team is likewise replaced. This factor alone may create significant pressure to engage in "earnings management" and, in some cases, outright financial reporting fraud.

The second is earnings-based compensation incentives to achieve key earnings targets. Executives face the pressure of losing significant compensation if specified financial measures are missed. Legislation and boards of directors have done relatively little to balance incentives that create such pressures. Indeed, compensation plans are still frequently tied to financial statement performance measures. Thus the incentive/pressure factors remain.

Rationalization

Rationalization is the only fraud triangle element that quite simply can't be regulated. It involves the ability for individuals to persuade themselves that it's okay to do something they know is wrong. This takes place within the mind of an individual, so it isn't seen and, thus, is impossible to regulate. It's perhaps for this reason that rationalization is also the least-researched element of the fraud triangle.

Yet a careful focus on the human tendency toward rationalization could prove to be an effective tool for mitigating fraud. With proper pedagogical approaches, people can be trained to immediately recognize the fact that they are "rationalizing away" unacceptable conduct. This suggests an innovative approach toward fraud prevention grounded in the *thought processes* of potential fraudsters—the objective of which is to put individuals on a pathway of proper thinking.

Many instances of fraudulent conduct might be averted if individuals were equipped with the kind of skill set that allows them to avoid a "What was I thinking?" *reaction* to their behavior in favor of an "I know I won't regret this later" *proactive* thought process. Put simply, it means enabling individuals to immediately recognize their rationalizations and, in turn, change their thought process to a much more appropriate one before they commit fraud.

Avoiding Fraud-enabling Thinking

To explore the potential benefits of a focus on the human tendency toward rationalization, we reviewed actual fraud cases to determine common circumstances that pertained to the incentive and rationalization sides of the fraud triangle. This resulted in a list of eight learning objectives we feel would mitigate the use or rationalization and help individuals avoid committing fraud.

To verify the relevance and importance of these items,

Table 1: Learning Objectives to Avoid Common Fraud Pitfalls

LEARNING OBJECTIVE	OVERALL MEAN 0 = Strongly Disagree, 100 = Strongly Agree
Develop an ability to recognize your own human tendency toward rationalization.	81.2
Understand that fraudsters typically are not "black-cloaked villains"; rather, they are "real people."	78.9
Recognize the psychological costs of "getting away with" fraud as well as the costs of getting caught.	78.7
Clearly define the specific values that are most important to you in both your personal and future professional lives.	77.8
Understand the importance of living within your means.	75.7
Build a trusted network as a means of mitigating nonsharable problems.	72.7
Understand the importance of maintaining your marketability.	72.3
Understand that you are an individual of value as reflected in the choices you make in life. Avoid defining your value based on the position/title you hold.	71.4

we presented accounting faculty with a description of each learning objective and asked them to identify on a scale of 0 to 100 (0 = strongly disagree, 50 = moderately agree, and 100 = strongly agree) the extent to which they agree that people should consider the objective in managing their career and conducting themselves in a manner consistent with the accounting profession's high ethical expectations. We received 886 responses. The overall results shown in Table 1 indicate a very high level of support for each learning objective, with mean scores ranging from 71.4 to 81.2.

1. Develop an ability to recognize your own human tendency toward rationalization.

As a means of soothing the conscience, humans will rationalize behavior that is known to be unethical. In their study "Psychological Pathways to Fraud: Understanding and Preventing Fraud in Organizations," Pamela R. Murphy and M. Tina Dacin found that most individuals who decide to commit fraud experience negative feelings because fraud is contrary to their ethical values (*Journal of Business Ethics*, July 2011). Furthermore, fraudsters are motivated to reduce that negative effect by rationalizing the fraud. Fraudsters are often quite adept at this "art" of rationalization.

This learning objective makes individuals aware of the fact that everyone is prone to rationalize and that many people do so to a degree that might surprise them. The primary means to keep people from "crossing the line" is first being able to recognize the precise moment at which they begin to rationalize and then making certain that doing so in a given situation won't ensnare them in an act of fraud.

2. Understand that fraudsters typically are not black-cloaked villains; rather, they are real people.

The media typically portrays fraud perpetrators as cunning and evil "villains," often to the point where most individuals simply can't identify with such people. This lack of affinity thus enables individuals to rationalize their own unethical behavior as "not as bad" as that of a fraudster. Thus, with a clear conscience, individuals may accept their own inappropriate actions that they simply perceive as being less questionable than that of "villains."

This learning objective helps individuals realize the very simple yet important fact that their own upbringing, education, socialization, and professional development are probably very much the same as those who chose to engage in fraud. This realization may enable people to more easily identify with fraud perpetrators and thus come to realize that they themselves aren't immune to the incentives, pressures, and rationalizations that well-known fraudsters have succumbed to.

3. Recognize the psychological costs of "getting away with" fraud as well as the costs of getting caught.

The costs of getting caught in a fraud—such as loss of reputation, incarceration, loss of livelihood—are clear. Yet those who commit fraud often don't fully appreciate the life-changing, devastating impact that getting caught can have on the people most important to them, such as family members.

The costs of "getting away with" fraud may be relatively less familiar, but fraud perpetrators have described them as equally devastating as the cost of being caught. According to Murphy and Dacin, some of the costs include (1) a constant fear of eventual suspicion or outright detection; (2) the need to continually lie to coworkers, superiors, subordinates, external stakeholders, family, and friends; and (3) the psychological stress associated with managing an unethical scheme.

This learning objective underscores not only the severe costs of getting caught in a fraud situation but also the unavoidable psychological costs of not getting caught. Individuals may better understand that there's a significant price to committing fraud whether you are caught or not.

4. Clearly define the specific values that are most important to you in both your personal and future professional lives.

Individuals often get "caught up" in a fraud situation because they don't set clear boundaries as to what they are or aren't willing to do to as a means to achieve success. When a potential fraud situation presents itself, individuals who aren't clearly grounded in firm values often succumb to incentive or pressure.

This learning objective helps ensure that individuals have considered and identified a core set of values *before* they encounter a potential fraud situation. Thus they will be equipped with a solid moral foundation that might otherwise have been absent from their lives and that could make the difference between proper conduct or a deeply regrettable mistake.

5. Understand the importance of living within your means.

Fraudsters commonly succumb to immediate financial pressure. This often results from living beyond their means. The amount of their salary or compensation is irrelevant. Even individuals who enjoy lucrative compensation plans nonetheless manage to "spend more than they make" as opposed to living a sustainable lifestyle.

This learning objective helps people recognize scenarios where they are living beyond their means and provides them with an ability to formulate a workable financial exit strategy in the event that they someday find themselves in potential fraud situation.

6. Build a trusted network as a means of mitigating nonsharable problems.

We all face problems and issues that we don't want to share with others. Nonshareable problems can become overwhelming to individuals who believe that such problems need to be resolved secretly, which often leads them to engage in inappropriate and perhaps even fraudulent behavior. They may view these problems as embarrassing or shameful. Practical examples of nonshareable problems are admitting that your company isn't meeting analysts' expectations or that your superior is domineering and leading you down an unethical path.

This learning objective emphasizes the fact that no one is perfect and that "we all have problems." It's important to feel comfortable sharing problems with people you trust in order to reach acceptable resolutions and thus avoid the often devastating effects that nonsharable problems can have. This objective encourages people to identify at least one trusted person they can share their problems with—no matter how deeply personal or potentially embarrassing those problems may seem—and seek an acceptable resolution.

7. Understand the importance of maintaining your marketability.

Fraud perpetrators are often people who feel "locked in" to a particular position, firm, or career path. Whether they have a limited set of credentials, a short-circuited professional network, or other such factors, these individuals may feel they have little choice but to yield to certain pressures and engage in fraudulent conduct. If they feel they can't find a similar position elsewhere in a reasonable time frame, they may feel pressured to preserve their current role "at all costs."

This learning objective underscores the importance of maintaining your marketability and alternative career options. Feeling capable and qualified to find new opportunities elsewhere can alleviate the pressures that people may face when presented with a "do I or don't I?" fraud situation.

8. Understand that you are an individual of value as reflected in the choices you make in life. Avoid defining your value based on the position/title you hold.

Many managers, especially senior managers, base their value as a person on the title or position they hold. Such an assessment of self-worth on a potentially short-lived role may create pressure to engage in fraudulent activities in order to preserve self-esteem and justify their value as a person.

This learning objective makes individuals aware of the fact that they will ultimately find themselves satisfied with some of the choices they make in life, dissatisfied with others, and that the best time to give thought to such matters is in the here and now. They thus come to realize that their true self-worth isn't defined by a formal title or position but by the choices they make in life and that the current role they serve as a manager is typically short-lived. Therefore, it would be illogical to participate in inappropriate conduct for the sake of maintaining a position or title.

Becoming Fraud Resistant

These eight learning objectives are far removed from the legislative/regulatory actions that have historically served as the primary means of fraud deterrence. Continuing education programs that direct participants to give careful and regular consideration to these learning objectives could help develop healthier mind-sets—the kinds of mind-sets that enable accounting professionals and others to more effectively sidestep significant pressures and the tendency to rationalize inappropriate behavior.

Applying these objectives in new, innovative, and perhaps even "entertaining" ways would arguably enhance the effectiveness of the much more conventional legislative and regulatory approaches to fraud deterrence. The learning objectives can even be used by individuals themselves for the purpose of ongoing self-reflection, serving as a means of assurance that they aren't falling victim to any one of these common pitfalls.

Formal legislation will always be necessary as a fraud deterrent. Likewise, internal controls will always be a key factor in minimizing the opportunity element of the fraud triangle. Still, in view of the unfortunate pervasiveness of corporate fraud, these efforts clearly are insufficient. The learning objectives presented here approach the issue from a different direction, providing a foundation for practical fraud-prevention efforts that focus on the incentive and rationalization elements of fraud. **SF**

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