PacificCPE

COURSE
11502B

Understanding the Fraudster: Profile and Psychology

Who commits fraud — and what drives them to do it? This course examines the behavioral and psychological forces behind fraudulent conduct, from the motivations that lead individuals down a dishonest path to the rationalizations that keep them there. By understanding common fraudster profiles and the warning signs associated with them, CPAs and tax professionals can sharpen their ability to assess risk across organizations and client engagements. When something feels off, this knowledge helps you respond with clarity and confidence rather than uncertainty.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the elements of the fraud triangle.

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Chapter 1: WHO COMMITS FRAUD AND WHY: THE PROFILE AND PSYCHOLOGY OF THE FRAUDSTER

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the elements of the fraud triangle.

CNBC author Dan Mangan (April 20, 2022) noted that the U.S. Department of Justice announced criminal charges against two people in California related to a scheme that allegedly made $144 million in false and fraudulent health claims to federal programs for unnecessary COVID-19 tests. Clinical laboratory owners, Imran Shams and Lourdes Navarro, both aged 63, were charged with health-care fraud, kickback and money laundering schemes that involved fraudulent billing for laboratory tests. The indictment also alleges that Shams and Navarro paid kickbacks to marketers who obtained specimens and test orders, and laundered the proceeds of the scheme through shell companies that Navarro controlled. The pair then made expenditures on real estate, luxury items, and personal goods and services with their ill- gotten gains.

In another example, according to a 2012 FBI Pittsburgh Division press release, Patricia K. Smith, age 57 at the time, and the former controller at Baierl Acura, plead guilty in federal court to charges of embezzlement. The Pittsburgh Post-Gazette alleges that Ms. Smith fraudulently transferred $10.3 million from Baierl Acura's accounts to her own, using the money to finance a spree of frivolity and generosity. Ms. Smith was a one-time trusted employee who worked at the car dealership from 1993, serving as the financial controller and working at the dealership for 11 years before embarking on her bad acts.

According to these sources, from late 2004 through mid-2011, Ms. Smith padded her $53,000-a-year salary with upward of $25,000 a week that she embezzled. What did she do with this extra money? She spent "$43,000 for a hotel in Paris, France, $1.8 million to pay her American Express account for private jet fare, $62,500 for six club-level Super Bowl tickets, and it goes on and on and on." Apparently, she was a religious woman and splurged on "The Vatican Package" ($5,000), which included Mass in Papal Audience with VIP seating, airfare for four, VIP tour of the Vatican Museum with a private tour guide, and a private tour of the Sistine Chapel with family before it is open to the public.

Ms. Smith told U.S. District Judge Gustave Diamond at her sentencing hearing that she spent the money on friends and family, saying "I wanted to earn their love, and I wanted to see what happiness really looked like."[1]

What causes a seemingly "good person" (at least before the revelation of their crimes) to commit bad acts? In this chapter, we examine "who commits fraud" and offer some insight into "why."

The authors examine this topic across several modules. Those modules, along with the learning objectives, include the following:

- Module 1 examines criminology, the study of crime and criminals, and its interface with fraud, financial crimes, and forensic accounting issues. The objective is for the reader to be able to describe occupational fraud and abuse, as well as the role of civil litigation in forensic accounting and fraud examination issues.
- Module 2 develops a profile of the garden variety fraudster using one of the most recognized tools in the antifraud community, the fraud triangle. The goal in this module is for the reader to apply the elements of the fraud triangle: nonshareable pressure, perceived opportunity, and rationalization to specific cases.
- Module 3 takes a look at some of the early efforts to fine-tune and improve the fraud triangle, adding the roles of personal integrity, capability, gender, and the influence of the organization. The goal here is for the reader to be able to describe the reasoning behind perpetrator decisions to commit bad acts.
- Module 4 reviews more recent findings from research that considers fraudsters whose profile is inconsistent with the fraud triangle: M.I.C.E., predatory (repeat) fraudsters, and collusive groups. The take-away from this module will be the ability to adjust the assessment of case issues, given the possibility of repeater offenders or collusive fraud teams. When complexity increases, particularly the ability to conceal bad acts, frauds become more difficult to detect and investigate.
- Module 5 offers a cautionary tale for practicing forensic accountants and fraud examiners related to courtroom testimony grounded in the fraud triangle. It offers a meta-model for moving from a focus on the perpetrator, to an investigation grounded in evidence, by using the triangle of fraud action (the "elements of fraud"). The important goal here is for the reader to recognize that while the fraud triangle and its improvements across time help us understand who commits fraud and why, when we conduct fraud and forensic examinations, gathering persuasive evidence is the key to success.

MODULE 1: CRIMINOLOGY, FRAUD, AND FORENSIC ACCOUNTING

Bethany holds the position of office manager at a small commercial real-estate company. Jackson Stetson, the owner, conducts numerous entertainment events each month to interact with, and locate, new clients. In addition, Mr. Stetson prides himself on his support of charitable organizations. In his capacity as a leader, organizer, and board member of several high-profile charities, Jackson has additional charity events each month.

Bethany is a trusted assistant to Mr. Stetson, runs many aspects of the company and organizes and hosts many of the social events for Mr. Stetson. Bethany has been with the company for many years and has a company credit card to pay for social events and incidentals associated with these events. The company pays the monthly credit card balance; and Bethany is supposed to save receipts and match those receipts to her company credit cards before seeking Mr. Stetson's approval for company payment. Initially, Bethany lost a few receipts, and Mr. Stetson waived the requirement that she provide all receipts. As the business grew, Bethany's schedule became "crazy," and she had less time for administrative responsibilities. Mr. Stetson was so happy with her work on his social events that he was willing to overlook her lack of attention to administrative details. The problem was that, over time, Bethany started to charge personal expenses on the company's credit card. Not only was the company paying Bethany's salary, they also paid her grocery bills and household expenses at retailers where she shopped for social event incidentals. Over a twenty-four-month period, Bethany was able to double her $80,000 annual take-home pay, and the additional income was tax-free! Eventually, Bethany was caught, convicted, and received a bill from the Internal Revenue Service for back taxes, interest, and penalties.

Criminology

Criminology is the sociological study of crime and criminals. Understanding the nature, dynamics, and scope of fraud and financial crimes is an important aspect of an entry-level professional's knowledge base. Fraudsters often look exactly like us, and many are first-time offenders. As such, to understand the causes of white-collar crime, we focus on perpetrators of fraud.[2]

Before talking about crime, it is prudent to consider why the vast majority of people do not commit crime. A number of theories have been put forth but essentially, people obey laws for the following reasons:

1. Fear of punishment
2. Desire for rewards
3. To act in a just and moral manner according to society's standards

Most civilized societies are dependent upon people doing the right thing. Despite rewards, punishment, and deterrence, the resources required to fully enforce all laws against every violation would be prohibitively expensive. Prevention is impossible, and even deterrence is costly to implement and does not guarantee an adequate level of compliance. The bottom line is that, in general, a person's normative values of right and wrong dictate their behavior and determine compliance or noncompliance with the law.[3] In other words, in most cases, people choose to follow the law because it is the right thing to do. Further, people usually follow laws with which they agree. For example, if the speed limit on a highway is 50 miles per hour, it is likely that some drivers will exceed that limit unless they understand and agree with the reason for it.

Occupational Fraud and Abuse

Occupational fraud and abuse is defined as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."[4] By the breadth of this definition, occupational fraud and abuse involves a wide variety of conduct by executives, employees, managers, and principals of organizations, ranging from sophisticated investment swindles to petty theft. Common violations include asset misappropriation, fraudulent statements, corruption, pilferage, petty theft, false overtime, using company property for personal benefit, fictitious payroll, and sick time abuses, to name just a few.

Four common elements to these schemes were first identified by the Association of Certified Fraud Examiners in its 1996 *Report to the Nation on Occupational Fraud and Abuse* (Section 3, p. 3), which stated: "The key is that the activity: (1) is clandestine, (2) violates the employee's fiduciary duties to the organization, (3) is committed for the purpose of direct or indirect financial benefit to the employee, and (4) costs the employing organization assets, revenues, or reserves."

Employee, in the context of this definition, is any person who receives regular and periodic compensation from an organization for his or her labor. The employee moniker is not restricted to the rank and file, but specifically includes corporate executives, company presidents, top and middle managers, and other workers.

White-Collar Crime

The term *white-collar crime* was a designation coined by Edwin H. Sutherland in 1939, when he provided the following definition: crime in the upper, white-collar class, which is composed of respectable, or at least respected, business and professional men. White-collar crime is often used interchangeably with occupational fraud and economic crime. While white-collar crime is consistent with the notion of trust violator and is typically associated with an abuse of power, one difficulty with relying on white-collar crime as a moniker for financial and economic crimes is that many criminal acts such as murder, drug trafficking, burglary, and theft are motivated by money. Furthermore, the definition, though broad, leaves out the possibility of the perpetrator being an organization where the victim is often the government and society (e.g., tax evasion and fixed contract bidding). Nevertheless, the term white-collar crime captures the essence of the type of perpetrator that one finds at the heart of occupational fraud and abuse.

Organizational Crime

Organizational crime occurs when entities, companies, corporations, not-for-profits, nonprofits, and government bodies, otherwise legitimate and law-abiding organizations, are involved in a criminal offense. In addition, individual organizations can be trust violators when the illegal activities of the organization are reviewed and approved by persons with high standing in an organization, such as board members, executives, and managers. Federal law allows organizations to be prosecuted in a

manner similar to individuals.[5] For example, although professional services firm Arthur Andersen's 2002 conviction of obstruction of justice associated with the Enron fraud was later overturned by the U.S. Supreme Court, the conviction (a felony offense) prevented it from auditing public companies. Corporate violations may include administrative breaches, such as noncompliance with agency, regulatory, and court requirements; environmental infringements; fraud and financial crimes, such as financial reporting fraud, bribery, and illegal kickbacks; labor abuses; manufacturing infractions related to public safety and health; and unfair trade practices.

Organizational crime is more of a problem internationally and often consists of unfair pricing, unfair business practices, violation of the FCPA (Foreign Corrupt Practices Act), and tax evasion. Organizations are governed by a complex set of interactions among boards of directors, audit committees, executives, and managers. In addition, the actions of external stakeholders such as auditors and regulators impact the governance of organizations. As such, it is often difficult to distinguish between those individuals with responsibility for compliance with particular laws and regulations and those infractions committed by the organization. In addition, when considerable financial harm has been inflicted on society as a result of corporate wrongdoing, the organization is often an attractive target because of its deep pockets with which to pay fines and restitution.

It is more common for corporations to become embroiled in legal battles that wind up in civil court. Such litigation runs the gamut of forensic litigation advisory services offered by forensic accountants, including damage claims made by plaintiffs and defendants; workplace issues such as lost wages, disability, and wrongful death; asset and business valuations; costs and lost profits associated with construction delays or business interruptions; insurance claims; fraud; antitrust actions; intellectual property infringement; environmental issues; tax claims; or other disputes. If you open any 10-K or annual report, you will likely find mention of pending lawsuits in the notes to the financial statements. Furthermore, these filings include only those lawsuits deemed to be "material" as defined by accounting standards. Most corporations are involved in numerous lawsuits considered to be below the auditor's materiality threshold.

Organized Crime

These crimes are often complex, involving many individuals, organizations, and shell companies, and often cross jurisdictional borders. In this context, fraud examiners and financial forensic professionals often think of terrorist financing, the mob, international hacking, cyber-crime, and drug trafficking. Some of the crimes typically associated with organized crime include money laundering, mail and wire fraud, conspiracy, and racketeering.

Money laundering addresses the means by which organized criminals take money from illegal sources and process it so that it appears "as if" it came from legitimate business sources.

Mail and wire fraud involves schemes that use the postal service or interstate wires, such as telephone calls, email, or other electronic communications, to execute the fraud. The crimes of

mail and wire fraud are often used by prosecutors to charge bad actors when other criminal charges are difficult to prove.

Criminal conspiracy occurs when two or more people intend to commit an illegal act and take some steps toward its implementation. A charge of conspiracy is often used as a means of prosecuting individuals involved in illegal organized activity. For example, if Alan, Bob, and Chad plan to rob a bank, and then research the bank's security system, and purchase a gun to implement their plan, they could be charged with criminal conspiracy to commit robbery, even if they don't go through with their plan.

RICO (Racketeering Influence and Corrupt Organizations Act) addresses organizations involved in criminal activity. For example, portions of the RICO Act

- Outlaw investing illegal funds in another business;
- Outlaw acquisition of a business through illegal acts;
- Outlaw the conduct of business affairs with funds derived from illegal acts.

Torts, Breach of Duty, and Civil Litigation

Black's Law Dictionary defines "tort" as "a private or civil wrong or injury, other than breach of contract, for which the law will provide a remedy in the form of an action for damages." When a tort is committed, the party who was injured is entitled to collect compensation for damages from the wrongdoer for that private wrong.[6] The tort of contract interference or tortuous interference with contracts occurs when parties are not allowed the freedom to contract without interference from third parties. While the elements of tortuous interference are complex, a basic definition is that the law affords a remedy when someone intentionally persuades another to break a contract already in existence with a third party.[7]

Another tort—negligence—applies when the conduct of one party did not live up to minimal standards of care. Each person has a duty to act in a reasonable and prudent manner. When individuals or entities fail to live up to this standard, they are considered "negligent." The legal standard for negligence has five elements.[8]

a. Duty—a duty to act exists between the parties

b. Breach—a determination that the defendant failed to use ordinary or reasonable care in the exercise of that duty

c. Cause in Fact—an actual connection between the defendant's breach of duty and the plaintiff's harm can be established

d. Proximate Cause—the defendant must have been the proximate cause or contributed to the injury to the plaintiff

e. Damages—the plaintiff must establish that damages resulted from the defendant's breach of duty. In order to win an award for damages, the injured party must generally prove two points:
   - The other party was liable for all or part of the damages claimed
   - The injured party suffered damages as the result of the actions, or lack thereof, of the offending party

Furthermore, the amount of damages must be proven with a reasonable degree of certainty as to the amount claimed, and that the defendant could reasonably foresee the likelihood of damages if they failed to meet their obligations. The focus on monetary damages often creates professional opportunities for forensic accountants to work for plaintiffs or defendants. Generally speaking, the threshold is fairly low for a person or organization to sue another in civil court for a tort, breach of contract, or negligence. While judges have the ability to issue summary judgments and dismiss frivolous lawsuits, most judges are more inclined to let the parties negotiate a settlement or let a jury decide the case based on the merits of the arguments and evidence put forth by the plaintiff and the defense. A critical aspect of civil litigation for the forensic accountant and fraud examiner is the understanding that both sides (plaintiff and defendant) are expected to tell their "story." The professional's role is to examine those competing and conflicting stories to see which one, or which elements of each side's story, is consistent with the story being told by the other relevant evidence. It also requires a thorough examination of monetary damage claims, in light of the evidence, particularly how those damage amount(s) relate to the various stories presented by the opposing sides in civil litigation.

MODULE 2: WHO COMMITS FRAUD AND WHY: THE FRAUD TRIANGLE

Fraudsters, by their very nature, are trust violators. Perpetrators, generally, have achieved a position of trust within an organization and have chosen to violate that trust. According to the ACFE, owners and executives are involved in only about one-fifth of all occupational frauds but, when involved, steal significantly larger amounts than lower-level employees. Managers are the second most frequent perpetrators. Finally, line employees are the principal perpetrators in the majority of occupational fraud schemes, yielding average losses to the company of approximately $60,000. Research suggests that although males are most frequently the perpetrators, women are the principal perpetrators in approximately 30% of all cases. Fraudsters are found in all age categories and educational achievement levels, but victim losses rise with both the age and education of the principal perpetrator. In the majority of cases, a perpetrator acts alone; however, when fraudsters collude, the losses to the victim organization increase more than fourfold. The following profile summarizes the characteristics of the typical fraud perpetrator.