

# **THE PSYCHOLOGY OF FRAUDSTERS**

Why do they do it?

Erik H. Lindquist, CFE Superior Accounting Conference 2017

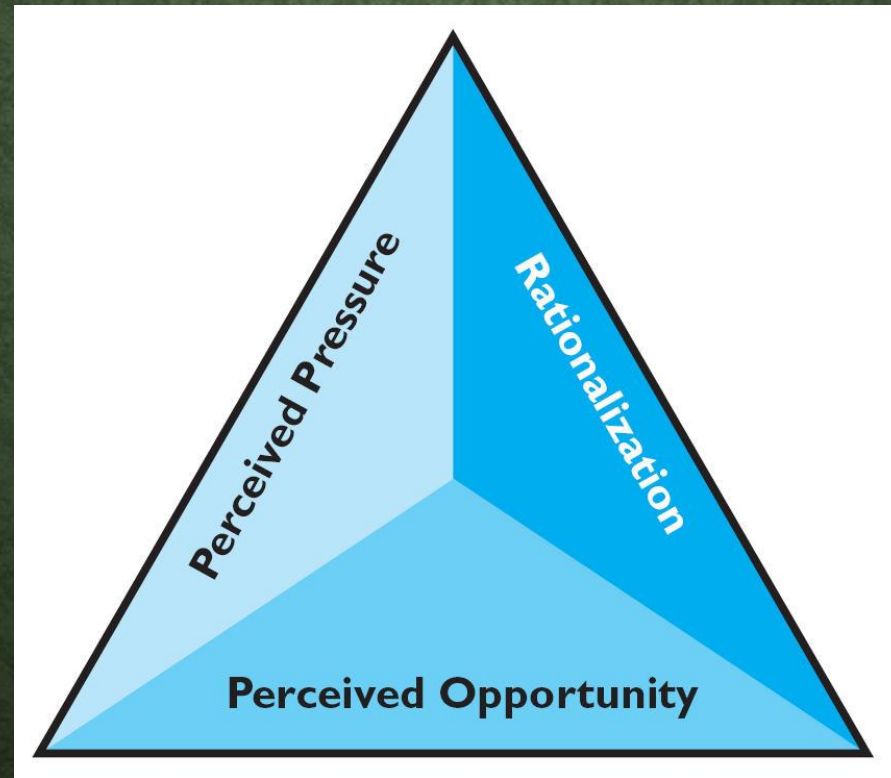
# WHO I AM

- My Background—
  - Corporate positions as Accounting Department Manager, Controller, CFO
  - Health Care Executive in Insurance and in Physician Practice Management
  - Academic Department Administrator in Medical School (MSU-CHM)
  - Small Business Owner – Retail Flooring and Franchise
  - Fraud Examiner and College Professor

# WHAT WE WILL DISCUSS TODAY

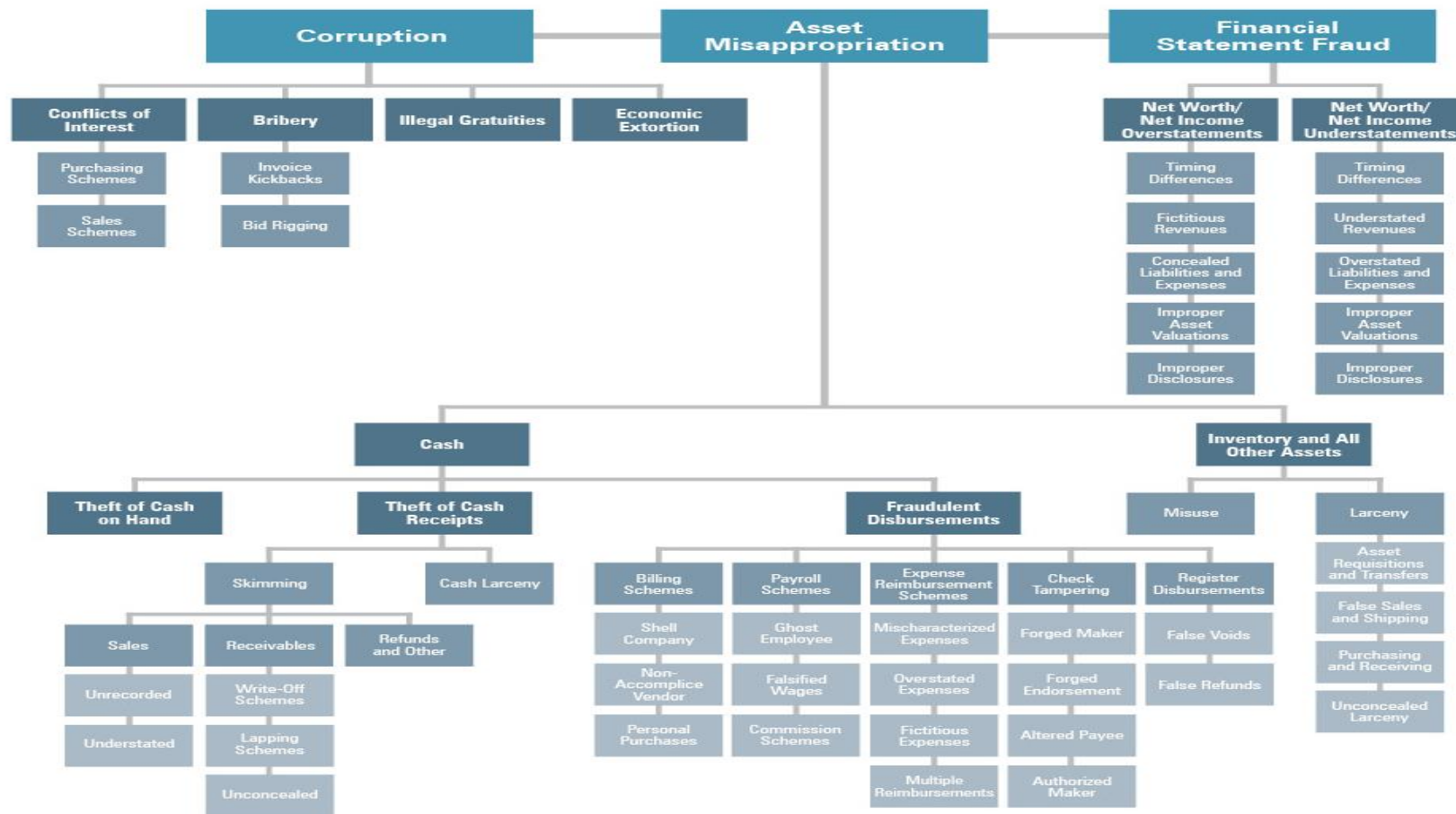
- The surprising history of Corporate Crime
- The role of community and peer pressure
- Bad decisions or poor reasoning
- Case studies of several convicted
- Remorse or stabilizing rationalization?

# FRAUD TRIANGLE



# HOW OCCUPATIONAL FRAUD IS COMMITTED

Figure 3: Occupational Fraud and Abuse Classification System (Fraud Tree)



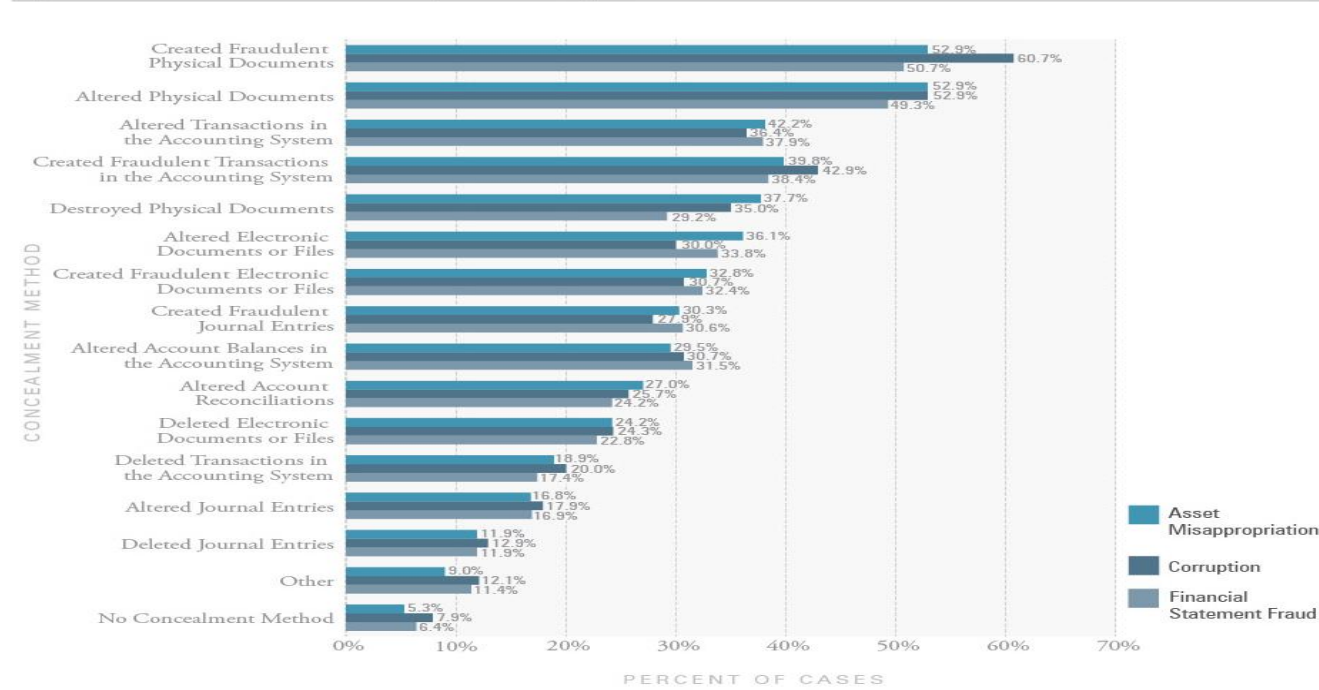
# SCHEME TYPES BY REGION

**Figure 8:** Scheme Types by Region—United States

Scheme	Number of Cases	Percent of Cases
Billing	289	27.8%
Corruption	258	24.9%
Non-Cash	174	16.8%
Skimming	167	16.1%
Expense Reimbursements	164	15.8%
Check Tampering	154	14.8%
Payroll	131	12.6%
Cash on Hand	125	12.0%
Cash Larceny	102	9.8%
Financial Statement Fraud	93	9.0%
Register Disbursements	29	2.8%

# CONCEALMENT OF FRAUD SCHEMES

Figure 20: Concealment Method by Scheme Type



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## TOP FIVE

Created Fraudulent Documents - 61%

Altered Physical Documents – 53%

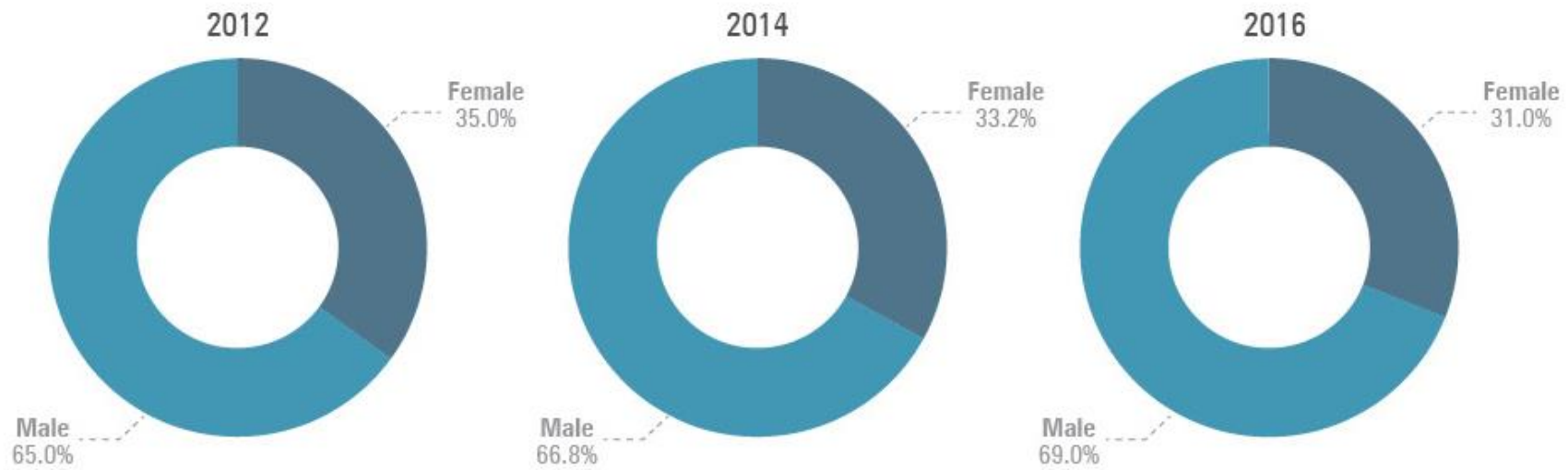
Altered Transaction in ACCG Sys – 42%

Created Fraudulent TRX – 42%

Destroyed Physical Documents 38%

# PERPETRATOR'S GENDER

Figure 79: Gender of Perpetrator—Frequency

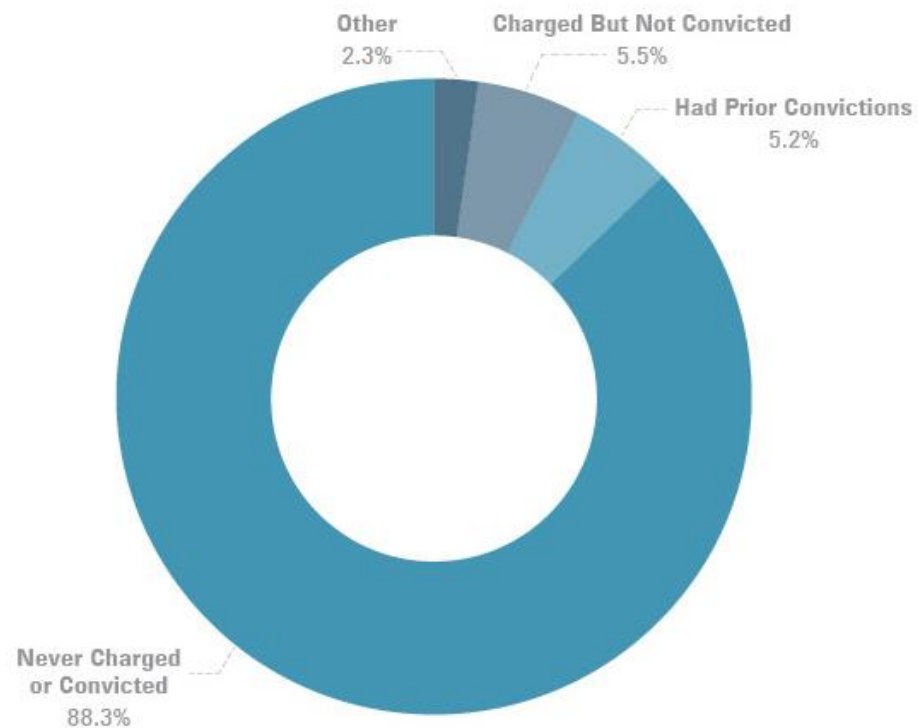


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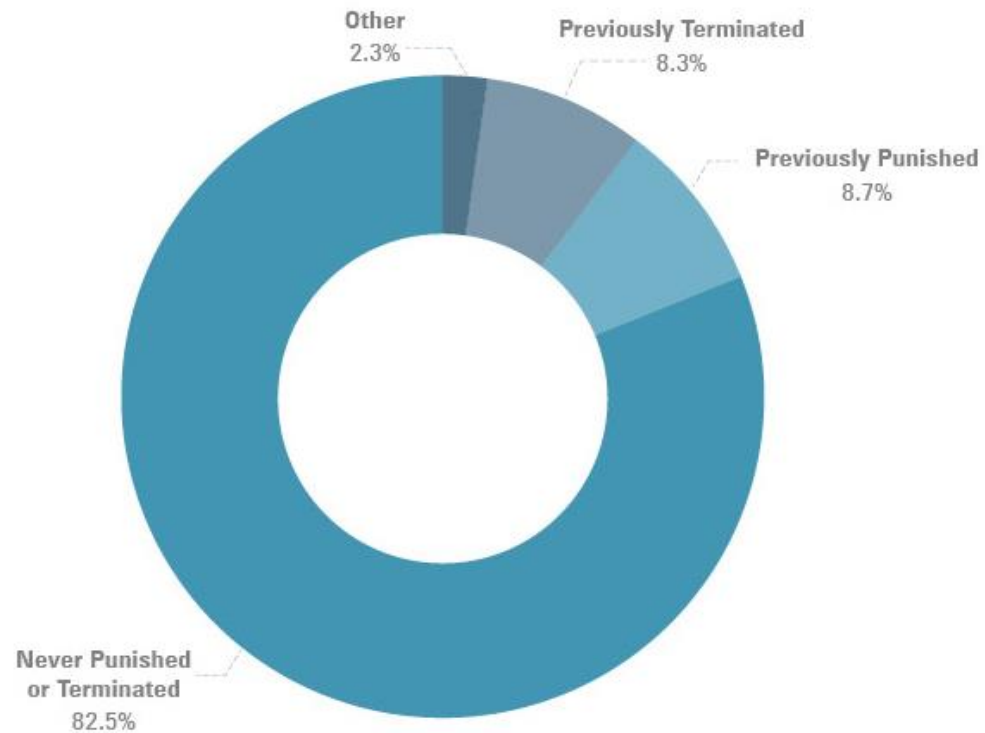
# PERPETRATOR'S CRIMINAL BACKGROUND

Figure 92: Criminal Background of Perpetrator



# PERPETRATOR'S EMPLOYMENT HISTORY

Figure 93: Employment Background of Perpetrator



# CASE STUDY #1

- Bob Daniel, CPA
- State Auditor Office-University Health System-Consulting Firm Doing Business With State of Texas
- Embezzled between \$300,000-400,000 before getting caught the FIRST time

# BOB DANIEL, CONT'D

- Made \$3,000/month-Spent \$3,000/month
- In Trouble With IRS
- Making a Series of Wrong Decisions
- Repeated His Offense Because Nobody Reported Him to the State Board of Accountancy
- Temptation to Steal Too Great to Overcome

# BOB DANIEL LESSONS

- Fraud Schemes Were Ongoing and Escalating
- Personal Financial Pressures Led to Committing Crime
- Internal Controls of *any* Stripe Would Have Detected Fraud

# **THE HISTORY...**

Was it always this bad??

# THE 20<sup>TH</sup> CENTURY

- Enter the 'robber barons' and the growth of a world economy
  - Much of what we call illegal today was NOT illegal 100 years ago
  - Regulatory changes were created to protect shareholders and investors
  - Deceptive Business Practices were simply a nod and a wink...it's how we got things done
  - The concept of 'Moral' business practice was just emerging

# THE 20<sup>TH</sup> CENTURY, CONT'D

- Prosperity also brought the first world famous Ponzi Scheme---Charles Ponzi and the Italian postage stamps...
- Wall Street Crash of '29 brought a wave of regulation and oversight
  - SEC
    - Securities Act of 1933/Securities Exchange Act of 1934 (creates the SEC)
  - Business leaders declared that US Senators were the bigger scandal by creating frightening headlines
- Business leaders who were targeted under these new regulations rarely saw anything more than a fine for the company and risked no personal retribution



# THE TIMELINE OF CHANGE

## Pre 1929

Free wheeling Capitalism

Caveat Emptor

Rapid Growth of Stock Market

Growth of the sophisticated investor

## Post-Crash

Edwin Sutherland introduces the concept of 'White Collar Crime'

Before Sutherland—crime was committed by 'lower classes' and the concept of who is capable of being a criminal changes...

1950's America seemed to show a public that corporate misconduct was *tolerated*

GE/Westinghouse Price-fixing with the TVA

## 1960's to present

White collar criminals start going to jail

Bid rigging identified and prosecuted

Robert Kennedy was instrumental in changing the federal atmosphere

1962 Luther Hodges (JFK Commerce) published "*A Statement on Business Ethics and a Call to Action*"

# THE TIMELINE OF CHANGE

## Watergate

Citizens begin to insist on behavior change

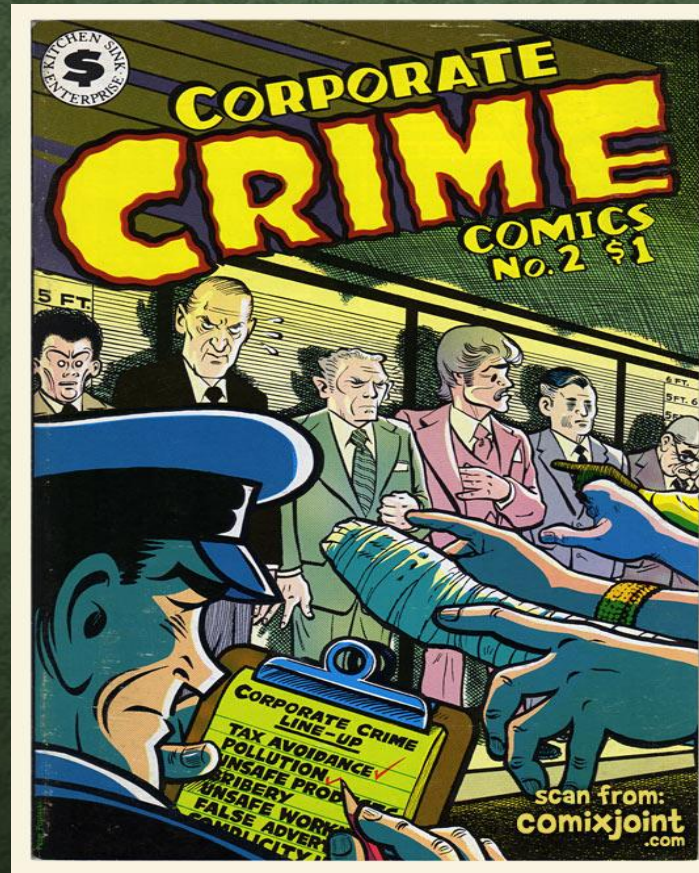
Corporate Crime Comics!! c1977

Tax avoidance-pollution-unsafe products-

Bribery-Unsafe workspaces-False

Advertising

Etc. etc. etc



## Our Current evolution

Elastic enforcement environment

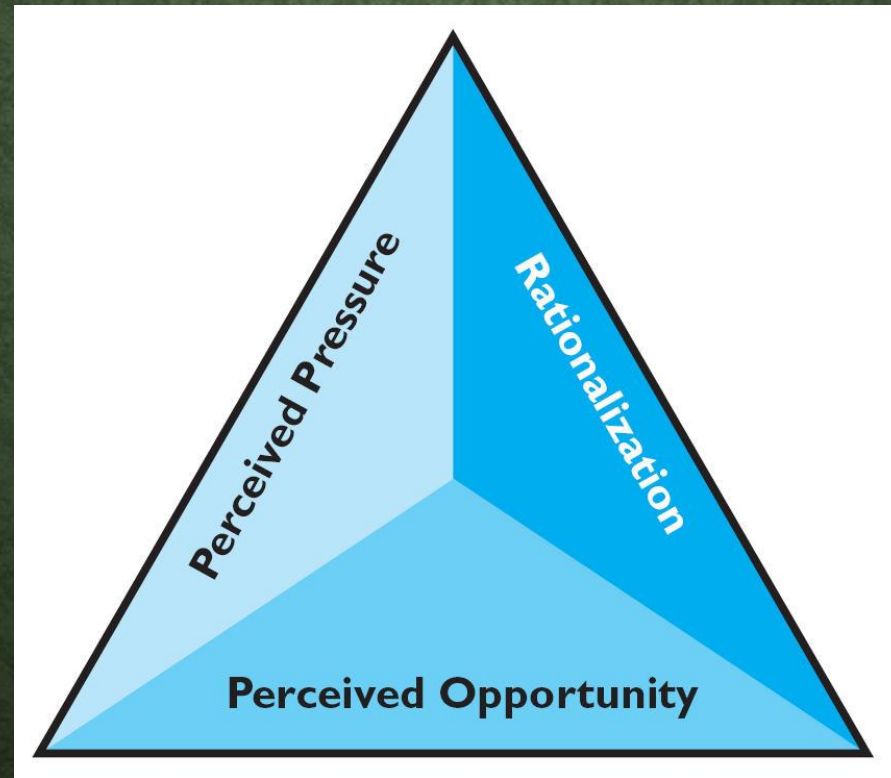
Strict/slack/strict/slack

Blurred Lines?

# YOU BE THE JUDGE...

- Nature or Nurture?
- Personality characteristics
  - Lack of Empathy
  - Ambition
  - Pride
  - Risk Aversion
  - Narcissism
- **ALL moderated and in a sense accentuated by circumstances and environment**

# FRAUD TRIANGLE



# CASE STUDY #2

- Fact set:
  1. Scott Harkonen, MD becomes CEO of InterMune
    1. Career begins as practicing physician but segues into research...
    2. Lead author in peer review journal
    3. Deep interest in finding treatment/cures for horrible orphan diseases
  2. Pursues Actimmune drug through phase 3 trial where promising results are found
  3. Press release:

# **CASE STUDY #2-(ACTUAL PRESS RELEASE)**

**InterMune Announces Phase III data**

**demonstrating survival benefit of ACTIMUNE in IPF**

**-- Reduces mortality by 70% in patients with mild to moderate disease—**

Brisbane, California August 28, 2002 – InterMune, Inc. NASDAQ: ITMN announced today that preliminary data from its phase III clinical trial of Actimmune (Interferon gamma – 1B) injection for the treatment of idiopathic pulmonary fibrosis (IPF), a debilitating and usually fatal disease for which there are no effective treatment options, demonstrate a significant survival benefit in patients with mild to moderate disease randomly assigned to act immune versus control treatment (P= 0.004)

# CASE STUDY #2

1. Press release was clarified with an immediate conference call hosted by Harkonen where he described the results were mixed in phase III study but demonstrated considerable survival benefit in mild to moderate IPF patients.... Harkonen felt this was an important disclosure to allow investment community to understand the studies outcome
2. **Immediately following the press conference a researcher from the University of Washington slams the press release and Harkonen's conference call by saying they were an absurd misrepresentation of exploratory statistical analysis**
3. Controversy surrounded the use of the P value (.04) because the statistical evaluation pretrial did not anticipate changes to the moderate disease patients
  - Harkonen went on to order an additional phase 3 trial in order to clearly demonstrate its efficacy, however in spring of 2007 a second IPL trial came out negative which caught the attention of the Department of Justice and the FDA
  - Harkonen was indicted on March 18, 2008 charged with wire fraud and misbranding
  - Harkonen stated "I never in 1000 years thought it would end up like this...I don't think I made a mistake"

• *Did he????*

# MAKING UNETHICAL DECISIONS

- The end of an accounting cycle approaches and a contract remains unsigned that is certain to be executed...
  - Negotiation meets an impasse on the last day of the month
  - Shareholders were expecting this contract to be rewarded and announced by the end of the month
- A. *Falsify the document to be effective on the last day of the month? Or***
- B. *Let the chips fall where they may and explain the problem to corporate leadership?***



# MORAL, COST-BENEFIT, EXPEDIENT

- KPMG Senior tax partner advised clients to not register a tax shelter with the IRS as required by law because:
  - A. "First, the financial exposure to the firm is minimal. Based upon our analysis of the applicable penalty sections we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees."
  - B. "Simply set up a reserve for any potential penalties in the rewards of the successful marketing of the product that will exceed the financial exposure"

*Is fraudulent activity actually driven by an economic model?*

# OUR MINDS ARE NOT READY FOR THIS MODERN BUSINESS WORLD?

- We more often rely on intuition...not deliberative reasoned calculated process
  - Your morning routine followed by your trip to the office/class followed by the finishing up of yesterdays undone work
- Most behavior is quick, automatic and intuitive—we are just more aware of the slower deliberative steps when solving a problem—like calculating the return on a savings account investment or:
  - *Question—a bat and a ball cost \$1.10; the bat costs a dollar more than the ball...how much is the ball?*

# OUR MINDS ARE NOT READY FOR THIS MODERN BUSINESS WORLD?

- Lying on paper is unemotional and separates the doer from the deed...sort of.
  - It is more difficult to lie to someone face to face----same is true for fraud
- The distance between the executive offices and the victims (shareholders/employees/citizens) has a similar dynamic
- Fixing an accounting 'error' becomes the first step in a billion dollar fraud at WorldCom—they all knew what the numbers *'should be'* so they made the entries to reflect that belief!

# THE PERPS LOOK IN THE REAR VIEW MIRROR

- Dennis Kozlowski and signing papers...
  - Huge stack of documents signed regularly-very overwhelming-mindless activity
    - Included documents which happened to forgive a couple hundred million dollars of Kozlowski debt. He just did what the company wanted...
  - Andrew Fastow and being a freakin' genius!
    - Structured transaction and special purpose entity's (SPE's) are ok except when they are ILLEGAL
    - Selling underperforming Enron assets to SPE which in turn is capitalized with Enron stock
    - With Fastow in charge of the SPE, he violated the regulation applied to them

The evolution of the use of these SPE's brought fame to Fastow internally and with the investment banking community—they were all willfully blind

# WHAT DO WE SAY? WHAT DO WE DO?

- If you see behaviors that are suspicious...memorialize it
- Whistle blowing is critical to identifying the bad processes and environments
- Half of Frauds are discovered through tips and/or accidental encounter
- Before you make a decision to push the legal envelope – pause—take a breath—reflect—WAIT  
24 HOURS
- The Risk-Benefit model is extraordinarily risky
- Your intuition is your enemy when faced with financial risk you are not familiar with or plays to a personal weakness e.g.narcissim/greed

# IT IS EASIER TO REFLECT ON LIFE WHEN:

- You have honored your core beliefs
- You continue to hold the respect of your friends and family
- You didn't look at life as a series of short term decisions but rather as a marathon of consequential actions
- You find yourself feeling grateful for the contributions/benefits you have brought to your community, business and for providing a positive roadmap for the next generation

*So let's do that, shall we?*

# SOURCES

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3. ACFE.COM

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