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FRAUD

What's your fraud IQ?

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Fraud is not an accounting problem or an internal control problem; it is a human problem. Not even the strongest system of controls can eliminate all risk of organizations' being defrauded by employees who are sufficiently motivated to find loopholes, ways to override controls, or opportunities for collusion. While most accountants are familiar with methods for identifying manipulated accounting data, effectively fighting fraud involves going further and understanding the human elements involved. Such knowledge can help CPAs design or assess internal control initiatives, recognize fraud red flags during professional engagements, and identify where organizations are most at risk. Take this quiz to see whether your knowledge of fraudsters' mindsets, characteristics, and behaviors is sufficiently honed to help you recognize the warning signs of fraud.

1. Research has shown that the most common reason that CFOs commit financial statement fraud is:

a. To cover up embezzlement or other fraud schemes.

b. Pressure from CEOs.

c. To increase the value of their own investments in company stock.

d. To hide their own errors or poor judgments that led to weak financial performance.

2. Melissa, a full-time retail store manager, is pursuing a college degree. Because of her work demands, she limits her school schedule to two night courses per semester. At this rate, she anticipates it will take her seven years to graduate. While closing the store one night during a shift that caused her to miss one of her classes, Melissa grew particularly frustrated with her situation. She began a scheme that involved skimming portions of the store's cash sales and processing refunds to her own credit card, intending to use the stolen funds to quit working and finish school faster. In turning to fraud, Melissa demonstrated which of the following thought patterns common among fraudsters?

a. Entitlement.

b. Inadequate fear of punishment.

c. Instant gratification.

d. Egoism.

3. In the 1960s, Stanley Milgram, an American social psychologist, conducted a study to understand why millions of Germans followed the orders of their Nazi leaders. His research produced interesting findings about why people engage in acts that seem to conflict with their morals, values, and ethics. Specifically, Milgram's experiment demonstrated which of the following?

a. Most people will follow orders from authority figures to perform acts that conflict with their personal morals, values, and ethics.

b. The more authority an individual has, the more likely he is to abandon his morals and engage in unethical actions.

c. People are most likely to engage in unethical actions when they do not fear the expected punishment.

d. An individual's propensity for engaging in unethical actions is genetically predisposed.

4. Which of the following is true regarding the behavioral traits and characteristics displayed by fraudsters?

a. The majority of fraudsters have a history of legal problems.

b. There are no observable patterns to the behavioral traits displayed by fraudsters.

c. The most common behavioral red flag among fraudsters is the tendency to live beyond their financial means.

d. Staff-level fraudsters are more likely to exhibit control issues, such as being unwilling to allow people to review their work, than executives who engage in fraudulent activity.

5. Which of the following individuals most fits the statistical profile of an occupational fraudster?

a. Kathryn is a 22-year-old customer service representative. She has been employed by the company for approximately five months. She has a high school diploma, and her criminal record shows a misdemeanor petty theft conviction when she was 19.

b. Charlie, a 38-year-old college graduate, works as a senior accountant. He has been employed by the company for approximately 3.5 years and has no criminal background.

c. Patricia is 53 years old and is the company's vice president of marketing. She has an MBA and has been employed by the company for 25 years, having worked her way up from an entry-level marketing position. She was charged with passing two bad checks seven years ago but was cleared of wrongdoing, and she has an otherwise clean criminal record.

d. Davis is a 57-year-old warehouse foreman. He is a high school dropout, and his criminal record shows two prior convictions for assault, one of which resulted in jail time. He has been employed by the company for almost 10 years.

6. According to research conducted by Robert Feldman, how many times does the average person lie during a 10-minute conversation?

a. None.

b. One time.

c. Three times.

d. 10 times.

7. How often can the average person correctly identify when someone is lying to him or her?

a. Approximately 10% of the time.

b. Approximately 50% of the time.

c. Approximately 75% of the time.

d. Approximately 95% of the time.

8. Which of the following statements is the most accurate regarding the behavior of a deceptive person (that is, a person trying to conceal something) during an interview?

a. When asked about hypothetical fraudulent conduct (e.g., "What do you think should be done to someone who steals from his employer?"), a deceptive person typically will display a disproportionately intolerant attitude.

b. A deceptive person will generally be more willing to terminate an interview than an honest person.

c. A deceptive person is more likely to engage in outright denials of an event or action than an honest person.

d. A deceptive person will frequently use phrases such as "to tell you the truth" or "honestly" to add credibility to his statements.

9. Rodrigo, CPA, is meeting with Amelia, the accounting manager, to discuss some anomalies within the company's cash disbursements system. Rodrigo asks Amelia a series of general questions about the cash disbursement process, then moves to the topic of several checks with out-of-sequence check numbers that cleared the company bank account. Which of the following behaviors is most likely to be a clue that Amelia is being dishonest in her responses?

- a. Amelia is sitting with her head and the trunk of her body facing Rodrigo, but her feet and legs are angled toward the door.
- b. As Rodrigo begins asking questions about the out-of-sequence checks, Amelia leans toward him slightly.
- c. The tone and pitch of Amelia's voice remain extremely consistent with each of her answers, revealing almost no emotion.
- d. When Rodrigo hands her documentation of the checks in question, Amelia accepts the documents and looks closely at them for quite some time.

10. Although the vast majority of fraudsters are first-time offenders, a handful of perpetrators are career criminals, and a few of those are considered psychopaths. Some of the most devastating frauds have been committed by individuals who fall into this group. Which of the following is a trait commonly displayed by psychopaths?

- a. Deep emotions.
- b. Impulsivity.
- c. An aversion to excitement or overstimulation.
- d. Feigned modesty.

Answers

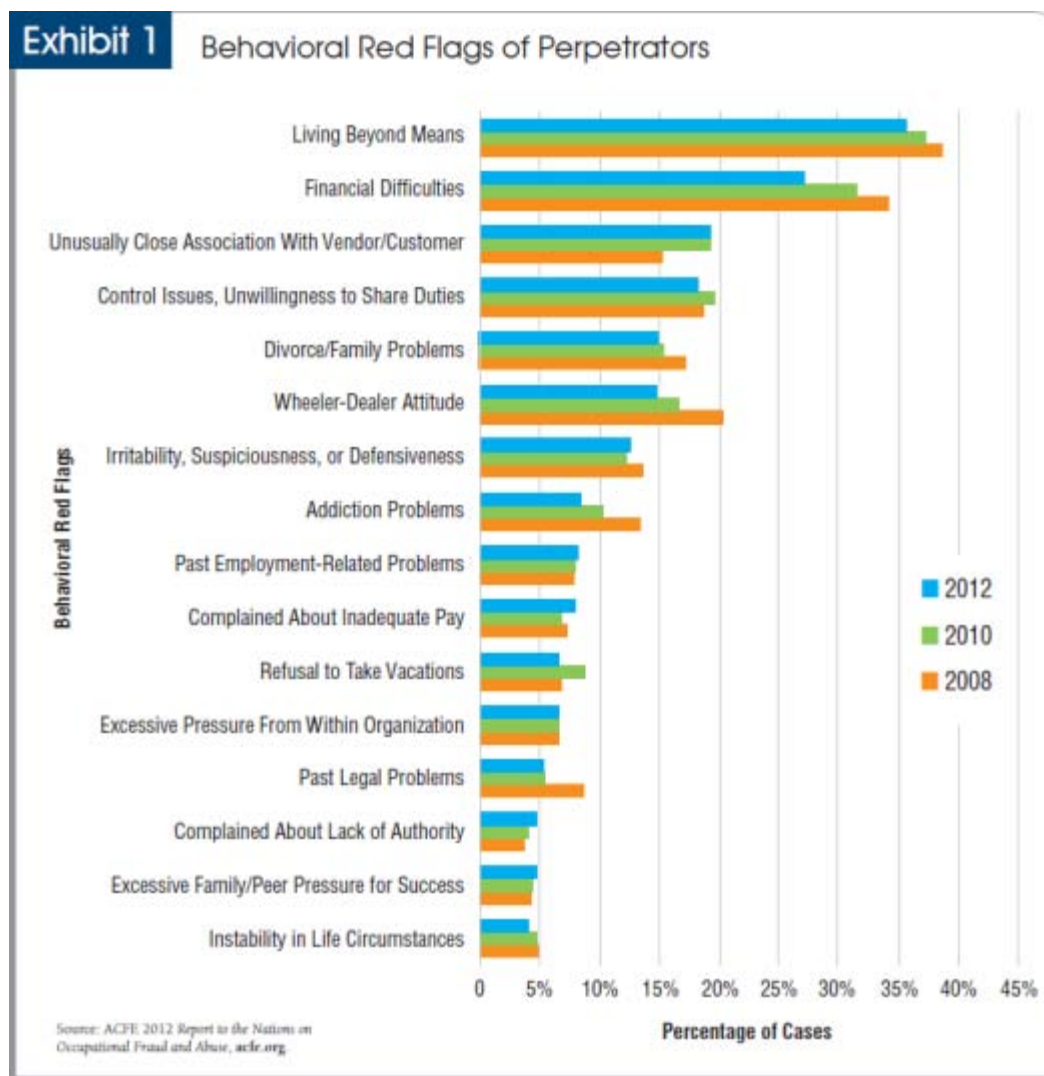
1. (b) In their article "Why Do CFOs Become Involved in Material Accounting Manipulations?," accounting professors Mei Feng, Weili Ge, Shuqing Luo, and Terry Shevlin discuss their research into the reasons CFOs fraudulently alter financial statements. Their findings indicate that CFOs generally do not commit such fraud for their own personal financial gain or to cover personal transgressions; instead, their fraudulent acts typically are the result of pressure from CEOs, who hold significant influence over decisions related to the CFOs' careers and compensations.

2. (c) Most fraudsters are trusted employees who—due to the convergence of pressure, opportunity, and the ability to rationalize a dishonest act—experience a lapse in their personal ethical framework. Interestingly, the ethical lapses that underlie fraud typically are exhibited in the form of thought patterns, or thinking errors, that fall within several broad and recognizable categories. One such category involves a perceived need for *instant gratification* (for example, a desire for wealth without the patience to earn it honestly). Melissa's decision to commit fraud rather than to wait seven years to finish her degree demonstrates a thought pattern of instant gratification. Many fraudsters display a similar desire for instant gratification; consequently, CPAs need to watch for signs of this thought pattern or circumstances that might lead to such an ethical lapse when considering the presence or prevention of fraud.

3. (a) Milgram's experiment involved the study's subject (dubbed the "teacher") acting out a series of learning exercises with another individual (dubbed the "learner"). The researchers instructed the teacher to test the learner on some basic concepts, and when the learner made a mistake, the teacher was told to give the learner an electric shock, increasing the shocks in 15-volt increments for each wrong answer. Unbeknownst to the teacher, the shocks were fake, and the learner was an actor who simulated the effects of receiving the shocks with increasingly loud cries of pain. In response to the learner's cries, many teachers demonstrated extreme amounts of stress and expressed a desire to stop; nonetheless, when ordered to continue with the experiment, most did. In fact, 65% of participants administered the final 450-volt shock. In the preface to his resulting book, *Obedience to Authority: An Experimental View*, Milgram stated that "the essence of obedience consists in the fact that a person comes to view himself as the instrument for carrying out another person's wishes, and he therefore no longer regards himself as responsible for his actions." Milgram's findings and summation underscore the need for CPAs to be mindful of the culture set and messages sent by an organization's leaders, as well as the relative mindset of obedience displayed by key staff members, as these factors play a critical role in determining the risk of fraudulent actions by employees at all levels.

4. (c) The Association of Certified Fraud Examiners (ACFE) has conducted research into the behavioral red flags displayed by perpetrators during the time of their fraud schemes and has identified notable trends. More than 80% of fraudsters exhibit behavioral warning signs of their misdeeds, and, not surprisingly, living beyond their means and experiencing financial difficulties consistently are the most commonly observed behavioral red flags (see Exhibit 1). In contrast, only about 5% to 10% of fraudsters studied had previous legal problems, a finding that emphasizes the limited effectiveness of relying on background checks as a fraud-prevention measure. An analysis of the observed red flags based on the position of the perpetrator reveals additional depth to

the trends, including the tendency of fraudsters at the managerial and executive levels to be much more likely than staff-level perpetrators to have an unusually close association with a vendor or customer, display control issues, or exhibit a wheeler-dealer attitude.



5. (b) ACFE research has revealed some trends in the statistical profile of individuals who engage in occupational fraud. As noted in the ACFE's 2012 *Report to the Nations on Occupational Fraud and Abuse*, perpetrators are most likely to be:

- In a staff-level position.
- Male.
- Between the ages of 31 and 45.
- Between one and five years of tenure at the victim organization.
- The holder of an undergraduate degree.
- Employed in the accounting, primary operations, or sales departments.
- First-time offenders.

Of course, CPAs should not take these findings to mean that all occupational frauds are committed by individuals falling into these categories or that all employees with these characteristics should be suspected of engaging in fraud schemes. However, noting commonalities among fraudsters can help CPAs dispel incorrect preconceptions about typical fraud perpetrators and better assess risks of where potential fraud might occur.

6. (c) Everyone lies. It's part of being human. To determine just how often we lie to each other, psychology professor Robert Feldman observed strangers who had just met while they engaged in small talk with the intention of becoming acquainted. The results indicate that, on average, people tell three lies during a 10-minute conversation, a finding Feldman has reached consistently in repeated studies, as he notes in his book, *The Liar in Your Life: The Way to Truthful Relationships*. The implications of this information on a CPA's work are notable. When much of one's professional responsibility involves relying on—or attesting to—the accuracy and completeness of statements made by others, the results of three undetected lies in each 10-minute conversation

could be disastrous. Building an awareness of not only the probability that other individuals are lying, but also of the common signs of deception and ways to ferret out dishonesty, is crucial to CPAs in reducing their chances of being duped by clients or co-workers and missing important warning signs of fraudulent conduct.

7. (b) In their August 2006 *Personality and Social Psychology Review* paper titled "Accuracy of Deception Judgments," Charles Bond Jr. and Bella DePaulo examine the combined results of hundreds of studies in which individuals attempt to determine whether statements are lies or truths. Their overall observations reveal that the average person can correctly determine whether a statement is truthful or deceptive 54% of the time—only slightly better than the chance odds of 50/50. More specifically, the individuals studied were able to correctly spot 47% of lies presented, while they identified true statements with 61% accuracy. The difference between these two rates is interesting and notable, as it illustrates the notion that people are inherently biased toward truth—that is, they tend to expect honesty from others and are more likely to believe a lie is a true statement than to believe a truth is deceptive. While this tendency is natural, it also clearly reinforces the importance of a "trust-but-verify" approach and the need for professional skepticism during CPAs' professional engagements.

8. (d) Individuals attempting to conceal something during a formal interview usually behave in certain ways that serve as red flags of their dishonesty. For example, recurrent use of oaths—statements such as "honestly," "I swear," or "to tell you the truth"—in responding to questions might indicate that the interviewee is attempting to add credibility to dishonest statements—particularly if these are not phrases the individual frequently uses in normal conversation. Other warning signs include a reluctance to terminate the interview, as if the interviewee desires more time to convince the interviewer of his or her innocence, and displaying a notably lenient attitude toward hypothetical fraudsters (e.g., stating that someone who might have committed fraud was likely just caught in a tough situation or expressing that such individuals should not be punished). Additionally, deceptive individuals are much less likely to voice direct denials to an accusation, and their denials are more likely to grow weaker with repeated accusations, whereas an honest individual's denials typically will grow stronger.

9. (a) For most people, lying causes stress and discomfort, and these feelings are typically released in physical, yet subconscious, ways. For example, if Amelia is attempting to deceive Rodrigo by providing dishonest answers, her body might respond by slowly moving into a "fleeing" position, in which her head and upper body still face Rodrigo, but her legs and feet point toward the door in an unconscious effort to escape the interview. Another possible sign of deception is an individual's leaning away from the interviewer when serious questions are posed. Changes in speech patterns also provide warning signs of dishonesty. If Amelia were to speed up or slow down her speech, or if her voice were to become noticeably higher, lower, louder, or softer as Rodrigo began asking about the checks, it could indicate that the line of questioning is a sensitive area for her and that her responses—or, more specifically, the deceptions therein—are causing her stress. Similarly, most fraudsters feel stressed when being handed evidence of their misdeeds and tend to react by glancing at the document and quickly pushing it away or handing it back to the interviewer. Knowing signs of deception to watch for in conversations with others can assist CPAs in realizing when they need additional verification of information from another party and in identifying areas that might be subject to manipulation and merit further exploration.

10. (b) Research conducted by Robert Hare, a psychologist who specializes in psychopathy, indicates that approximately 1% to 2% of people in the U.S. are psychopaths. However, the percentage of fraudsters who are psychopaths is likely higher, as many of the traits that underlie fraud, such as an ability to appear charming and to manipulate others, are inherent in a psychopathic personality. In their book, *Snakes in Suits: When Psychopaths Go to Work*, Hare and Paul Babiak discuss the symptoms of psychopathy and how they can be manifested in the corporate world. A psychopath in the workplace could come across as: glib; superficial; egocentric; grandiose; lacking remorse; lacking empathy; deceitful and manipulative; seeking power; emotionally shallow; impulsive; poor at controlling behavior; needing excitement; and lacking responsibility.

Many of these traits can actually help an individual advance through the corporate ranks. In the right light, such individuals can appear charismatic, commanding, and bold, and might even be upheld as natural leaders. However, these characteristics can also greatly aid in committing and concealing fraud. CPAs should be acutely aware of how people with such characteristics can raise a risk of misconduct in an organization.

Scoring

If you answered nine or 10 questions correctly, congratulations. Your solid knowledge about who commits fraud will assist you in protecting organizations from the thieves within. Keep up the good work.

If you answered seven or eight questions correctly, you're on the right track. Continue to build on your knowledge of the characteristics and behaviors of fraud perpetrators.

If you answered fewer than seven questions correctly, consider strengthening your knowledge about fraud perpetrators and their risk factors to help ensure that you have what it takes to keep assets and resources protected from potential fraudsters.

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To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

AICPA RESOURCES

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- [“Criminal Minds,”](#) Aug. 2012, page 26
- [“Small Businesses, Big Risk,”](#) Aug. 2012, page 38
- [“What’s Your Fraud IQ?”](#) May 2012, page 44
- [“What CPAs Need to Know About Organized Crime,”](#) April 2012, page 38
- [“What’s Your Fraud IQ?”](#) Feb. 2012, page 36
- [“What’s Your Fraud IQ?”](#) Nov. 2011, page 42

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