Fraud Intelligence

For the prevention, detection and control of fraud in all its guises

Triangles have three sides, not two

Opportunity and motive may be the more intuitive elements in fraud commission but ***Richard Minogue*** *and* ***Veronica Morino*** *believe that rationalisation should command equal attention and they have a template.*

Gentlemen crooks like Raffles or even Robin Hood are entertaining and many of us can even empathise with their motives and means. Less amusing are government officials who steal from public funds, oil companies that cut corners in the pursuit of profits, risking death or environmental destruction, or those charismatic conmen who make "Madoff" with your money. Whilst people seem to be able to rationalise almost any action, after the damage is done it is hard to find any real justification.

The Fraud Triangle

Rationalisation of actions is familiar to students of fraud from the "Fraud Triangle", which has appeared in a number of versions since originally proposed by Donald Cressey in 1973. Why people commit fraud is viewed as a combination of three factors: a perceived *need* for money or personal advantage, a perceived fraudulent *opportunity* to obtain it, and an ability to *rationalise* the fraudulent actions. Traditionally we spend a lot of time on the first two, opportunity and motive. However, fraud still happens. We argue that not enough time is spent countering the human tendency to rationalise inappropriate or unethical behaviour.

Opportunity

When we spot an opportunity to obtain what we desire, and can be convinced that our action is justified, why not go ahead? Fraud is not abnormal or irrational from a psychological point of view. There is a potential fraudster in each of us!

Our decision to commit fraud, or to refrain, is determined by our perceptions. The opportunity we see may be real or illusory, and the probability of detection and punishment may be higher or lower than we imagine. The need we feel may stem from a real crisis, financial or otherwise, or from an unsatisfactory comparison of our situation to those around us. And, finally, rationalisations are pure perception. We create a convenient perception, even distort reality, in order to fit our requirements.

If fraud is normal and rational behaviour, how is it that most of us nevertheless avoid fraudulent actions? Perhaps we see the risk of getting caught as unacceptably high and are reasonably satisfied with what we can achieve honestly. Perhaps, with our feet firmly on the ground, we avoid self-serving, conscience-suppressing rationalisations. We see that fraud is wrong, and therefore avoid it. But before congratulating ourselves for our moral fortitude, let's do some critical self-evaluation.

In an anonymous poll taken at a large gathering of security managers in Sweden a few years ago, we asked the question: "In the last five years, have you made any home improvements using labourers whom you paid in cash?" No less than 67% answered affirmatively and, perhaps worse, another 7% claimed they could not recall. With the relatively high levels of Swedish income tax, social charges and VAT there is a strong incentive for tax fraud. The opportunity and need are present, and the rationalisations are easy enough to find. Are we more honest? Let's ask ourselves, when was the last time we purchased services without a receipt? Or exaggerated an insurance claim? Or downloaded pirate music, films or software? Or (as certain parliamentarians or managers) abused our expense privileges? Do we "borrow" company office supplies for personal use? We need not look very far to find bad examples in our own behaviour. Why are we not plagued by a guilty conscience? We have rationalised our actions.

While we argue that fraud is common, even normal, that does not mean we should give up on prevention efforts. On the contrary, we need to be more effective at reducing the cost of fraud in our organisations. Traditionally, we concentrate on the "Opportunity"

side of the triangle. We use various internal controls intended to make it more difficult for a potential fraudster to complete transactions against the best interests of the organisation. Preventive controls, such as password protection, authorisation limits, and segregation of duties are designed to limit the ability to executed unauthorised transactions. Detective controls, including budget variance analysis, account reconciliation and exception reports are intended to bring both intentional and unintentional problems to light. We might also publicise the disciplinary actions taken against offenders as a deterrent for others. By strengthening controls and emphasising the risk of punishment, we reduce the real and perceived opportunity for fraud.

Need and greed

To a lesser extent, we also work with the "Need" factor. For example, when recruiting for key positions, we might perform background checks and psychological tests to avoid hiring those with inappropriate motivations. An inherent problem here is that the motivation that drives the fraudster is hard to distinguish from the driving force of successful managers. While we would not deliberately hire someone with a gambling addiction as a financial manager, we might want our managers to be driven by a hunger for wealth. To some extent, we design remuneration and incentive programmes based on greed.

It has long been recognised that an ill-conceived incentive system can prompt employees to take inappropriate risks, to behave unethically or to commit fraud. The dividing line between malpractice and fraud may be hard to distinguish and the former can easily lead to the latter, as in the Barings bank debacle. An ultimatum such as "achieve the budget or you will be fired" might lead to fraud, particularly if the budget is unachievable through honest means. We should therefore avoid imposing unreasonable demands or offering excessive incentives that could create an overwhelming need to commit fraud.

The third side – rationalisation

The third side of the triangle has received least attention. Can an organisation take proactive measures that reduce employees' tendency to rationalise inappropriate behaviour? To answer the question, we attempted to categorise common rationalisations used by fraudsters. In the figure overleaf, the vertical line represents the individual dimension. To what extent is the individual consciously breaking the rules? The horizontal line represents the perpetrator's perception of his social environment. Is the organisation lenient towards rule-breakers, or are the rules strictly enforced?

Detached

In the first quadrant, 'Detached', the subject deliberately violates the rules in an environment where rule breaking is not tolerated. To justify his action, the rule-breaker perceives the situation as so exceptional that the rules are simply not applicable or relevant. The present situation is so extreme, either due to force majeure, or implying a right of self-defence, or saving oneself or one's employer from a financial crisis, that they are able to 'detach' themselves from the norm altogether. A person with insurmountable debts to pay, for example, might find fraud justifiable as the only way to stave off financial ruin. Similar is the situation in which an individual regards himself as so important or so special that he is above the moral standards that apply to others. The individual is detached from the official norms by virtue of their own perceived superiority - the logic of the narcissistically disturbed personality. We also find it in the career criminal, who has no intention of following the rules.

Decadent

The second quadrant, 'Decadent', describes a situation in which the fraudster see rules being broken all around them, and is able to use that as an excuse for doing the same. They know what the rules are, and realise that they are about to do something in violation but doubt whether anyone will care, or stop them; they perceive the environment as corrupt. A typical case might be an employee who observes more senior managers apparently breaking rules for their own benefit. Perhaps the employee's observations are accurate, or perhaps they are mistaken – it is their perception rather than the factual reality that enables rationalisation, as if forcing a square peg into a round hole, the perception might be modified a bit to fit better.

Devoid

We describe the third quadrant as 'Devoid', where the perpetrator of a fraudulent or corrupt act does not perceive that their act is a violation of valid rules. Similar to the second quadrant, the fraudster sees rules being broken by others, but they also perceive that these others seem to be devoid of any guilt or shame at all, and the rule book devoid of relevance. The fraudster in this category is just going along with the crowd; it seems to be the normal thing to do. The

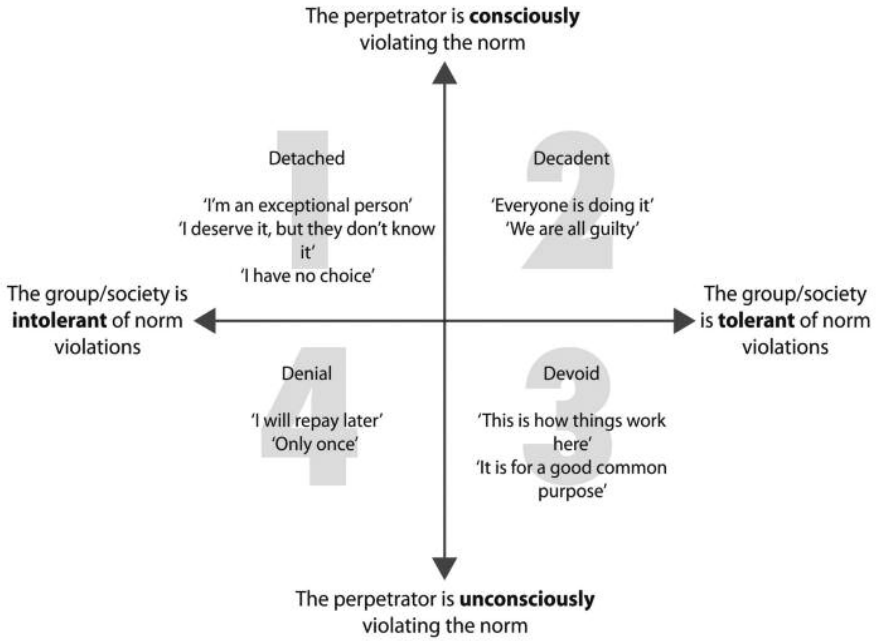

***Figure 1**: Four Categories of Rationalisation – Taken from the book "The Anatomy of Fraud and Corruption" (Brytting, Minogue, Morino). Reprinted with the permission of Gower Publishing.*

norm that may seem obvious to an outsider, for instance not to steal, is simply not relevant from the perspective of the perpetrator. The person falling into this group tends to lack experience from other organisations that function differently. Yet at some subconscious level they probably understand their fraudulent actions are wrong, and must be kept hidden from outsiders.

Denial

Finally, the fourth quadrant describes a situation in which the perpetrators are in a state of 'Denial': they conceal their actions and know that others will not approve of their actions if they are detected, but they have created rationalisations that trivialise their fraud. The employee borrows from the cash box, telling himself he will make good later. He is not fully aware that the rationalisation is a lie, that he will not return the money.

The rationalisations that permit us to commit fraud become available based on our perception of the organisation's tolerance or intolerance to fraud and on our awareness of what is permitted or not permitted. This suggests an approach to fraud prevention. Rationalisation is about changing names. As long as the tempting opportunity comes with a label attached calling it 'fraud' or 'corruption', it will be condemned. Fraudsters change the label to something more acceptable or trivial. If we can raise employee awareness about what constitutes fraud, we can reduce the availability of the unconscious or subconscious rationalisations in the "Devoid" and "Denial" quadrants. And, if we can eliminate the misperception that the organisation tolerates misbehaviour, we can reduce the availability of "Decadent" and again the "Devoid" rationalisations. Through employee training and other forms of internal communication we can expose rationalisations for what they are and render them ineffective. In a few short hours, employees can learn about the fraud triangle and apply it to their own situations. They can learn about the code of conduct and discover that management is serious about ethics.

Of course we are left with the quadrant where fraudsters have detached themselves from the need to follow the rules. The narcissists, career criminals and desperate cases are perhaps beyond the reach of awareness training. But if we raise awareness throughout the organisation, these few individuals may be easier to isolate and address through other means.

The persistence of fraud as a significant cost for organisations of every kind and around the world suggests both that fraud is a common occurrence and that prevention efforts are inadequate. While it may be impossible to prevent fraud completely, we believe that organisations could greatly improve their success by concentrating on all three sides of the fraud triangle. The importance of effective controls to reduce fraud

opportunities is already well understood. Management and incentive systems should be designed with care to avoid creating unreasonable pressure. And fraud awareness programmes are required to deflate rationalisations by increasing employees' understanding of appropriate behaviour and ensuring that they maintain an accurate perception of the organisation's lack of tolerance of fraud. This third side of the triangle may be the weakest link for most companies today. Even though management may have the best of intentions, until the rest of the organisation is on board the risk of fraud will remain unmanaged.

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Many of the ideas described in this article are taken from their book, "The Anatomy of Fraud and Corruption" (Brytting, Minogue, Morino), which has recently been published by Gower Publishing: www.gowerpublishing.com/isbn/9780566091537

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