

**BRINGING FREUD TO FRAUD:
UNDERSTANDING THE STATE-OF-MIND OF THE
C-LEVEL SUITE/WHITE COLLAR OFFENDER THROUGH “A-B-C” ANALYSIS**

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OUR CURRENT UNDERSTANDING

“If everything seems under control, you’re just not going fast enough.”
-Mario Andretti

This quote, from the legendary Formula One race car driver, may be appropriate for competitive motor sports, but can present significant dangers when applied to the world of corporate finance and corporate governance.

Frauds, especially large corporate misdeeds, have broad impact through our economy. We therefore expect a lot from top executives in corporations and quasi-governmental institutions. We expect them to be stewards of the financial assets in their care and, at the same time, to be alert to the profit potential that might reside in a new product or service (i.e., value creation and value preservation). When this balance becomes tilted, the negative consequences can be severe.

The effects of the Wall Street Financial crisis of 2007-2009 are still with us. A 2012 U.S. Department of Treasury Report reckons a colossal \$19.2 trillion loss in household wealth, accompanied by 8.8 million lost jobs directly attributable to the crisis. Blue-chip investment banks such as Bear Stearns, Lehman Brothers, and Merrill Lynch no longer exist, having collapsed or having been absorbed by others. Scandalously dishonest activities in the subprime marketplace involving “Alt-A” or “Liar’s loans” and “hustle” processing (quick mortgage processing of loans paralleling the “high speed swim lane” (HSSL) at Countrywide), and the utilization of suspect financial wizardry surrounding CDOs (collateralized debt obligations) and CDS (credit default swaps) made the entire global financial system of checks and balances appear grossly inadequate. Only now are we seeing some big settlements with the large banks such as Bank of America, J.P. Morgan Chase, Wells Fargo, etc. related to the crisis. Mammoth Ponzi schemes by Bernard Madoff and Allen Stanford have come to light. Parallel investigations into rampant insider trading has led to convictions at Galleon Funds (Raj Rajaratnam, Rajat Gupta), and SAC Capital, along with multi-million dollar fines and penalties. From Europe, we have seen the emergence of the LIBOR, Euribor, and even foreign exchange rate rigging schemes bringing the trust and confidence among financial service industry professionals to a

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new low. Clearly, we need a fresh approach to understanding the global epidemic of fraud and white collar crime.

Much like “Watergate,” Enron has become a synonym word for the series of spectacular accounting misstatement frauds that littered the landscape with failed firms and billions of dollars of lost stockholders’ and retirees’ equity. Enough time has passed that the investigations are over, the trials are completed, and more than a few former stars of corporate finance are in jail. Scroll back a decade or more, and you encounter the “S&L” crisis and the “HMO” mess. Again, huge sums were lost, massive investigations were conducted, and people went to jail.

It is intriguing to consider whether we can revisit these earlier times to see what was of value in improving our understanding of the current issues we face.¹ Do longitudinal studies offer promise in understanding current issues? Could using a behavioral lens help us arrive at a superior understanding of fraud, which is, in the ultimate analysis, a human endeavor? (cf. Ramamoorti, 2008).

This backdrop highlights questions predicated on a central theme: Why do well-educated, well-paid, apparently “nice” people indulge in such conduct? Why does an individual commit fraud? Clearly, some of these C-level suite white-collar criminals are so wealthy that they would not appear to need the money. To understand this requires understanding fraud. Fraud is perhaps best defined as:

*All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprise, trick, cunning, or dissembling, and any unfair way which another is cheated.*²

As compact as Black’s definition is, “fraud” still encompasses a huge range of human activity. The word itself is malleable. Standing alone, “fraud” is a noun, as in “A fraud was committed.” If we add “de” in front of it to form “defraud,” it comes a verb, as in “Sam defrauded Bill.” If we add “ulent” to the end of it, it becomes the adjective “fraudulent,” as in “Dan engaged in fraudulent behavior.” A multi-headed hydra in its diverse manifestations, even the word “fraud” appears capable of showing itself as different parts of speech to suit the occasion.

Indeed, frauds take on a dizzying variety of forms, from the corporate frauds mentioned above, to the welfare recipient selling his or her food stamps at a discount to gain cash to buy alcohol or drugs, to the scam artist calling old people at home to sell them overpriced or worthless goods, to the person filing an inflated insurance claim.

This paper focuses on occupational fraud. “Occupational frauds” refer to:

¹ See, for example, *The Dialectics of the Savings and Loan Crisis and the Case of Silverado Banking, Savings, and Loan*, by Davita Silfen Glasberg, *The American Journal of Economics and Sociology*, October 1998. Also see *The Best Way to Rob a Bank is to Own One*, by William K. Black, Austin, TX: The University of Texas Press, 1995. (Note: Dr. William K. Black was the former Executive Director of the Institute for Fraud Prevention (IFP), which funded the current study).

² Henry Campbell Black, *Black’s Law Dictionary*, 5th Edition, St. Paul: West Publishing Company, 1979, p. 468.

*The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.*³

To narrow the focus further, for business-oriented reasons that will be explained, it is important to note this occupational fraud can be committed by a wide variety of people. Individuals have the potential to choose to steal in various ways from the organizations that employ them, from the warehouse worker who claims overtime he did not work, to the executive who produces inflated financial results to cash in his stock options at a better price.

Our premise is these events are human acts, and as such, are complex and multifactorial. As a team of investigators, we believe however there are likely patterns that are universal. Because fraud is broad in definition we will seek to discover how human beings commit fraud: alone as one "Bad Apple" in a gang or cabal or a "Bad Bushel", or in a larger environment of thievery as in a "Bad Crop". Our collective experience and the historical record seem to indicate all three are possible, even happening simultaneously. In the case of ENRON, the courts determined collusion between senior officers. What of Bernie Madoff, was he just a Bad Apple, or was he part of a bushel? What of the record breaking collapse of the financial markets of 2007-08? Was this a series of "Bushels" or perhaps an entire Crop? For Madoff and the financial services industry, it is still too soon to know for certain. One thing is certain, however, the senior leadership played a role in each of these catastrophic failures.

FOCUS AT THE SENIOR MANAGEMENT LEVEL

Because of their role either by inattention or active encouragement of fraud, this paper will concentrate on the activities of those at the top: the "C" suite⁴ executives who perpetrate fraud. Often, and rather surprisingly, they perpetrate fraud for no discernible reason. They hold good positions, make good money, and have high standing in the community. Why do they risk it all by committing fraud, thereby putting their reputations and very freedom at risk, endangering their families, and causing harm to hundreds or many thousands of employees, retirees, and stockholders who trust them?

What Do We Know?

There is a fair amount of information known about these people, largely through the many media reports and books that massive frauds tend to spawn, but mainly through the work of the Association of Certified Fraud Examiners (ACFE). ACFE, formed by Joseph T. Wells and a handful of colleagues in 1989, has made tremendous strides in the space of a little less than two decades. It now has over 50,000 members throughout the world, and its designation of "Certified Fraud Examiner," gained by passing an examination, is recognized and prized by many individuals and institutions.

³ Joseph T. Wells, *Occupational Fraud and Abuse*, Austin, Texas: Obsidian Publishing Company, 1997, p. 3.

⁴ "C-suite" as a substitute for the suite of the CXOs, viz., CEO, COO, CFO, CIO, etc.

For over a decade, ACFE has compiled and published the “Report To The Nation,” (RTTN) which is a “where we are” analysis of occupational fraud in the United States. The numbers, discussed below, have been amazingly consistent over this sixteen year period.

Regarding methodology, RTTN is compiled by asking CFEs in the field to report their most significant or interesting fraud case in the past year. A number of questions must be answered, and these are compiled into the data that supports that year’s RTTN. The CFEs are, for example, asked to estimate the percentage of revenue their employer loses to fraud. This number has ranged from 5 to 7 percent over a sixteen year period, and usually settles near 6 percent. ACFE then takes this percentage and applies it to the Gross National Product of the United States for the given year, thus producing an estimate of the amount of occupational fraud (the only category measured) for that year. In 2012, the most recent year reported in 2011, that figure globally began to approach \$4 trillion.

From a methodological perspective, this data is weak. It is not objective. It cannot be verified by independent analysis. It relies on the “estimates” of CFE’s, and it assumes the fraud rates being reported apply evenly to all organizations, etc. ACFE is forthright in agreeing with all these criticisms, noting it is the best they can do. Furthermore, no one else, including the U.S. Government, has any better methods to estimate the numbers.

To tackle corporate fraud is to fight a beast of a size and dimension that is not as precise as desired. Despite the imprecision, there is fairly firm data from the reports provided in the RTTN: the nature of the offender. From RTTN data, a great deal is known about who commits these frauds. This data is firm, in the sense that it has been investigated and some action was taken against the perpetrator. Their titles, positions, educations, genders, lengths of service, and the like are matters of company records. This data has tended to remain consistent over the decade RTTN has been published. In other words, for all its self-acknowledged methodological weakness, the ACFE’s RTTN data shows a surprisingly robust longitudinal consistency that is difficult to quarrel with.

Here is what ACFE has found:⁵

- Males account for a little more than half of all incidents, which mean females are also active in such activities.
- As one progresses up the corporate ladder, the percentage of males increases, possibly because they tend to hold higher corporate positions. This data point is changing with time.
- Well over 60 percent have college degrees. In a “white collar environment” formal education often equates to organizational position.
- There is solid evidence of proportionality. If an employee steals a dollar, holding all other variables constant, a manager steals 4 dollars, and an executive steals 16 dollars. Again, this “makes sense.” The higher one goes, the more access to assets and spending authority they have, and the less supervision they are subject to.

⁵ See *Report to the Nations*, 2012, available online at the ACFE Web site, www.acfe.com. Since 2012, RTTN has gone global, the report is now called the *Report to the Nations*.

- On average, the fraud scheme lasts eighteen months. These are not “moment of impulse” crimes. They typically tend to continue until they are discovered.
- They also tend to get bigger with time. Obviously, the longer the scheme remains undetected, the greater the loss to the organization.
- The average tenure in the organization defrauded is between 10-15 years. These are not recent “hires” that see a quick opportunity and seize it. They are “loyal” long-term employees. Hence, we must pay heed to the “violation of trust” angle.
- The most common age range of offenders is from 45 to 55 years. These are the people often viewed as the pillars of the community.
- Over 90 percent have no criminal record. Pre-employment background investigations are a vital tool to keep dishonest people out of an organization, assuming assessments are done correctly, but we seem to be seeing “good people go bad.”

While the ACFE statistics are highly useful, there are still gaping holes in our understanding of this problem. Simply put, “Why do ‘good’ people go ‘bad’”? With the assistance of ACFE data, the criminals can be described, but they cannot be explained.

In the not too distant past, criminology in the United States took a revolutionary step. Those in law enforcement came to realize that “locking up bad guys and throwing away the key” wasn’t solving very many problems. The focus turned from solving crimes to preventing crimes. This change in strategy towards crime is generally believed to be successful, even in cities as large and complex as New York. Generally referred to as “community policing,” it took the joint efforts of many outsiders to pull together – sociologists, urban planners, psychologists, statisticians, and numerous other disciplines. It required about 30 years, but this strategy seems to have worked.⁶

There exists a trap this article will revisit. A bias was aptly described early on by Alison (1971) in his discussion of the Cuban missile crisis as “organizational routine.”⁷ Alison noted team members tend to see only what they have been trained to see despite good intentions and professional credentials, to approach an issue as complex as executive misbehavior in the manner “prescribed” by various professions. Such observed frailties in human cognitive behavior falls under the description “selective perception” and is a form of “confirmation bias” long studied by psychologists (e.g., Kahneman, Slovic & Tversky, 1982; see also Kahneman, 2011).

Other than ACFE’s work, we have mainly anecdotal “evidence” as to what motivates offenders, often in the form of “biographies” of their lives and misdeeds.⁸ Some researchers and theorists have attempted to cast a very wide net in attempting to “explain” all crime.⁹ In the end, it is a human act in the complex environment of the workplace, with significant financial impact. A multi-disciplinary team is essential. The paper focus e5 on senior corporate executives as they

⁶ One detailed discussion of such efforts, see *Turnaround: How America’s Top Cop Reversed The Crime Epidemic*, by Peter Knobler and William Bratton, New York: Random House, 1998

⁷ *Essence of Decision*, Graham T. Alison, New York: Little Brown & Co., 1971

⁸ *Frankensteins of Fraud*, Joseph T. Wells, Austin, Texas: Obsidian Publishing Company, 2000

⁹ *A General Theory of Crime*, by Michael R. Gottfredson and Travis Hirschi, Stanford: Stanford University Press, 1990

have the potential to do the most harm in terms of undermining governance and oversight as well as outright theft themselves.

EXPLAINING C-SUITE FRAUD REQUIRES THE BEHAVIORAL SCIENCES

Bringing Freud to Fraud: Fraud is a Human Act.

The most fundamental question towards understanding the crime is “Why did they do it?” This question is where we focus in this paper. Along the way, we will draw attention to A-B-C Analysis, tracing and linking actions back to individual motives, group influence, and generational/cultural/societal antecedents.

Let us start with Sigmund Freud. Freud pioneered the “science of the irrational,” and he demonstrated in a compelling way how unconscious processes not only exist, but can be seen in concrete and observable phenomena such as neurotic symptoms, dreams, and the small acts of daily life (e.g., the eponymous Freudian slip). Fromm (1951) describes Freud’s seminal contribution as introducing the concept of the “unconscious” as referring to those feelings, and wishes that motivate our actions and yet of which we have no awareness. Further, Freud posited that a powerful “censor” protects us from becoming aware of our unconscious strivings (e.g., we fear losing the approval of our parents and friends, and we repress such strivings, the awareness of which would make us feel guilty or afraid of punishment.) He challenged human consciousness as the ultimate datum of psychic experience, arguing instead that “most of what we are conscious of is not real and that most what is real is not in our consciousness” (Fromm, 1970).

In addition to tracing the unconscious/subconscious origins of individual human motives, Freud (1921) discussed the influence of group psychology in terms of the “primitive sympathetic response of the group.” He intuitively commented, “Something is unmistakably at work in the nature of a compulsion to do the same as others, to remain in harmony with the many.” Subsequently, he referred to concepts such as “collective neuroses” and of the “pathology of civilized communities” (Freud, 1935). We will discuss group psychology and influence in a later section.

There is another question just beneath the surface that the behavioral sciences have already uncovered: Why does fraud bother us so much? Why is it that we are disturbed so much by the events of a theft by senior officers?

From research into trauma victims, it is well known that it is harder to understand, forgive and adapt when we believe we have been wronged by another human being. This research has shown that when a natural disaster wipes out lives and causes the loss of hundreds of millions of dollars we are not as troubled as when the loss results from dishonest human beings cheating honest others. It becomes a question of fairness and the hard-wired, human/primate tendency for

“inequity aversion” gets forcefully exhibited.¹⁰ Being a victim of a crime is one of the most unsettling of all traumas, and when the leaders are accomplices it rocks us to our core.

Behavioral Economics and Evolutionary Psychology: Expanding the Fraud Triangle

Ramamoorti (2008)¹¹ noted that other academic fields in parallel to those which typically study fraud are becoming curious about the concepts of social engineering and the science of persuasion. Yet, it may be this is new syntax for old patterns seen in other forms of criminal acts. Greed is more of a “label” and does not constitute a valid, causative scientific explanation and is certainly not the final answer. More must be done to understand the problem; we must return to the root cause: the human mind. We will begin to do that.

The original fraud triangle of incentive, or pressure, opportunity, and attitude or rationalization has been compared to three elements needed to start a fire (oxygen, fuel, and heat).¹² Another less well known triangle is the “triangle of fraud action” (act, conceal, or cover-up, then conversion to another story). In understanding the act, there is potential insight into why but also how fraud is perpetuated without discovery. This model helps frame the need to understand fraud as a human act that happens multiple times, but not just once. Cressey’s (1973) idea of rationalization in the fraud perpetrator’s mind to justify their acts to themselves and others finds expression in the fraud triangle. Psychologist Leon Festinger (1957) has labeled this cognitive dissonance, and philosopher Eric Hoffer articulates it as follows: “A doctrine insulates the devout not only against the realities around them but also against their own selves. The fanatical believer is not conscious of his envy, malice, pettiness, and dishonesty. There is a wall of words between his consciousness and his real self.”

There are strong currents moving the field inside and out to broaden the study of fraud away from the classical economic models of how markets work and what drives capitalism, and more into the world of human behavior and the behavioral sciences. In the study of markets, the focus has been traditionally large groups of people, and when economists speak to behavior their thinking is in terms of averages and aggregates like “the corporation,” an “industry,” or in macro-economics, entire countries or geographical trading blocs or regions. Beneath this is an assumption that *homo economicus* is rational. Fraud is typically understood to be motivated by greed and an aberration of the underlying models of accounting and economics. In the wake of the Wall Street financial crisis of fall 2008, in widely publicized Congressional testimony, even a humbled Alan Greenspan admitted that he had put too much faith in the self-correcting power of

¹⁰ Monkeys Reject Unequal Pay, by Sarah F. Brosnan & Frans F. de Waal (2003). Yerkes Primate Research Center at Emory University, Atlanta, Georgia. A brown capuchin monkey (*Cebus apella*) will toss a cucumber to the ground if she is offered the inferior item at the same time that her partner is unfairly favored with a more delectable grape. The experimenters concluded that aversion to inequities—a hard-wired sense of fairness—is probably innate not only to humans but to other species.

¹¹ Ramamoorti, Sridhar. The Psychology and Sociology of Fraud: Integrating the Behavioral Sciences Component Into Fraud and Forensic Accounting Curricula. *Issues in Accounting Education*, Vol. 23 No. 4. pp. 521-533. November, 2008.

¹² Albrecht, W. Steve; Wernz, Gerald W.; Williams, Timothy L. (1995). Fraud: Bringing Light to the Dark Side of Business. Irwin Professional Publishing, Burr Ridge, Illinois.

free markets and had failed to anticipate the self-destructive power of wanton mortgage lending.¹³

From outside the field comes the need. It has been reported that the FBI is overwhelmed and understaffed because of other agency demands. In addition, the complexity of managing an organization is escalating exponentially. The AICPA has also highlighted the unique challenge caused by senior officers simply overriding of controls in a paper devoted specifically to this subject.¹⁴ At the same time, senior leaders are neither aware nor apparently concerned—not wanting to face the harsh glare of public criticism. Perhaps they simply do not want to know. Bethany McClean frequently discusses the common factors that led to the disaster at Enron. When asked how concerned are they about the same thing happening at their organization, she says “They’re not – none of them think it will happen to them, despite the fact they believe it is common, happening in other organizations and urgently needs attention!”¹⁵ Ramamoorti and Olsen (2007) have referred to this misplaced confidence and feelings of relative invincibility as the Lake Wobegon Effect.

Yet new thinking is influencing the models. The concept of the rare but still occurring “Black Swan” made popular by the text of the same name¹⁶ is an example of new concepts impacting the role of human behavior and its impact in the world. It has been of particular interest to economists and those who study the market. In addition, Grazioli *et al.* present¹⁷ a comprehensive view on the cognitive side of fraud detection and offer specific actions that can be taken by the auditors, which results in the discovery of fraud. Donald Cressey long pursued an expanded role of fraud studies to understand the human factor, ultimately providing us with the “fraud triangle” conceptualization. Geis and Meier (1977) added in the understanding as well. Neil Roesse conducted research on counterfactual thinking (“would have, could have, should have”) that may have great relevance to better understanding how white –collar criminals go about rationalizing their behavior to themselves (see Roesse and Olson, 1995). And Robert Hare¹⁸ began to apply his model of psychopathy onto the leadership of organizations using stories in the media and extrapolation based more broadly on his work on criminal behavior.

FRAUD BEHAVIOR IS MULTIFACTORIAL BUT CAN BE PARSED FOR ANALYSIS

The ABC Model: A Backbone upon which to Place a New Model for Fraud.

It is our hypothesis that fraud occurs either because of an individual criminal’s intent, a duo, or team of “bad boys” who push ethical envelopes, and/or a culture of passivity. We have called it

¹³ “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief,” Alan Greenspan told the House Committee on Oversight and Government Reform. (Reported on October 23, 2008 in the New York Times by Edmund L. Andrews).

¹⁴ Audit Committee and Oversight of Financial Reporting. *Management Override of Internal Controls: The Achilles’ Heel of Fraud Prevention*. American Institute of Certified Public Accountants. 2000.

¹⁵ Personal Communication, Conference on White Collar Crime,. Bethany was a guest of the Group for the Advancement of Psychiatry, Committee on Work and Organizations. Fall 2007.

¹⁶ Nassim Nicholas Taleb. *The Black Swan: The Impact of the Highly Improbable*. New York: Random House. 2007.

¹⁷ A Cognitive Approach to Fraud Detection: Grazioli, *et al.*

¹⁸ *Snakes in Suits: When Psychopaths Go to Work*, Hare, Robert, Babiak, Paul, 2006.

the Bad Apple, Bad Bushel, or Bad Crop Syndrome: *the ABCs of white collar crime*. We have in our experience seen the bad apple, the bad bushel, and if you stretch the metaphor, one of us has an in-depth understanding of the bad crop in the last three decades working in consultation to Arthur Andersen. Duane Kullberg retired managing partner of Andersen in the 1980s noted¹⁹ he frequently saw problems with overly proud partners and would warn them “when you start believing your own BS is when the trouble starts.”

Fraud happens out in the Open so it is a Fundamental Problem of Perception.

Ironically, fraud is the only crime in which the victim cooperates with the criminal. All who invested directly with Bernie Madoff did so willingly. There are several tools that criminals use to distract, the classic being the physical bump to distract from the pickpocket. The pickpocket takes advantage of the physical bump garners more attention than the sensation of having our wallet lifted. But a pickpocket victim is not cooperating with the thief. In the case of fraud, the fraudster deploys diversionary tactics similarly by taking advantage of the task-focused nature of the work place.

Fraud is Deception, Fooling another's Perception.

Andy Fastow used Special Purpose Entities (SPE's) in an openly mocking way, giving them names like “Raptors,” “Chewco” etc. As he did, he was fraudulently presenting Enron's finances right out in the open. It took a major article and a whistleblower for it to be exposed finally. How did that happen? To understand this situation we must address how an individual makes a decision. In order for a person to make a decision they must make a judgment first.

THREE RECOMMENDED TOOLS: JUDGMENT MODEL, EMOTION, AND REVERSAL THEORY

Impaired Judgment Plays a Role in Fraud

Perception is the first step in one model of what makes judgment. Leopold Bellak argues there are three steps²⁰ in judgment: the first is to discriminate, the second is to anticipate, and the third is to behave accordingly to what would be best. Bellak's model has been adapted for assessing executive judgment. Over 30 years²¹ Daven Morrison, *et al.* have evaluated executives for their ability to:

1. Collect the data
2. Boil it down to its essence
3. Act

Good judgment requires an executive to: first, perceive what is relevant in the world; then, weigh what is most important; and finally, use that information to inform his or her actions. In contrast

¹⁹ Personal Correspondence.

²⁰ Bellak, Leopold, M.D. *Overload, The New Human Condition*. pp 77 and 94 Human Sciences Press, New York, N.Y. 1975.

²¹ *Know Thyself: Judgment Capability Factors*; David Limardi, Carol Morrison, and Daven Morrison, PM Magazine, Vol 90, Number 8, September 2008.

to those managers who fail, those who are most successful tend to do well in ambiguity.²² Specifically this means that strong executives—that is, those possessing high levels of integrity--have perceptions that remain accurate when the environment is ambiguous.

Judgment, as individuals and as groups of individuals, is perhaps the fundamental area to understand in order to understand fraud. The factors undermining judgment will help the next generation of those seeking to prevent or deter fraud and create healthier corporate cultures. There are some who believe that ethical mistakes are not due to “bad morals,” but rather systematic errors in decision making.²³

Related to fraud, there is only a small subset that were evaluated and later found to have been involved in fraud. Relative to their judgment, one evaluated executive who was stealing had gaps in his ability to collect the data. Specifically he had a measurably poor capacity to tolerate ambiguity. Two others were strong in collecting the data, but were part of a powerful “brotherhood” that had hatched plans to commit a crime. Their shared vulnerability was hyper-competitiveness which impacted all three steps of judgment.²⁴

EMOTIONS

Emotions can be understood and can be an important part of problem solving. Sylvan Tomkins theory of emotions has proven to be a second pragmatic conceptual model for understanding executives and likely will provide insight into the state of mind of the C-Suite Fraudster. In psychology it is a theory that “carves nature at its joints.”

Tomkins’ theory of affect postulates that human emotion has a biological function just as our heart and lungs do. The functions are twofold: to communicate²⁵ an unmet need, and to provide motivation for action.^{26,27} Tomkins successfully argues that as people navigate their lives they are constantly receiving stimulation. This stimulates *affect* (what psychiatrists, psychologists and neurologists have used for “emotion”). The affect then results in action. His refined work on the human face identified nine core emotions²⁸ common to all people:

1. Interest
2. Enjoyment
3. Surprise
4. Anger
5. Fear

²² *Choosing Successful Management Consulting Psychology Journal* , Vol. 47, p. 108-114.

²³ *Ethical Leadership and the Psychology of Decision Making: Sloan Management Review*, Jan 1996, Bazerman, Messick,

²⁴ The Institute for Fraud Prevention is currently studying these factors in more depth. Greg Trompeter and Ann Norris are the primary investigators using over 2,000 executive assessments.

²⁵ Darwin, C. (1872), *The Expression of the Emotions in Man and Animals*. Chicago: University of Chicago Press, 1965.

²⁶ Tomkins, S.S. (1962-1963), *Affect, Imagery, Consciousness* ,Vol. I, p. 337. New York: Springer.

²⁷ Basch, Michael, “The Concept of affect: A Re-examination.” *Journal of the American Psychoanalytic Association* 24:759-77.

²⁸ Basch, Michael Franz. “Affect: The Gateway to Action,” *Understanding Psychotherapy*, p. 72, Basic Books, Inc., New York, NY, 1988.

6. Distress
7. Shame
8. Disgust
9. Contempt

Nathanson refined it further: Stimulation leads to Affect leads to Reaction: S-A-R. An example would be while driving on ice a person would hit the brakes. The intersection would rush up at the driver skids, and that stimulation would produce the core emotion fear. This action then would cause the rider to react and hopefully produce a safe stop on the road's shoulder. Another example would be finding a mass on our bodies. The distress of not knowing if it is cancer would cause our reactions to seek help.

This model of emotion has applications to all three aspects of the A-B-C model of Fraud behavior. It underlies the deception of the victim by the Bad Apple, it plays a role in willing and unwilling co-conspirators in Bad Bushels, and it heightens the sense of dehumanizing and lack of concern for others when it takes over entire industries as with Bad Crops. These mechanisms are explored. We begin with the core human behavior of defrauding someone and build the case by outlining how emotions work in general and then in the case of fraud,

Both functions of emotion – communication and motivation to take actions relate to fraud.

At birth and shortly thereafter, humans are unable to use any spoken language. No newborn baby has ever said (nor ever will) “I am hungry”, or “It is cold in here.” However, all newborns have the capacity to communicate; they do so through their emotions. This communication continues from birth into adulthood and throughout life. Emotions are primary and exist in time before thought. Basch has shown the rapid communication of affect (emotion) to be virtually instantaneous everywhere and aided his work in understanding patients on the analysis couch.²⁹

Emotions also serve as motivation to take action. Tomkins was the first to show the primacy of emotions for motivation. They become wards of the state. Why? Although they retain their ability to solve high-level problems, they cannot prioritize. It is the emotion that provides value to different pressures. Here's an example. No matter how much you like reading this paper, you may at some point have to stop to attend to the next pressing matter. Emotion is the fundamental factor that forces you to shift focus.

Emotions and the BAD APPLE

Fraud is a human act in which emotions are manipulated.

Fraud committed by Bad Apples occurs because they cause you to shift focus and permit them to take your money. In their paper on ethics and decision making, Bazerman and Messick argue that certain information is ignored, which then becomes a slippery slope towards ethics lapses. They point to problems in decision making.³⁰ It is possible that the error is ignoring the emotion

²⁹ *Psychoanalysis and communication science. Annual Psychoanal*, Basch, Michael 4:385-421.

³⁰ *Ethical Leadership and the psychology of decision making: Sloan Management Review*, Jan 1996, Bazerman, Messick.

in the message, as the rational or verbal part of the brain is “peacemaker” which makes sense of something even when it is not logical or even bizarre.^{31,32}

Popular uses of emotion to manipulate decisions are well known. Not all are criminal. People in marketing use emotions to excite us about a product that might not be particularly exciting, for example, laundry detergent. Others are clearly criminal in their use of emotions. “Social engineering” in the worlds of computer technology to access personal information or protected passwords is a popular subject currently for IT security, but the tactics used are as old as crime itself. They use a sense of distress, (“I’m lost I can use your help.”) or anger (“I’m a powerful person and you will be in trouble if you don’t comply.”) It is a step away from the Nigerian princes of email scams. Serial killers are infamous for playing helpless to seduce their victims.

Fraudsters use fear to frighten us about losing our money. For example, there have been frequent e-mail scams where a threat is quickly amplified, but by giving out personal information they will help us by taking our fear away. The bad apple knowingly deceives the victim. How is it possible for larger frauds to be committed given the required oversight: internal and external auditing controls? This area is where the bad apple recruits a bad bushel.

Emotions and the BAD BUSHEL

Fraud manipulates emotions to keep groups in lines leading to bad bushels.

In the case of Bernie Madoff, reports of investigations document his inclusion of his auditor and two computer programmers. Threats and financial rewards were used to keep his conspirators silent.³³ Fear and the threat of embarrassment or shame (another emotion subsequently explained in more depth) were used to allow Madoff to grow his program, sustain it over time, and transition from a Bad Apple to a Bad Bushel.

Restating, fraud is a human act that is not hidden. The fraud itself happens openly in the “books”. We believe that part of the distraction similar to the bump of the pickpocket is the manipulation of emotions in key gate-keepers. The supervisor assumes the salesman is being honest with his expense report, and the senior auditing partner assumes the CEO and CFO are sharing all the relevant information.

Like e-mail frauds, senior officers may use the negative emotions of fear and distress that are readily recognized in the “Nigerian Prince.” They also may use the positive emotion of excitement at large bonuses or raises to distract and cajole. In addition, given their experience with power, they commit white collar crimes in a more complex way by using shame and related emotions, contempt, and disgust.

³¹ Gazzaniga, M.S. (2000) Cerebral specialization and inter-hemispheric communication: Does the corpus callosum enable the human condition? *Brain*, vol. 123, 1293-1326.

³² Cooney, J.W. & Gazzaniga, M.S. (2003). Neurologic disorders and the structure of human consciousness. *Trends in Cognitive Sciences*, 7 (4), 161-165.

³³ *Accountant for Madoff Is Arrested and Charged with Securities Fraud*, The New York Times, William B. Rashbaum and Diana B. Henriques. Contributing Colin Moynihan and Kenny Porpora, November 14, 2009, *Two Are Charged with Helping Madoff Falsify Records*, The New York Times, Diana B. Henriques.

The C-Suite fraudster manages to distract those who would discover the crime by essentially dismissing questions as “small minded,” or dismissing the entire profession as “bean counters.” The specific tactics used on the governance or audit committee is bypassing or forcing the processes to go too fast to do a proper job. Their tactic is to shame the function. To make the entire leadership team function, a business unit, or even the whole organization to turn against the audit committee, they use their power to attack.

And this process is due to the power of embarrassment or the affect, shame. In our experience, shame is a critical emotion if not the critical emotion that disrupts all workplaces. Freud described shame “as the shortest fuse with the longest burn.” When the threat of shame is greatest, that is when the most aggressive attacks will come. All three of the authors are familiar with this situation when confronting some who has committed a crime and is avoiding capture.



Enron used this tactic on Andersen. Internally, Andersen did the same tactic on their own governance. One common defense against experiencing shame is going on the attack, which can become a pattern that is perceived as arrogance or hubris. Jeffrey Skilling and Andy Fastow were arrogant. Skilling famously remarked on an open call recorded on videotape: “What is the difference between Southern California and the Titanic? The Titanic had its lights on when it went down.”³⁴ While perhaps even more tellingly, Andrew Fastow brazenly stole answers to his introductory finance course at Continental Bank.³⁵

This shame begins to explain the actions of Enron, but what of the silence of others? What is happening with their judgment? Emotions still play a role in the problem. As with decisions, an inattentive or distracted C-Suite allows the environment to become ripe for fraud, and also for fraud to go on longer than if the leaders were vigilant.

Emotions as an ACHILLE’S HEEL

³⁴ McLean, Bethany & Elkind, Peter. *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*. London, England: Penguin Books. 2003.

³⁵ Personal communication from other classmates.

Emotions play a critical role in fraud, yet they are not part of the perceptions of executives.

Despite the importance of emotions in decision making and the clear evidence of their importance in survival, the average executive is not aware or knowledgeable of them. Not only are these leaders out of touch, they do not understand how to use them as data to problem solve. One of the subtests of the Wechsler Adult Intelligence Scale (WAIS) is the Picture Arrangement. The WAIS is a proven IQ assessment tool, and the Picture Arrangement measures a person's ability to understand and organize their social environment. Clinically, the test provides insight on how well an executive can predict the impact of his or her personality on a group and the reciprocal impact of the group on the ability to read the executive. An important part of doing this well is the ability to read the emotions. On this section of the WAIS, generally executives do quite poorly. This emotional ignorance also correlates to interviews also done in consultation.

The Minds of Senior Executives Perpetrating Fraud are Difficult to Study.

In reviewing evaluations of executives for this paper, all consultations were informally reviewed for those who were planning, already involved in, committing or had committed a crime against the organization. Out of 1,500 executives seen in consultation, there were three; the incidence is rare: 0.2%. This means interpretation based on profiling may prove difficult despite the significant cost of the perpetrators. Ron Schouten, MD, an attorney and psychiatrist from Harvard, makes a similar case against profiling for workplace violence.³⁶

Because it is difficult to assess, we recommend a retrospective study of criminals convicted of C-suite crime. Ideally the study would be a joint process combining interviews of both psychiatrists and certified fraud examiners. Really, all senior officers should have a psychiatric exam. This suggestion might seem outrageous, but physical exams are not uncommon. In fact, most executives do not use their body as much as they use their minds.

It is likely they have found ways of avoiding working with evaluators.

The work of Morrison Associates is with understanding the mind of the senior executive, and is limited by those who were willing to be evaluated. The authors have reason to believe that the overall incidence is much more as several individuals who eventually either did commit crimes or in other ways harmed the organization (abused the privileges of power for personal gain) were actively avoiding working with anyone who might discover their plans. Likely they did so because they rightfully feared they might be exposed.

Senior Officers when distracted perform more poorly.

In 2007, a paper regarding the distractions of a CEO impacting the performance of the organization³⁷ highlighted the fact that senior officers are people and are vulnerable to life events

³⁶ Schouten R: *Violence in the Workplace* p. 321. In Kahn JP, Langlieb AM, Eds. Mental Health and Productivity in the Workplace. San Francisco: Jossey-Bass, 2003.

³⁷ *Do CEOs Matter?* Morten Bennesen, Francisco Pérez-González and Daniel Wolfenzon.

that can impair attention by dividing it. The resulting distractions literally cost the company – direct to the bottom line.

This distraction was dismissed in the media and by other CEOs,³⁸ but it is not data that ought to be ignored. The US Navy has recognized for decades the importance of life events impacting their officers and at one point grounded their pilots if their “Life Change Units”³⁹ exceeded what was accepted as an upper limit. In addition, this data corresponds to mental and physical illness as well. The average person is familiar with the cold caused by “stress,” such as during the holidays. More recently, a commonly referenced public health paper⁴⁰ confirmed the danger of cell phone calls and driving. The factor leading to increased risk of collisions was the same: distracted attention.

Clearly, a fraudster has an advantage if the senior staff is distracted. In addition, the senior officers (CEO, CFO, or COO or this combination) who are able to distract the rest of the organization, are more likely to be successful in their completion of a fraudulent act.

There is evidence for distraction in virtually 100% of consultations to senior leaders

On the surface the senior executive will easily note the increased volume of e-mails, voice-mails, and other correspondence as he or she rises in the organization. As they open up and share their pressures less superficially, executives also note the pressure from work and family mismatch or even more personally, the concerns they have for a child with Attention Deficit Disorder (ADD), a parent with Alzheimer’s, or the distraction of the construction of a new home. For those who have loving sounding boards (other individuals who truly give them “tough love”), they are already aware of how their performance deteriorates because of these distractions. Executives who are aware, worry about being distracted, and are potentially less vulnerable to fraud.

If emotions are critical, then the CEO and team should be astute interpreters of emotion. In our experience they are not.

Senior Officers cause more problems by being ignorant of emotions. Ignorance of emotions has several problems. First, it eliminates a rich pool of data. Simply by being ignored the critical data contained in emotion walks through the room like a man in a gorilla suit. Unlike a gorilla suit it is not silly, but rather a critical inner peek at motivations and unmet needs. When the senior suite is ignorant of emotions, the fox has the run of the hen house. So, even if they are not actively committing fraud or white collar crime, they are allowing a rich culture for the viruses and other germs of fraud to grow.

Finally, as previously mentioned, the fields of accounting, finance and economics have had virtually no interest, nor understanding of the role of emotions, and therefore, the advice and guidance that comes from these fields are limited in terms of their shining light on human

³⁸ Scholars Link Success of Firms To Lives of CEOs: A Family Death Hurts, Studies Say, as Does Buying a Mansion, Mark Maremont, The Wall Street Journal, September 5, 2007.

³⁹ Rahe RH, Mahan JL, Arthur RJ (1970). "Prediction of near-future health change from subjects' preceding life changes".

Journal of Psychosomatic Research 14 (4): 401–6.

⁴⁰ Association between Cellular-Telephone Calls and Motor Vehicle Collisions, *NEJM*, D. Redelmeier, M.D., R. Tibshirani, Ph.D, Volume 336: 453-458, February 13, 1997, No. 7.

behavior. The combination of emotionally blind senior executives and a regulatory system informed by pure mathematical models we believe is disastrous.

Why do they do it? Where were those who should have reined them in?

Executives are often unaware of their own emotions that drive them to achieve.

This then impairs their ability to be in charge of their internal motivations, and more susceptible to bad judgment or being influenced by others in a maladaptive way. In all of our consultations we find early life experiences do make a difference. We titled this paper Bringing Freud to Fraud because Freud's seminal ideas continue to remain influential. His dynamic approach to the mind and the development of the mind remains true to this day. Johanna Tabin, PhD was a student of Anna Freud's (Sigmund's daughter). Both are well known for their collective contribution to psychoanalysis. Dr. Tabin recently observed;

I continue to be impressed with how my work takes me back to critical times in childhood in which there were important events that still impact my patients to this day. There are watermarks, left on their personality, that remain "in charge" if the individual does not have the courage to explore them. Their ability to explore events helps determine their overall satisfaction with life.⁴¹

These watermarks are evident in the executives who wish to be financially sound after growing up poor, in others who are still competing with siblings, and others who are still making amends with hurts caused by ineffective parents or tragedies they were not prepared to handle as young children. They carry these wounds into adulthood, compartmentalized, but at the same time still beholden to them.

Even more amazing is the capacity of the human mind to create blindness, paralysis, and even a nearly full term uterus when there is no physical cause. (Although beyond this paper, false pregnancy or "pseudocyesis"⁴² occurred in Freud's partner's case and was one of many hysterical symptoms, which led to the concept of the talking cure and other core ideas of Freud.) The listed individuals did these acts that ruined the public's perception of them (and hence their value) for reasons clearly other than greed. What might those motivating reasons be?

The many faces of "greed" in C-Suite Crime: hyper-competitiveness, perfectionism, excessive pride (narcissism), and more.

Martha Stewart, Bernie Ebbers, Andrew Fastow, and even in psychiatry Charles Nemeroff⁴³ can be described as greedy. But the origins of their greedy behavior are unique to their personalities. In our experience, greed is good for newspaper headlines, but is only the tip of the iceberg. What does cause problems in executives? More specifically to our earlier model, what does impair judgment?

⁴¹ Jean-Paul Sartre, French philosopher and advocate of existentialism, famously observed, "Childhood decides."

⁴² Kaplan, Harold I., M.D.; Sadock, Benjamin J., M.D.; Grebb, Jack A. Synopsis of Psychiatry. Chapter 2: Human Development Throughout the Life Cycle, pg. 27. Williams & Wilkins, Baltimore, MD, 1994.

⁴³ *Top Psychiatrist Didn't Report Drug Makers' Pay*, Harris, Gardiner. New York Times, October 3, 2008.

There are many unconscious factors that lead to greedy behavior in the senior executive suite. One important factor is hyper-competitiveness. This factor is the engine in roughly 50% of the executives we see that causes them not to see win-wins but to frame more situations than necessary as win-lose. By doing so, the executive misses her chance to help others, to be helped, and to find a solution different than her own. Hyper-competitiveness drives her to seek all the praise for her team's wins and to compare herself regularly to others' perks like salary and board positions. It can also feed into the gang mentality that "everyone else is doing it". The hypothesis of gang behavior is described in the next section.

Perfectionism is also common in senior executives according to research. This drive toward standards that can be too harsh can create a culture of intolerance that enables resentment and hurt feelings that can either lead to fraud or allow it to be tolerated. Clearly excessive nurturance needs and a general excessive self-reliance and distrust of others found in narcissism can also cause problems.

Executives who are not in charge of their biographies are at risk of their biographies taking charge.

Human motivation as it relates to fraud, is perhaps the most compelling area of research. Fraud is expensive, distracting, and wasteful. Repeating our core premise: fraud at its core is a human act (Ramamoorti, 2008; Ramamoorti and Olsen, 2007). The senior officer who lacks insight and is incapable of introspection is a ticking time bomb. Senior executives do a great deal of good by being curious about them in a critical way. This curiosity is another argument for not only a mental health exam, but also an annual mental health exam. Current thinking about fraud deterrence may be a problem. Understanding from other fields not previously considered will be a critical part of our success.

Perhaps most perplexing of all for those who study fraud is "Why did the nice guy do it?" To understand why someone who is the model citizen in all other walks of life decides to commit fraud means understanding why people change their minds. "What are the conditions?" "In what ways do they change their minds?" How do we understand the "rationalizing" side of the fraud triangle?

REVERSAL THEORY

Articulating the state of mind and how it changes – potential applications to the C-suite

ACFE data previously quoted on fraudsters, in particular that they are long-standing employees and are in middle to late adulthood, it is our hypothesis that something changes in their relationship to work, their employer, and the "rules." What is curious about people is not only what doesn't change over time, but also what does change.

Reversal theory is a model of human motivation that looks at how individuals adapt to changing needs of their environment. Michael Apter outlines the potential of his theory readily: "Reversal theory is an approach that moves beyond a limited perspective of goals and rewards to look at

the complexity and changeability of human motivation and behavior.”⁴⁴ The theory has helped question when affects are combined with thoughts to get to emotion; for example, how people with low stimulation can be either relaxed or bored, or with high stimulation excited or relaxed.⁴⁵ Truant and troubled children may help us understand the motivation to commit fraud and the limits of models to provide effective deterrents.

Early in his thinking on reversal theory, psychologist Michael Apter recognized the need to revisit deterrence measures on children who were truant. As he became curious about those who were not responding to the typical threats and withdrawal of rewards, he discovered a group of children who were motivated by the thrill of being naughty. From this, he discovered the inherent nature of the mind to switch or “reverse” motivation depending on the context. An example is from play-to-task and back-to-play depending on being with family at work or with friends. Another polarity is between conforming and rebelling. The final two poles fall across mastery and sympathy, and between being other-centered and self-oriented.

REVERSAL THEORY EXAMPLES

Articulating the state of mind and how it changes – potential applications to the C-suite

Consider the following list:

- Jeffrey Skilling at Enron; best schools, best grades, phenomenal wealth, and free reign at an energy company; yet he actively deceived his employees and the market.
- Elliott Spitzer as New York Governor had a stellar political career built on prosecuting those who were committing some of the worst vices towards women; yet he was involved in prostitution in a manner that anyone would recognize would eventually be discovered.
- Mark Foley, a successful congressman who openly advocated for the protection of children, yet secretly pursued the young men of Congress for his own sexual pleasure.
- Bernard Madoff and Sir Allen Stanford used massive Ponzi schemes to give the appearance of generating steady returns on multi-billion dollar investments
- Raj Rajaratnam, Galleon Funds, and later, Rajat Gupta, a director of Goldman Sachs, accused and convicted in one of the largest “insider trading rings” on Wall Street.

All of these individuals betrayed their core principles. Their common basic story of dishonesty is as old as the Greek tragedies, yet our explanation “greed” stagnates through the ages. **Greed is not the full answer. Becoming curious about what lies beyond greed needs to be understood.**

ACFE data previously quoted on fraudsters, in particular that they are long-standing employees and are in middle to late adulthood, it is our hypothesis that something changes in their relationship to work, their employer, and the “rules.” What is curious about people is not only what doesn’t change over time, but also what does. **Why does the honest person change?**

⁴⁴ Training Session, Summer 2008.

⁴⁵ Reversal Theory: Motivation, Emotion and Personality, Apter, Michael; Routledge 1989, p. 7.

Ideally to understand fraud a new model that incorporates the changing motivations of executives and the people they manage is essential. The “changeability” to not choose fraud will help discover new deterrents. **There exists a model of human motivation that looks at where, why, and how individuals change.**⁴⁶

Reversal theory is a theory of personality, motivation, and emotion in the field of psychology. It focuses on the dynamic qualities of normal human experience to describe how a person regularly reverses between psychological states, reflecting their motivational style and the meaning they attach to a given situation at a given time. For example, sometimes a roller coaster seems exciting; other times, it may cause anxiety. Sometimes a crying baby creates sympathy; other times it causes irritation.

The theory distinctively proposes that human experience is structurally organized into metamotivational domains, of which four have been identified. Each domain consists of a pair of opposing values or motives, so that only one of each pair can be experienced in any given moment.

Reversal theory was developed primarily by British psychologist Dr Michael J. Apter since its inception in the mid-1970s alone with psychiatrist Dr. Ken Smith. The theory has been researched, developed, and applied extensively.

Reversal theory is organized around a series of metamotivational states, organized into four pairs called "domains." Each pair in a domain represents two opposite forms of motivation; however, only one state in each pair can be active at a time. We reverse between the states in each pair depending on a number of factors, including our inherent tendency to adopt one style over the other.

The four pairs (or domains) are as follows:

- Means-Ends - The two states in the first pair are called "Telic" (or "Serious") and "Paratelic" (or "Playful") and refer to whether one is motivated by achievement and future goals or the enjoyment of process in the moment.
- Rules - The next two states are called "Conforming" and "Rebellious" (or "Negativistic") and refer to whether one enjoys operating within rules and expectations or whether one wishes to be free and push against these structures.
- Transactions - The next two states are called "Mastery" and "Sympathy" and relate to whether one is motivated by transacting power and control or by care and compassion.
- Relationships - The final two states are called "Autic" (or "Self") and "Alloic" (or "Other") and refer to whether one is motivated by self interests (personal accountability and responsibility) or by the interests of others (altruism and transcendence).

⁴⁶ “Reversal theory moves beyond a limited perspective of goals and rewards to look at the complexity and changeability of human motivation and behavior” Michael Apter Training Session, summer 2008.

Ways of Being Motivated	Opposing Choices	
Transaction or Relationship	<u>Sympathy</u> For each other	<u>Mastery</u> For Achievement
Journey or Destination	<u>Serious</u> Get the task done	Playful To enjoy the action of playing
Who am I doing it for?	Self	Other
How do I feel about rules	Conform Rules keep order	Rebel Unjust rules need not be followed

Ideally to understand fraud a new model that incorporates the changing motivations of executives and the people they manage is essential. In addition, a model that can help understand the “changeability” to not choose fraud will help discover new deterrents. Michael Apter outlines the potential of his theory readily: “Reversal theory is an approach that moves beyond a limited perspective of goals and rewards to look at the complexity and changeability of human motivation and behavior.”⁴⁷ His work has helped not only delinquent children but also athletes who tighten up in competition and lose despite having the skill to win.

The theory has direct correlation to the needs of understanding fraud. Using all eight polarities, Dr. Apter argues there may be many reasons people may be motivated to use their position of power as senior officers to steal from the company. Here are Michael’s ideas: ⁴⁸

It might arise from the serious state (a desperate need for money to avoid bankruptcy for example), the playful state (the fun of the risk), the conforming state (everyone is doing it in a given company), the rebellious states (the pleasure of doing wrong), the mastery state (beating the system), the sympathy state (e.g., as a form of self-indulgence), the self-oriented states (personal gain) or the other-oriented state (using the money e.g., for one's family).

Is there evidence for motivations beyond “greed?” Interviewing senior executives about motivation, personal gain is not uncommon, but so is joining in with others as well as to please family members (e.g., a spouse). Willie Sutton, the famous bank robber, provides an excellent example of the person who commits crimes for the fun of it. Mr. Sutton *never* said he robbed banks “because that’s where the money is” he did it as explained in is his own words: “Because I enjoyed it. I loved it. I was more alive when I was inside a bank, robbing it, than any other time in my life. I enjoyed everything about it so much that one or two weeks later I’d be out looking for the next job. But to me the money was the chips, that’s all.”⁴⁹

What of the “BAD CROP?”

⁴⁷ Training Session, summer 2008.

⁴⁸ Personal correspondence, fall 2008.

⁴⁹ *Where the Money Was: The Memoirs of a Bank Robber*, Sutton, Willie, Linn, Edward; Ballantine, 1977.

Is Freud always behind fraud: Is there a limit to the human mind as the cause of fraud? Gang theory.

Reversal theory highlights the critical question behind the changing of a person's mind which appears to be a critical factor in the perpetration of fraud. It also likely plays a role in the co-opting of members into a complex fraud. The theory also argues for mind sets to change if they feel safe and removed from harm. Michael Apter argues for a protective frame with crime similar to the protective frame that fans of sports feel as they yell passionately at their team from the stands with no real threat of being involved in the actual game. As noted previously, this indifference to the harm was obvious to those on the outside as they learned of what was happening inside of Enron. What if Enron like indifference spread beyond one organization to an entire industry or marketplace? Could that happen? Is it happening now? There is evidence in the field as well as the field of terrorism that supports this possibility.

Fraud may be due to large group phenomena, like gangs, and if so, profiling, or describing individual's behavior as narcissistic or psychopathic might be missing the forest for the trees. There is consensus that those who are recruited for suicide bombings are mentally healthy, in contrast to being mentally ill.⁵⁰ Jerry Post MD, who is a primary investigator of this phenomena, notes:⁵¹ "Not only that individual psychology pathology is of no help in understanding terrorist psychology, but also indeed that terrorist groups screen out emotionally unstable individuals because they would pose a security risk."

In this way they are likely similar to other stable and resilient psychopathic groups, like the mafia. Joe Koletar has seen this in his work on "criminogenic" cultures.⁵² This does not mean they are not influenced by the C-suite. In fact it can be argued that, the relative attention of the senior leadership will determine whether or not this is uncovered early, late or too late in the efforts to commit fraud. The ability of the CEO and his or her team to focus attention on the organization is critical.

While it is rare to find a researcher with experience in both gang and corporate behavior, some do exist. Those who have such experience have commented on the similarities between the two behavior sets. On the surface, they could not be further apart. Gang members are usually under-educated, ethnically based, poor, live in close geographic proximity, engage in impulsive types of crime, are easily identified by their "colors" (gang insignia, of whatever type), ritualistic behaviors, have lengthy criminal records, care nothing about normal societal expectations, and are young. However, the gang leaders are often mature, self-controlled, organizational leaders who manage multi-million dollar organizations with a clear understanding of profit, loss, labor, and threats from competition.

Corporate offenders differ in almost every way: they are older, well-educated, have no criminal record, live throughout the U.S. and the world, come from a variety of ethnic groups, rarely

⁵⁰ "The Psychological Causes of Terrorism" Chapter 1, Volume 1 in Addressing the Causes of Terrorism, The Club de Madrid Series on Democracy and Terrorism, 2005, from the International Summit on Democracy, Terrorism and Security March 8-11, 2005.

⁵¹ Personal correspondence, 11/26/08.

⁵² *Fraud Exposed*, Joseph W. Koletar, Hoboken, New Jersey: John Wiley & Sons, 2003.

engage in truly impulsive acts, blend in easily with the well-dressed portions of society, and are perceived as doing “good” versus “bad” things.

Yet the harm they can cause is massive. How do corporate offenders resemble gang members? They do not confront society head-on; rather they push the edges until they break; they have badges of rank (their “colors”) in the form of corporate jets, trophy wives, club memberships, cover stories in financial publications, vacation homes in the “right” places. They have a high, if subtle, disregard for the norms of society; use their lack of criminal records to gain power, influence and acceptance in society. They behave in remarkably similar, non-impulsive manners (slow, steady erosion of controls meant to reign in their behavior); and, with the assistance of expensive counsel they can easily afford, or often paid by the organization, avoid serious consequences.

Conclusion: Future Directions

This article has sought to demonstrate that there exist many new insights into the mind, behavior, culture, and the factors disrupting people at work. Many of these insights have potential in helping to understand white collar crime and in particular crime in the C-Suite. The new insights imply a new multidisciplinary paradigm for research. Multi-disciplinary tactics have within them a challenge, however, of agreeing to common terms. This challenge has a corollary in a classic Indian fable of six blind men attempting to describe an elephant (John Saxe’s poem, 1899). Our paper strongly recommends pursuing the following areas for exploratory and confirmatory research while maintaining an approach free of technical jargon.

To this point, it has been argued that the study of fraud needs new thinking based on the fact that fraud is a human act. We recommend research focusing on either active perpetrator of fraud or by allowing passive permission of fraud, because the damage done by the C-Suite can be the most expensive. Building on the themes of this paper there are four broad categories for research. The first is the unique challenges of this study. The subsequent three categories follow the **ABCs** of white collar crime:

- The Bad **A**pple: Individual Personality Characteristics of those that Commit Fraud
- The Bad **B**ushel: Group Dynamics of Collusive Behavior
- The Bad **C**rop: The Larger Cultural/Societal Factors that Enhance or Permit Fraud

Future Research Needed

- 1) Possibly the most pressing issue in fraud research is funding. As yet to establish an ROI (Return on Investment) argument has not been made that might persuade corporations, organizations, and academic institutions to “invest” in this sort of research. Can an ROI model be developed?

Academic fields: economics, business, organizational behavior, and occupational psychiatry.

- 2) There is a paucity of data. The statistics from the ACFE are useful, but even the ACFE's sampling approach has methodological weaknesses. The best government data is from the FBI Uniform Crime Reports, but the approach includes so many categories of "white collar crime" as to limit their usefulness. Some of the fraud surveys by the major CPA firms are providing significant information. How is better data obtained?

Academic fields: criminologists, sociologists, and statisticians.

- 3) What is the relative efficacy of each of the many tools available in the detection and prevention of fraud? The tools in the detection of fraud "arsenal" include: external audit, internal audit, hotlines, "tone at the top," ethics training, fraud examiners, outside consultants, etc.

Academic fields: statisticians, business, and economists.

- 4) The 2004 study by the US Secret Service and the Computer Evidence Response Team of Carnegie Mellon University reviewed a number of financial institution frauds over several years. In over 70 percent of the cases other employees were aware of, but did not participate in, the illegal acts. Why didn't they report what they knew?

Academic fields: psychologists, sociologists, and organizational psychiatrists.

- 5) Do sentencing practices, in those cases where matters go to prosecution, have any discernible impact on fraud rates?

Academic fields: see above.

- 6) The internal audit function in most organizations is understaffed, underpaid, has high turnover, is often viewed as a "developmental" assignment for young employees, has a poor structure for career advancement, and is perceived as an unpopular job. Might corporate support (perhaps via a better ROI) change this problematic perception?

Academic fields: human resources, accounting, and business.

The Bad Apple: Are there identifiable individual personality characteristics that help identify the C-Suite members vulnerable to fraud, and if so what are they?

- 7) The ACFE data argues that the average Occupational Crime Offender is between 45-55 years of age, has a college degree, no arrest record, and has been with the company/organization for 10-15 years. Why do responsible people commit bad acts?

Academic fields: psychologists, sociologists, criminologists, forensic psychiatrists, and anthropologists.

- 8) The gender breakdown of occupational fraud offenders is roughly fifty-fifty male and female, and has been so for many years. Why are women more active in fraud than in the past?

Academic fields: see above.

- 9) Profiling seems to work in crimes from homicide to rape to arson and terrorism. Is there a role for profiling in dealing with occupational fraud?

Academic fields: psychologists, sociologists, criminologists, and law faculty.

10. In their general theory of crime, Gottfredson and Hirschi claim that all crime can be traced to a poor history of impulse control (A General Theory of Crime, Michael R. Gottfredson and Travis Hirschi, Stanford, California: Stanford University Press, 1990). Persons with experience in both street and corporate crime see weaknesses in this theory. It may explain the impulsive and often violent actions of the young thug on the street, but it seems incapable of explaining the more methodical crimes commitment by corporate executives. (For a counter-argument to the general theory see, for example, *Fraud Exposed*, Joseph W. Koletar, Hoboken, New Jersey: John Wiley & Sons, 2003).

Is there a theory that explains corporate crimes by executives?
Does Michael Apter's Reversal theory apply?

Academic fields: Sociology, psychology, organizational psychiatry and organizational behavior, anthropology, history, and Reversal theory.

11. In the experience of many fraud professionals, most frauds seem to be motivated by greed and not need. Why do people feel "entitled" to something that is not theirs, and risk their reputations and freedom in the process?

Academic fields: psychologists, sociologists, anthropologists, psychiatry, and criminology.

12. Are there other motivating paradigms to understand fraud behavior in the C-suite?

Academic fields: psychologists, sociologists, occupational psychiatry, and criminology.

13. What social/economic reference points does one use when they decide to take the risk of committing a fraud? Why do well-paid people want more?

Academic fields: psychologists, forensic and psychiatry.

14. Is fraud, for some, a thrill-seeking experience? Revenge? What role does Michael Apter's model of motivation provide?

Academic fields: psychologists, and psychiatry.

15. Why do many successful fraud offenders make the mistake of overtly displaying their new lifestyle, since it only attracts attention to them? (See # 19) Are they trying to prove something, or trying to get caught?

Academic fields: psychologists, criminologists, psychoanalysis, and anthropology.

16. Related to the above question is the marked tendency for those sponsoring a fraud inquiry to respond to findings with a “bad apple,” “Let’s put this behind us” attitude. There is little incentive to “look sideways,” nor to deal with the factors that precipitated the fraud. If the factors continue, one may expect similar crimes to occur in the future. How can organizations and their executives be sensitized to such issues?

Academic fields: organizational behavior, psychology, legal, and organizational psychiatry.

17. When one reads the accounts of high-level executives who have committed fraud there seems to be an unusually consistent theme. They were active in their community, they supported or founded charities, their pictures were in newspapers for their good works. What is the linkage between these two sets of behaviors, assuming there even is one? Are they trying to achieve some sort of psychological “balance” between good and bad deeds to ease their psyches? Are they trying to store up good deeds to use as mitigating factors if and when their bad deeds are discovered? Or, are they truly committed to their (paid for) charities?

Academic fields: psychology, psychiatry, psychoanalysis, anthropology, and neurology (brain science)

18. Conversely, does organizational loyalty ensure ethical behavior?

Academic fields: psychologists, sociologists, and criminology.

19. Who’s minding the store? There is evidence that distraction causes significant problems in judgment and ability to react to the environment. How does this relate to those bad apples being able to leverage others’ distractions to steal from the organization?

Academic: business, neurology, psychiatry, organizational development, and criminology

Bad Bushel:

Are there group dynamics that permit, encourage or facilitate fraud, and if so, what are they?

20. The corporate security function of most organizations is often staffed by former law enforcement officers with great skills and experience in the conduct of investigations,

collection and preservation of evidence and, perhaps most importantly, interviewing. Yet, they are rarely involved in internal fraud investigations. Why?

Academic fields: accounting, criminal justice, organizational behavior, and business.

21. Most organizations have an IT department, but they are rarely asked to do data mining to reveal useful trends that might indicate misconduct. Why do organizations refrain from using resources available to them?

Academic fields: computer science, business, and accounting.

22. “C-suite” executives and Audit Committees often have a poor understanding of risk, or have a false sense of security in the risk monitoring mechanisms already in place. How do we increase their awareness of the dimensions of risk?

Academic fields: business, accounting.

23. Exit interviews have become *pro forma* exercises. Often, even for those organizations that choose to use them, the intricacies of pre-employment background investigations are little understood. How might this research educate organizations to use the tools at their disposal better?

Academic fields: business, human development, and psychologists.

24. Who’s minding the store? There is evidence that distraction causes significant problems in judgment and ability to react to the environment. How does this relate to senior leaders being able to oversee their organizations?

Academic: business, neurology, psychiatry, and organizational development

Bad Crop:

Are there larger factors that permit bad apples and bad bushels to take fraudulent action, and if so, what are they?

25. Outside consultants calling on corporate executives often present a compelling case for why they should be engaged to perform some form of risk assessment, only to have the executive note that they are called on almost every day by some outside provider touting the need to be aware of another form of risk. They note that if they listened to everyone they wouldn’t bother getting out of bed in the morning. How do we present “risk” in a reasonable manner to stand out from the clutter of the crowd?

Academic fields: business, psychologists, and occupational psychiatry.

26. Who owns risk – the Board of Directors, the Audit Committee, the CEO? Few organizations have a Chief Risk Officer. Risk tends to be spread across many areas of the organization, and the responses are piecemeal and disjointed. How do we develop a comprehensive view of risk, and who is responsible for it?

Academic fields: business, law, and accounting.

27. The great racecar driver Mario Andretti once said “If you’re in control, you’re not going fast enough.” That may be fine for Formula One racing, but corporations seem to have adopted the same philosophy – pushing the boundaries to gain profit and market share. How does risk management fit into such a mindset?

Academic fields: business, law, philosophy, and organizational behavior.

28. One of the great quandaries of fraud investigations is that the better the fraud investigators do their jobs, be they attorneys, accountants, or forensic professionals, the worse they make their “patrons” look. This result is because most fraud investigations uncover losses or misdeeds much greater than initially anticipated. This factor also promotes a tendency for organizations not to “look sideways.” (i.e., If it is happening in Unit “C,” is it happening in other units as well?) How do we deal with this phenomenon?

Academic fields: Organizational behavior, psychologists, legal, and anthropology.

29. The book “The Tipping Point,” (Malcolm Gladwell, 2006) gained wide popularity as it tried to explain the sometimes extremely subtle means by which societal events move from “A” to “B.” We face such a dilemma in understanding executive behavior. We want, indeed expect, executives to be aggressive and hard-charging, yet there are clear lines we do not want them to cross. We attempt to do this through regulatory bodies (SEC, etc.) and both internal and external monitors (internal and external audit). The recent track record has not been good. How do we improve our abilities to define and monitor behavior that may be approaching the “tipping point?”

Academic fields: Accounting, legal, psychology, anthropology, sociology, and psychiatry

30. Who’s minding all the stores? There is evidence that distraction causes significant problems in judgment and ability to react to the environment. How does this relate to a workplace increasingly parsed into micro-attention moments because of Blackberries, e-mails, texting, etc.?

Academic: business, neurology, psychiatry, and organizational development

Appendix A

To begin this exploration our paper has set out to understand one of the most costly forms of fraud: C-Suite fraud. How is it different and how it is similar to other fraud are curious questions and virtually unknown. To do this work, our professional field of inquiry will need to be precise in the description of fraud leads to a requirement for precision in describing the behaviors in the perpetration of fraud. We recommend a sound theory or model for understanding behavior in general as a place to start.

Evolutionary Psychology Approach for Rigorous Scientific Foundation to Behavioral Study

It was Darwin's genius to couple penetrating theoretical insight with robust empirical confirmation based on observation and tests involving a wide range of species to craft the "theory of evolution." Indeed, the value of an evolutionary psychology approach is that it furnishes us with a sound theoretical framework that in turn enables us to generate a set of testable hypotheses concerning behavioral responses and psychological mechanisms and then confirm or challenge them using empirical data through observation and experiment (Dubar, Barrett & Lycett, 2007). Specifically, we use the classic "Tinbergen Four Whys" strategy to eliciting a satisfactory answer to the fundamental question: why does an animal display a particular trait, or, why do people in high places seem to violate trust and perpetrate fraud? (cf. Nobel Laureate Niko Tinbergen, 1973).

The *Tinbergen Four Whys* strategy involves generating the following four levels of explanation: Questions about

- (a) the history and development of a trait both over geological time (its *phylogenetic* cause) and
- (b) within the lifetime of an individual (its *ontogenetic* cause),

Questions to

- (c) determine how a behavior enhances the survival and reproduction (its *functional or ultimate cause*) and
- (d) identify the factors that trigger a particular behavioral response to occur (its *motivational or proximate cause*).

Most students of elementary biology are familiar with the advantage of evolution. For example, a moth's adaptive coloring is **phylogenetic**. By having camouflage it survives predators, reproduces and the DNA continues through multiple generations. The camouflage is not behavioral but structural. Behaviors are more complex. Further examples of predators and their prey enhance the application of the concepts.

Through evolutionary processes, the same moth also will be still when any shadow passes overhead. By doing so it avoids predators, too. The shadow is a proximate cause producing a **phylogenetic behavior**. When a flock of birds migrates farther one season and finds more food and less predators than others of its species, the collective behavior is **ontogenetic**. The **proximate** cause may be a storm which blows the flock of course, overcrowding in the usual nesting place, increased predators, or lack of food, but if the further migration is sustained in the flock it is within a lifetime and thus fits the definition of "ontogenetic." There is a species of goose, the Nene, which inhabits Hawaii and is considered to have originated from a flock of

Canadian geese which had been blown off course during a storm. In their case their behavior was being flightless and thus very vulnerable to predation. The **motivational** cause for being flightless is more food and less predators. The **ultimate** cause is energy conservation (flying burns a lot of calories).

Over geological times, let's assume the birds were albatrosses. When a tiger shark migrates to where these albatrosses are nesting and discovers food every year when the birds first take flight. The annual migration of the tiger sharks are another example of a **functional or ultimate** cause.

Animal:	Behavior:	Phylogenetic or Ontogenetic	Proximate	Ultimate
Moth	Freezing still with shadow	Phylogenetic	Bird flying over	survive predation to reproduce
Geese	Flying further to better breeding grounds	Phylogenetic	Storm	Larger broods, more mates, better health
Geese	Flightless	Ontogenetic	No predators	Calorie conservation
Tiger Shark	Migration to breeding grounds	Phylogenetic	Steady food	Longer life, survival to reproduce

Dubar et al. (2007) proceed to provide the following compelling argument for adopting the Tinbergen Four Whys strategy: "By formulating our questions carefully and making sure our answers are pitched at the appropriate level of explanation, we can identify whether behaviors are adaptations produced by the process of natural selection, whether they are by-products of selection for other traits, whether they were initially selected for other purposes but have been co-opted by evolution...or whether they serve no evolutionary function at all...to understand the advantages that traits confer on individual organisms, how these interact with other traits...and how a species' evolutionary history constrains the range of adaptations that are possible."

Does Fraud Exist in Nature?

Related to fraud specifically there are some interesting examples in the animal world. There is the opossum which plays dead – the phylogenetic behavior is recognized quickly by all, as are the motivational and functional causes. There are predators, specifically fish which have "lures" to trick their prey. The alligator snapping turtle also does this. Lastly there is the Cuckoo bird. This bird pulls perhaps the biggest fraud of all by laying an egg in another's nest and completely avoiding the work of raising their own young.

<u>Animal</u>	<u>Fraud Behavior</u>	<u>Purpose</u>
Opossum	Plays dead	To not be eaten
Alligator snapping turtle	Suspends lure of "worm from mouth"	To eat
Cuckoo bird	Lays eggs in another birds nest	Avoid parenting responsibilities

In this paper, we explore the behavioral side of fraud, and psychiatry, as we have noted, is only one of many disciplines. With conviction of fraud, the behaviors are proven to be intentional and not due to a mental illness. The fraudster via his or her actions is playing out a risk/benefit ration as in nature, with the predators (the legal system) and the prey the victims. Why do they take action depends on the individual. The **phylogenetic** reason is for advantage.

Reducing genetics to basics, an organism's pursuit of life can be seen as constant struggle for advantage. The implications and associations to this "Darwinian" model are dark and alarming to those who search for higher meaning. Even DNA itself evolves as it reproduces. Over time the process is very efficient. This is from an idea called "selfish DNA:

The theory of natural selection, in its more general formulation, deals with the competition between replicating entities. It shows that, in such a competition, the more efficient replicators increase in number at the expense of their less efficient competitors. After a sufficient time, only the most efficient replicators survive.

– L.E. Orgel & F.H.C. Crick, Selfish DNA: the ultimate parasite

By understanding the mind as a resource that allows human beings as a whole and as individuals to survive, the Freud model of the mind is a blend of both the phylogenetic and the ontogenetic. As psychiatry has known for many years, the individual plays out risk/benefit scenarios with many choices in life related not only to the law, but also sex, drugs, and faith. In the emotion model, the affects are PHYLO as we are all hardwired for them, as are the domains of Reversal Theory. They provide a foundation for understanding the motivations behind all human beings as we all play out the risk/benefit options in our lives.

For this paper and for deterrence specifically, we are interested in the ONTO for why people commit fraud. The actual reversals, for example why the person chooses to be so rebellious and not conform to the law are ONTO. The pressure, perceived opportunity, and rationalization are all PROXIMATE causes. Reversals in general and affects in general are all FUNCTIONAL.

We believe these concepts are essential to understanding fraud. We encourage further dialogue with experts in behavior, human behavior and adaptive behavior in particular. The concepts and models suggested are the best based on our collective experience with the current study of fraud those who have been convicted of fraud and experience with evaluating senior leaders in the C- suite.

Appendix B

The Blind Men and the Elephant John Godfrey Saxe (1816-1887)

**It was six men of Indostan
To learning much inclined,
Who went to see the Elephant
(Though all of them were blind),
That each by observation
Might satisfy his mind.**

**The First approached the Elephant,
And happening to fall
Against his broad and sturdy side,
At once began to bawl:
"God bless me! but the Elephant
Is very like a WALL!"
The Second, feeling of the tusk,
Cried, "Ho, what have we here,
So very round and smooth and sharp?
To me 'tis mighty clear
This wonder of an Elephant
Is very like a SPEAR!"**

**The Third approached the animal,
And happening to take
The squirming trunk within his hands,
Thus boldly up and spake:
"I see," quoth he, "the Elephant
Is very like a SNAKE!"**

**The Fourth reached out an eager hand,
And felt about the knee
"What most this wondrous beast is like
Is mighty plain," quoth he:
"'Tis clear enough the Elephant
Is very like a TREE!"**

**The Fifth, who chanced to touch the ear,
Said: "E'en the blindest man
Can tell what this resembles most;
Deny the fact who can,
This marvel of an Elephant**

Is very like a FAN!"

**The Sixth no sooner had begun
About the beast to grope,
Than seizing on the swinging tail
That fell within his scope,
"I see," quoth he, "the Elephant
Is very like a ROPE!"**

**And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right,
And all were in the wrong!**

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