

DIFFERENT TYPES OF FRAUDS AND THEIR IMPACT ON BUSINESS AND ECONOMY

DR. SANJEEV GUPTA

M.Com., FCS, LL.B, MIMA, Ph.D

A company is an 'artificial person', invisible, and intangible, created by or under Law, with a discrete legal entity, perpetual succession and a common seal. It is an association of various stakeholders, namely, shareholders, investors, customers, employees, vendor partners, governments and society. The parties having stakes in a company can be expressed in one word, SPICE, where S stands for shareholders, P for public at large, I for investors, C for customers, and E for employees. The concept of corporate fraud is very broad. It encompasses a variety of criminal and civil violations. The frauds committed by a company, known as corporate frauds, tend to become complex in nature. Corporate frauds have shown an unprecedented increase in India in recent years and have posed serious questions before the academicians, researchers and professionals, on the effectiveness of corporate governance mechanism, government regulatory mechanism, and the role of corporate and individual ethics. With the advancement of commerce and technology, India, like many other countries, has been in the grip of corporate frauds.

Nature of Corporate Frauds

Corporate frauds are non-negotiable in nature that adversely affects the interest of the stakeholders. The consequences of a corporate fraud include:

1. Financial loss;
2. Compliance and regulatory infringements;
3. Breach of civil law, resulting in litigation;
4. Adverse publicity, particularly when labeled as a 'scandal' or 'fraud' by the media;
5. Personal damage to the career of those managers who were not involved in the fraud; and
6. Disruptions to the business and, in the worst

case, liquidation thereof.

A company, being a separate legal entity has a high credibility in the eyes of the persons concerned. Keeping in view the special legal status of a company, the high respect it commands, if properly managed, can grow by leaps and bounds. The basic truth lies in the fact that corporate frauds shielded behind a facade of the aforesaid legal entity, popularly known as the "Corporate Veil". A company works under a variety of legal statutory requirements which are mainly formulated to protect all the stakeholders. Since a company is run by human beings and human conduct is very individualistic, the conduct of a company is the aggregate of the conduct of the individuals who are running it.

Since the industrialisation of India, there have been several corporate frauds of diverse nature - stock market fraud, mass scale cheating of investors and shareholders, companies vanishing into thin air, systematically making a company sick and putting a company before the Board of Industrial and Financial Reconstruction, or bringing it under liquidation before the High Courts, could all be different shades of corporate frauds. Corporate frauds are often initiated by the insiders with the help of certain unscrupulous professional and consequent non-monitoring by Governmental agencies.

Corporate frauds generally come to public all of a sudden, with little time left for investors and government agencies to take any preventive action.

According to N. Vittal, Legendry Chief Vigilance Commissioner of India, the three dimensions of any

corporate fraud are: (a) the human dimension, (b) the technology dimension; and (c) the legal dimension.

(a) The human dimension: Insiders are the main perpetrators to commit a corporate fraud. Insiders are mainly dedicated employees who never take leave and when they fall sick and somebody else looks into what the dedicated employee was doing, it is found that he had been perpetrating a regular fraud by fiddling around with the accounts.

(b) The technological dimension: The second dimension of a corporate fraud is the fast-changing technology. The technology has two dimensions -- to prevent frauds and to pamper frauds. The major risks of IT would be (a) Environment risks, (b) IT operations risks and (c) IT product risks.

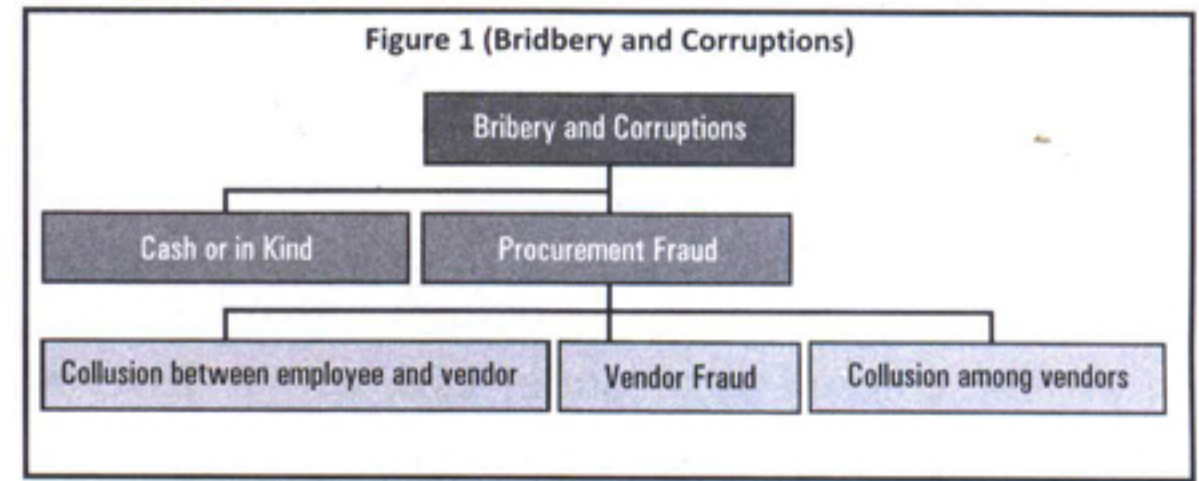
(c) The legal dimension: The third dimension which encourages a corporate fraud is the failure of the regulatory mechanism and inadequate legal penalty. The Sick Industrial Companies Act and the Board of Industrial and Financial Reconstruction have been thoroughly misused by the corrupt people and fraudsters to take advantage at the cost of the public interest. It is imperative to strengthen the regulatory mechanism and to provide adequate penalty to deter scams.

Corporate frauds are generally (a) highly complex, (b) result of a web of financial transactions used to commit fraud, and (c) based on human ingenuity.

Types of Corporate Frauds

Corporate frauds can be committed internally or externally in a company by employees, customers, vendors, management, Chief Financial Officer, Board of Directors, and/ or any functional head. An internal fraud is a fraud occurring within the organisation and is committed by employees, or the Board of directors. External fraud is a fraud committed by the outsiders. Corporate frauds may of different types encompassing the various activities and legal procedures involved. As per the research studies and

expert surveys, corporate frauds can be divided into five categories:



Procurement frauds arise out of the following:

(a) Collusion between employees and vendors. It includes kickbacks, bid rigging, gifts, or other enticements.

(b) Vendor's fraud against the company. A vendor might commit fraud against a company by substituting goods of inferior quality, overcharging the company, or engaging in false-billing.

(c) Collusion between multiple vendors. Vendors might collude to artificially inflate the prices of goods and services in bids or proposals, or to help one another receive certain contracts based on an agreement between them.

KPMG's India Fraud Survey Report 2010 revealed that 57 per cent respondents experienced bribery and corruption-related frauds. This percentage increased in two years, from 43 per cent, as per KPMG's India Fraud Survey Report 2008.

Bribery and corruption impact the performance of stock market by increasing volatility and deterring institutional investors from making long-term investment. The corruption can erode the very pillar of economic growth and could impact the valuation of a company, thereby denying the shareholders of a fair price. It increases the overall cost of conducting business as capital is borrowed on higher cost. The biggest impact of corruption on business is its tendency to skew the level-playing field and attract organisation with lesser capabilities to execute projects. Bribery is a serious economic crime as it adversely affects the country's economic development. It promotes inefficiencies in utilisation

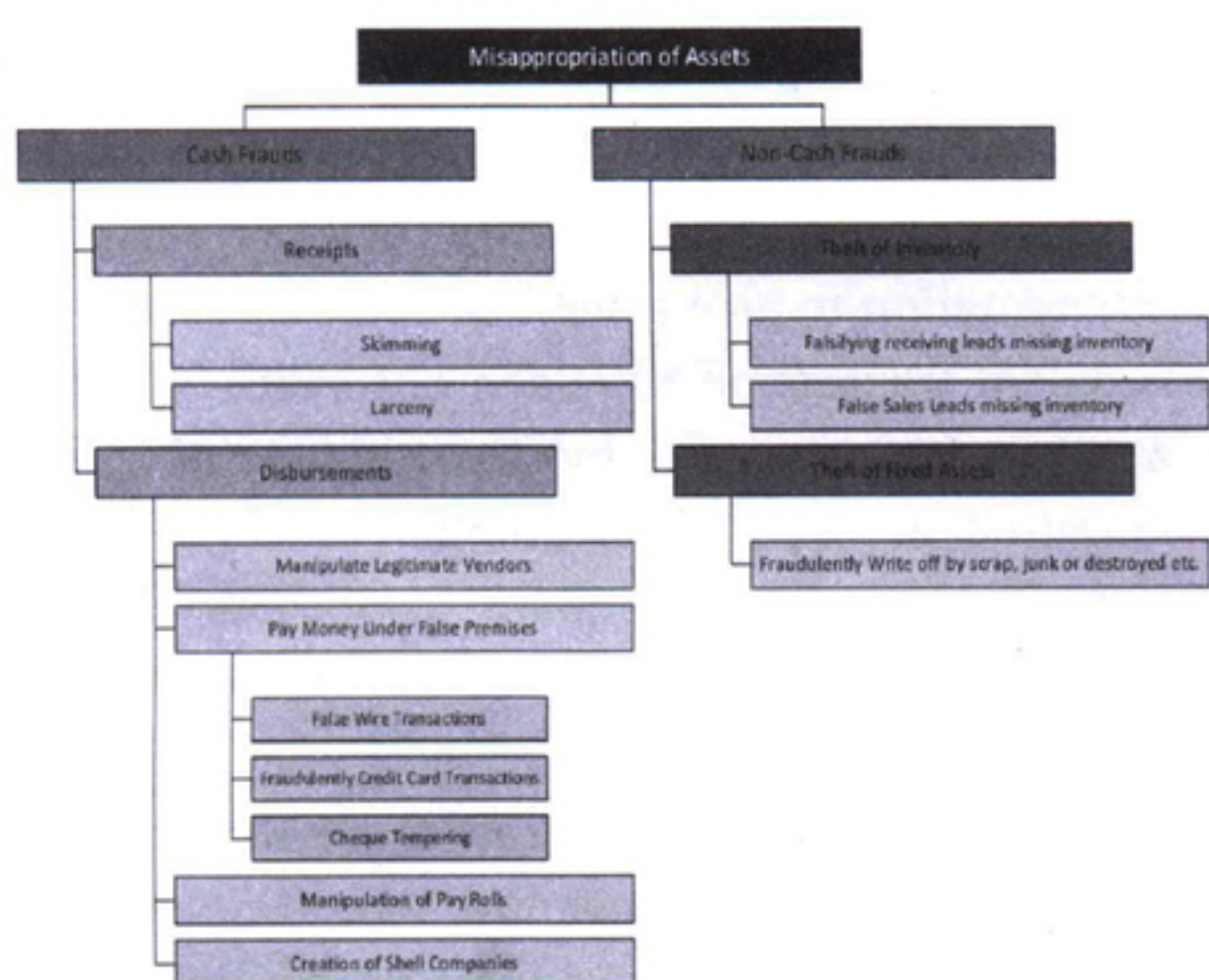
of resources, distorts the market, compromise quality and destroys the environment.

Misappropriation of Assets

Asset misappropriation fraud involves taking cash and other assets. Various schemes can be used to accomplish this. Assets misappropriation schemes include those frauds in which a perpetrator employs tricks or deceit to steal or misuse an organisation's resources. Specific assets of the organisation are taken to directly benefit the individuals committing the fraud.

The various ways to misappropriate the assets of an organisation are shown in Figure 2.

Figure 2
Misappropriation of Assets



Asset misappropriation includes the misuse or theft of assets belonging to a company. Asset misappropriations can be divided between cash schemes and non-cash schemes. Cash schemes simply involve the theft of money, via cheques, money orders, or paper currency; they can be further divided between schemes focusing on cash receipts and those related to cash disbursements. Non-cash schemes involve all other thefts of assets, such as inventory, equipment, supplies, or information.

The theft of cash, either by way of a cheque or currency, can be (a) skimming, which is stealing the

funds before they are recorded in the books of the company, and (b) cash larceny, which is the theft of funds after the transaction has been recorded.

Cash misappropriation also includes the fraudulent disbursements, which occurs when an employee causes an organisation to pay money under false pretense.

Non-cash fraud is aimed at stealing anything the company owns other than cash or cash equivalents. This might be by the way of theft of inventory, supplies, fixed assets, or other hard assets owned by the company.

Fraudulent receipts can be in the form of skimming or larceny. Skimming is the removal of cash from a firm prior to its entry in its accounts. They are known as off-book frauds, they leave no direct audit trail. Skimming schemes generally assume such forms as unrecorded sales, understated sales and receivables, and theft of cheques through the mail.

Larceny is the unlawful taking and removing of another's personal property with the intent of permanently depriving the owner, and is a kind of theft, like acquiring the property of the company and using it for personal purposes.

Fraudulent Disbursement is a type of cash misappropriation which occurs when an employee causes an organisation to pay money under false pretext.

Non-cash fraud is aimed at stealing anything the company owns other than cash or cash equivalents. This might be a theft of inventory, supplies, fixed assets, or other hard assets owned by the company.

Assets misappropriation is a major problem for the organisations throughout the world. As per ACFE (2008), organisations lose around 7 per cent of annual revenues to frauds such as assets misappropriation.

Implementation of whistle-blowing policy, clear segregation of duties, monitoring of cash receipts and deposits, regularly reconciling bank statements,

periodic audits and promotion of a culture of fraud awareness, among the staff can protect the organisation from asset misappropriation. As seen in the case of Tyco International, the type of fraud was assets misappropriation. It affected the company's public appearance and corporate reputation. The effects of this type of fraud tend to be limited to the parties directly involved, but this can have significantly adverse effects on many people.

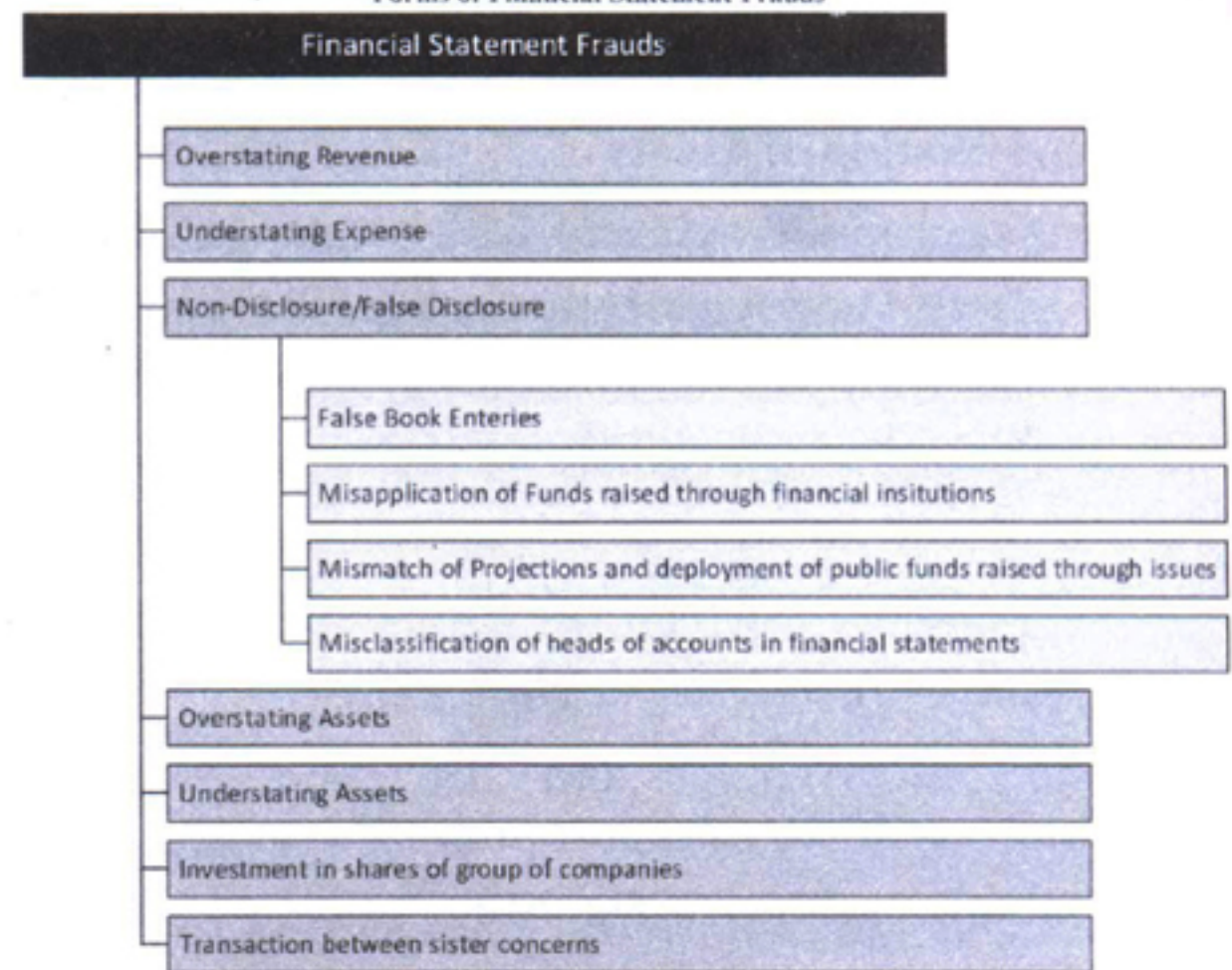
Cash flow of the business suffers for misappropriation of assets and this fraud can also impact the staff morale and reputation, resulting in lost productivity, and increased employee turnover and absenteeism. This type of fraud is best prevented through segregation of duties, monitoring employees, and examination of accounts and documentation.

Frauds through Manipulation of Financial Statements

Financial statement frauds take the form of manipulation of critical accounts, such as overstating revenue, overstating assets, understating assets, investment in shares of group companies, and non-disclosure/ false disclosure. KPMG India did a survey on corporate frauds and on the perception of respondents they found financial statement frauds were the most common form of corporate frauds. They analysed different types of financial statements, like related party transactions, use of off-shore entities, creating fictitious revenue, advanced revenue recognition, unrecorded/ concealed liabilities and other forms. In their survey report of 2010 KPMG found that people believed in that 'Advanced revenue recognition' and 'unrecorded/ concealed liabilities and expenses' are the most common form of financial frauds. The different types of transactions which amount to manipulation of financial statements are shown in Figure 3.

KPMG reported that the major reasons for financial statement frauds included the management override of controls for meeting market expectations and performance-based remuneration. Moreover, the

Figure 3
Forms of Financial Statement Frauds



frauds were often orchestrated by senior management and usually involved a group rather than an individual.

An alarming increase in the use of falsified documentation to give a semblance of legitimacy to fraudulent transaction has been observed. Financial statement frauds are the most costly type of frauds committed at companies. Companies engaging in fraud might make inadequate disclosures, fail to disclose issues at all (also called non-disclosure), or make false disclosures.

The revenue overstatement can occur through the early recognition of revenue, the booking of completely fictitious revenue, or an incorrect application of the accounting rules. Expenses can be understated by failing to book expenses, improperly capitalising the expenses, or not booking the returns and other credits.

A company can enhance its balance sheet by overstating assets and understating liabilities. Reserve accounts can play a role in this manipulation, and they are very pliable, given that the ending balances require the judgment of management.

A financial statement fraud provides an indirect benefit, in the form of increased stock prices, a greater value to stock options, continued bank financing, a

periodic bonus, a promotion, or a host of other financial results. Fraudulent financial statements are financial statements that are intentionally misstated in order to mislead users. The general users of financial statements include management, financial analyst, shareholders, suppliers and others. Financial statement fraud is the least common occupational fraud, but it is easily the most costly.

Financial non-disclosure and inadequate disclosure of relevant information affect the qualitative aspects of the statements. The classification of expenses as one-time rather than recurring can have a dramatic impact on the perceived financial condition of a company. Other issues, such as the impending legislation and pending lawsuits, require disclosure. Failure to make an adequate disclosure is a common practice among executives committing fraud. Traditional independent audit often does not detect fraud. Such audit is not designed to detect fraud. At times, an external audit does find fraud, but the users of financial statements should not count on this. Companies have to design internal controls with fraud in mind.

Financial statement fraud is a serious threat to the users' confidence in published audited financial statements. The capital market expects vigilant and active corporate governance to ensure the integrity, transparency, and quality of financial information (Rezaee, 2005).

The impact of financial statement frauds is to get higher remuneration by the management, to get loans from the banks or financial institutions by showing a rosy picture to them by creating fictitious revenue, failing to provide for bad or doubtful debts, and concealing liabilities and other expenses, with an intention to defraud the bankers.

Corporate Espionage

The term 'corporate espionage' has turned synonymous with 'industrial espionage'. With the intensification of competition and enlargement of profitability in business ventures, corporate officials began resorting to some innovative methods for

obtaining information of their rivals. Industrial espionage refers to all the undercover activities that are performed by entrepreneurs for acquiring information of their business rivals for commercial gain. Targeted victims of espionage activities range from rival business organisation to governmental agencies.

Information can make the difference between success and failure, or profit and loss account in the business world. Theft or infringement upon the intellectual property or secret information of a company is the aim of corporate espionage.

Corporate espionage is a threat to any business whose livelihood depends on information. The information sought after could be a client list, supplier agreement, personal rewards, research documents, and prototype plans for a new product or service.

As per the American Society for Industrial Security and Price Waterhouse Coopers, in 1999, 1000 companies lost more than \$ 45 billion from the theft of trade secrets. Insiders, who have immediate access to valuable information of the company and can misuse their privileges and may be stolen by outsiders who are spies, attackers, or hackers before using the related information and technology practices, may steal the trade secrets (Robinson, 2003).

A company can become victims of corporate espionage due to the following factors:

- 1 Social engineering;
- 2 Dumpster driving;
- 3 False pretenses;
- 4 Viruses and Trojan horses; and
- 5 Corporate identity theft.

As per the KPMG Survey Report (2010), theft of intellectual property and trade secrets are the major ways of corporate espionage and this type of frauds are common in IT and service-sector companies.

Corporate espionage not only leads businesses to bankruptcy but also affect the ties with friendly nations. Non-financial damages to business include

public embarrassment for a company, tarnishing of the corporate image, loss of business confidence among partners or shareholders and a public misconception that the company is a security risk. Out of the long-term effects of a corporate espionage is an erosion of the company's research and development base. The process of developing new idea and bringing them to fruition is very expensive, and the loss of resulting technology or research information can be financially debilitating. The national economic strength of a country is gauged in part by the health of its business firms and their ability to succeed in the global market place.

Thus, the effect of corporate espionage is almost wholly negative. This type of fraud can be prevented by keeping sensitive information secret and by putting a check on employees' behaviour.

Financial Statement Fraud and its Economic Impact

Any person or organisation can be affected by a financial statement fraud that has an interest in the success or failure of a company. A bank that gives credit to the company, a shareholder who invests money in the company, and the organisation that enters into a contract or agreement with the company, all can be affected if there is a manipulation in the company's reported earnings or assets. Employees can also be affected by the manipulation in the financial statement. It has the power to put employees out of work once the fraud is exposed. Good financial results (actual or fabricated) can be linked to promotions, enhanced salary and benefit packages, bonus, and the value of stock options.

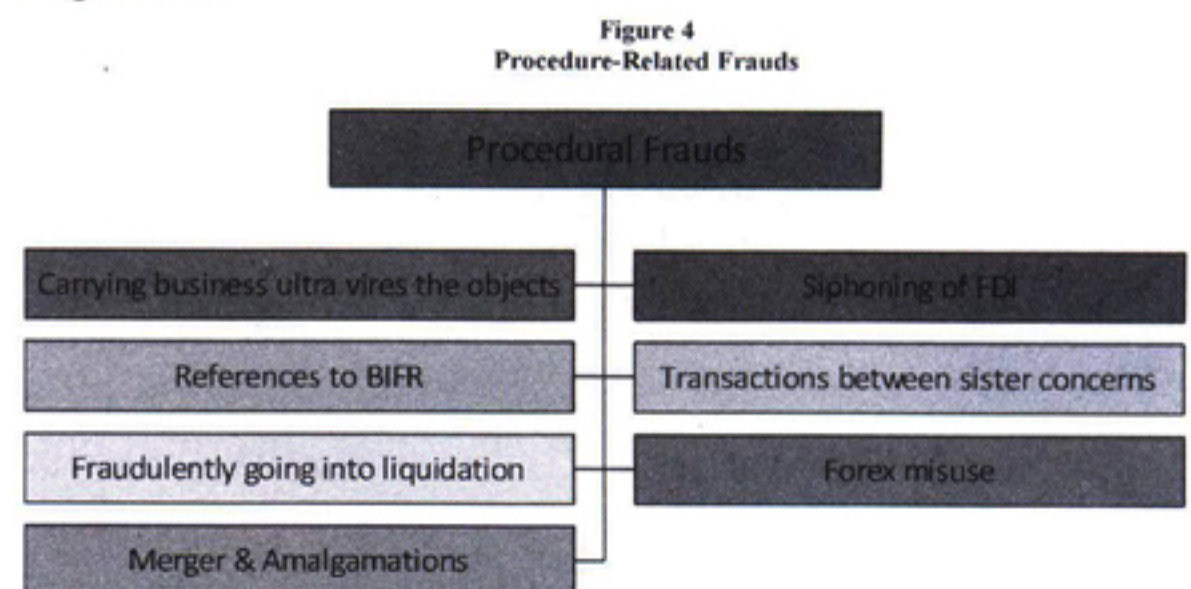
Financial statement fraud will cause shareholders to overpay for their investment in the company and to get less value for their money. Shareholders may lose part or all of their investment if the company fails or has to go through some sort of re-organisation. Financial statement fraud directly harms the investors and the creditors who lose all or part of their investment if such fraud results in bankruptcy, failure, reduction in the stock prices or delisting by the Stock

Exchanges. Financial fraud can also have an adverse impact on the confidence and the trust of investors, other market participant and the public in the quality and integrity of the financial reporting process. Users of financial statements will lose because of their wrong financial decision (e.g. non-investment in the case of investors made on unreliable, and misleading financial information).

Financial statement fraud contributes to considerable economic loss by investors and creditors.

Procedure-related Frauds

Different types of frauds are committed by over ruling or bypassing the procedures, and carrying on business ultra vires the objects, fraudulently going into liquidation, siphoning off of funds and related-party transactions. Understanding what motivates employees to steal from companies is the key to detecting and preventing internal procedure-related fraud. Major procedure-related frauds are shown in Figure 4.



Liberalisation of Indian economy and incentives for foreign earnings and Foreign Direct Investments are being used as tools for committing certain corporate frauds.

The modus operandi of such companies is to incur large expenditure on software development/technical know-how and to pay high salaries to their managerial and top personnel and to grant huge loans and advances, particularly to their sister concerns. Such companies either earn a negligible profit or incur loss. Such companies also siphon off funds to such projects where Foreign Direct Investment is banned.

Exporting companies which have Foreign Direct Investments often engage in Hawala transactions and do not do any productive work except create illegal wealth.

Large-sized public sector companies which misutilise the public money in order to continue to remain in business usually engage themselves fraudulently in pursuing objects which are not the main objects of the company and are in violation of the provisions of section 17 of the Companies Act, 1956. Such companies usually have negative net worth but wait for an opportune time on the basis of their large capital to attract the gullible investors into the project which is ultra virus their objects.

Companies which have either public stakes or financial stakes of banks/financial institutions after siphoning off the funds of the companies try to take immunity and seek cover of this fraudulent activity by obtaining winding-up order (usually getting winding up petitions filed by their own generated creditors). The motive of such companies is apparently illegal.

Certain companies belonging to a group engage themselves to invest in shares of other companies (belonging to their group). Such shares are purchased at the par value. The funds of the flagship company are routed through the investor company for investment in the investee company. After a short-time holding of these shares by the investor company, they are sold to individuals (who are directors/ relatives of directors of the investee company) at a rock-bottom price, say Re. 1/- per share, against the original investment of Rs. 10/- per share.

In the process, the valuable public funds of a flagship company are systematically siphoned off through the aforesaid investment route which finally lands up in the hands of a few individuals who maintain the controlling interest in such group companies. Such fraud goes undetected as any professional who audits the account in this regard makes no disclosure.

Siphoning off of funds between two or more companies is a procedural form of fraud. The material

sent by one company to another company for job processing undergoes several processes and the material comes back, and there is no disclosure of an inherent fraud on the quantities received back which are beyond the normal losses. There is no accounting for the scrap generated which does not come back to the company. This system results in the evasion of the excise duty and in many cases also sales tax. The transaction of sale/purchase with related parties is camouflaged by raising credit/ debit notes to give favourable prices to related parties, thereby putting the company to loss.

Corporate restructuring via strategic alliances is merger and acquisition due to the need to build differential capabilities in more areas than a company has resources or time to develop. The economic reforms and deregulation of the Indian economy have brought in more domestic and international players in Indian industries. The merger and amalgamation schemes are required to be approved by the jurisdictional high courts. The merger and amalgamation scheme are prepared with an intention to defraud the creditors, and to avoid government dues. The major cases are briefly described as below:

i) In Mohan Exports India Ltd., [In Re: [1999] 95 Comp Case 53 (Del)], the High Court refused to accord sanction to a scheme of arrangement on the ground that the said scheme was meant solely to affect transfer of valuable assets of the transferor company to the transferee company without payment of the government dues and the court found the scheme to be not bona fide.

ii) In Bedrock Ltd., [In Re: [2000] 101 Comp Case 343 (Bom)], the Bombay High Court found the scheme to be lacking bona fides because it was to ostensibly dispose of unutilised assets to pay off the creditors, and in reality to profit from the proceeds thereof.

It is seen that a large amount of money belonging to a Bank or the Financial Institution is systematically siphoned off and such cases are referred to the BIFR either for a rehabilitation package, or for winding up.

Impact of Corporate Frauds on Business and Society

Corporate frauds can have a devastating effect on the business firm in which the fraud has occurred. Such effect on the organisation is due to the fact that an individual who is employed by the organisation has knowledge of the financial system, as well as company's confidential information, and is able to manipulate them over a period of time. These individuals also have a working knowledge of the various counter-frauds, counter intelligence, and security procedures, which have been established, and can find ways and methods to circumvent the counter-fraud and security counter measures, which have been put in place.

The loss in the organisation can also have an impact on the local, state or national economic conditions based on the size of the business affected by the fraud. With the lack of policy in an organisation's business, there is an inherent lack of control. This can be the lack of control of systems, programs and even people.

When a company suffers a loss from fraud, it would make up for it by raising the costs, which ultimately means higher prices for consumers. It can also mean less pay for employees and even cutting of jobs. The effect can continue to ripple when it comes to those employees or investors who now find themselves unable to pay off the loans, and the credit becomes harder to obtain.

The fraud can also have a social impact on the organisation. It can allow the organisation to lose the confidence of the company's stockholders of the organisation. It can also contribute to a loss of confidence in the organisation by its advertisers. The negative publicity from the media can also impact how the organisation is perceived and supported by the community in which the organisation operates as well as its customer-base. The cumulative effect on all of the negative circumstances may also have a major impact on the organisation's reputation and stock value which often lead to the closure of the business or an unprecedented loss of revenue.

Concluding Remarks

With greed dominating the thought process and the action of a large number of persons, frauds have acquired an undesirable but inevitable presence in the corporate world. Corporate frauds and misconduct remain a constant threat both from the macro and micro perspectives of the economy.

A transparent, ethical, and responsible corporate governance framework essentially emanates from the intrinsic will and passion for good governance, ingrained in the business entity. The global financial crises during the recent past, along with some of the large corporate failures and frauds, have revealed that while the corporate governance superstructure in India is fairly durable, there are certain weaknesses that while the corporate governance superstructure in India is fairly durable, there are certain weaknesses that might have their roots in the ethos of individual business firm.

Corporate frauds assume different forms and types reflecting the tripartite relation between key components, viz, motivation, rationalisation, and behaviour.

Most of the studies contribute to the fact that corporate decision makers have a strong incentive to commit fraud. Legal penalties that are substantial to both the firms and managers should deter themselves. The complexity of corporate frauds can be attributed to the fact that various modes are used in indulging in corporate frauds, which are not easily detectable. The studies on the unethical decision-making on part of managers are limited in Indian context in spite of large cases of reported frauds and the sum involved. Also, given the established weaknesses in the statutory and corporate governance framework, it motivates to examine what is the nature and consequences of fraud to the business and economic systems and the modifications in the regulatory framework required.