

Kıymet Çalüyurt  
Samuel O. Idowu *Editors*

# Emerging Fraud

Fraud Cases from Emerging Economies

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## Emerging Fraud



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Kıymet Çalıyurt • Samuel O. Idowu  
Editors

# Emerging Fraud:

Fraud Cases from Emerging Economies

*Editors*

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## Foreword

I have been privileged to attend the annual International Conference Series on Governance, Fraud, Ethics and Social Responsibility (IConGFE&SR) organized by Assoc. Prof. Kzynet Tunca Çalzyurt who is Manager of the Social Graduate School of Trakya University. These meetings have always provided enormous interest to anyone interested in fraud risk management and forensic accounting. Not only are papers presented by academics but also by regulators, civil servants, and investigators.

Fraud and white-collar crime are prevalent across both developed and developing countries. Both the explicit costs (in terms of detection, investigation, prosecution, recovery, and prevention) and implicit costs (in terms of the impact they have on the safety by which ordinary economic transactions are conducted and savings and investment are made) are enormous.

Even though there are many cultural and regulatory differences across countries and states these costs are always high. What may be ethically acceptable in one country may not be in another, and what may be unlawful in one may not be in another. In any meaningful study of the nature of the fraud and its consequences, it is necessary therefore to understand a sufficient amount of detail as to how the fraud was perpetrated. The cases presented here contain that.

As a result of internationalization, cross-country frauds are becoming increasingly common. They are not restricted to identity theft and credit card fraud but most other conventional frauds, thefts, and scams. This raises many new problems for prosecutors and legislators. These frauds are not only facilitated by the Internet, but it also makes them much easier to perpetrate. In the past, the ability to be a confidence trickster involved a variety of skills. Now, the Internet enables the perpetrator not only to avoid face-to-face contact but provides him (or her) with complete anonymity. Documents no longer need to be “forged”; a simple scan may be sufficient. Perpetrators no longer even have to develop scams; copycat frauds and scams are rife. These developments not only make perpetration easier and cheaper, but also remove the individual from ethical awareness and responsibility, allowing him (or her) to hide behind the computer screen.

It is sometimes the case both in corporations and in business education that these matters are ignored, sometimes to the extent that as if they do not exist. But what is

the point in wealth creation if it is stolen from you? Such denial is not healthy. These problems and issues need to be confronted and combatted. This book can only help and I commend it to you.

Sydney, Australia

Paul Barnes

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## Preface

Fraud is a scary and unacceptable practice in any business environment. To pretend that fraudulent practices are not rampant in this modern age of the Internet, where it is possible for anyone, anywhere in the world with easy access to a personal computer (PC) or cellphone, to hide behind these gadgets and easily transact business across national borders using the world wide web (www), is to demonstrate a high level of ignorance about life in the twenty-first century. This is perhaps a micro perspective of the problem.

Fraud is not only a phenomenon of the Internet; in other words, fraud is not only committed by those you did not know or have never met—total strangers. Recent well-publicized cases of fraudulent acts by some senior executives of companies which have led to serious consequences in some developed economies and perhaps some unpublicized ones by corrupt and dishonest employees and senior executives in many developing economies provide us with enough evidence to believe that the crime is probably a global one. This, so to speak, is our understanding of the macro level of the problem and the area most of the chapters in this book have focussed on—executive and employee perpetrated fraud.

From what has been said in the two preceding paragraphs above, our readers would probably have been forewarned that fraudulent practices are not only aimed at or perpetrated against individuals through either the Internet or some other means but also against corporate entities by either total strangers or their own employees and some senior corporate servants. This was why we believe that the publication of a book such as this one would be a welcome reading around the world in order to alert corporate leaders, legislators, and other stakeholders of the real threat the problem poses to both the bottom line corporate survival and economic development of nations.

When fraudulent acts are committed against a corporate entity, a host of its stakeholders are adversely affected in one way or another. Its shareholder's wealth is eroded, employees might end up losing their jobs and future livelihood, suppliers and loan creditors might end up getting little or nothing when the entity folds up due to insolvency, the government might lose revenues from corporate and personal taxes and in addition must bear the social costs of the ensuing social and economic problems, customers might end up losing a valuable supply source for goods and services, and even the local community might experience a decline in people's



prosperity and consequently have to face a series of social and economic problems. The chain of resulting consequences might be endless.

The resulting problems are everybody's business; it is therefore important that we should all pull resources together to find solutions to this unacceptable "white-collar" crime as it is sometimes called which directly or indirectly affects us all.

London, UK  
Edirne, Turkey

Samuel O. Idowu  
Kıymet Tunca Çalıyurt

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## Acknowledgments

Our first “thank you” goes out to all those who have assisted us in making the publication of this edition of the book a reality—our contributors who are stationed in different countries around the world. We are indeed very grateful to you all.

We would also like to thank to members of the International Group on Governance, Fraud, Ethics and Social Responsibility and the Scientific Committee members of the International Conference.

They have also ensured the success of the publication.

We would equally like to thank some of our friends and colleagues for being there for us during the preparation and final stages of the book. Maurice Pratt of London Metropolitan Business School, UK, thank you for reading one of the chapters for us.

Finally we would like to thank our respective families for their unwavering support when things became a bit more challenging for us as a result of our other commitments.

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### **Samuel O. Idowu**

Samuel O. Idowu is a senior lecturer in accounting at the city campus of London Metropolitan Business School, London Metropolitan University, UK, where he was course organizer for Accounting Joint degrees and lately the Course Leader/Personal Academic Adviser (PAA) for students taking Accounting Major/Minor and Accounting Joint degrees. He is a fellow member of the Institute of Chartered Secretaries and Administrators, a fellow of the Royal Society of Arts, a Liveryman of the Worshipful Company of Chartered Secretaries & Administrators, and a named freeman of the City of London. Samuel has published about 40 articles in both professional and academic journals and contributed chapters in edited books. Samuel has been in academia for 24 years, winning one of the Highly Commended Awards of Emerald Literati Network Awards for Excellence in 2008. One of his books which he edited with two others won the 2011 Cambridge University Top 40 Sustainability Books. He has examined for the following UK professional bodies: the Chartered Institute of Bankers (CIB) and the Chartered Institute of Marketing (CIM) and has marked examination papers for the Association of Chartered Certified Accountants (ACCA). His teaching career started in November 1987 at Merton College, Morden Surrey; he was a Lecturer/Senior Lecturer at North East Surrey College of Technology (Nescot) for 13 years where he was the Course Leader for B.A. (Hons) Business Studies, ACCA, and CIMA courses. He has also

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She has published papers and book chapters both nationally and internationally on fraud, social responsibility and ethics in accounting/finance/aviation disciplines and NGOs.

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Dr. M. Nauman Farooqi is an associate professor and Coordinator of Norway and The Hague International Exchange Programs in the Department of Commerce at Mount Allison University in Canada. He is also the current chair of the university's Research Ethics Board. Dr. Farooqi's corporate experience includes serving as the Chief Executive Officer (CEO) of a money management company where he successfully launched a multi-million Dollar mutual fund. His public sector experience includes a World Bank funded consulting assignment with the Privatization Commission of Pakistan. Dr. Farooqi has taught extensively on M.B.A., Executive M.B.A., and B.B.A./B.Com. levels. He was awarded the Paul Pare Award for Excellence in recognition of his excellence in both teaching and Research at Mount Allison University, Canada, in 2005 and 2006. He was also the award winner for the Student Administrative Council's Teaching Award for the Faculty of Social Sciences in 2005. He was also nominated for the prestigious 3M Teaching

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Dr. Yüksel has received four best paper awards at various international conferences. She has been nominated several times for the Faculty of Economics and Business Teaching Awards and was awarded the Dean's Citation for Outstanding Teaching, at the University of Sydney. Dr. Yüksel is a research active academic member of the Faculty. Her research interests include international marketing, cross-cultural marketing and consumer behavior, culture and consumption, anti-consumption behavior of consumers (public policy, political marketing, and boycott behavior), and consumption choices under risks and self-threat. Her research explores consumers' evaluations and decisions as they involve counting on, trusting, following, or reacting to events; others include brands and products together with consumer information processing in relation to brand, corporate, country image, and cultural perceptions.

Dr. Yüksel teaches and has taught various marketing subjects at the following institutions; Sydney University, Michigan State University, and Technical University of Istanbul in the following areas: Marketing Management, Services Marketing, International and Global Marketing, Integrated Marketing Communications, Advertising Management, Consumer Behavior, Sales Management, Marketing Research, and Introduction to Management.



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## Seven Social Sins in Today's World

*Wealth without work  
Pleasure without conscience  
Knowledge without character  
Commerce without morality  
Science without humanity  
Religion without sacrifice  
Politics without principle*

Mahatma Gandhi



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# Emerging Fraud: Some Introductory Comments

By

Kıymet Tunca Çalıyurt, Graduate School, Trakya University, Edirne, Turkey  
&

Samuel O. Idowu, London Metropolitan Business School, UK

This book, “Emerging Fraud: Fraud Cases and Emerging Economies” is the first in a series of books to be published by the International Group on Corporate Governance, Fraud, Ethics and Social Responsibility (IGonGFE&SR), which organizes International Conferences on Governance, Fraud, Ethics and Social Responsibilities (IconGFE&SR).

IGonGFE&SR and IconGFE&SR network were founded by Assoc. Prof. Kıymet Tunca Çalıyurt who is a Manager of the Social Graduate School at Trakya University, Edirne, Turkey. The main aim of the network is to bring together academics and practioners from around the world who research and work in the areas of accountability, fraud, ethics, and social responsibility, in order to create and increase awareness on issues relevant to these areas and disseminate the results of their studies using this internationally recognized platform.

This book has several tenures. The first one is that it focuses on both theoretical and practical information on fraud in countries around the world with particular emphasis on developing countries. Another tenure is that chapters were written by scholars who are leaders in the field in their respective countries. Readers are provided with information on fraud and related issues from Turkey, India, Australia, Canada, Romania, Nigeria, Pakistan, and Slovenia.

Corruption has increased dramatically in the world since the 1980s and a peak level was observed in the first decade of the 2000s. It was also observed in general terms that attempts made to develop and implement new legislations to ease the burden of fraud cases have been mostly unsatisfactory globally, but in particular in many developing economies. This is still the case within the small and medium size enterprices (SMEs) and across sectors which rely heavily on the internet to conduct their commercial activities. “Emerging Fraud: Fraud Cases and Emerging Economies” intends to fill an important gap in the attempt to detect, prevent, and fight against fraudulent acts by anyone regardless whether they are within or outside an entity.

The reader for this book is academicians, practioners, policy implementing institutions, business and management students, and the general public. We hope



that the book provides the additional scientific contributions needed to expand the fraud literature and to help scholars who research in the area.

The book has been divided into four parts: Part I, which focuses on a general overview of issues relating to fraud, is made up of six chapters. Part II focuses on pertinent cases in the crime of fraud and other antisocial white-collar crimes from three countries. Part III explores in two chapters fraud from banking and marketing professions. Part IV is a chapter on summing up.

Çaliyurt in the opening chapter of the book on “*Reporting Fraud using the Fraud-Free Company Model: A case for the SMEs in Emerging Economies*” considers the problem of fraud in the very vulnerable SMEs. The chapter suggests that small- and medium-sized enterprises which are determined to guide against this white-collar crime should use what Çaliyurt calls the fraud-free company model. The model the chapter notes is suitable for all SMEs regardless of whether they are based in the developed or developing world. The model could be used by them all, in order to reduce the incidence of the so called *white-collar crime*—fraud.

Özkul and Pamukçu in a chapter on “*Fraud Detection and Forensic Accounting*” explore the relatively new field of *Forensic Accounting* and the roles of internal and external auditors in the fight against the crime of fraud. The chapter gives a particular consideration to the issue in four developed economies—the UK, Canada, Australia, and the USA.

Çitak in Chap. 3 critically analyzes the effects of measurements on multinational companies’ (MNCs) scandals—the Fraud Act. The chapter critically assesses the effect of Sarbene-Oxley Act of 2002 in the United States of America on financial reporting.

*Forensic Accounting for financial malpractices in developing countries: An analytical review of the state of the art* is the theme of the fourth chapter of the book. Sadiq the author of that chapter looks at the meaning and nature of forensic accounting, what forensic accountants do, and the nature of corrupt practices in developing economies while focusing especially on his country of origin—Nigeria.

Trifu in a chapter on “*The double way interrelationship between the shadow economy and the economic growth*” explores in detail the effects of shadow economy and development. This author notes that any government wanting to revive its economy must ensure that it discourages the incidence of shadow economy and the temptation by its citizens and those multinational corporations that operate within its borders. This should hopefully, argues Trifu, ensure the impulse to investments and development in all the country’s economic domains.

Farooqi in a chapter entitled “*What is Hawala? An Introduction to the multi-billion dollar informal value transfer system*” provides a detailed explanation of how Hawala works, and what it entails. Farooqi argues that some misinformed activists are lobbying for the abolition or regulation of Hawala operations, but he believes that the best method to stamp out Hawala is to encourage its open operation in order to reduce its economic advantages.

Dubrovski in the seventh chapter on “*Fraud as a distinctive part of management mistakes in countries in transition*” writes from the perspective of Slovenia and

highlights how managerial mistakes could impede economic development of an emerging economy.

*Kaur* in a chapter on “*Corporate Fraud: Auditors and Managerial Liability*” provides a situational analysis of the failure in corporate governance and inappropriate accounting practices to save a one-time Fortune 500 listed Indian company *Satyam* from becoming “India’s Enron.”

Chapter 9 of the book on “*The effect of corruption on country level-investment: The case of case of Pakistan*” by *Gohar, Shariq, and Azim* provides a comprehensive assesment of the effects of corruption on Foreign Direct Investments (FDIs) in different parts of the world with particular reference to Parkistan.

The penultimate chapter by *Mermud* on “*Fraud in modern Banking—Highlights on on-line Internet Banking Fraud*” argues that the banking sector was probably the most affected globally by the incidence of fraud. The chapter looks at the various methods used by internet fraudsters around the world.

The final chapter on “*Fraud in Marketing and Consumption*” by *Yüksel* looks at the incidence of fraud in Marketing by customers and corporate entities. The chapter considers some of the unacceptable practices going on in marketing and argues that customers and some marketers are both involved in these fraudulent acts.

In a concluding chapter entitled “*Emerging Fraud: The summing up*” by *Idowu* argues that for these antisocial white-collar crimes—fraud, bribery, corruption, false accounting, and other unacceptable social ills of our time need to be wiped out of our systems through our concerted efforts and we are all capable of achieving this goal by our individual and collective actions.

We hope that the first book in the series meets your requirements and also that you would bear with us for any mistakes and/or omissions that may appear anywhere in the book. No harm or disrespect was intended to anyone.

Associate Professor Kıymet Tunca Çaliyurt  
Samuel O. Idowu  
Editors  
Summer 2011



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## **Part I**

# **A General Overview of Fraud**

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# Reporting Fraud Using the Fraud-Free Company Model: A Case for the SMEs in Emerging Economies?

1

Kıymet Tunca Çalıyurt

We shall require a substantially new manner of thinking if mankind is to survive

– Albert Einstein –

In the ever more competitive platform where modern companies operate, they have had to experiment with new types of management ethos in order to keep up with competition. These new types of management aim to improve companies' image in the eyes of the public, to increase turnovers and add sustainable values to their bottom lines. It is often the case that some of the desired actions necessary to achieve these goals are possible in practice while some of them are only possible in theory.

In recent years, the goal of embedding sustainability and sustainable development, social responsibility, and good corporate governance in corporate practices continues to pose many challenges to the twenty-first century companies' operational activities. Social responsibility, ethics, corporate governance, and fraud are subtitles of sustainable development. Sustainable development is a concept often used to describe mankind's ability to create a world which is environmentally conducive for him and other life forms to exist. Blackburn (2007) in fact argues that sustainable development is a state of existence where the current generation of man and all other life forms is environmentally, socially, and economically sufficient without damaging the ability of future generations to take care of themselves (Blackburn 2007, xiii). It is often the case that in some parts of the world, fraud is ignored by those who make economic decisions on behalf of others. It is, however, a vital issue for being socially responsible.

Those responsible for making economic and social decisions on behalf of others should understand and be aware of the Brundtland Report as it relates to fraud. The 1987 Report defines sustainable development as *"a development that meets the needs of the present without compromising the ability of future generations to meet their own needs"* (Brundtland Report 1987). If fraud is perpetrated in the company, then corrective actions need to be taken; otherwise sustainability of the company would be made much more difficult.

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The term “White-Collar Crime” was first used by Edwin H. Sutherland during the speech he made to the American Sociological Association in 1939 (Aydin 2006). A lot of things have changed with regard to the white-collar crime against businesses since 1939: there was no world wide web in 1939 and the world was a lot poorer in many respects that year when Sutherland made his speech. The drive for higher profits and higher stock values which could encourage fraudulent actions to be taken was less intense than Morale was undoubtedly higher fraud (or white-collar crime) and related issues were probably alien to most people.

Our world is now a very different place. There are many agencies involved in the drive for corporate entities to take sustainable actions which would enable them to inculcate fraud preventing and detecting actions in their strategies; for example, the Global Compact suggests a principle on fraud which it encourages corporate entities to weave into their system of control. The principle states the following:

Businesses should work against corruption in all its forms, including extortion and bribery.  
(The Global Compact, Principle 10)

Despite some of the actions which have been taken to date, some of the more successful companies that issue nonfinancial reports like social responsibility reports, sustainability and corporate governance reports, in addition to their traditional annual financial reports continue to be threatened with survival issues; for instance, with liquidation because of the now rampant global disease of “white-collar fraud” which pervades our world as a result of many factors, for example, the massive increase in the use of the world wide web technology—the Internet.

To complicate issues further, some of these fraudulent practices were not committed by total strangers to these companies, but were in fact perpetuated on them by those who were statutorily given the *stewardship* role to steer the corporate wheel to success—managers (see, for example, the case of Enron which proved that “prevention fraud” should be included in management practices). Cases such as this have made it more compelling that all corporate entities should take the issue of “fraud” seriously and make it a top priority in their corporate agendas. It also suggests that companies should be more transparent with their shareholders and other interested stakeholders if fraudulent acts were perpetrated on the company either internally or externally. It is often the case that misinformation or lack of information complicates matters unnecessarily.

More transparency means more reporting, employing more competent staff, and more expenditure on pertinent issues. Being transparent might initially be perceived as an obstacle in the short term but could in fact be a source of many value-adding benefits to the companies in long term. These actions should hopefully place companies in a stronger and more effective position when things are done properly with little or no room for laxity.

Experiencing fraudulent acts could have a devastating effect on companies. However, the prior goal of companies should be to “stand free” after the event unless it occurs within their will. “Free standing” may be in different ways, but what

every establishment wants is to maintain “the faculty of standing free as long as it desires.” A few questions need to be answered, for example:

- How can this be achieved?
- In what ways would the “intra-corporation frauds” that unwittingly result be avoided?

The only solution is that companies should utilize the “Science of Prevention and Examination” in their systems of management—which should facilitate effective implementation and supervision of pertinent activities.

Implementation is related to ethics, social responsibility, corporate governance, sustainability, and accountability, which are ingredients of success but are difficult to come by in a company that experiences “fraud” in its day-to-day existence. Some of these internally perpetrated fraud cases have led to a situation where confidence in financial statements has been badly shaken. Hence, it has now become apparent that perpetrating “fraud” on companies is unacceptable and would make it difficult for such companies to be successful in all their operational activities.

Publicly listed companies in both developed and developing countries have taken a series of actions to fight against internally committed fraud (see, for example, Sarbanes-Oxley Act 2002 or the Public Accounting Reform and Investor Protection Act; popularly known as the SOX Law in the USA and The Cadbury Committee’s—The Code of Best Practice (the Code), December 1991 in the United Kingdom). Despite these attempts by governments of different countries around the globe, news of fraud continues to come from both developed and developing countries around the world. Global fraud losses are estimated in the Association of Certified Fraud Examiner’s 2010 “Report to the United Nations” at 5% of the world’s gross domestic product (GDP). In the USA, this comes to USD700 billion (Ratley 2010, p 5).

Unfortunately, Entrepreneurs of Small and Medium Enterprises have fallen far behind larger companies around world in this issue. This was perhaps because some countries have not taken enough steps to install the necessary protection required in this regard by SMEs within their economies. There are several possible reasons for this, for example, the absence of legislation, lack of expertise on the part of those in corporate management to put in place the necessary implementation and inspection mechanisms in order to monitor their operational activities, and reinforcement of issues relating to accountability in their agendas for SMEs’ protection.

Our recommendation to companies which aspire to be successful in substantiating their implementation policy on fraud is that they should take effective actions to put in place a corporate management team which is socially responsible and reports on how they are dealing with sustainability and sustainable development issues which are perceived as useful ingredients of success in today’s global market.

Recently, it was discovered that the concept of modeling and rating of “fraud-free company” was used for the first time in the literature. This concept has some relevance when dealing with white-collar crime—fraud. The question to ask then is “What is a ‘fraud-free company’ in this context?”

## 1.1 The Fraud-Free Company

A “fraud-free company” is one that internalizes and implements scientific techniques of prevention fraud in every step of the company’s management. It involves the implementation and supervision of its systems in order to elucidate all the steps and actions it has taken, in the company’s annual Fraud Prevention Report.

“Fraud prevention techniques” shown below should be internalized by a company in all its systems and implementation processes in order to become a “fraud-free” company. The issues involved are listed below:

- Internal supervision and control procedures that are elucidated in every platform
- Corporate management
- Ethical codes and implementation procedures
- Implementation of issues relating to social responsibility
- Internal control of its accounting systems
- Disclosure requirements of its financial and nonfinancial reporting systems

The company should elucidate details of the practice in fraud prevention it has implemented in all its systems in the Annual Fraud Prevention Report. The Annual Fraud Prevention Report is a new reporting method which any company that chooses to adopt the method would find useful. In recent years, some SMEs have made progress by changing their status from limited to public limited companies (PLCs) by being listed on their country’s stock exchanges. The new reporting standard is designed to improve the reputation of those companies adopting its use with regard to fraud. It is possible to initiate this through full listing on stock exchanges, since the use is currently voluntary but would in due course become mandatory. Moreover in time, the public opinion would perhaps demonstrate confidence in those companies which elucidate fraud prevention reports, through different actions, for example, through the buying of their shares by investors and/or through the purchase of their goods and services by customers. The consequential effect of this would be that the companies which elucidate these reports would become more popular with stakeholders when compared with companies which fail to adopt the standard. Fraud Prevention Reporting would invariably become very important in raising awareness and confidence in the SMEs as a result of their perceived actions against fraud practices.

In the **Annual Fraud Prevention Reports**, companies would be expected to disclose the actions they have taken to internalize the fraud prevention techniques—information would be disclosed on the steps they have taken with reference to internal supervision and control procedures, corporate management systems, determining and implementation of ethical codes, social responsibility initiatives installed, disclosure of information in their financial and nonfinancial reports, and control procedures in the accounting systems. Figure 1.1 exemplifies this model.

The case of Enron in the USA noted above has clearly demonstrated to the corporate world that the resultant effect of not coming clean on the issue of internally inflicted fraud is liquidation followed by a series of unhappy events,





**Fig. 1.1** The Fraud-Free Company model

not the least the adverse effects it would have on a long list of innocent stakeholders. It was noted that Enron's share price rose to about US\$90 level when things were in fact not in order only to fall to a level of less than US\$1. This was an indication that it is possible for a company that is experiencing a high level of internally inflicted fraudulent acts to mislead the market and general public by displaying and indicating that its performance was indeed very good when the reverse was in fact the case. A company which indulges itself in internally inflicted fraud could either go in liquidation or be taken over by another company. This does not necessarily mean that its stakeholders would derive the maximum benefits from the takeover. The company would have involuntarily lost its status of free standing because of fraud. For this reason, a company which does not internalize *Fraud Prevention precautions that also involve delinquency* in every step of management–implementation–supervision cannot hope to achieve the desired success it craves for any more even when it implements sustainability, social responsibility, ethical codes, and effective corporate management initiatives.

Fraud in SMEs is a corporate disease that brings along many delinquencies and changes for the managers. And those companies which are unfortunate to catch this disease would find it difficult to be free standing, in which case they would inevitably be absorbed by corporate hunters.

## 1.2 Grading Companies Using the Fraud-Free Company Model

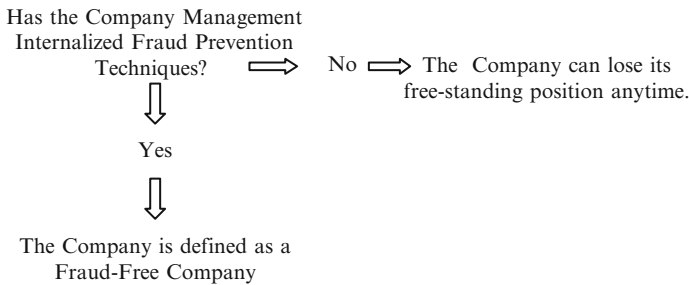
Companies implementing the Fraud-Free Company Model should be graded. There are many reasons why grading should be undertaken for these companies and some of them are listed below:

- Those companies which have taken adequate measures against fraud through their activities in terms of their expenditures and control systems are likely to enjoy the confidence of their stakeholders and the stock markets. Grading in terms of the aforementioned criteria would differentiate these companies from others as a result of their efforts in prevention fraud.
- Another reason for grading is that it is important for a company to disclose the level of its protection against fraud to its stakeholders, especially potential shareholders in developing countries where SMEs often find it very difficult to attract investors because of the high level of internally perpetrated fraud.
- Planning and budgeting are important for a company that wants to move on to a higher grade.

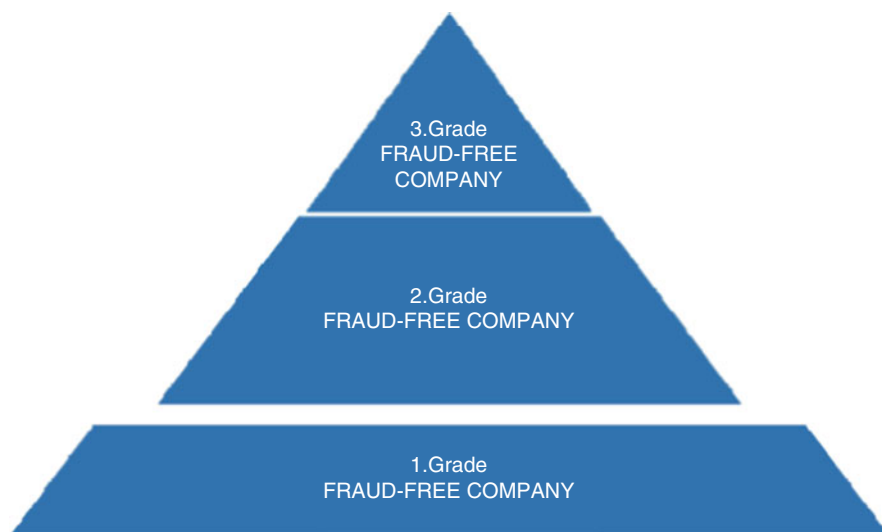
The flow chart in Fig. 1.2 describes what determines whether a company is a fraud-free company or not.

Figure 1.3 above depicts the three grades under which companies are capable of being categorized in the rating model. Initially, all companies are assumed to fall in the upper third grade of Fraud-Free Company Rating Measures. Companies in the upper third grade take adequate steps against pilferages which automatically protect them against fraud which could be perpetrated by both internal and external stakeholders. For this reason, every company has (even the smallest level of) protection mechanism in its systems against fraud.

This model can be used in developing countries, especially by equity investors and loan creditors who are willing to provide funds and loan credit to SMEs.



**Fig. 1.2** Flow diagram of a fraud-free company



**Fig. 1.3** Fraud-free company rating

In time, this model can become widespread and transform a third grade fraud-free company to a first grade one. There will be much difference in trust between a first grade fraud-free company and a third grade fraud-free company. The companies which issue Annual Fraud-Free Company Reports would come into prominence.

Section 1.4 below looks at the features of the three ratings of fraud-free companies.

## **1.3 Features of the Three Ratings of Fraud-Free Companies**

### **1.3.1 Features of a First Grade Fraud-Free Company**

The following are some of the features which a first grade fraud-free company should possess.

- The definition of intra-company fraud is clearly indicated, and it is also stated that it is a delinquency against which corporate managers have put in place appropriate sanctions to deal with any incidence relating to it.
- Fraud Prevention Program should be implemented in the company.  
*.....that building a good fraud prevention program is an extremely difficult task. Accountants and auditors must be sensitive to the needs of the business by instituting controls that will prevent or detect fraud without impeding business activity (Louwers et al. 2011). Independent auditors have the responsibility for fraud prevention in the company. Statements of Auditing Standards 99 states that “The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising Professional skepticism, the auditor should*

*not be satisfied with less than persuasive evidence because of a belief that management is honest” (SAS 99). This regulation requires the audit committee to always organize a meeting for brainstorming on fraud (Citak 2009).*

- Fraud Risk Assessment should be prepared and revised for the company.  
*...that auditing standards issued in recent years have brought into focus the auditor’s consideration of a client’s control environment and fraud risk assessment SAS No:109 emphasizes the importance of the control environment for mitigating risk of fraud. (Sanchez 2007).*
- Procedures for dealing with internal control and supervision of the company’s control systems are revised annually by the Fraud Investigation Experts.  
*...that corporate fraud can be classified into two broad categories: (1) frauds directed against the company and (2) frauds that benefit the company (Singleton et al. 2006).*
- The company has installed the latest technology to protect against the incidence of fraud.  
*... that the department of Justice defines cyber crime as “any violations of criminal law that involve knowledge of computer technology for their perpetration, investigation, or prosecution.” When the crime involves Money, it is usually referred to as computer fraud (or e-fraud). Sample types of cyber crimes is computer intrusion, credit card fraud, ID theft, online e-mail extortion. ... (Pearson and Singleton 2008)*
- The company regularly works with Fraud Investigation Experts to ensure that its systems are robust in dealing with any occurrence of fraud.
- The company elucidates an Annual Fraud Prevention Report.
- The company employees are properly trained in respect of planning and dealing with any incidence of fraud.
- Organizational Fraud Risk Assessment is used in the company.  
*.....that the preparers of the risk assessment documentation need to answer three questions. Are fraud risks identified? Are internal controls linked to the fraud risk? Are fraud risks reduced to an acceptable level? (Vona 2008)*
- Prospective employees who are deemed to have received rigorous trainings in dealing with preventing the occurrence of fraud are given priority during a company recruitment and selection exercise.
- Information about the company’s activities concerning prevention and dealing with the incidence of fraud is shared with shareholders and other stakeholders in plenary sessions organized by the company.
- Fraud prevention activities are being reported within the company to related parties regularly.  
*...that information blockage is a pervasive problem within large corporations (Cohan 2002).*
- Continuous Monitoring is being used for fraud prevention.  
*.....that continuous monitoring is an evolving use of technology to improve operations integrity and information and transaction quality (Cangemi 2010).*

### 1.3.2 Features of a Second Grade Fraud-Free Company

- In suspicious circumstances, the company brings in fraud investigation experts in addition to independent supervision and interior supervision service.
- The company involves the service of independent and interior supervision experts.
- The company involves audit plan for potential risks like risk management, information technology risk, and operational risk.

*.....that according to PricewaterhouseCoopers' report (PwC 2010) which found that increasing areas of focus in audit plan in the next 3 years as follows; (risk management 91%, information technology risk 83%, operational risks 81%, emerging risk identification 78%, regulatory and policy compliance 78%, strategic initiatives and programs 69%, special requests 67%, financial controls 67%).*

### 1.3.3 Features of Third Grade Fraud-Free Company

- The company is neither involved in any particular activity which could prevent fraud nor incurred any fraud prevention expenditure. The owners and managers of the company have their own planned measures.

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## 1.4 Fraud-Free Company and the Developing Countries

Every company wants to plan about how it could increase its size, be free standing, and how it could collaborate and develop with other companies. Unfortunately, even those companies which believe that they are properly managed and are performing well have also discovered that they are not immune against “the disease of fraud” that affects most companies, especially after the fraud incidence experienced by many companies in the 2000s. This problem has resulted in many companies taking a series of steps to deal with the problem. But several studies continue to suggest that a growing number of companies believe that the incidence of fraud would continue to increase as the twenty-first century wears on.

The reality in many emerging economies is that the way the incidence of fraud affects corporate entities is substantially different as one moves from one country to the next. Since the main subject of this book focuses on emerging economies, the new concept—fraud-free company (which is believed to have been used and introduced for the first time in this book), deals with the incidence of fraud, and emerging economies would be explored together in this chapter.

It is crucial to note that regardless of which country or with which perspective one looks at the issue, every event is perceived differently in different countries, by people and establishments at different levels. While financial, social, and cultural progressions present a distinct importance to developed countries, their reflections on developing countries are quite different.

Fraud at corporate level is not just a minor or an isolated issue. Fraud is one of the many serious problems facing all economies, regardless of whether they are developed or developing. It, therefore, means that a unified approach is required in solving the problem. The problem is also one of the remaining obstacles standing in the way of forming a fair financial system worldwide. Considering that some developed countries have taken adequate measures to dealing with the problem should not be perceived as a success, since this would only be a temporary solution to dealing with the problem. Our world is now often referred to as a global village, with free trade between countries being the order of the day. It, therefore, means that any country which fails to formulate an adequate strategy to improve its international trading activities would face a series of fraud-related financial problems.

The existing direct relationship between the developed countries and the developing countries in which international business is transacted is perhaps one of the many reasons which have necessitated us to looking at the issue of “fraud” from different perspectives. Many reasons could be advanced for why developed countries are involved in economic transactions with the developing countries of the world. Some of these which are listed below make them part of the causes of fraud-related problems in these countries:

- Cheap labor
- Cheap raw material
- Cheap sales and communication offerings
- Low facility and establishment expenditures
- Cheap natural resources
- Lower taxation rates
- Modern Information Technology Systems and others

Some companies headquartered in the developed countries which operate in several developing countries face serious problems in their host countries because of the informal platforms of existence some of them use when transacting business. These companies work very hard to ensure that they remain ethical in their dealings. The following examples can be given for those situations:

- Existence of the informal economy in many of these countries
- The absence or failure to implement fraud prevention and examination legislations
- Even the informality, fraud, or unethical practices which go to the court are not dealt with quickly by the court, which lead to frustration by the plaintiffs

In a situation like this, the company has a choice of either choosing to orientate itself to the environment, that is “take a stance of; if you cannot beat them, join them” or leave the country altogether. It might choose to register a complaint about the problem to the relevant watchdogs or authorities in the country. The success of making a complaint in many of these countries is hard to predict because of cultural differences. If a company were to experience an incidence of fraud in a country, the most reasonable action that the company should take is to work in cooperation with international fraud prevention institutions and with their national connections in order to reduce the incidence of fraud.

What is being emphasized here is that a company which is carrying on business in a developing country, which has no problem with informality and fraud in its

home country, cannot isolate itself from the informality and fraud incidence in its developing country of operation. Yet some companies prefer to trade with foreign countries due to the hazy financial circumstances in these countries. In countries where there is extensive incidence of fraud, it is often the case that companies make forward plans in order “to put their business on a proper footing.” This unethical situation gives them success at least in the short term. What about the long term? Perhaps some of them believe that it is not very important for them to think in terms of the long term when they take advantage of the prevailing unethical circumstances.

What would the local companies of a country where there is an existing **Corruption Economy** (1) do while foreign companies flee that country? How will the SMEs, for example, survive in such a system? These companies account for over 90% of businesses worldwide and are responsible for 50–60% of employment (Raynard and Forstater 2002). These questions deserve to be clearly answered.

Being a well-known brand in an environment where there is a threat of “getting involved with fraud” is very hard. There is a tendency for fraud to be effected in the production process and provision of relevant documents during the many stages involved in the production of merchandise and services which makes it difficult when competing with companies from the developed economies. In other words, it is very hard to mess with globalization and with the existing informal systems in the country at the same time. In time, companies which are unable to satisfy the following requirements:

- Fit in the ongoing systems
- Get support from the government authorities and other providers of funds
- Take advantage of the preventive regulations in conducting business transactions
- Produce enough “ethical” action plans in an informal environment which improve their competitive advantages
- Fit into the fraud-free business environment

would unknowingly lose their independence. They would, therefore, have to form alliances or be unwillingly taken over by some global brands. It is very hard to be an “ethical” company in a developing country as well as being a “fraud-free company.”

As a result of these reasons, companies should decide whether or not they are going to implement the Fraud-Free Modeling, and carry out actions in order to move on to the first grade from the third. And they should share these with interest groups with the help of their reporting tools.

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## 1.5 To Become a Second Grade Fraud-Free Company

In suspicious situations, the company seeks support from the Fraud Investigation Expert apart from its own independent supervision and interior supervision service.

When a company moves up from a third grade company to a second grade company in the Fraud-Free Company Model, it would experience change in directions; for example, its growth potentials would change for the better. In this case, the company should consider taking the following actions:

- *The management should consider the possibilities of the existence of fraud in its structure by asking its senior managers whether they are aware of the existence of unexplained events taking place within the company. These senior managers should be encouraged to ask their subordinates to provide them with feedback information on this issue.*
- *The company should annually ask Fraud Investigation Experts to prepare “fraud investigation” reports which should be published and shared with all their stakeholders.*

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## **1.6 Issues to Consider in Order to Move up from a Second Grade to a First Grade Fraud-Free Company**

The following are some of the important issues that a company desiring to move up from a second Grade to the first Grade in the Fraud-Free Company Model should consider:

- *Its senior managers should have in place a clearly defined corporate plan on intra-company frauds with understandable sanctions against anyone caught indulging in the practice. (For example, gifts are items and services of value that are given to any outside parties, but items like normal business entertainment items, such as meals and beverages, are not to be considered gifts.) (Wells 2007)*
- *The company should have a contract with a firm of Fraud Investigation Consultants which should be given easy access to the CEO.*
- *Every Fraud Prevention Transaction and expenditure the company has incurred in implementing it should be elucidated in the Fraud Prevention Report annually. It should be confirmed by the corporate administrative council and be made available on the company’s website.*
- *The Human Resources Department should give all new employees a standard test on fraud prevention and these employees should be trained in this matter.*
- *The company should install a Computerized Fraud Prevention Technique in its systems.*
- *The company should educate and develop all its employees on fraud legislations and they should be given examples of fraud cases in their own particular field at least once a year.*
- *Provisions should be made in the company’s annual budgets to deal with fraud investigations/transactions and other pertinent issues.*
- *All employees should be made to read and sign an agreement on corporate rules on fraud and unethical practices by the Human Resources Department.*
- *The company should take out an insurance policy to protect itself against the incidence of fraud.*
- *Fraud prevention activities should be reported to related post-holders regularly.*
- *Continuous Monitoring and Continuous Control Systems should be implemented for fraud prevention activities.*



## 1.7 Discussion

In this chapter, the following issues, namely, model, grading, and reporting of “fraud-free companies,” were explored in terms the incidence of white-collar crime—fraud in the developing countries and how they affect the SMEs in these nations. While exploring these issues, it was noted that SMEs should be classified according to their activities in the implementation and the expenditures incurred in the process of prevention fraud.

Corporate fraud, bankruptcies, and several unacceptable acts have always been a part of the business environment to some extent. Every time a problem comes to the fore, there is great amazement, but business history has on records dozens of major failures, frauds, massive corruption, and other related social problems each decade. The big ones often hit during recessions or periods of other economic problems, as should be expected (Giroux 2008). In developing countries, it is normal for SMEs to go into liquidation because of insufficient capital. Some SMEs would tend to find unethical solutions to these problems in order to survive. Yet SMEs cannot be free from all the consequences of fraud because of their own unilateral ethical stance in countries with a high incidence of corruption and where fraud is not considered as a serious economic problem. In these countries, those SMEs which work on reversing the trend in white-collar crime—fraud, are unlikely to survive for a reasonable period of time since they would find it very hard to compete with those companies which flow with the trend.

The Turkish economy, for example, consists of 99% SMEs which are mostly managed and run as family businesses. A family business failure does not feature in the statistics of business failures provided by the Istanbul Stock Exchange Index (Corporate Governance Association of Turkey 2010). However, we cannot generalize this situation for all SMEs and family businesses. Turkey, as a developing country, has taken a serious stance to prevent the perpetration of fraudulent corporate acts by fraudsters within the country, especially to protect the SMEs. According to the Transparency International study of 2007, in Turkey, the results of the study show that 6% of the respondents paid bribes to obtain services (Eigen 2003). The research also shows that the respondents believe that the inculcation of suitable corporate governance in Turkish business environment is expected to increase to about 67% in the future (Ernst and Young 2010). Corruption is a main problem and “Corruption Economy” is part of Turkish economy. The term “corruption economy” was first used by Prof. Dr. Osman Altuğ of Marmara University, İstanbul, Turkey, who increased awareness in its informality in Turkey over the last 20 years. During this period, the country faced a lot of scandals, especially in the banking sector. However, we are still unsure of the actual financial loss by the SMEs because of bribery and corruption. There are no measurement systems in place to establish this and also there is a lot of ignorance in SMEs about fraud.

Turkey has had to make an attempt at combating this corporate disease because of EU regulations. After a period of 11 years of discussions, the Turkish Grand National Assembly has published new Turkish Trade Code which is revolutionary in a sense for the Turkish economy and should hopefully discourage people from

getting involved in fraudulent transactions. According to the new Code (Turkish Trade Code 2011), limited liability companies and corporations should have independent auditing service even if they are not publicly listed companies. This requirement means that some 700,000 limited liability SMEs, in addition to those already taking this action, will now need to have independent auditing services which will also provide support to prevent unethical practices by SMEs.

Providing assurance against fraud on an ongoing basis is a very important subject for the Turkish SMEs. Standard setters for independent auditing services have identified both the going-concern and fraud as having inherent risks that affect all areas of the audit (AICPA 1990; IAASB 2004a, d). It means that all SMEs would need to apply corporate governance requirements in their systems of management after the new code comes into operation in 2013. It is expected that in addition to detecting fraud in financial statements, the external auditors would have the responsibility for detecting illegal acts by client companies (Braiotta et al. 2010, p 291).

The companies that were established with the hope of remaining in operation for an indefinite time period, which believe that they are successful, soon realize at the very late stage that they were being internally damaged by fraud and thus making them lose their free standing positions through the incidence of fraud. This should be a lesson to those SMEs which are short-termists in their outlook and in finding solutions to a series of problems including inadequate capital.

In this situation, the company should reconfigure itself with the help of fraud prevention techniques. In other words, it would have to change its status to a “fraud-free company.” This new format would increase the company’s responsibilities; for instance, it would need to work with Fraud Investigation Experts, scanning the written regulations with the scope of looking at its systems to ensure that they are fraud proof. This might involve using Computerized Fraud Investigation Techniques to ensure that both its internal and external control procedures are up to date, and to ensure that its reporting of transactions is consistent with prevention fraud and capable of being made public. This would undoubtedly involve increased workload and consequently more expenditure. But in the long run, the company and all its stakeholders would derive enormous benefits from the exercise. For instance, the company would find it a lot easier to raise finance as and when necessary, shareholders’ wealth would be maximized, and customers would be more confident in conducting transactions with the company.

What effect would this action of attaining the status a fraud-free company have on companies wanting to go public, especially in developed countries? It is suggested that intra-company frauds should be eliminated which should enable a company to progress from the third grade status to the first grade status in the Fraud-Free Company Model. It is also suggested that the company should develop itself in prevention fraud in order to provide protection against fraud by taking the development in trade and technology into consideration. In this respect, the companies which aspire to become fraud-free companies should install the technique in the processes required by all its divisions, regardless of whether these are national or international.

Every company is a unique formation with different features. Because of this, the suggested Fraud-Free Company Model should be designed and updated independently for each company, taking cognizance of the company's features. It is a necessity to seek help from a person who is professionally qualified, for instance, a Certified Public Accountant (CPA), and who has undertaken the relevant training in fraud investigation.

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### Conclusion

Fraud, ethics, CSR, and CG are main issues in any business life and they are fertile areas for research by scholars wanting to publish the results of their studies in the areas. Reports released by Association of Certified Fraud Examiners commented that the incidence of fraud increases all the time, and especially SMEs are more vulnerable than larger companies. Fraud is everywhere, but SMEs in developing countries need education on how they should guard against it since most of these SMEs lack the tools to deal with it and measure it (Caliyurt 2010).

The incidence of fraud, which sadly is still rampant in many developing countries, needs to be controlled for their economies to thrive. Leaders of these countries must take a decisive action to reduce the incidence of this social ill gradually. They need to place appropriate legislations for the protection of all; alongside these legislations must be heavy punitive sanctions to discourage both individuals (including politicians) and corporate entities from indulging in this unacceptable social ill which adds no value to anyone but damages the economies and consequently economic progress of these nations. The model described in this chapter and the grading of companies according to their actions in this area would go a long way to discouraging and improving economic and social lives of these emerging nations.

Several initiatives have been proposed in this chapter. That fraud is a social ill which must be wiped out of all economies including the newly emerging ones must be publicized globally. Using the Fraud-Free Company Model, grading and reporting are credible initiatives which should hopefully be a new genesis in the drive to internalizing fraud prevention at every stage of business transactions.

The chapter suggests that in the very competitive environment that modern businesses operate, especially in the developing countries where SMEs have the opportunity of going public and helping them gain trust, the SMEs should elucidate the issue of *Annual Fraud Prevention Transaction Reports*. The companies which elucidate these kind of reports would be at a competitive advantage over those which fail to do so. And of course, it is recommended to all companies to use enterprise-wide risk assessment for developing the methodology to identify and clarify the population of fraud risks, perform a fraud likelihood analysis, and link the management and audit responsibility to the fraud risk (Vona 2008).

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## 2.1 Definitions of Fraud

A quick search for the meaning of fraud in the dictionary states that fraud is “deceit, impersonation with intent to deceive, criminal deception done with the intention of gaining an advantage.” The Institute of Turkish History explains the word fraud as “a deceptive trick, scam, game, artifice, cabal which is committed to cheat, mislead someone” and “contributing something useless to something in order to gain advantage” (Institute of Turkish History 1998, p 995). According to another definition, fraud is “to create a misjudgment or maintain an existing misjudgment to induce somebody to make a contract” (Arzova 2003, p 118). Another definition says “it is to enrich oneself by intentionally reducing the value/worth of an asset in secret.”

Fault is another term encountered when studying the concept of fraud. Fault is defined in the dictionary as “wrong, mistake, error,” “wrong, mistake, error committed involuntarily and unconsciously.” Fault stems from the deficiencies originated from the person or environment.

Intention is the most important element which distinguishes fraud from fault. Moreover, the person committing fraud has an objective of moral or material gain.

Debugging frauds, which are heavily committed on documents, from faults and bringing them to light is a difficult but not impossible task. Experienced auditors could detect frauds, thanks to their knowledge and experience. Fraudsters definitely leave traces, and experienced auditors could find the fraud and the fraudster by tracking traces (Arzova 2003, p 119).

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## 2.2 Types of Fraud

There are two types of fraud committed in business (Bozkurt 2003, p 2):

- Personal use of business resources
  - Drawing up financial statements of the business falsely
- Examples of frauds that employees commit to benefit themselves are given as follows (Bozkurt 2003, p 2):
- Embezzlement of the money during its collection but before it is recorded in accounts
  - Stealing the cheques of business
  - Tampering the bank records and taking monetary advantage
  - Gaining advantage through forgery of documents
  - Making payments which should not be made or previously made
  - Creating fictitious debts and having payments done in favor of oneself
  - Giving discount improperly or without authority
  - Creating ghost suppliers and having payments made in their favor
  - Inventory and scrap theft
  - Office supplies and fixed asset theft
  - Creating fictitious expenses and obtaining disbursements
  - Padding expense items
  - Benefiting from placing redundant order
  - Creating ghost employees and embezzling their wages/salaries
  - Accepting bribes from the customers and suppliers of the business with various reasons
  - Using credit cards of the business for personal objectives
  - Benefiting from overstated personal expenditures
  - Manipulating the overtime periods and obtaining extra payment
  - Benefiting from padded travel expenses
  - Selling business assets under the market value
- Objectives of financial statements fraud:
- Increasing the market value of the business
  - Making financial statements consistent with budgets
  - Obtaining unfair earnings by presenting falsely the value of the business

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## 2.3 Statistics on Committed Frauds

Statistical information given below will give you an idea about the size of fraud:

- It is estimated that employee frauds cost businesses \$400 billion per year in the USA (Bozkurt 2003, p 1).
- Studies conducted in developed countries reveal that businesses lose 6% of their annual income due to fraudulent activities.
- It is estimated that the amount of the daily loss per person due to fraud is about \$9 in the USA.
- Research studies have shown that the amount of the loss businesses suffer because of their employees' fraudulent activities is far greater than the loss they suffer because of the customers.

- With an average of \$185,000, male employees lose four times higher than female employees (\$48,000) (Arzova 2003, p 119).
- There exists a linear correlation between the position of the employee and the losses.
- 5% of the employees is determined to commit fraud no matter what (Bozkurt 2003, p 1).
- 10% of the employees is inclined to commit fraud.
- 85% of the employees might be inclined to commit fraud under suitable conditions.

Here, attention should be paid to the third group with 85%. They will be the target mass when taking precautions against fraud (Bozkurt 2003, p 1).

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## 2.4 Characteristic Features of the Fraudsters

Under this title, we will examine the characteristic features of people who commit or are likely to commit fraud on businesses. However, it does not imply that the person with these traits will definitely commit fraud. These characteristics should hopefully guide investigative auditors to detect the fraud.

- (a) Gender: A survey by Association of Certified Fraud Examiners (ACFE) with 2,000 fraudsters revealed many characteristics of fraudsters. According to this survey, three out of four of the people who commit fraud in businesses are male. This difference is explicit also in the monetary value of the fraud.
- (b) Marital status: It is shown that the number of married employees who attempt to commit fraud is higher than unmarried employees. With respect to the amount of fraud, the difference is 1–3. In addition, many of them have children and a happy marriage.
- (c) Education status: Generally as the level of education increases, the number and amount of the fraud also increase. The amount of the fraud is much higher, especially with employees who had received good education.
- (d) IQ level: Employees with higher IQ levels or those claiming to be so have a higher level of desire to commit fraud. The underlying reason of this situation is that this kind of people challenges the internal control structures and security systems of business they work in, and satisfies themselves by breaking through them.
- (e) Age level: Employees of any age could attempt to commit fraud, but the number and amount of the fraud are higher with older people. The number of fraud older people commit is 28 times higher than those young people commit.
- (f) Working conditions: Generally employees who come earliest and leave latest commit fraudulent activities more. Especially employees who present their unfinished jobs as an excuse and want to work alone until late hours of the night have higher probability of committing fraud. Moreover, it is estimated that many of the managers who are caught as a result of fraudulent activities do not take a leave unless they have to. The reason is predicted that they think whoever is assigned to replace them when they are away would discover and report the irregularities before their return.

- (g) Position at the business: Any person working in the business has a probability to somewhat commit fraud. However, studies indicate that with respect to the amount of fraud, employees at managerial positions are by far ahead of other employees. When employees have a trustworthy position, they are monitored less; this is considered as the underlying reason of the preceding fact. Moreover, due to their position, they are in a better position to understand the entity's internal control structures and gaps in them and are thus able to conduct fraudulent activity more easily. Unfortunately, the first reaction of many fraud victims is "I could never expect him/her to do that."
- (h) Relations outside of business: Another indicator is the level of relations employees have with third parties of the business. When an employee becomes very intimate with people buying/selling goods and services from the business, conditions become congenial for fraud to be perpetrated.

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## 2.5 Reasons Why Employees Commit Fraud

When business frauds are analyzed, it is ascertained that three components come together when committing the white-collar crime. These are pressure, opportunity, and justification that constitute the "fraud triangle." Components of the fraud triangle are similar to the fuel, spark, and oxygen which together cause fire. When the three come together, inevitably fire breaks out (Bozkurt 2003, p 3).

### 2.5.1 Pressure Factors (Bozkurt 2003, p 4)

Pressure factors could be gathered into three groups:

- Pressures with financial content
- Pressures stemming from bad habits
- Pressures related with job

Pressures with financial contents generally show up when people are in need of cash. These pressures could be classified as below:

- Itching palm and greediness
- Desire to live well
- High amounts of personal debts
- High amounts of health expenditures
- Unexpected financial needs

The very first reason of employee fraud is that they are poor due to lower income they receive, and want to live under better conditions.

Pressures with financial content could come into view in the long term as well as in the short term. An employee who has been working in business for a number of years could commit fraud for some reason.

Studies show that on average 30% of employees conduct fraudulent activity in the first 3 years, and the remaining 70% attend to forgery processes between the 4th and 35th years of their professional life.



Pressures arising from bad habits have attributes related with pressures with financial content. Being a gambler, drug or alcohol addict, and keen on nightlife are among the several reasons causing fraud. This kind of habit is accepted as the worst kind of factors motivating fraud. There are many examples of women employees committing fraud to buy drug or alcohol for their children or husbands; or of managers who are very successful in their professional lives but commit fraud because of their gambling ambition.

Pressures related with the job could be explained as being dissatisfied with the job, the idea of an unfair attitude, not getting promoted when expected, having worked with lower wage, or not being admired by supervisors.

### 2.5.2 Opportunity Factors (Bozkurt 2003, pp 4–5)

Opportunity factors are the third component of the fraud triangle. They directly involve top management and owners of the business in particular. Providing the opportunity to commit fraud is one of the most important factors arising from frauds. Since the business could greatly influence opportunity factor, this point should receive particular attention for fraud prevention.

The control structure of the business and fraud has an inverse correlation. The most effective way of reducing employee frauds is to establish an “Internal Control System.” The important points when establishing the system are given below:

- A healthy internal control environment
- A proper accounting system
- Control procedures which operate effectively

Other factors which provide employees with the opportunity to commit fraud are as following:

- Weak moral policies
- Undisclosed contracts made with third parties and partners
- Incapability to assess the quality of the job employees performed
- Absence of a well-disciplined environment in which fraudsters will be punished
- Weakness of the information flow among employees within the business
- Ignorance, indifference, and inabilities of top management
- Lack of healthy audit works

When there is a situation where environment to punish the fraudster is absent because of the concerns such as loss of prestige and counter threat, the feeling of “you can get away with it” will be evoked among employees, thus the business will be exposed to frauds.

### 2.5.3 Efforts to Justify Fraud (Bozkurt 2003, p 5)

The third component of the fraud triangle is fraudster’s developing defense mechanisms in order to justify his/her action. Some efforts of the fraudsters to justify themselves and the excuse they made up are given below:

- (a) I had borrowed the money, I would pay back
- (b) This is in return for my efforts for the business
- (c) Nobody has suffered as a result of this
- (d) I have taken the money for a good purpose
- (e) I did not know that this was a crime
- (f) Business had deserved this
- (g) Since business evades tax, I have taken something which was already mine

At the macro-level, in order to overcome these justifying excuses, business should explain ethic rules to employees, inform them that fraudsters would definitely be penalized, establish moral code in the organization, and provide training on them.

## 2.6 Fraud Detection

Once committed, those involved in the fraudulent acts would normally find it difficult to end the habit. We could explain development process of fraud with an example as below.

Let us assume that a teller in the bank commits fraud. Some of the dates when this crime was committed are presented in Table 2.1 (Albrecht and Albrecht 2003, p 65).

When arrested, the teller made the following explanation: “I can’t believe that I could take high amounts for a long time before anyone suspected” (Albrecht and Albrecht 2003, p 68).

**Table 2.1** Development of fraud crime

April		May		June		July		August		September	
1st	10\$	1st	20\$	2nd	40\$	8th	400\$	4th	20\$	2nd	400\$
4th	20\$	5th	30\$	3rd	50\$	9th	700\$	8th	20\$	5th	100\$
7th	20\$	6th	30\$	4th	50\$	14th	400\$	11th	30\$	12th	100\$
9th	20\$	7th	20\$	5th	50\$	15th	600\$	14th	30\$	15th	200\$
10th	20\$	8th	20\$	9th	30\$	16th	600\$	19th	20\$	16th	400\$
14th	40\$	9th	30\$	10th	40\$	23rd	600\$	22th	40\$		
16th	30\$	12th	30\$	11st	30\$			26th	400\$		
22nd	30\$	13th	30\$	12th	50\$			27th	600\$		
23th	30\$	14th	30\$	13rd	50\$			28th	400\$		
24th	30\$	15th	30\$	16th	50\$						
25th	30\$	16th	40\$	17th	50\$						
28th	30\$	19th	40\$	18th	30\$						
29th	30\$	20th	40\$	20th	70\$						
30th	30\$	21st	40\$	23rd	100\$						
		22nd	20\$	24th	200\$						
		27th	30\$	25th	400\$						
		28th	40\$	26th	600\$						
		29th	40\$								

As seen from the table, the theft originally started with a very small amount but there was an increasing trend as the time progressed on. When the fraudster observed that he was not caught, he started to act more greedily and the amount taken from the safe started to increase day by day. Actually, in a 2-week period following the 23rd July, the theft stopped. The reason for that was because the auditor came to the branch and started his job. As seen from the table after the auditor had completed his task, the teller continued to the crime; this time he once again started to steal with smaller amounts. He observed the system for a short period of time to see whether the auditor could easily have spotted the theft. When he was satisfied that it might be difficult for the auditor to reveal the fraudulent activity and he might not be caught easily, he once again started to steal higher amounts (Albrecht and Albrecht 2003, p 69).

The amounts in this example are small; however, almost all fraudulent activities would normally start with small amounts, but if not discovered, it would then increase to higher amounts. If in the interim any situation were to threaten or frighten the fraudster, the theft would stop. But if that situation were to cease, the fraudulent activity would continue. It is more difficult to prevent frauds committed by top management or owners of the firm. Due to this fact, initial detection of fraud is a critical factor. For instance, the president of a New Hampshire Company had presented his employees as independent contractors. Thus, he did not pay the payroll taxes for 3 years which in total amounted to \$211,210. Moreover, he also abstained from paying indemnity fee by misinforming an insurance company about the number of people he had working for the company.

Fraud could not be prevented when committed by the owners of a small business who at the same time performed accounting duties themselves, as in our New Hampshire company example above. There would be nobody to stop the crime if the fraudsters were in fact owners of the business. In that case, what should be done is that the relevant authority should find a way of detecting the fraud.

Over time, the importance of initial detection of fraud has increased because the number of fraudulent events has increased. Detection of fraud begins with the notification of red flags which indicates that something is wrong. This might come to light as a result of trends in the number of employees, managers, and victims concerned about the loss in business assets. There are two main ways to detect frauds:

- (a) Detection by chance
- (b) Conducting a proactive research and encouraging initial identification of symptoms

Many fraudulent acts have been detected in the past by chance. Unfortunately, the incidence of fraud proceeds during detection and losses consequently increase. In many cases, people who are exposed to fraud in the organization do know that fraud was being committed, but could not bring it to light either because they are not sure and unwilling to blame someone directly or are unsure of how to go about reporting it and might also be afraid of being labeled as whistleblower.

In recent years, organizations perform a series of efforts to detect fraud. The most frequent one is establishing hotlines through which employees make

anonymous calls to draw attention to the fact that the crime is being committed. Some of these hotlines are within the organization while others are outsourced to some independent organizations. For instance, ACFE provides paid hotline service. Experience has indicated that organizations which establish these hotlines have detected many fraudulent events. However, it must be noted that there might also be false reports made to these hotlines by disgruntled employees.

Apart from the hotline, organizations also take some proactive precautions. Technological developments could be used by these organizations to analyze their databases in order to detect red flags. For instance, banks regularly utilize some software to detect fraudulent overdraft balances. These programs would be used by banks to draw attention to customers' accounts with unreasonable volume of transactions within a short period of time well before customers are aware of these fraudulent transactions. Insurance companies also use relevant software in order to identify fraudulent claims by customers immediately after taking out insurance policies (Albrecht and Albrecht 2003, pp 69–70). Research studies have supported the view that many fraudulent events are detected not by auditors but by employees and managers. For instance, the ratios of detection by different groups given in a study by Durant (2002) are depicted in Table 2.2.

According to the result of a study conducted by the ACFE in 2002, respondents were asked to explain how they detect the incidence of fraud in their companies. The results of the 532 responses received are shown in percentages in Table 2.3 (ACFE 2002, p 11).

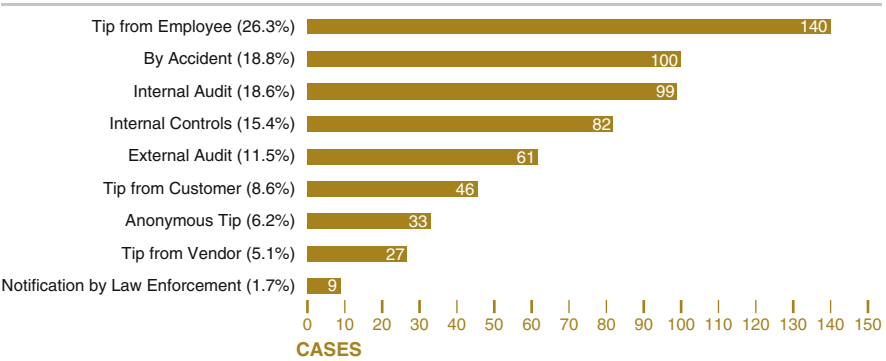
In total, 8 exceed 100% because some participants cited more than one method for initial discovery of the frauds.

Fraud is quite a costly problem for organizations. Nevertheless, it is often the case that the person in charge of preventing fraud in most organizations is “someone” but not a particular individual(s). Independent auditors often claim that detecting fraud is not their responsibility. Internal auditors also claim that their functions are to assess controls and increase the organization's operational efficiency. Security personnel of a company would argue that in many organizations, their role is to investigate and file fraud cases in the court of law. Managers would similarly state that their main job is to manage the business, albeit fraud could be committed anywhere in the organization. Employees, despite being in the best position to detect fraud, are unsure of where and whom to refer suspected cases of fraud to when they happen; as a matter of fact, some employees believe that reporting fraud will be considered a disgrace (Albrecht and Albrecht 2003, p 68). The current model employed to fight against fraud in many organizations is shown in Fig. 2.1 (Albrecht and Albrecht 2003, p 98).

**Table 2.2** Percentage of fraud identified and reported by different groups

Management	20%
Internal auditors	25%
Employees	40%
External auditors	10%
Chance	5%

**Table 2.3** Initial detection of fraud



**Fig. 2.1** Dealing with fraud:  
current model



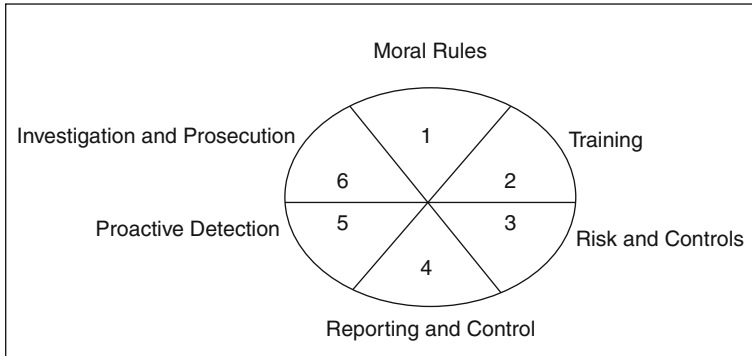
There are four stages in the model shown in Fig. 2.1. The first stage—fraud incident—raises consciousness, while training and other prevention criteria are out of question. In such an environment, fraudulent event occurs. Then the company moves to crisis mode because it wants to identify the fraudster and is too eager to prevent the event from becoming known publicly, save losses, and reduce the impact of fraud on the organization.

The second stage is the investigation stage. All security procedures and internal control are included in this stage. Much of the investigation is conducted by interviewing and document examination. The investigation might not end up with a decision but could take long time and be costly at the end of the day.

Before the third stage begins, investigation is completed and the company decides how to take action against the fraudster. There are four possible decision actions: do nothing, fire the fraudster, transfer the fraudster to another section, or fire the fraudster and start legal proceeding.

In fourth stage, the file is closed, the employee is changed, new controls are applied or not applied, and the problem is resolved.

In this model, nothing is done after this fourth stage until a new fraudulent event takes place. Fraudulent events do not decrease; they might in fact become a chronic



**Fig. 2.2** Organizations with fraud awareness reduce fraud

problem. Fraud savvy model which is a better approach in fighting against fraud is depicted in Fig. 2.2.

There are six elements in fraud savvy model. The most important element is the establishment of moral rules (Lindborg 2005). Two points are important in establishing these rules:

1. The developed rules must be embraceable by everyone working in the company
2. Creating a proper behavior model

The second element in the model is training of employees on a series of consequences of fraud and how to act when fraud is suspected. As mentioned before, what will provide benefit is not detecting or investigating but preventing the incidence of fraud (Albrecht and Albrecht 2003, p 99).

The third element in fighting against fraud includes risk assessment and a good internal control system. The important point in internal control systems is identifying where each fraud is stemming from, thus preventing possible frauds in the future from its very source.

The fourth element is the use of reporting and monitoring systems. The reporting of fraud should be facilitated. There is no doubt that murder and bank robbery are crime. However, fraud is such a crime which could continue for several years. Because hotlines and other reporting systems are not used very frequently, employees could abstain from reporting suspected frauds. Monitoring includes watching the performance of internal auditors, external auditors and managers, and audits and investigations. In companies with tight monitoring and reporting systems, fraudulent events are likely to decrease. Reporting also includes conveying the fraud-related information to the people concerned. This does not contain giving all details of fraud in local newspapers. It involves communicating the fraudulent activity to auditors, security personnel, managers, employees, and those concerned.

The fifth element is the application of proactive detection methods. No matter how good the prevention efforts are, fraud could still be committed. Since the loss

that fraud causes increases as time period gets longer, initial detection is important. Today computer software is used for initial detection of fraud.

The last element in fraud savvy model is investigation and prosecution. In investigation procedure, the following issues must be determined (Albrecht and Albrecht 2003, p 100):

1. Who will conduct the investigation?
2. How will the event be communicated to management?
3. Whether or not the law enforcing authorities should be brought in.
4. Who will determine the scope of investigation?
5. Who will determine the methods of investigation?
6. Who will trace secret information in suspected fraud?
7. Who will interview, examine documents, and undertake other stages of investigation?
8. Who will determine the company's reaction against fraud?

Doing nothing about the perpetrators should not be preferred; in contrast, taking lawsuit against the perpetrator should be preferred.

Since the 1980s in some Western countries, particularly in the USA, a new profession in the field of accounting and auditing has emerged. This profession is referred to as "forensic accounting" with its original name (Bozkurt 2000). Forensic means "pertaining to court," "being accepted as a standard in legal cases." This profession identifies a field composed of accounting, auditing, and investigative skills.

In this concept, forensic accountants provide an account analysis to determine the facts necessary to resolve a dispute before it is brought before the court or the lawsuit process takes its course. The term forensic accountant is generally used for certified public accountants (CPAs) who perform the activities of analyzing, examining, investigating, auditing, and questioning that follow an organized way in order to find the truth or reach an expert opinion by starting with the truth. Forensic accounting and litigation support involve the services provided by CPAs on legal issues (Crumbley 1995, p 25).

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## 2.7 Forensic Accounting Definition and Literature Review

Maurice E. Peloubet is credited with developing the term forensic accounting in his 1946 essay "Forensic Accounting: Its Place in Today's Economy." By the late 1940s, forensic accounting had proven its worth during World War II; however, formalized procedures were not put in place until the 1980s when major academic studies in the field were published (Rasey 2009).

Forensic accounting is the specialty area of the accountancy profession which describes engagements that result from actual or anticipated disputes or litigation. "Forensic" means "suitable for use in a court of law," and it is to that standard and potential outcome that forensic accountants generally have to work (Crumbley et al. 2005).

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 careers of the future. The job of forensic accountants is to catch the perpetrators of the estimated \$600 billion theft and fraud occurring in the US companies per year. This includes tracing money laundering and identity theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorce cases (Weygandt et al. 2008, p 30).

Forensic accounting has been pivotal in the corporate agenda after the financial reporting problems which took place in some companies around the world (see, for example, Enron, Tyco, and WorldCom, just to mention a few). These scandals resulted in the loss of public trust and huge amounts of money. In order to avoid fraud and theft, and to restore the badly needed public confidence, several companies took the step to improve the infrastructure of their internal control and accounting systems drastically. It was this development which increased the importance of accountants who have chosen to specialize in forensic accounting and who are consequently referred as “forensic accountants.”

### **2.7.1 Fraud Triangle**

Forensic accounting relies on the fraud triangle to identify weak points in the business systems and find possible suspects in cases of fraud. It consists of three core concepts which together create a situation ripe for fraud: incentive, opportunity, and rationalization. People must have the incentive and opportunity to commit financial fraud, as well as the ability to justify it. Recent analysis has suggested adding a fourth concept to make a diamond—capability. Just because someone has the opportunity or incentive to steal does not necessarily mean that they have the capability to do so. For example, if someone does not understand how to make journal or ledger entries in the books of accounts, they would not know how to manipulate numbers no matter what the incentive or opportunity is (Rasey 2009).

### **2.7.2 Forensic Accounting Versus Fraud Examination**

Forensic accounting and fraud examination are different but related. Forensic accounting work is done by accountants in anticipation of litigation and can include fraud, valuation, bankruptcy, and a host of other professional services. Fraud examinations can be conducted by either accountants or non-accountants and refer only to antifraud matters (<http://www.journalofaccountancy.com/Issues/2003/Oct/TheFraudExaminers.htm>).



## 2.8 Forensic Accounting and the Accounting Profession

The accounting scandals involving Enron, WorldCom, Global Crossing, and other companies have put accountants in the public spotlight as never before in their history. After these accounting scandals, public confidence in the accounting profession has been seriously undermined. However, the scandals have created business for forensic accountants and developed opportunities for forensic and investigative accounting. Forensic accountants have been conducting these activities for quite some time in a quiet professional manner. New laws and regulations resulting from these scandals will make the role of forensic accountants more important than ever before in the business world (Sutong 2005).

Forensic accountants, also referred to as forensic auditors or investigative auditors, often have to give expert evidence at the eventual trial (Crumbley et al. 2005). All of the larger accounting firms as well as many medium-sized and boutique firms have specialist forensic accounting departments. Within these groups, there may be some further sub-specializations: some forensic accountants may, for example, just specialize in insurance claims or personal injury claims, fraud construction, or royalty audits.

Forensic accountants utilize an understanding of business information and financial reporting systems, accounting and auditing standards and procedures, evidence gathering and investigative techniques, and litigation processes and procedures to perform their work. Forensic accountants are also increasingly playing more proactive risk reduction roles by designing and performing extended procedures as part of statutory audit, acting as advisers to audit committees, fraud deterrence engagements, and assisting in investment analyst research.

The skeptical mindset is something that has long been inherent in forensic accountants and other internal investigators when looking for evidence of fraud. The investigator historically has asked a set of questions different from those of conventional auditor, who is monitoring the financial statements to see whether they are in compliance with generally accepted accounting principles (GAAP) and thereby fairly represent the financial conditions of the company (Silverstone and Sheetz 2007).

What turns a well-trained and experienced accounting professional into a good financial investigator, however, is the knowledge of human behavior, a sixth sense for red flags, and a good intuitive feel for the significance of evidence. The skeptical mindset should raise questions about the reasonableness of all transactions and the evidence that underlies them. Since the magnitude of the amounts taken in a long-term fraud, for example, is often invisible except for a small irregularity in the accounts, the financial investigator must be curious and tenacious enough to follow up even the most initially unpromising clues. The judgments made through this skepticism will open up new hypotheses or close down old ones by testing them against the accumulating evidence until only one explanation is left. “When you have eliminated the impossible, whatever remains, however improbable, must be the truth” (Silverstone and Sheetz 2007).

Fraud auditing, forensic accounting, and/or fraud investigation (i.e., forensic accounting) put things together rather than take them apart, as is the case in financial classical auditing or modern method of systems analysis. The process of forensic accounting is also sometimes more intuitive than deductive, although both intuition and deduction play important parts. Financial auditing is more procedural in many regards and is not intended to work as effectively as the tenets of fraud auditing and forensic accounting (Singleton et al. 2006, p 43).

Traditional auditing has a focus on error identification and prevention. Prevention is the result of an effective internal control system. The auditor reviews the effectiveness of the internal control system by sampling transactions and not by a complete review of all transactions. The process can reveal errors. All errors are not considered equal. Some are important and are referred to as material. For example, omission of a million dollar loan that is not recorded in the accounting records might be a material error. Other errors are not material. An example of an error that might not be material would be an arithmetic error due to rounding that causes the reported amount to be ten dollars more or less than the actual amount. These examples are not meant to imply that there are absolute dollar amounts that denote the difference between material and not material (Gray 2008).

Fraud management involves a whole gamut of activities: early warnings and alarms; telltale symptoms and patterns of various types of fraud; profiles of users and activities; fraud detection, prevention, and avoidance; minimizing false alarms and avoiding customer dissatisfaction; estimating losses; risk analysis; surveillance and monitoring; security (of computers, data, networks, and physical facilities); data and records management; collection of evidence from data and other sources; report summaries; data visualization; links to management information systems and operation systems (such as billing and accounting); and control actions (such as prosecution, employee education and ethics programs, hotlines, and corporation with partners and law enforcement agencies) ([http://www.intelligententerprise.com/020528/509feat3\\_1.jhtml;jessionid](http://www.intelligententerprise.com/020528/509feat3_1.jhtml;jessionid)).

Forensic accounting profession has some requirements. Certified fraud examiner (CFE) is a designation awarded by the ACFE. The ACFE is a 41,000 member-based global association dedicated to providing antifraud education and training. In order to become a CFE, one must meet the following requirements:

- Be an associate member of the ACFE in good standing
- Meet minimum academic and professional requirements
- Be of high moral character
- Agree to abide by laws and code of professional ethics of the ACFE

### 2.8.1 Professional Requirements

At the time of certification, at least 2 years of professional experience in a field either directly or indirectly related to the detection or deterrence of fraud is required. The ACFE recognizes the following areas as qualified professional experience:

- Accounting and auditing
- Criminology and sociology (sociology is acceptable only if it relates to fraud)
- Fraud investigation
- Loss prevention (experience as a security guard or equivalent is not acceptable)
- Law relating to fraud

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## 2.9 Forensic Accounting Applications Around the World

As we discussed above, accounting scandals have put the accountants under public spotlights as never before in their history. Then forensic accounting profession has gained increasing importance. Now let us look at the applications of forensic accounting in four developed economies around the globe.

### 2.9.1 United Kingdom

Over 160 cases of serious fraud with charges in excess of £100,000 came to the UK courts in the first half of this year, according to KPMG Forensic—the highest number of cases in a 6-month period in the 21-year history of its Fraud Barometer.

The cases had a total value of £636 million which, if replicated in the second half of the year, would also lead to the highest value of fraud in the Barometer's history (currently £1.2 billion in 1995). Professional gangs were the most active perpetrators of fraud, with 70 cases worth some £450 million, and their main victims were investors, who suffered to the tune of £320 million. Much of this stemmed from a £200 million investment fraud case involving the attempted fraudulent sale of the Ritz Hotel in London. Company managers were also active perpetrators, responsible for £150 million of fraud against their own employers in 32 cases. Government suffered £150 million of fraud, mostly in the form of tax and duty evasion and fraudulent benefit claims. The main victim in terms of number of cases was the financial sector. Over a quarter of fraud cases (44) were against financial institutions, with a value of £111 million.

Commenting on the figures, Hitesh Patel, partner at KPMG Forensic, said: “These figures are bad, but the worst is yet to come. It will be a number of years before the impact of the recession fully feeds through into the fraud statistics. Hard times mean more people driven to fraud by personal pressures, and more investors willing to believe in cooked up investment schemes. Companies too remain vulnerable to the threat within—their staff—as evidenced by the £150 million of fraud that managers have been tried for in the last 6 months alone” (<http://www.kpmg.co.uk/news/detail.cfm?pr=3541>).

### 2.9.2 Canada

In Canada, forensic accounting is accepted as a profession. The Certified General Accountants Association of Canada comments that they recognize that the profession of fraud investigation is relatively new and that such a duplication of effort by the CICA in developing standards for its IFA specialty is inefficient and may be confusing to the public and to fraud examiners designated by the ACFE. As such, CGA Canada supports efforts at establishing a national or international joint effort which promotes inclusion. Above all, the exposure draft process of the CICA should not be a vehicle for by which to embody these CA-IFA standards in the CICA Handbook. Choosing such an administrative method to approve these CA-IFA standards as part of the handbook circumvents the authority of the Accounting Standards Board and the Auditing and Assurance Standards Board to consider and approve applicable standards ([http://www.cga-canada.org/enca/ExposureDraftResponses/ca\\_exd\\_2006-02-23\\_ifa.pdf](http://www.cga-canada.org/enca/ExposureDraftResponses/ca_exd_2006-02-23_ifa.pdf)).

### 2.9.3 Australia

As noted earlier, the forensic accountant works within an environment that also includes government, industry, and professional regulators. The forensic accountant's work may be in conjunction with these entities or with consideration to the rules, regulations, and guidelines enforced by them. The regulator depends on the nature of the engagement. Some of the most relevant and commonly encountered regulatory bodies in **Australia** include the following (Dellaportas and Gibson 2005):

- Australian Securities and Investments Commission (ASIC): ASIC regulates companies, financial markets, and other professionals involved in finance, investments, superannuation, insurance, deposit taking, and credit. It enforces the relevant laws to protect the public, in conjunction with other regulators and investors and consumer protection groups.
- Australian Tax Office (ATO): The ATO administers and enforces legislation relating to taxation, superannuation, and excise. Of particular relevance to the forensic accountant, the ATO watches for the effects of aggressive tax planning, tax evasion, and persistent tax debtors. All of these could lead the ATO to take action either in or out of court.
- Financial Action Task Force (FATF): The FATF is an intergovernmental body formed to develop and promote national and international policies on combating money laundering and terrorist financing. The FATF issued a document entitled *Forty Recommendations: a global framework for combating money laundering*, in 1990, and eight special recommendations on terrorist financing following 11 September 2001.

Other notable regulators interacting with the forensic accountant's work include professional organizations such as CPA and ICAAA, as well as specialist bodies such as APRA and AUSTRAC, to name but a few. Whenever the forensic expert

undertakes an assignment, he or she needs to consider if there is a regulator relevant to this work, and the impact of that relationship on the work to be performed.

The work of Australian Federal Police (AFP), state and specialist police, or government task forces also includes areas in common with the forensic accountant. For example, the AFP's current focus includes dealing with major fraud or money laundering. A forensic investigation of corporation may uncover significant fraud or misconduct such that the corporation decides to involve the police to pursue a criminal prosecution, or it may be that the forensic accountant's investigation takes place concurrently with the ongoing police inquiries.

In addition, Australia is one of the most important countries which have educational program in forensic accounting in graduate degree. The master of forensic accounting emphasizes a forensic rather than a control-based or risk management approach to the analysis of corporate governance and the possibility of fraud, other forms of misconduct, abuse, and corruption. Both courses build on the expertise acquired in undergraduate and postgraduate studies and/or business experience in the areas of corporate regulation, corporate governance and ethics, financial accounting and audit, and finance and banking and management (<http://www.uow.edu.au/commerce/accy/current/UOW010315.html>).

### 2.9.4 The United States of America

On 30 July 2002, the landmark legislation known as the Sarbanes-Oxley Act (SOX Law) was enacted into the United States Law. The Act was named after its principal authors, Senator Paul D. Sarbanes (D-Md) and Rep. Michael G Oxley. The Act seeks to restore investor confidence in the US financial markets, corporate governance, and financial reporting.

The Sarbanes-Oxley Act was passed by the US legislature in the wake of accounting scandals such as Enron, WorldCom, and Xerox, all of which seriously undermined investor confidence. Through strictly United States legislation and its impact is far reaching on the accounting and financial markets. The Act applies to all Securities and Exchange Commission (SEC)-listed companies, and so extends to subsidiary and associated entities of SEC-listed companies outside the USA.

The Enron and WorldCom scandals highlighted the role of the auditor in ensuring the integrity of financial reporting, and in particular, the auditor, as an independent and objective professional. The Act prohibits professional accounting firms from providing non-audit services to audit clients, with the exception of tax services and specialist management advice. Non-audit services specifically include appraisal or valuation services, and fairness opinions that are traditionally the work of the forensic accountant. Investigation services, often related to audit issues, are not prohibited unless there is a requirement to provide court testimony.

The impact of the requirements of Sarbanes-Oxley is that forensic practices must seek work outside such traditional sources as existing audit clients, although this potentially opens up avenues into other clients. In turn, clients may lose benefits of

the inherent in-house knowledge and experience obtained from the audit engagement, but they may also benefit from a different expert, as perspective.

However, in so far as the nature and performance of the audit engagement were seen to threaten the forensic accountant as independence, the Sarbanes-Oxley provisions go some way to enforcing and promoting objectivity and restoring the accounting professions' reputation (Dellaportas and Gibson 2005).

In the USA, forensic accountants have been employed by the Federal Bureau of Investigation (FBI), Central Intelligence Agency (CIA), Internal Revenue Service (IRS), Federal Trade Commission (FTC), Homeland Security, Bureau of Alcohol, Tobacco and Firearms, Governmental Accountability Office (GAO), and other government agencies. The focus is on what is referred to as *white-collar crime*, notably *fraud*. This is why financial and other skills are required. Outside of government employment, big employers of forensic accountants include financial intermediaries such as banks and insurance organizations plus divorce attorneys. Forensic accountants often testify in civil and criminal court hearings. In this capacity, they serve as expert witnesses. They do not testify as to whether fraud has occurred. This is the court's decision. The expert witness presents evidence. Forensic accountants have a number of organizations that support their work. Here is the list of key organizations that support forensic accountants' work along with the URL to access them: ACFE (<http://acfe.com>); American College of Forensic Examiners (<http://www.acfei.com>); Association of Certified Fraud Specialists (<http://www.acfsnet.org>); National Litigation Support Services Association (<http://www.nlssa.com>); National Association of Certified Valuation Analysts (<http://www.nacva.com>); American Institute of Certified Public Accountants (<http://www.aicpa.org>); and The Institute of Business Appraisers (<http://www.go-iba.org>) (Gray 2008).

The US Government Accountability Office (GAO) is encouraging people to use its FraudNet system to report waste, fraud, abuse, or mismanagement related to funds distributed under the American Recovery and Reinvestment Act of 2009. The \$787 billion stimulus act was signed by President Obama on 17 February.

FraudNet is an e-mail, phone, and fax hotline that processes allegations about federal agencies and federally funded programs. Tips may be provided anonymously, and the GAO keeps all inquiries confidential. The GAO may refer allegations for follow-up to its own investigative units, appropriate inspector general offices, or to the Justice Department.

"The Recovery Act has set aside billions of dollars to create jobs, invest in infrastructure, and fund other measures to counter the current economic downturn. Experience tells us that the risk of fraud and abuse grows when large sums are spent quickly, eligibility requirements are being established or changed, and new programs created," Gene L. Dodaro, acting comptroller general of the United States and head of the GAO, said in a press release.

Below you can see the statistics about fraudulent activities in the USA:

1. Even small businesses that have been victims of employee fraud are failing to put proper systems in place to prevent future occurrences, according to a Sage Software survey conducted by M/A/R/C Research. The findings suggest that

proper use of accounting software may be a valuable weapon in a company's fraud prevention arsenal.

The survey found that 21% of small businesses did not have a system in place to prevent employee fraud and another 13% did not know whether they did or not. Furthermore, almost a quarter of companies which have suffered fraud losses in the past have still not established preventive measures. Twenty-eight percent of small businesses that responded to the survey said they had been victimized at some time by employee fraud.

Of the respondents that had internal control systems in place to prevent fraud, 47% were using their accounting software as a fraud prevention tool ([http://www.journalofaccountancy.com/Issues/2008/Oct/High\\_Tech\\_Fraud\\_Prevention.htm](http://www.journalofaccountancy.com/Issues/2008/Oct/High_Tech_Fraud_Prevention.htm)).

2. The Financial Crimes Enforcement Network (FinCEN) released a report that showed that subjects of mortgage loan fraud (MLF) suspicious activity reports (SARs) were the subjects of SARs related to other activities—including check fraud, securities fraud, and foreign wire transfers to Nigeria—at higher rates than the overall incidence of those SAR types.

The study, MLF connections with other financial crimes, examines the activities of people reported in depository institution SARs for MLF between July 2003 and June 2008, by evaluating SARs filed by money services businesses (SAR-MSB), securities brokers and dealers of insurance companies (SAR-SF), and casinos and card clubs (SAR-C).

The report said:

- Securities fraud was identified in 23% of SAR-SFs reporting MLF subjects, compared with 16% of all SAR-SFs in the same 5-year period.
- Approximately 70% of the examined SAR-MSBs described suspicious wire transfers by MLF subjects; 34% of those reports described transfers to foreign countries by MLF subjects. Nigeria was the most frequently reported destination of those funds, accounting for 10% of MLF subject activity reported in SAR-MSBs. In contrast, wire transfers to Nigeria reported in all SAR-MSBs represented only 3% of activity.
- In SAR-SFs, FinCEN found an unusually high number of reports of suspicious documents, fraudulent identifications, and forgery among MLF subjects.
- Check fraud by MLF subjects was reported in the SAR-Cs at an unusually high level, 17%—compared with only 3% of all SAR-Cs during the same 5-year period.

FinCEN also released Advisory FIN-2009-A001 to highlight red flags that are potential indicators of loan modification/foreclosure rescue scams. The advisory notes that the red flags only show possible indications of fraud. Some of the red flags include a homeowner making payments to a third party other than the mortgage holder or servicer; the so-called foreclosure specialist charging an upfront fee; the homeowner being pressured to sign paperwork he or she did not have an opportunity to read and did not thoroughly understand; the foreclosure specialist giving a guarantee that the home would be saved “no matter what”;

and the foreclosure specialist falsely claiming to be affiliated with the government (<http://www.journalofaccountancy.com/Issues/2009/Jun/Fraud>).

3. The Deloitte Forensic Center analyzed and reported on hundreds of SEC Accounting and Auditing Enforcement Releases (AAERs) issued from January 2000 through December 2007. The results of the analysis were compiled in the report **Ten Things About Financial Statement Fraud**—Second Edition, released in December of 2008. Among the findings:

From 2000 to 2007, the SEC issued 383 financial statement fraud AAERs relating to registered companies. In the years following the Enron and WorldCom collapses, the number of AAERs issued more than doubled from 35 in 2000 to 75 in 2003. The number has since fallen to fewer than 50 per year, beginning in 2005.

The analysts identified 1,403 alleged fraud schemes in the 383 financial statement AAERs used in the study. (A single release often identifies multiple, simultaneous schemes operating in a company.) The average number of fraud schemes identified per AAER increased to an average 4.2 in 2007, up from 2.7 in 2000.

Revenue recognition fraud schemes were the most common type, at 38% of the total. Five types of manipulation schemes (A/R, assets, expenses, liabilities, and reserves) combined to make up another 38% of the total types of schemes. Rounding out the list were improper disclosures (11%), asset misappropriation (4%), bribery and kickbacks (4%), investments (2%), aiding and abetting (2%), and goodwill (1%).

Of the 1,403 schemes identified in the AAERs studied, two industries accounted for two-thirds of the total schemes identified: technology, media, and telecommunications (37%) and consumer business (29%) (<http://www.journalofaccountancy.com/Issues/2009/May/StateofSchemes>).

4. SARs for suspected mortgage fraud increased 44% in the 12-month period ending June 30, 2008, according to Filing Trends in MLF, a report compiled by the FinCEN. In the most recent reporting period, financial institutions filed 62,084 SARs relating to mortgage fraud compared with 43,054 filings in the period between July 1, 2006, and June 30, 2007 (<http://www.journalofaccountancy.com/Issues/2009/May/Fraud>).

FinCEN proposed revised rules and new guidance that would permit certain affiliates of depository institutions as well as broker-dealers in securities, mutual funds, futures commission merchants, and introducing brokers in commodities to share SARs within a corporate organizational structure for purposes consistent with the BSA. FinCEN said it is seeking comment on whether the guidance should apply to other financial institutions in addition to the aforementioned ones.

Consistent with the BSA's purposes of promoting financial institutions' efforts to detect and report money laundering and terrorist financing, as well as ensuring the confidentiality of a SAR or any information that would reveal the existence of a SAR, the proposed rules and guidance permit the aforementioned financial institutions to share a SAR, or information that would reveal the existence of the



SAR, with an affiliate provided that the affiliate is subject to a SAR regulation issued by FinCEN or the Federal Banking Agencies. FinCEN believes the proposed changes will benefit industry by:

- Helping financial institutions better facilitate compliance with the applicable requirements of the BSA and more effectively implement enterprise-wide risk management.
- Helping financial institutions assess risks based on information regarding suspicious transactions taking place through other affiliates or lines of business within their corporate organizational structures.
- Enabling a filing institution to share the SAR with certain affiliates, thus eliminating the present need to create a separate summary document which has to be crafted carefully to avoid revealing the existence of the SAR itself.

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### Conclusion

In recent years, corruption in the US companies has attracted the attention on fraud in many US organizations. Detection and prevention of corruption have given rise to the profession of forensic accounting. Forensic accounting, which has been growing rapidly as a profession in the world and has been accepted as a profession in countries such as Canada, Australia, the USA, and the UK, is beginning to gain the importance that it deserves.

The traditional auditor was following a reactive approach during the audit process. Now we see that proactive approaches have begun to replace the reactive solutions. Once the loss has occurred, neither detection nor investigation could compensate the loss. In fact, these procedures would also cost business a large sum of money. Due to this fact, the most important thing companies have to do with regard to fraud is to prevent the crime from being committed. To prevent the crime, two concepts move to the top of the corporate agenda: deterrence and motivation. Rules, regulations, and legislation play deterrence role, while motivation is provided with education and training.

The landmark legislation Sarbanes-Oxley Law has significantly contributed and consolidated the effectiveness of the code of ethics and moral standards in the organizations. Countries enact and adopt new regulations as the need arises as a result of corruptions, fraud, and bankruptcies due to unethical applications on the part of corporate entities.

Rules and legislations are one side of the issue. In order to have a solid and strong fight against fraud and other wrongdoings in the companies, employees should be trained. Here, forensic accountant comes first as the person primarily in charge of identification, investigation, and detection of fraud. Therefore, it will be meaningful for corporations to contribute authority and capabilities of the forensic accountant. Besides, related institutions should provide a good and sound theoretical education to raise awareness about the role of forensic accountants.

Australia is a good example from all of the aspects we mentioned above. They have many institutions which collaborate together in the fight against the crime. Moreover, higher institutions in the country offer graduate and postgraduate

courses on forensic accounting. As a result of these factors, the amount of loss due to fraud is by far less in Australia than in the USA and UK. As we mentioned, US loses \$600 billion per year, and a study by KPMG says that the figure for the UK is roughly about £200,000 per year, while the figure for Australia is \$4.5 billion (AUD).

In conclusion, forensic accounting will no doubt be one of the best careers of the future. As in the case of Australia, other countries and companies in other parts of the world should make material and moral investments for this profession, in order to ensure that individuals, corporations, all of an economy sectors, government departments, and countries are protected and consequently the entire world would be a better place for all.

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# A Critical Analysis of the Effects of Measurements on International Company Scandals: The Fraud Act

## 3

Nermin Çıtak

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### 3.1 Introduction

Following a series of global corporate scandals and the incidence of employees' fraudulent activities in the companies they work for over the two decades, the desire by stakeholders for more reliable information has increasingly become greater. Corporate scandals such as Enron, WorldCom, Vivendi, Royal Ahold, etc., which shook the corporate world to its very root as a result of some accounting irregularities, have weakened the trust and confidence of the public to a very high degree, whereas the concept of trust was supposed to be the basis on which international investment and economic development should be grounded (Gunn 2007). According to Chambers (2008), despite a series of measures which have since been taken, these scandals which were first reported in the media in the 2000s continue to hunt the corporate world. This was confirmed by the global mortgage crisis which originated in the USA in 2008 and was originally referred to as *credit crisis*, but eventually became a global financial crisis.

As a result of all these events, several actions have been taken first in the USA and subsequently around over world to uncover the events which led to these fraudulent activities in order to prevent similar events from taking place in the future. The US Government led the way in this area when it passed the Sarbanes Oxley Law, popularly known as the SOX Law, in 2002. A series of government regulations have since been enacted in this regard in other countries of the world following the SOX Law. These governmental attempts were designed to ensure to prevent the reoccurrence of these scandals and to restore confidence in financial reporting.

It was extremely important that the precautions taken were robust enough to uncover and prevent similar occurrences from taking place. With these objectives at

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the fore, the many studies and analyses of the *The Association of Certified Fraud Examiners* (ACFE) would serve as the basis on which comparisons would be made in order to discover whether actions taken to prevent dishonest employees' from engaging in unacceptable practices such as practicing tricks, frauds, and fraudulent financial reporting, and also to elicit whether or not the attempt to dissuade people from engaging in these irresponsible practices are effective.

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## 3.2 Explaining the Acts of Fraud

There are two ways of obtaining something from somebody illegally. One of them is to use physical force and the other is to trick the owner of the good to give it out without being aware that he/she has been tricked. The first explanation means to rob. Also, this concept has a more violent and mediatic connotation. The second explanation connotes two concepts: deception and swindling. Additionally, trick causes much more losses than robbery (Albrecht and Albrecht 2003). The concept of trick has a very wide scope and field of application. It can be defined in many ways. It is in fact guilt, where an employee illegally enriches him/herself using the company's assets and resources or by gaining unjust profits (Arens et al. 2006; Biegelman and Bartow 2006). The components forming the tricky act are defined in the ACFE Fraud Report (2006) as follows:

- It is an activity conducted secretly
- The person carrying out the fraudulent act benefits from it
- It certainly includes the component of intention
- In any case, the company suffers as a result of the act

In order for a trick to be formed, three components should be present. These are pressure, opportunity, and proving to be right (Vanasco 1998; Schilit 1994). Once these three elements come together, the presence of fraud will be inevitable. The act of fraud can be conducted in many ways. It is not possible to reveal the act only by looking at the company's accounts or financial tables. In the determination of the act of fraud, there are a lot of signs. For example, that a worker drives a luxurious car more expensive than she/he can buy with the money she/he earns could be a sign of trick (Carozza 2008).

The act of fraud, especially the ones directed toward companies, is considered as an important problem in the world, and for this reason, a lot of precautions are being taken in the prevention of fraud. It is nearly impossible to find a broadcast organ, a person, or an institution which states that fraud is not an important problem. Despite all the precautions taken, the incidence of fraud that takes place in companies continues to increase day by day in terms of both its frequency and the sums involved. To be sure about the frequency and the full financial cost of fraud committed against companies is nearly impossible (Bozkurt 2009).

### 3.3 Types of Fraud

The ACFE in 2002 grouped frauds committed against companies under three main categories. These are as follows:

First, the misuse of company assets (worker's tricks): This type of fraud can be defined as the misuse of the company assets and resources by its employees. This is tantamount to the company's employees stealing money from the safe or goods from stocks. Or using the company's assets, e.g., office equipment or other movables, for his/her own benefit, is an example of this type.

Second, fraud: With the aim of providing benefit for oneself or for someone else outside the company, it is workers' disregarding both the company's rights and other people's rights who may be affected by this. Clash between the benefits and bribery can be given as an example of this type. This type of trick can be carried out by both managers and other employees of the company. However, the impacts of both groups' tricks can change in terms of the resulting damages on the company.

Third, fraudulent financial reporting: Fraudulent financial reporting is to provide wrong information intentionally about the company's financial state of affairs with the intention to mislead the end users of the financial information. Thus by providing wrong information or withholding some aspect of the required information, the recipient is misled into believing the end results of the information obtained. This type can be realized by showing the company in either a better or a worse financial state depending on the position the provider of the information wanted the recipient to see (Stowoly and Breton 2000). For instance, showing incomes and profits higher than they are in reality, and showing expenditures and losses lower than they are depending on the picture the provider of the information wishes the receiver to see also belong to this type.

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### 3.4 Sarbanes Oxley Act (SOX) and Its Novelties Regarding the Prevention of Fraud

The twenty-first century commenced with a few accounting scandals in some developed parts of the world. As a result of this, governments of these countries have taken a series of precautions. These precautions have resulted in the development of some accounting and audit guidelines for financial reporting purposes.

These corporate scandals have clearly demonstrated the inadequacies of the audit process carried out by external auditors in some respects and demonstrated the need for an urgent fundamental change in order to restore confidence and put things on the right footing (Defond and Francis 2005). For this reason, a series of measures have been taken primarily in the USA. Before the SOX Law was passed, Securities Exchange Commission (SEC) explained that it was in support of companies which were desiring to establish audit committees which are open to the public through a notification that was published as a result of frauds in accounting in 1972 in order to gain the trust of

public and with the intention of protecting the investors. On the other hand, in 1974, the SEC wanted to know whether companies had audit committees, and an explanation from them on whether the audit committees were independent or not if they had them in place. It then established a line of regulations stating that the audit team should be founded and be responsible for ensuring the effectiveness of the company's internal control structure, trustability of the financial reporting, and appropriateness of the activities in terms of the regulations in the name of company's board of directors (Uyar 2004).

However, it later became apparent that these regulations were inadequate; otherwise, the Enron scandal would not have taken place, which was the reason why the now famous SOX Law (2002) was launched on 30 July 2002 (Linck et al. 2005). The SOX Law includes the most comprehensive and important accounting regulations and institutional management principles that have been put in place after the crisis experienced since the 1930s (Moeller 2004; Ijiri 2005; Linck et al. 2005). The SOX Law has made important provisions as to what is expected of companies in this regard to ensure that a similar occurrence does not take place. The law also made clear the various sanctions and punishments to those caught contravening the law in this area. The objectives are to discourage anyone who might nurse the idea of getting involved in a similar act.

The relationship between the SOX Law and corporate disclosure is to ensure that by giving more information to stakeholders, the disclosure responsibility of the company management is drastically increased which then affords adequate protection to the rights of the investors while increasing the responsibility of supervision of the audit team and providing independence to the audit process, the auditor, and the client company. With this law, the auditor will report not to company management, but directly to audit committee. This situation will result in auditor's responsibility moving toward the shareholders rather than the company management (Uyar 2004).

The SOX Law (2002) is composed of 11 main titles. The Act established the Public Company Accounting Oversight Board (PCOAB) with which all public companies must now register.

One of the most important subjects in the law is that of independent audit. The mistrust in the audited published financial statements was caused as a result of the relationship between the auditor and audit process not being independent enough. This meant that the relationship between the auditors and companies available to public was very limited (Uysal 2004).

Other regulations introduced by Sarbanes Oxley Act (2002) are explained in the following section:

1. The necessity for company's financial statements to be approved by the board of directors, for the disclosure of all subjects that may affect the company's financial reporting as at the reporting date have been clearly defined, and for a process of evaluation to be carried out within 90 days was mentioned. Furthermore, the law also mentioned under the heading of "Effecting in an inappropriate manner" the responsibility of the management to determine and act to remove any event which the company's managers perceive as misleading or be construed as being fraudulent which would adversely affect the audit or act in a way which results in providing incorrect and misleading reporting of the financial state of the company or be regarded as illegal.

2. The Act also puts the onus on the company's management to establish an effective internal control structure and procedure. It is also important that the management provides in a report an evaluation of the effectiveness of the internal structure and procedure the company has in place at the end of each year. Additionally, the Chief Financial Officer (CFO) is required to conduct himself/herself in such a way that his/her personal and professional affairs do not conflict with his/her professional duties. The CFO must be honest and ethical; he or she must correctly, honestly, completely, punctually, and clearly report on the company's financial affairs. The CFO is required to behave in an appropriate way at all times in line with the government's rules and regulations.
3. Listed companies should explain the changes occurring in financial terms and activities as soon as possible in order to protect the investors. In the eighth part of the law, the responsibilities of the company regarding fraud are explained. According to this, there are new obligations with regard to this subject. These are stated below:
  - Resorting to illegal applications such as making fraudulent alterations or changes in the accounting records in order to prevent any federal research or bankruptcy lawsuit will be punished by up to 20 years imprisonment and a heavy fine.
  - It is necessary that companies keep their audit and study documents for 5 years after their financial year ends. Any changes made in order to mislead or deceive on these documents will be punished by up to 10 years of imprisonment and a heavy fine.
  - In the event that investors are provided with misleading information on purpose and cheated as a result, those involved in the misleading act will be punished by up to 25 years of imprisonment and a heavy fine.
  - Those employees who pass on information about their companies to the capital markets board of their managers' wrongdoings, or assist and help researchers about the subject, will be protected by the court.
  - In the event that the statements of accounts are not approved by the company's management according to the standards of accounting, the punishment will be US\$1,000,000 and/or imprisonment of up to 10 years. If the appropriateness of the statements of accounts in terms of the standards is not approved on purpose, the punishment will be US\$5,000,000 and/or imprisonment of up to 20 years.

According to Tekin (2003), as understood from the explanations with SOX Law above, traditional executive-oriented company organization in the USA has been changed and audit-oriented system has been launched. Along with this, via this law, extra cost is added to the companies. This cost is predicted to be about US\$150–250 million for a medium-sized company. These extreme precautions taken by the USA and which partially conflict with other countries' regulations have caused serious problems in its relations with Continental Europe (Corporate Governance and Sarbanes Oxley Law, paragraph 5). Although SOX's costs have decreased in time, especially for small companies, SOX means high cost (Riotto 2008; Coates 2007).

As a result of the regulations by SOX, with the increase in the costs to companies, many research studies have been conducted on the SOX's effects on the market. One of these research studies has been done by Chhaochharia and Grinstein (cited in Ribstein 2005) and in this study, it is stated that the regulations



taking place in SOX have a positive and statistically important impact on big companies, yet they do not have so much impact on smaller companies.

New regulations entailed by SOX, as explained above, have especially resulted in considerable increase in companies' audit fees.

### **3.5 The Study of the Effects of the Precautions Taken After Global Corporate Scandals on Fraud Act**

#### **3.5.1 General Information About the Reports**

In many parts of the world, especially in universities and professional institutions in the USA and Europe, various studies have been conducted on fraud. The results arising from these studies are published and used as a bedside source in many publications (Bozkurt 2009). In Bozkurt (2009) study, due to its being related to the subject, the publications of some of these professional bodies which are conducting research studies on fraud and similar white-collar crimes have increased our understanding of the problem and they are also helping to reduce the incidence of the problem. The names of some of these institutions and their publications are given below:

- ACFE 2002, 2004, 2006, and 2008 dated fraud reports
- A fraud report dated 2007 and prepared by an international audit company Pricewaterhouse Coopers: “Economic Crime: People, Culture and Controls”
- The report dated 2007 and prepared by an international audit company KPMG: “A study on the profile of an abuser”

Some of the most serious studies on fraud are fraud reports published by the ACFE (2002, 2004, 2006, 2008). The number and the incidence of fraud published are found in these reports and the costs of the fraud are determined, and also the costs of the tricks are set in accordance with company types and sectors. The ways of revealing the frauds and audits related with SOX are ascertained. Numerical explanations on the subject will be made in detail in the part below.

Another important study carried out on this subject was by Pricewaterhouse Coopers (2007) titled “*Economic Crime: People, Culture and Controls*.” In this report, it was stated that trick is one of the most important subjects for companies of various size and in different sectors in the world, and for this reason, when preparing the report, senior managers of 5,428 companies which were chosen from 40 countries participated in the study. The report notes that 43% of these managers identified some important events in the period between 2005 and 2007. Another important finding in the study relates the vast amount of investment between 2005 and 2007 for the prevention of the fraud. The report notes that during the period, the incidence of fraud was found to stay the same. In order for the prevention of fraud to be facilitated in companies, some companies have stated that by complying with the legislation in the area, they have been left to bear a considerable sum of money, while some others fight against the crime by using alternative methods.

The same report also notes that despite the fact that studies to prevent frauds result in extra costs to companies, the losses suffered by companies through bad reputation are higher.

The other study conducted on company tricks was released by KPMG in 2007 titled “*The Report of a Profile Research of Abusers.*” This report focused on abuse investigations recently carried out by the Abuse Prevention and Investigation Departments of KPMG in Europe, India, Middle East, and South Africa (EMA). In this report, it was mentioned that in order to analyze the problem, 360 profiles were chosen—one in every two in Europe, approximately one in every three in South Africa, and one in every four offenders in India and the Middle East. The report notes that the loss suffered was more than 1 million €.

**3.6 Studies on Fraud and Losses Suffered as a Result of the Crime**

As noted in the previous explanations, fraud reports published as a result of the studies on fraud by the ACFE, Pricewaterhouse Coopers, and KPMG are analyzed, and these reports are compared by years in order to come to a decision on whether there is a change in fraud losses. Tables 3.1–3.5 and Fig. 3.1 below provide the results of these studies, followed by this author’s explanations of them.

Table 3.1 and Fig. 3.1 show the losses suffered by American companies between 2002 and 2008. They show that the loss suffered in 2002 was \$600 billion but increased to \$994 billion in 2008. Other reports published on the crime confirmed these figures. For instance, in a study conducted by Pricewaterhouse Coopers (2007), the approximate loss between 2003 and 2005 per company was \$1,732,253, but between 2005 and 2007 it increased to \$2,420,700. Another important issue on this subject was that managers did not mention the size of the fraud and the loss occurring directly as “yes it is an important loss.” This demonstrated that the managers did not have enough knowledge about the gravity of the crime and the financial losses resulting from it. Again in the same report, it was found that the approximate loss between 2005 and 2007 was more than \$4.2 billion. Despite this fact, the companies did not believe that the amount of losses suffered as a result of this problem was material. There are also problems arising from other similar antisocial problems such as money laundering, bribery, and corruption which equally damage a company’s reputation and give it a bad image. All these affect the company adversely in many areas; for instance, it affects

**Table 3.1** Losses of American companies as a result of fraud by years

Year of report	2002	2004	2006	2008
Reported fraud number (item)	663	508	1.134	959
Resulting losses (in Billion USD)	600	660	652	994

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.2** Approximate fraud costs—USD according to the company type

Company type	2002	2004	2006	2008
Private firms	127,000	123,000	210,000	278,000
Public company	150,000	100,000	200,000	142,000
Government	48,000	37,500	100,000	100,000
Nonprofit organizations	40,000	100,000	100,000	109,000

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.3** Approximate fraud percentages according to company type

Company type	2002 (%)	2004 (%)	2006 (%)	2008 (%)
Private firms	31.9	41.8	36.8	39.1
Public company	30.0	30.3	31.7	28.4
Government	24.7	15.8	17.6	18.1
Nonprofit organizations	13.4	12.2	13.9	14.3

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.4** Approximate fraud costs according to sectors—USD

Classification of the sectors	2004	2006	2008
Banking/financial services	101,000	258,000	250,000
Government and public administration	45,000	82,000	93,000
Healthcare	105,000	160,000	150,000
Manufacturing	125,000	413,000	441,000
Retail	35,500	80,000	153,000
Education	31,000	100,000	58,000
Insurance	172,500	100,000	216,000
Construction	145,000	500,000	330,000
Religious, charitable, or social services	–	–	106,000
Services—other	139,000	163,000	100,000
Services—professional		300,000	180,000
Transportation and warehousing	225,000	109,000	250,000
Real estate	385,000	200,000	184,000
Technology	–	–	405,000
Utilities	30,000	124,000	90,000
Oil and gas	101,500	154,000	250,000
Wholesale trade	–	1,000,000	150,000
Arts, entertainment, and recreation	–	175,000	270,000
Telecommunications	–	–	800,000
Communications/publishing	150,000	225,000	150,000
Agriculture, forestry, fishing, and hunting	–	71,000	450,000
Mining	–	17,000,000	–
Other	145,000	–	–

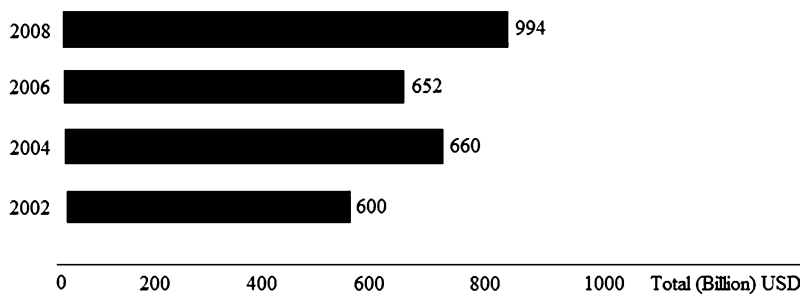
Source: ACFE Reports (2004, 2006, 2008)

**Table 3.5** Fraud numbers according to sectors and percentages

Classification of the sector	2004 cases	% Cases	2006 cases	% Cases	2008 cases	% Cases
Banking/financial services	56	11.1	148	14.3	132	14.6
Government and public administration	53	10.5	119	11.5	106	11.7
Healthcare	37	7.3	89	8.6	76	8.4
Manufacturing	65	12.9	101	9.7	65	7.2
Retail	40	7.9	75	7.2	63	7.0
Education	31	6.1	73	7.0	59	6.5
Insurance	46	9.1	78	7.5	51	5.6
Construction	17	3.4	35	3.38	42	4.6
Religious, charitable, or social services	—	—	—	—	39	4.3
Services—other	56	11.1	60	5.8	35	3.9
Services—professional	—	—	58	5.6	34	3.8
Transportation and warehousing	17	3.4	27	2.6	31	3.4
Real estate	11	2.2	30	2.90	29	3.2
Technology	—	—	—	—	28	3.1
Utilities	13	2.6	34	3.28	22	2.4
Oil and gas	16	3.2	32	3.09	17	1.9
Wholesale trade	—	—	30	2.90	17	1.9
Arts, entertainment, and recreation	—	—	22	2.1	16	1.8
Telecommunications	—	—	—	—	16	1.8
Communications/publishing	13	2.6	16	1.5	14	1.5
Agriculture, forestry, fishing, and hunting	6	1.2	8	0.8	13	1.4
Mining	—	—	1	0.1	—	—
Other	47	9.3	—	—	—	—
Total	524	—	1,036	—	905	—

Source: ACFE Reports (2004, 2006, 2008)

#### YEARS



**Fig. 3.1** Losses of American companies as a result of fraud by years. Source: ACFE Reports (2002, 2004, 2006, 2008)

the company's share value on the stock market; it could damage its relations with the suppliers and customers which could consequently affect its bottom-line results both in the short and the long term.

Table 3.2 shows the incidence of fraud between 2002 and 2008 according to the types of companies and the financial costs of fraud in approximate terms. Before the SOX Law came into force, in public companies the approximate rate of fraud was 30%. It decreased to 28.4% in 2008, and in government institutions, it decreased from 24.7% to 18.1%. Financial statement fraud is planned by some public companies in order to raise their stock share prices and obtain a bank loan easily. (Mulford and Comiskey 2002).

As shown in Tables 3.2 and 3.3, approximate rate of fraud in private companies in 2002 was 31.9%, and by 2008 it increased to 39.1%—an increase of 7.2% over the time period. In the same manner, the approximate fraud costs increased from \$127,000 in 2002 to \$278,000 USD in 2008.

Tables 3.4 and 3.5 show fraud percentages and numbers according to sectors. The 2002 ACFE report has not determined fraud costs according to sectors, but the report provides the data for 2004, 2006, and 2008, as shown in the tables. As shown in Tables 3.4 and 3.5, the sector with the highest fraud rate is banking and financial services. In the banking and financial services sector, there was a 3.5% increase in the incidence of fraud between 2004 and 2008. Other sectors which follow the banking and financial services sector in terms of fraud percentages and costs are public institutions, healthcare, and production sectors. Despite the fact that the fraud percentage in the production sector seemed lower when compared with that of the banking and financial services sector, fraud costs were found to be higher. In fraud costs, there was an increase of \$316,000 compared to the costs in 2004.

In the research conducted by KPMG (2007), all the sectors in Europe can be said to have been affected by fraud more or less at the same rates. The sectors of infrastructure, public institutions, and healthcare came first with 29%, followed by industrial markets with 19%, and then by information, communications, and entertainment sectors with 17%.

Tables 3.6 and 3.7 show that the highest figures are found in companies which employ less than 100 people, considered in terms of the percentages for both fraud costs and the incidence of fraud. Again in the same tables, it could be seen that in companies with more than 10,000 employees, fraud costs are lower than that of

**Table 3.6** Approximate fraud costs according to the number of employees—USD

Number of employees	2002	2004	2006	2008
Less than 100	127,500	98,000	190,000	200,000
100–999	135,000	78,500	179,000	176,000
1,000–9,999	53,000	87,500	120,000	116,000
More than 10,000 people	97,000	105,500	150,000	147,000

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.7** Approximate fraud percentages according to the number of employees

Number of employees	2002 (%)	2004 (%)	2006 (%)	2008 (%)
Less than 100	39.0	45.8	36.0	38.2
100–999	20.1	21.1	20.3	20.0
1,000–9,999	23.4	19.8	24.8	23.0
More than 10,000 people	17.5	13.3	18.9	18.9

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.8** The distribution of the frauds in small companies

Method	2004 (cases)	Percentage (%)	2006 (cases)	Percentage (%)	2008 (cases)	Percentage (%)
Billing	74	33.0	94	24.7	98	28.7
Check tampering	74	33.0	111	29.1	87	25.4
Corruption	56	25.0	87	22.8	79	23.1
Skimming	68	30.4	105	27.6	71	20.8
Expense reimbursement	41	18.3	88	23.1	53	15.5
Cash on hand	56	25.0	75	19.7	53	15.5
Cash larceny					52	15.2
Non-cash	39	17.4	67	17.6	51	14.9
Payroll	45	20.1	68	17.8	48	14.0
Fraudulent financial statements	22	9.8	46	12.1	42	12.3
Register disbursements	7	3.1	6	1.6	12	3.5

Source: ACFE Reports (2004, 2006, 2008)

companies with less than 100 employees. This situation demonstrates that smaller companies are at a higher risk than larger ones.

Despite the fact that there was a decrease in fraud costs in 2004, in companies with less than 100 employees in 2006 and 2008, again there was an increase. In companies with more than 10,000 employees, the fraud percentage which was 13.3% in 2004 was observed to increase to 18.9% in 2006 and remained at 18.9% in 2008—an increase of 5.6% over the 2004 percentage.

Table 3.8 demonstrates the distribution of fraud methods in small companies. According to the table, the most frequent type of fraud in small companies relates to billings with 28.7%. The main underlying reason for this is the lower probability of being detected when compared with other types of fraud. Furthermore, there is the possibility that mistakes are made in invoices. In the smaller companies, the main reasons for the high incidence of fraud are the absence of institutionalization, poor internal control systems, and the failure to apply principle of separation of duties among employees (Bozkurt 2009).

In the research conducted by KPMG (2007), the percentages of the possibilities of the realization of fraud acts according to the company size were determined. According to the report, it was discovered that in Europe 23%, South Africa 8%, and India and the Middle East 21% of the companies with endorsements of

**Table 3.9** Approximate distribution of costs according to fraud methods—USD

Method	2002	2004	2006	2008
Asset misappropriation (employee's frauds)	80,000	93,000	150,000	150,000
Corruption	530,000	250,000	538,000	375,000
Fraudulent financial statement	4,250,000	1,000,000	2,000,000	2,000,000

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.10** Approximate fraud percentages according to fraud methods

Method	2002 (%)	2004 (%)	2006 (%)	2008 (%)
Asset misappropriation (employee's frauds)	85.7	92.7	91.5	88.7
Corruption	12.8	30.1	30.8	27.4
Fraudulent financial statement	5.1	7.9	10.6	10.3

Source: ACFE Reports (2002, 2004, 2006, 2008)

1 billion € or more were likely to experience the incidence of fraud. Again in the same research, it was found that small- and middle-sized companies were at equally the same level of risk as big companies. In all, 50% of the companies in Europe, 63% of those in South Africa, and 34% of those in India and the Middle East with endorsements of less than 50 million € were found to have experienced the incidence of fraud at some point. Based on these results, it was understood that small- and middle-sized companies are seriously at risk of fraud being committed against them.

When looked at the tables of approximate fraud percentages according to the method of fraud, employee-perpetrated fraud is seen to a higher percentage than others. However, the figure of fraud committed in fraudulent financial reporting was about 10%; when considered in terms of the cost, this represents the group causing the biggest problem. The average rate of employee fraud was set at 85.7% in 2002. In the following years such as 2004, 2006 and 2008 these rates were increased to 97.7%, 91.5% and 88.7%. This situation shows us an increase in the fraud costs and in the percentages of the employee fraud (Tables 3.9 and 3.10).

In corruption, the 2002 figure was 12.8%, while that of 2004 rose to 30.1%. The respective figures for 2006 and 2008 were 30.8% and 27.4%. The fraud costs figure for 2002 was approximately \$530,000, while there was a decrease in the figure for 2004 by about \$180,000, as the figure for that year was \$250,000. The figure for 2006 was about the same as that for 2004. In 2008, the figure was \$375,000. Among the methods used to perpetrate fraud, fraudulent financial reporting had the lowest fraud percentage but had the highest total in terms of cost. In 2002, while the approximate figure was 5.1%, in 2004 there was an increase of 2.8%, as the figure for that year was 7.9%, in 2006 there was also an increase of 2.7% as the figure for that year was 10.6%. In 2008, the figure was 10.3%. In 2002, in spite of the fact that the approximate fraud cost was \$4,250,000 before the SOX Law came into force, it increased by a certain percentage, but after the SOX Law became effective, it decreased to \$1,000,000 in 2004. However, when the approximate fraud costs of 2006 and 2008 were compared to those in 2004, it went up to \$2,000,000, an

**Table 3.11** Frauds of monetary worth and approximate cost—USD

Method	2002	2004	2006	2008
Cash larceny	25,000	80,000	73,000	75,000
Skimming	70,000	85,000	76,000	80,000

Source: ACFE Reports (2002, 2004, 2006, 2008)

**Table 3.12** Frauds of monetary worth and approximate percentages

Method	2002 (%)	2004 (%)	2006 (%)	2008 (%)
Cash larceny	8.9	23.9	14.2	10.3
Skimming	31.8	28.2	18.9	16.6

Source: ACFE Reports (2002, 2004, 2006, 2008)

increase of 50%. Any significant decrease is not seen in the costs and in percentage terms of the employee fraud, corruption and financial reporting fraud as seen from the results above.

The results of a similar research by Pricewaterhouse Coopers (2007) show that fraud costs increased to an important level. Approximate fraud rate resulting from wrong use of goods was 30%, accounting frauds was about 12%, sum of losses incurred from wrong use of goods was \$1,280,000, and the loss suffered in accounting frauds was \$1,477,000.

Cash fraud is the easiest form of fraud with the greatest chances of detection. Having said this, it should not be assumed that fraud criminals avoid this type of fraud. Tables 3.11 and 3.12 provide information on the monetary worth and approximate costs in percentages. Cash Larceny in 2002 was \$25,000; it increased to \$80,000 in 2004. In 2006 and 2008, a visible decrease in cash frauds was not observed. A decrease in skimming was observed between 2004 and 2008.

In a study carried out by KPMG (2007), cash larceny was found to be much higher. According to this report, cash larceny in Europe was 22%, the figure for South Africa was 25%, and that for India and the Middle East was 24%. When these results were compared with the ACFE report of 2008, it was noted that cash larceny appears to be 200% higher in Europe, South Africa, India, and the Middle East.

Table 3.13 shows the decrease in the losses suffered by companies in percentage and monetary terms with the application of the control systems stipulated by the SOX Law. As shown in Table 3.13, it could be observed that the installation of the process of *surprise audits* in a company's control systems is an effective method of reducing the incidence of fraud. The presence of surprise audits reduces the problem by 66.2%. The second important control was the setting up of a system of job rotation. Companies which have the system of job rotation in place reduce the incidence of fraud by 61% compared to companies with no system of job rotation. Hotline is an effective method against any kind of fraudulent acts and it ranks third in the table. In the event that there are hotlines in companies, fraud acts were seen to decrease to 60%.



### 3.7 Effects of SOX-Related Controls on Companies in Uncovering or Preventing the Crime of Fraud

Another important element in the ACFE (2008) report relates to the effectiveness of the compulsory control systems required by the SOX Law. As required by the law, companies are obliged to apply certain controls in order to prevent the crime from being committed. Table 3.14 demonstrates the effectiveness of SOX-related control systems in companies which are public, private, nonprofit organizations, and public sector institutions.

When Table 3.14 is analyzed, the effect of these controls on fraud by public companies is detected to be at considerable amounts. Public companies are able to

**Table 3.13** Median loss based on presence of antifraud controls

Control	Yes	No	% Reduction
Surprise audits	70,000	207,000	66.2
Job rotation/mandatory vacation	64,000	164,000	61.0
Hotline	100,000	250,000	60.0
Employee support programs	110,000	250,000	56.0
Fraud training for managers/executives	100,000	227,000	55.9
Internal audit/FE department	118,000	250,000	52.8
Fraud training for employees	100,000	208,000	51.9
Antifraud policy	100,000	197,000	49.2
External audit of F/S	150,000	250,000	40.0
Code of conduct	126,000	232,000	45.7
Independent audit committee	137,000	200,000	31.5
Rewards for whistleblowers	107,000	150,000	28.7

Source: ACFE Reports (2008)

**Table 3.14** SOX-related internal controls in public companies (256 cases)

Control	Control in place?				Median loss			Months to detection		
	Yes	No	Yes	No	% Reduction	Yes	No	% Reduction	Yes	No
Independent audit committee	228	89.1%	13	5.1%	139,000	463,000	70.0	18	24	25.0
Management certification of F/S	226	88.3%	8	3.1%	135,000	3,725,000	96.4	18	15	—20
External audit of ICOFR	212	82.8%	16	6.3%	125,000	1,150,000	89.1	18	27	33.3
Hotline	197	77.0%	28	10.9%	100,000	784,000	87.2	16	24	33.3
Management review of IC	188	73.4%	36	14.1%	110,000	425,000	74.1	14	18	22.2

Source: ACFE Reports (2008)

abide by the controls enforced by SOX. Public companies which have SOX-related controls have suffered less losses, the percentages fall between 70% and 96% compared to that in companies that have not had these controls in place. As seen in Table 3.14, all the controls exercised are positive to a considerable extent. For instance, the approximate losses by companies with independent audit committees were less than 70%, and the frauds could be detected earlier than 6 months compared to that in the companies which have no independent audit team. Another important control tool is Management Certification of F/S. The companies using this control system was found to suffer less than 96.4% loss. However, the period for uncovering the fraud was within 18 months in companies where financial statements are approved by the management, and 15 months in companies open to public where this control system was not used. External audit (89.1%) and hotlines (87.2%) also have positive impacts on companies open to the public in a similar manner. In the event that these two controls were present, the period for uncovering the fraud was seen to be shorter when compared with that in companies where these controls were absent. Management review of internal control by creating a positive impact on companies that are open to public with a percentage of 74.1% is found to be the control method enabling the fraud to be uncovered within 4 months.

Table 3.15 provides information on private companies’ SOX-related controls with the effects on fraud. Though private companies are not obliged to abide by SOX, most of them voluntarily adopt the requirements of the law in order to prevent the incidence of fraud. The rules specified by SOX also guide private companies and assist them in preventing and uncovering fraud. Especially, hotlines have created considerable effect on the prevention of fraud in private companies. In companies with hotlines, the period to uncover fraud has reduced to 50%: in companies with hotlines, the period to uncover fraud is 12 months, while in

**Table 3.15** SOX-related internal controls in private companies—352 events

Control	Control in place?				Median loss			Months to detection		
	Yes	No	Yes	No	Yes	No	% Reduction	Yes	No	% Reduction
Management certification of F/S	113	32.1%	182	51.7%	236,000	310,000	23.9	18	24	25
External audit of ICOFR	106	30.1%	201	57.1%	250,000	300,000	16.7	15	26	42.3
Management review of IC	87	24.7%	211	59.9%	150,000	266,000	43.6	13	24	45.8
Independent audit committee	87	24.7%	239	67.9%	264,000	295,000	10.5	12	24	50.0
Hotline	66	18.8%	254	72.2%	115,000	350,000	67.1	12	24	50.0

Source: ACFE Reports (2008)

companies without hotlines this period is 24 months. Among other controls used by private companies is management review of internal control with a rate of 43%. In companies with management review of internal control, the approximate loss is about \$150,000, while companies without these have a figure of \$266,000. In the event of these controls being in place, frauds are determined and uncovered 11 months earlier than in the absence of these controls.

Nonprofits in their combat against frauds experience certain difficulties when compared with other types of companies. These types of companies do not save enough resources for more effective controls in uncovering or preventing frauds, and for this reason, they cannot be successful in detecting the perpetrators of the crime. As seen in Table 3.16, the commonest controls used by nonprofit organizations are hotlines (59.7%), and management review of internal control (56.5%) as it is in private companies. The period for uncovering frauds is seen to reduce to a rate of 60% with hotlines and to 50% with management review of internal control. As seen in Table 3.16, there are other important issues used by the audit committee to assist in the approval of the financial statements by the management.

According to ACFE's 2008 Report, it was identified that public institutions funded by taxpayers use control systems similar to those used by large companies in detecting and preventing fraud. As seen in Table 3.17, in these public sector institutions, as a result of the systems put in place for fraud prevention, the most effective method was found to be the external audit, with a decrease of 69%. External audit is followed by the independent audit committee with a rate of 37% when considered in terms of the period for exposition of fraud; external audit and management review of internal control come with a rate of 33.3%. Another important issue seen in Table 3.17 is that hotlines which are ultimately effective in other types of companies are the least effective in public sector institutions with a rate of 17.4%.

**Table 3.16** SOX-related internal controls in nonprofits—129 events

Control	Control in place?		Median loss		% Reduction	Months to detection		
	Yes	No	Yes	No		Yes	No	% Reduction
Independent audit committee	69	53.5%	57	44.2%	115.000	109.000	−5.5	19 24 20.8
External audit of ICOFR	68	52.7%	51	39.5%	90.000	100.000	10	16 30 46.7
Management certification of F/S	56	43.4%	61	47.3%	110.000	109.000	−0.9	24 24 0.0
Hotline	41	31.8%	80	62.0%	50.000	124.000	59.7	12 30 60.0
Management review of IC	35	27.1%	82	63.6%	50.000	115.000	56.5	12 24 50.0

Source: ACFE Reports (2008)

**Table 3.17** SOX-related internal controls in government—163 events

Control	Control in place?				Median loss			Months to detection		
	Yes		No		Yes	No	% Reduction	Yes	No	% Reduction
External audit of ICOFR	99	60.7%	39	23.9%	61,000	197,000	69.0	24	36	33.3
Hotline	90	55.2%	56	34.4%	100,000	121,000	17.4	21	30	30.0
Management certification of F/S	77	47.2%	54	33.1%	82,000	113,000	27.4	24	24	0.0
Independent audit committee	64	39.3%	84	51.5%	74,000	118,000	37.3	24	28	14.3
Management review of IC	62	38.0%	71	43.6%	100,000	150,000	33.3	20	30	33.3

Source: ACFE Reports (2008)

### 3.8 The Effects of SOX-Related Controls on the Exposition or Prevention of Fraud on Financial Statements and Listing of the Controls in Terms of Their Importance

The SOX Act became law in response to many fraudulent disclosures in financial statements of some large American corporations. It was deemed necessary to initiate and install some control mechanisms that could assist in uncovering and preventing fraudulent disclosure in financial statements. In the ACFE (2008) report, the effects of SOX-related control mechanisms in all financial statements to detect fraud activities were analyzed. The report found that the presence of the precautions taken to prevent and control fraud did not necessarily reduce the approximate loss as a result of fraud in financial statements, but only hotlines were able to meet the objective. In the same report, it was mentioned that companies which apply SOX-related control were able to confront fraudulent practices in financial statements. The report notes that the detection of fraudulent activities in financial statement took longer in companies which have independent audit committees.

Table 3.18 provides information on SOX-related control. It could be seen that the table reveals some interesting findings. Except for hotlines, other controls are found to have a positive effect on the prevention of fraud in financial statements. Management Certification of F/S has revealed some negative effects with a rate of −169.2%. In companies where no such control exists, the loss incurred was about \$1,300,000, while the figure for companies with no such control in place was \$3,500,000. Furthermore, in Table 3.18, Management Certification of F/S has shown that the companies using this control tool detect frauds 5 months later than the companies without this control tool. Another important control tool in the table is the independent audit committee. Table 3.18 shows that in companies with the independent audit committee, the approximate loss was \$7,000,000, while that in companies without the committee was \$1,500,000, and the rate of loss was

**Table 3.18** SOX-related internal controls in financial statement fraud cases—99 events

Control	Control in place?				Median loss			Months to detection		
	Yes		No		Yes	No	% Reduction	Yes	No	% Reduction
Management certification of F/S	53	53.5%	32	32.3%	3,500,000	1,300,000	−169.2	33	28	−17.9
External audit of ICOFR	41	41.4%	40	40.4%	3,250,000	1,868,000	−74	24	30	20
Independent audit committee	40	40.4%	47	47.5%	7,000,000	1,500,000	−366.7	36	30	−20
Management review of IC	34	34.3%	43	43.4%	3,000,000	2,000,000	−50	25	30	16.7
Hotline	24	24.2%	53	53.5%	2,000,000	2,500,000	20	26	30	13.3

Source: ACFE Reports (2008)

determined to be −366.7%. While in companies without an independent audit committee, the incidence of fraud was uncovered within a period of 30 months, the period for the companies with an independent audit committee was about 36 months. Its effect in uncovering financial statements fraud was −74%. The effect of management review of internal control was set to be −50%. Hotlines were found to be the only control tool with a positive effect on approximate losses in SOX-related control of fraud in financial statements. The companies with hotlines have approximate loss of \$2,000,000, while the companies without them lost \$2,500,000. Additionally, in Table 3.18, it was seen that companies with hotlines uncover frauds 4 months earlier than the companies without them.

Another important subject seen in the ACFE (2008) report was the order of control in terms of their importance in uncovering or preventing fraud. According to the ACFEs report, in asset misappropriations (employee's frauds), corruption, and financial statement fraud, the more important control mechanisms are shown as follows, in Table 3.19.

In the detection of fraud in terms of the misuse of company's resources (internally committed fraud—employees fraud), the most effective method comes in via the system of internal audit. This is followed by surprise audits and the management examination of the internal control; hotlines were in the fifth position. The effectiveness of these methods was ranked in the following order: in first place was internal audit, in the second place was hotlines, and this was followed by surprise audit. Hotline was found to be more effective in uncovering corruption than employees' frauds. Like the independent audit of the financial statements, control was primarily aimed at determining the financial statement fraud. Despite the rewards for whistleblowers which was thought to be less effective in uncovering and preventing the financial statements' fraud, it is occurring in the first place and this is followed by internal audit and hotlines. This situation overlaps with the data in Table 3.18, on SOX-related control in financial table statements.

**Table 3.19** ACFE's order of control asset misappropriations (employee's frauds), corruption, and financial statement fraud according to their level of importance

Misappropriations (employee's frauds)	Corruption	Financial statement fraud
Internal audit/FE department	Internal audit/FE department	Rewards for whistleblowers
Surprise audits	Fraud hotline	Internal audit/FE department
Management review of IC	Surprise audits	Fraud hotline
Mandatory job rotation/vacations	Management review of IC	Surprise audits
Fraud hotline	Rewards for whistleblowers	Mandatory job rotation/vacations
Rewards for whistleblowers	Mandatory job rotation/vacations	Audit of F/S
Audit of ICOFR	Audit of F/S	Management review of IC
Audit of F/S	Audit of ICOFR	Audit of ICOFR

Source: ACFE Reports (2008)

## Conclusion

As a company becomes more successful in financial terms, the number of stakeholders wanting to use its financial statements in making a series of decisions increases. It is, therefore, important that the information contained in such financial statements is accurate and reliable. The list of these stakeholders is long. Some of them are managers, collaborative partners, employees, investors, credit institutions, suppliers, customers, tax authority, and consumers. The information passed on to them must be reliable to assist them in making informed decisions.

Corporate financial scandals emanating from fraudulent financial reporting and other irregularities are not only a disease of the developed world, but are also a phenomenon of the less developed parts of the world, albeit not as widely publicized as those in the well-developed parts of the world. The occurrence of these financial scandals has resulted in questioning the effectiveness of the regulations and operations designed to uncover and prevent fraud. According to the limited data available, the hotlines put in operation after the SOX Law appear to have some desirable effects with public companies, private, and nonprofit organizations in order to uncover and prevent the incidence of fraud. Together with hotlines, surprise audits, management review of internal control, the rewards for whistleblowers, mandatory job rotation/vacations, and internal audits are also effective in uncovering and preventing such crime.

In some studies carried out on employees' frauds, corruption, and fraudulent financial reporting, which are generally grouped as internally perpetrated fraud and dealt with in the reports used in this study, a distinct decrease in the incidence of fraud was not observed. This was noticeable in fraud related to financial statements, which was the starting point of most corporate scandals experienced in different parts of the world. In the ACFE report of 2008, apart from hotline, which is one of the SOX-related control systems in financial statements fraud, other types of control that could be used are ineffective in

reducing other categories of fraud. We can only hope that other actions taken by governments and law-enforcing agencies would serve as a deterrent in preventing this global disease for the sake of everyone.

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# Forensic Accounting for Financial Malpractices in Developing Countries: An Analytical Review of the State of the Art

# 4

Abubakar S. Kasum

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## 4.1 Introduction

Financial irregularity is a problem of global concern. It is a major concern to developing nations of the world. It is so endemic that fraud and corruption are gradually becoming normal way of life in third world countries. Financial irregularities are so common that almost no individual can wash his or her hands clean of it. Although it is witnessed in both the public and the private sector organizations, the prevalence is higher in the public sector of developing economies. Public funds are in many instances misused by the political class of these countries. Experience in Nigeria shows that financial malpractice incidents are attributable to office holders from the presidential to the ward level (ward is the smallest unit of government usually having representation at the local government). No money is entirely free; every amount of money has its legal use, and consequently, misuse of any amount would have some negative effects, on some other aspects of life in the economy, in particular the legally intended area. The ultimate effect of these can be felt by the organization or a whole nation. If the effect is not felt directly, it may have some indirect effect on facilities and infrastructure that were intended to be positively affected.

Unless it is impossible, individuals or establishments adversely affected by the fraudulent or corrupt practices might want to seek redress. The individual, corporate body, and interested government organs would consequently like to take actions toward seeking redress using divergent institutions like the police and the law court. Whatever an investigator wants to do will not be complete if the extent to which the affected person is unquantifiable. This and other pecuniary matters are the areas where the service of an expert, the “forensic accountant,” has been engaged for a very long time in some developed countries and probably, recently, extending to developing nations. It is not that financial misappropriation is

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completely eradicated in the developed countries of the world. It occurs even in sophisticated forms. So much that Grazoli et al. (2006) confirmed that detection by looking for red flags and various other clues of deceit has become of the question effectiveness for fraud. It is, however, too rampant and not adequately tackled in the developing countries, and perpetrators get away, almost always, with the act. This is to say that the nefarious acts are not uncovered, investigated, prosecuted, and adequately punished. Consequently, many of those involved are left free and hence there is no deterrent for future acts. This study provides an overview of forensic accounting, as a tool in the fight against financial crimes that have impacted seriously and negatively on the economies of the third world nations.

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## 4.2 Forensic Accounting

Joshi (2003) ascribed the origination of forensic accounting to Kutilya, the first economist to openly recognize the need for the forensic accountant. He mentioned 40 ways of embezzlement centuries ago. He, however, stated that the term “forensic accounting” was coined by Peloubet in 1946. Crumbley (2001) wrote on the same issue when he stated that a form of forensic accounting can be traced back to an 1817 court decision, and also that a “young Scottish accountant issued a circular advertising his expertise in arbitration support in 1824” but that Peloubet was probably the first to publish the phrase forensic accounting. Investigation of fraud and corruption is confirmed thus, not to be new, even in Nigeria, the country of this author. It is only gaining prominence because of the growing wave of the crime under the seemingly new nomenclature of the last 5 years (Coenen 2005).

Forensic accounting, which is also called investigative accounting or fraud audit, is a merger of forensic science and accounting. Forensic science according to Crumbley (2003) “may be defined as application of the laws of nature to the laws of man” and refers to forensic scientists as examiners and interpreters of evidence and facts in legal cases and offers experts’ opinions regarding their findings in the court of law. The science in question here is accounting science, meaning that the examination and interpretation will be of economic information.

Joshi (2003) defined forensic accounting as the “application of specialized knowledge and specific skill to stumble up on the evidence of economic transactions.” Zysman (2001) puts forensic accounting as the integration of accounting, auditing, and investigative skills. Simply put, forensic accounting is accounting that is suitable for legal review, offering the highest level of assurance and including the now generally accepted connotation of having been arrived at in a scientific fashion (Crumbley 2006).

Coenen (2005) stated that forensic accounting involves the application of accounting concepts and techniques to legal problems. It demands reporting where the accountability of the fraud is established, and the report is considered as evidence in the court of law or in the administrative proceeding (Joshi). It provides an accounting analysis that is suitable to the court, which will form the basis of discussion, debate, and ultimately dispute resolution (Zysman 2001).

This means that forensic accounting is a field of specialization that has to do with the provision of information that is meant to be used as evidence, especially for legal purposes. The persons practicing in this field (i.e., forensic accountants) investigate and document financial fraud and white-collar crimes such as embezzlement and investigate allegations of fraud; estimate losses, damages, and assets; and analyze complex financial transactions. They provide these services for corporation, attorneys, criminal investigators, and the Government (Coenen 2005). Their engagements are usually geared toward finding where the money went, how it got there, and who was responsible. They are trained to look beyond the numbers and deal with business reality of the situation (Zysman 2001).

Investigative and forensic accounting engagements are those that:- require the application of professional accounting skills, investigative skills, and an investigative mindset; and - involve disputes or anticipated disputes, or where there are risks, concerns or allegations of fraud or other illegal or unethical conduct (Canadian Institute of Chartered Accountant 2006).

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### 4.3 Composition of Forensic Accounting

Forensic accounting encompasses both litigation support and investigative accounting. Litigation support provides assistance of all nature in a matter involving existing or pending litigation. It deals primarily with issues related to the quantification of economic damages, while investigative accounting is associated with the investigation of criminal matters (Zysman 2001).

Under litigation support, forensic accountants assist in the following:

- Obtaining documentary evidence to support or refute a claim.
  - Reviewing of the relevant documentation to form an initial assessment of the case in an identified area of loss.
  - Examining for discovering, including, the formulation of the act regarding the financial residence.
  - Attending the examination for discovery to review the testimony, assist with understanding the financial issues, and formulate additional questions to be asked.
- Investigative accountants, on the other hand, perform the following:
- Review factual situation and provide suggestions regarding possible courses of action
  - Assist with the protection and recovery of assets
  - Coordinate and cooperate with other experts (Zysman 2001)

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### 4.4 Forensic Accounting Engagement

Coenen (2005) identifies the following as areas of specialty in forensic accounting:

- Investigating corporate fraud
- Litigation services
- Business valuation
- Computer forensic

However, Zysman (2001) in a more elaborate form captured the assignments undertaken by forensic accountants as including the following:

- Criminal investigations, which are usually on behalf of the police with the aim of presenting evidence in a professional and concise manner.
- Shareholder and partnership disputes that involve analysis of numerous years of financial records for valuation and qualification of the issue in dispute.
- Personal injury claims, where, for example, economic losses have been suffered following a motor accident or wrongful dismissal by an employer. They help quantify these losses.
- Business interruption and other types of insurance claims. These assignments involve a detailed review of the policy to investigate coverage issues and the appropriate methods of calculating the loss.
- Business/employee fraud investigations, which can involve fraud tracing, asset identification and recovery, forensic intelligence gathering, and due diligence review.
- Matrimonial dispute involving the tracing, locating, and evaluation of assets.
- Business economic losses, where contract disputes, construction claims, expropriation, product liability claims, and trademark problems are the issues.
- Professional negligence, to ascertain the bridge and quantify the loss involved.
- Mediation and arbitration, as a form of alternative dispute resolution.

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## 4.5 Approach to Work

Zysman (2001) outlined the following steps in executing forensic engagements:

- Meet with the client to obtain an understanding of the important facts, players, and issues at hand
- Perform a conflict check as soon as the relevant parties are established
- Perform an initial investigation to allow subsequent planning to be based on a more complete understanding of the issues
- Develop an action plan that takes into account the knowledge gained by meeting with the client and carrying out the initial investigation, and set out the objectives to be achieved and the methodology to be utilized to accomplish them
- Obtain the relevant evidence (this may involve locating documents, economic information, assets, a person or company, another expert, or proof of the occurrence of an event)
- Perform the analysis (this may involve calculating economic damages, summarizing a large number of transactions, performing a tracing of assets, performing present value calculations utilizing appropriate discount rates, performing a regression or sensitivity analysis, or utilizing a computerized application such as spreadsheet, database, or computer model, and utilizing charts and graphics to explain the analysis)
- Prepare the report

Often a report will be prepared which may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitation of scope, and findings and/or opinions. The report will include schedules and graphics necessary to support or explain the event properly. Joshi (2003) stated that the job demands reporting where the accountability of the fraud is established, and the report is considered as evidence in the court of law or in the administrative proceeding. The Canadian Institute of Chartered Accountant recommends communication of work in the form of the following:

- Written, oral, or visual
- Draft, interim or final
- Points form or narrative
- Formal, affidavit or letter

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## 4.6 Organization of the Forensic Accounting Profession

Forensic accounting is an offshoot of the general professional accounting and is affiliated to professional accounting bodies. For the purpose of practice, individual firms of general accounting practitioners departmentalize and train specialists in investigative accounting within their general practice firm. For example, the Canadian Institute of Chartered Accountants established the Alliance for excellence in investigative and forensic accounting in 1998. Crumbley (2003) also stated that forensic accountants are typically CPA/CAs who specialize in those types of engagements where there is a need for such evidence. In the words of Crumbley (2006), the forensic accountant is a certified public accountant who performs an orderly analysis in an attempt to obtain the truth on which to form an expert opinion. In firm practice, Crumbley (2006) stated that there are between 380 and 500 forensic accountants in the firm of PricewaterhouseCoopers.

On the other side, separate bodies are also springing up for forensic accountants, and professional bodies specializing in same discipline are being established. Examples are the Association of Certified Fraud Examiners, National Association of Forensic Accountants, America College of Forensic Examiners, Certified Fraud Deterrence, Certified Forensic Financial Analyst, and Forensic CPA Society (Crumbley 2006). Some specialist practice firms include Zymas Forensic Accounting Incorporated, Kessler International, Sequence Incorporated, Gottschalk Forensic Accounting and Valuation Inc., LBC International Investigative Accounting Inc., etc.

The practice is just gaining popularity in Nigeria, one of the largest economies in Black Africa. As such, there can only be instances of professionals engaging in investigative activities, and there can be knowledgeable and experienced person in investigative accounting. The kind of organizations mentioned above which are common in Canada and the USA is being recently established in Nigeria.

## 4.7 Financial Malpractices

Williams (2005) defines corrupt practice as any immoral, illegal, and unethical act which includes cheating, lies, fraud, etc. Khan (2005) puts corruption as the misuse of resources entrusted in ones' power for private benefit. The forms, he said, include bribes, cronyism and nepotism, political donations, kickbacks and artificial pricing, and fraud of all kinds. Fraud also has been classified into three categories, which include asset misappropriation, corruption, and fraudulent statements. They involve theft or misuse of assets, improper use of influence in a transaction for own benefit, and falsification of financial statement, respectively (O'Keefe et al. 2001).

Ribadu (2004) identified the obstacle to prosecution of corruption to include failure of law enforcement agencies, constitutional constraints, attitude of defense lawyers, inadequacy of existing procedural laws, congestion and slow pace of court proceedings, jurisdiction problem, and cost of investigation and prosecution.

In the public sector, "total revenue from oil and gas will never be totally accurate because in our governing situation there is plenty of money. A clique of politicians and impunity reigns allowing corruption to thrive". . . big firms collude with those who are responsible for governance, i.e., those. . . who have the power to collect the revenue derived from the exploitation and exportation (Williams 2005).

Table 4.1 shows some of the high-profile embezzlements by some developing nations' leaders during the last 40 years.

The effects of the above scenario are reflected in many standard of living indices of the countries concerned, as shown in the GDP per capita and others in the table below.

Table 4.2 shows clearly that GDP per capita, life expectancy rate, literacy level, and school enrolment of developing countries shown in the table are not

**Table 4.1** Embezzlements by some developing countries' leaders over the last 40 years

Head of government		Estimates of funds allegedly embezzled
Mohammed Suharto	President of Indonesia, 1967–1998	US\$15–35 billion
Ferdinand Marcos	President of Philippines, 1972–1986	US\$5–10 billion
Mobutu Sese Seko	President of Zaire (Congo DR), 1965–1997	US\$5 billion
Sanni Abacha	President of Nigeria	US\$2–5 billion
Siobodan Milosevic	President of Serbia Yugoslavia, 1989–2000	US 1 billion
Jean-Claude Duvalier	President of Haiti, 1971–1986	US\$300–800 million
Alberto Fujimori	President of Peru, 1990–2000	US\$600 million
Pavlo Lazarenko	Prime Minister of Ukraine, 1996–1997	US\$114–200 million
Arnoldo Aleman	President of Nicaragua, 1997–2002	US\$100 million
Joseph Estrada	President of Philippines, 1998–2001	US\$78–80 million

Source: Transparency International (2004)

**Table 4.2** Standard of living indices, life expectancy in years, and literacy rate of some selected countries

Country	Population	Life expectancy	No. of children	Literacy rate (adult) (%)	GDP per capita (in \$)
China	1.320 billion	69 years	2	93.3	2,486
India	1.12 billion	61 years	3	66	1,042
USA	301 million	78 years	2	<5	45,884
Indonesia	225 million	63 years	2	91	1,923
Brazil	191 million	67 years	2	90.5	6,880
Russia	141 million	66 years	1	99	9,156
Pakistan	162 million	62 years	4	54.9	886
Japan	127 million	82 years	1	<5	34,462
Bangladesh	158 million	64 years	3	53.3	428
Nigeria	147 million	47 years	5	49	1,127
Mexico	105 million	74 years	2	92.4	8,508
Germany	82 million	76 years	1	<5	4,021
Peru	27 million	71 years	3	90.5	4,040
Haiti	9 million	60 years	4	62.1	681
Nicaragua	5 million	72 years	3	80	1,135
Philippines	87 million	71 years	3	93.4	1,656
Ukraine	46 million	68 years	1	99.7	3,054
UK	61 million	79 years	2	<5	44,718
Congo DR	62 million	46 years	6	NA	144
Serbia	7 million	73 years	1	NA	5,940

Source: World Bank Report (2007)

comparable with those of developed economies like the USA, Japan, and the UK. Where the developed nations are talking of GDP of forty thousand US Dollars (\$40,000+) and above per head, developing countries are talking in the range of one hundred to one thousand five hundred US Dollars (\$100–\$1,500). Life expectancy of above 70 years is noted in the table for the developed nations, and 40s to early 60s years for developing nations, and the table also shows similar alarming rates for developing countries in other indices shown in the table. What could be inferred from the table is that resources that would have gone into improving people's lives are embezzled by their leaders and those around them. Going by the above, one would agree, nonetheless, that financial malpractice is a menace that should be battled, especially in public offices, in the interest of citizens.

## 4.8 Conditions Favorable to Corrupt Practices

According to Babalobi (2008), causes of corruption in Nigeria include:

- Weak government institution
- Poor pay incentives

- Lack of openness and transparency in public service
- Absence of key anticorruption tools
- Ineffective political processes
- Culture and acceptance of corruption by the populace
- Absence of effective political financing
- Poverty
- Ethnic and religious difference
- Resources scramble

The above-listed conditions could be said to be common in many third world countries like Nigeria—this author's home country. It is possible that his experiences could have influenced his submission in this chapter.

### Conclusion

Through our review, we are able to establish the nature and meaning of forensic accounting, what forensic accountants do, who are the practitioners in the field, and how they are organized. We have also studied the nature of corrupt practices in developing economies, the magnitude of some documented cases, and the negative impacts they have on citizens' welfare. Based on the result of our library analysis, we conclude the following:

- Forensic accounting practice is neither new internationally nor new in developing countries.
- Financial malpractices taking place in developing countries are alarming and are not only crumbling the economy, but also affecting the image of these countries.
- The services of the experts (forensic accountant) are required in developing countries, for fight against fraud and corruption cases.
- Their services are required in the public sector organizations of developing countries.

Adefila et al. (2005) stated that fraud and corrupt practices are globally endemic. Tackling it, therefore, becomes also a global challenge. A good forensic structure can help alleviate developing countries' plight. In line with the above, the following are suggested:

- The Institute of Chartered Accountant or Auditors in the developing countries should encourage formalization and specialization in the field of forensic accounting.
- The governments should develop interest in forensic accounting and accountants for monitoring and investigating suspected and confirmed corruption cases.
- Practicing accountants in the countries concerned should rise up to the challenge, work toward specialization, and possibly establish firms for forensic accounting practice only.
- Academia should emphasize skill development in the field of forensic accounting.



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# The Double-Way Interrelationship Between the Shadow Economy and the Economic Growth (GDP Rate)

# 5

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## 5.1 Introduction

The **underground economy**, **black market**, or “**shadow**” **economy** is considered a market consisting of all kinds of commerce, on which applicable taxes and/or regulations, and procedures of trade are being avoided. In modern societies, **the underground economy** covers a vast area of activities. It is generally smallest in countries where economic development and freedom are the greatest, and become progressively larger in areas where corruption, regulations imposed, or legal monopolies restrict legitimate economic activity.

It is considered an informal economy and includes not only illegal activities (which are the order of the day in this market), but also legal ones, regarding merchandises and services, *which incomes are undeclared in order to avoid the payment of applicable taxation*. The precise understanding lies on the specific mechanism of taxation and regulations implemented in each country considered.

The **shadow economy** needs a perfect delineation or understanding, with a view to achieving pertinent analyses, and forecasts actions that are to be followed by the removal of some activities from this sphere and their transfer within a *real economy*. The whole mechanism, thus conceived, has been based on the use and implementation of the *general social-economic development policies led by the government* as a kind of universal panacea of equally solving the problems related to the **shadow economy**.

It is believed that the **shadow economy** is mainly subsistence economy where black market labor reaches approximately half of this kind of economy. As we intend to point out in what follows, *the main cause of a shadow economy is the incidence of high level taxation*, which results in the massive tax evasion phenomenon.

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## 5.2 Shadow Economy, Corruption, Economic Infrastructure, and Romania

### 5.2.1 Shadow Economy

For Romania, more than two thirds (67%) of the **shadow economy** are found in the formal sector of the economy, that is, in the sector represented by the legal bodies organized as trading companies, quasi-companies, and public institutions. And, as we speak about exports, respectively imports, when we refer to the adhesion to an economic block formed of several states, such as the European Union (EU), the weakly developed states undergoing the transition process contribute in different percentages to the **shadow economy** of the community. Romania, in its turn, takes part in this process with one-third (33%) of its gross domestic product (GDP) and a quarter of its manpower.

Speaking at the level of the fiscal stress (the fiscal degree), that is, of the determining vector in defalcating a more or less important part of the economic activity, we feel the need of a comparison, an important one in our opinion, between the EU, the different OECD member states, and Romania. A comparison drawn up in 2004, the year of the most important EU expansion “wave,” is as follows:

OECD	37.7%
EU	42.4%
Romania	29.6%

Source: Revenue Statistics, OECD, 2004

In the case of Romania, this author’s country, the lower taxation degree against the average of certain OECD, or UE member states, is explained for that date by the narrow taxation scale (like nowadays, by neglecting the evidence of *Laffer’s* curve teachings), as well as by a consequence of the existing fiscal evasion phenomenon.

Since we cannot avoid mentioning the curve highlighted by the Californian Professor Arthur Laffer, there is, in its frame, a situation that interests us, **the minimum taxation rate**, that is, the rate matching not only minimal but also efficient red tape so that the whole state mechanism can function.

While the fiscal tax may be submitted to quantification, the intensity of the regulations represented by the assembly of disposition, procedures, and operation that is applied to taxpayers to get the working license, or to its normal working, constitutes the major cause of the trend toward a shadow economy.

This type of economy is a relevant presence, even if in a discrete manner, in all states, regardless of their socioeconomic development and the political system that governs them. Still, we can make significant differences in this respect. Thus, while the transitional countries are affected, *in the first place*, by **fiscal fraud** which consists of the main **black market labor exporters**, the developed countries focus on fighting against **criminal activities** on the role.

### 5.2.2 Corruption

**Corruption** constitutes, however, the *determining factor* in the existence of *shadow economy*. A large amount of the facilities obtained as a consequence of the corruptive act return to the **shadow economy**, while the rest by means of the well-known money-laundering procedure, that is, recycled, enter the **real economy**, a fact which is especially noticed when talking about fiscal paradise. All starts from the way the law is observed by the civil servants who, in exchange for “small gifts,” either cancel, postpone, or spread out certain payments, or grant fiscal facilities to help the enterprising individual reach his/her goal, more or less honestly.

**Corruption** is an economic activity, and we can even talk about **the economics of corruption**, since one starts with rather limited resources, undergoes specific operational processes, benefits of special “financing”, has special action and affirmation possibilities and while his/her final goal is not only satisfying different interests, but mainly achieving and maximizing the profit. Moreover, **corruption** is an extremely real, national, not submitted to the hazard and which has strong historical, economic, social and political determinations.

We can speak, in this case, as a significant characterization, *of interrelations between more powerful psychological elements (subjectively, specific to each person) and the economic-social realities to deal with.*

The consequences of the corruptive process are to be noticed in the replacement of resource distribution by means of the mechanisms that are specific for the free, competitive market with the “shadow economy,” which is only possible because of the general situation in the economy, to the interfering degree of the state, to the visible political and ethical factors. The corruptive mechanism is very simple and manifests by the participants’ desire to earn more, desire whose intensity increases as the differences between the incomes of the corrupt ones (civil servants) and those of the corruptors are significant, a decisive role being held to the moral environment of that society.

One of the indicators that may offer us an approximately true-to-life image over the size of the global corruption phenomenon is the Corruption Perception Index (CPI), a composite index, reached at following at least three surveys in the business environment, reflecting the opinion of all the factors that make decisions concerning the investment and trading activities. The index presents a variation scale from 10 (inexistent corruption or almost inexistent) to 0 (the highest corruption level).

This is how the data concerning this index would look based on the 2007 annual report drawn up by *Transparency International*.

The first place is held by Denmark with a score of 9.4, equal to that obtained by Finland; Great Britain holds the 13th place with 8.4; France is in the 19th place with 7.3 points; Malta comes in the 33rd place with 5.8 points; Cyprus is in the 39th place with 5.3; and the last places in the EU ranking are held by Bulgaria in the 64th place with 4.1 points and Romania in the 70th place with 3.7 points.

The Community’s average was 6.5, which means that Romania is far behind the states that have a public, healthy, and balanced life. Taking into account the fact

that in 2003 the CPI was of 2.8, we can notice that Romania has not been very successful in reducing the size of this social shortcoming.

However, according to the international available statistics from the end of the last century, the transition group of countries has had a double percentage of the **shadow economy** in terms of total official GDP than the group of the developed countries within OECD (max. 30% than 16%). Compared with the developing countries, the weight of the **shadow economy** is greater, with a **maximum level at between 45 and 50%**.

The problem of the weakly developed states, as well as those in transition, is the fact that they cannot *achieve the necessary requirements* by themselves. This is why it is necessary for the donating states (found on top of the CPI ranking) to assist technically these other states by building the awareness of the public decision makers and achieve the institutional integrity in the states facing a strong corruption phenomenon.

We also believe that for the transitional countries, which build and consolidate their reforms and socioeconomic structures that are meant to be viable, are influenced, also in what concerns the increase in the corruption level, by the multinational companies, by those who act globally, and are interested to provide hospitable hosts and who may grant as many economic advantages as possible so that they might maximize the profits.

As well as this, the multinational companies have in view the covering of the most important segments of the transition states' market, reaching in many cases (including Romania) to hold if not a national monopoly, a real regional and zone area monopoly. Not to mention the offshore areas that play a decisive role in exploiting the resources, as well as in the money-laundering activity.

Estimating the level of the shadow economy in the transitional countries is hard to achieve, their size and projection into the real economy being rather unknown. We can talk about a multidimensional phenomenon that encompasses more aspects and causative factors than the ones presented in this paper.

Since we were talking about the proportion that is difficult to forecast in terms of the penetration between the real economy and the shadow economy, here is how one of the most important macroeconomic indicators, the real economic growth, and the underground (**shadow economy**) must exist in an understanding of the same kind as between two opposite economic categories, while the efficient reduction measures will have results only under the circumstances of advance no recession periods. The tendency toward investment is inversely proportional to the level of corruption in the analyzed host country.

For Romania, this "practice," this mechanism of the socioeconomic life, is old, belonging to the Phanariot period, and preserved during the nineteenth and twentieth centuries.

This is why the measures to be implemented so as to reduce the weight of the *shadow economy* on the echelons of corruption, of fiscal evasion, and of black labor depend first of all not only on the government officials' political will, but also on that of the political class in general, to observe the law and nothing more. Watching

all the tax dodgers and applying the corresponding penalties are also actions that may prove efficient.

We can also add the general measures of restricting the dimensions of the corruption, so a kind of interruption from the source of the shadow economy:

- Punishing those that prove to be guilty of corrupt practices
- As much as possible, keeping the politicians away from the activities of the public administration
- Motivating payment with adequate and flexible rewarding systems
- Selecting and promoting the employees according to their performance (in fact, the last two measures have to be considered of maximum importance)

However, we believe that knowing the economic theory and practice within the developed economies with a very low level of corruption and with vigorous and healthy public life, since this is how one can really put into practice the free market mechanism, where a very important role reverts to the state, in its quality of third important player in the economy.

### 5.2.3 Economic Infrastructure

However, we consider that the most significant liaison between *shadow economy* (the precise degree or weight in the economy) and the amount of GDP is given by the foundations of each economy of the world. None of these economies could develop, increase the GDP rate, and, in nowadays conditions, overpass the financial and economic crisis' effects without a structure of the economy and society called **infrastructure**, especially **economic infrastructure**, a complex and multidimensional functional system.

In the term **infrastructure**, the prefix **infra** in Latin means “under, beneath”; therefore, the term means exactly those elements that sustain the whole construction of a national economy (the present case).

In this way, this author has shaped the entire notional range of the concept of **economic infrastructure**, i.e., of all basic aspects that make a region's functioning possible, for reaching the proposed purposes, first of all that of **economic development**. The reach of the respective objectives of mezzo and macroeconomic nature cannot be efficiently and expertly accomplished by private entrepreneurs, but the same state interference is necessary for creating and moreover maintaining these infrastructures which, through the elaborated regulations, might effectively provide the national economy functioning under best conditions.

The question righteously asked: what would be the optimum (desirable) level of **economic infrastructure** which requires the best *state intervention* for the respective infrastructure maintenance and improvement so that they are able to assure the fulfillment of the proposed major objectives?

Discussions on this question have not brought about a unanimously accepted standpoint by experts in the field. The labor force percentage involved in the respective activities is as variable as the sums necessary for accomplishing and functioning **development infrastructures**, sums that may result in significant

growths first as a consequence of ITC advancements and also through the prism of population number and density growth. This situation also considers an optimum expenditure of a level which must fall within the desirable beach, taking into account social and economic dimensions and the potentials which the national economy has available.

**Economic infrastructure's** permanent care and improvement (as shaped by this author) represent a vital aspect so that civilization (nation) could continue its temporal existence and at the same time hinder its collapse. Those who had in view this problem permanently assured for advance (constituting themselves into civilizations "core") to others' detriment, i.e., so-called periphery, according to Immanuel Wallerstein's theory.<sup>1</sup>

An impulse which is necessary for developing an emerging economy's infrastructure was given in the 16th mid-century Florence, which Wallerstein considers as the moment of new European space creation, under the form of a "world economy". Similarly, the world modern system, that is, in both North and West Europe's structure, Western civilization was born and it rapidly developed the world over, that market, urban society, as sociologists termed it, with decisive impact upon the entire development of states and communities throughout the world.

From the core of **economic infrastructure**, the determining element in accomplishing the above-mentioned desires is *transport infrastructure*, taking into account that transport and shipping are considered the circulatory system of any economy, the element which sets in motion and therefore in connection with various areas (regions) of a country, but especially neighboring countries decisively contributing to creating *development regions*, also assuring at the same time numerous relationship between the world's states. Upon the structure of this infrastructure category, other functional components of economic **infrastructure** can also be built and developed.

We are in full action and affirmation of globalization, a phenomenon which implies among other characteristics strong interaction between the world's states through increasing unfolding trade operations unfolding velocity that results, per total, in general growth of economic efficiency through gathering and accentuating the resource and capital movement to more profitable areas or fields.

With regard to this phenomenon inoculated to all economic and social life segments and focusing on analysis especially upon transport infrastructure, three key features crystallize in order to meet globalization requirements, features which embody considerations and applications belonging to both present-day revolutionary technology domain and, especially, institutional domain of public force involvement with proper creation of the respective infrastructures:

1. *Interoperability*, implying the means to find ways for the most adequate and flexible means and ways to assure the fluency of material, human and financial

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<sup>1</sup> In synthesis apud Borțun (2001)

flows, and efficient utilization of integrated organization networks, not only within trans-border relationships but also within already formed economic regions.

2. *Interconnecting*, which is a natural consequence of the former and claims especially technical order aspects to assure compatibility and quality in functioning transport and communication between neighboring states, and also in providing the entire network of service performance at most modern standards.
3. *Considering intermodal flows and processes*, assuring aspects which use several transport forms, international shipping, and even electronic trade so that per total costs be diminished and respective operation efficiency be increased through possibility of carrying out “door-to-door” action directly to beneficiary, taking into account concrete conditions in each country participating to world trade circuit.

The whole thinking of constructing **integrated economic infrastructures** should be done not only in the short run, but also in medium and long ones so that they assure productive processes and human resources in achieving **economic growth**, as shown, and become an aspect closely related to **economic development** general process.

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### 5.3 Discussion

The most important conclusion coming out from this chapter so far is that **economic infrastructure development degree** decidedly depends on a country's **economic type** and its **general economic development level**. Thus, an inefficient unviable **infrastructure** asymmetrically developed, and it also stays at a low accomplishment and sustaining level, representing the characteristics of a **survival economy** of states within the category of those world's less developed countries or most indebted ones. At the same time, it is also necessary to take a closer look at Abraham Maslow's known concept, the Pyramid of human needs, which placed on the first level, the lowest one, just the assurance of those necessary to meeting primary survival needs. Not accomplishing this desire might become very hard to imagine the chances of accomplishing the other infrastructural levels, especially scientific research and innovation.

Once all these elements have been accomplished, the economic infrastructure would become more conducive for progress to be made in terms of economic development. We are in a situation similar to that described by Lawrence P. King and Balasz Varady in their 2002 article,<sup>2</sup> in the sense that globalization Manichaeism (good and evil dualism existing in certain proportions within a certain phenomenon or concept) for the less-developed or developing countries (in-transition ones included) makes necessary foreign direct investments in a manner that is able to

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<sup>2</sup> King and Varadi (2002)



evaluate a country's general potential and assure (help) economic development it needs.

Thus, policies regarding infrastructures, coordinated and shared between participants to international exchanges, become obligatory requirements of **integrated development** of increasing policy, implementing liberty, and growing development level also for world's poorest countries, a possible thing in the context of globalization and due to risk diffusion synergy and cost diminishing not generated by activities comprised in **economic infrastructures** category.

For the world's first economy, irrespective of economic cycle, **one half of economic growth registered in the last half of the century** was due just to *utilized human capital* and, more precisely, to *its productivity within economic activity*; the other half being the result of investing in productive and technological means. But these achievements, too, are also people's work with their physical and intellectual capacities.

Here, it is the way human factor is well evaluated, motivated, and trained in order to assure as much new values as possible at the level of the entire national economy. And it is considered, thus, a safe means of exit from whatever economic and social depression, and an adequate dynamic growth rhythm of GDP for the whole year, reaching 7.1% (percentage) points, the thing under a condition when demand was compressed in the last quarter of the last year, with direct impact upon most activity sectors. Construction and agriculture registered growths in the fourth trimester, while more industry, and also financial and real-estate activities and only services for companies registered diminished.

The fact that Romanian economy's structural scaffolding is weak, GDP's rate not expressing any boom of a healthy economy, and shortcomings in the face of disturbing external factors determined analysts like Merrill Lynch (much challenged by the present crisis) foresee for Romania in 2020 *a GDP decrease with 5%*.<sup>3</sup>

It is the most unfavorable situation among a number of developing and emerging states such as the following:

Russia	2.5% GDP evolution
Turkey	2% GDP evolution
Hungary	GDP decrease only 0.1%
Ukraine	Decrease -2%
Kazakhstan	Growth 2.9%
Israel	Increase with 1.5%
Saudi Arabia	+2.8%
Egypt	Growth with 3%
South Africa	Evolution +3.8% the most significant

<sup>3</sup> Source *Bank of America Merrill Lynch securities*, Portfolio.com

We can say that the “good” things are represented by a healthy and sustainable economy, with adequate base of infrastructure for a normal GDP rate, and on the other hand, “bad” things are represented not only by the trend to avoid taxes and regulations, in a word **the shadow economy**, but also by the effects of the actual crisis, which permit the increase in the weight of **shadow economy** in the whole economic system.

Therefore, **the shadow economy** and the **fraud temptation** are expected to go down only in the case of the revival of the economy, especially in the case of the emerging ones, with an optimum of the fiscal policy, in order to assure the impulse to investments and development in all the national economic domains.

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# What is Hawala? An Introduction to the Multi-Billion Dollar Informal Value Transfer System

# 6

M. Nauman Farooqi

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## 6.1 Introduction

Every year billions of dollars are transferred across countries and continents using informal value transfer systems (IVTS). The IVTS is any system, mechanism, or network of people that receives money for the purpose of making the funds or an equivalent value payable to a third party in another geographic location, or not in the same form. Hawala is one of the key forms of IVTS. IVTS were established means of transferring valuables and money long before any of the formal methods were conceived (Holt et al. 1970; Lewis 1995). Much is unknown about IVTS, e.g., its size, its exact method of operation, and consequently, measures needed to control its expansion. Regulation and monitoring of IVTS remain a difficult task due to the sketchy paper trail left by IVTS transactions. Although many countries have put in place regulations to check these transfers, incongruities in these various national legislations render the task of monitoring and regulation complex and unwieldy.

Hawala has been the target of US and international media since the 9/11 terrorist attacks involving Al Qaida. It is alleged that Al Qaida used Hawala to transfer money, undetected, across international borders to finance their terrorist activities. Since then, governments, academics, and journalists have written extensively on Hawala. They have analyzed the function of Hawala both in benign fund transfers and transfers used by criminals and terrorists for unlawful purposes. Although increasing regulatory regimes have been put in place, the use of IVTS continues due to its efficiency and cost effectiveness. As such many stakeholders question whether non-regulatory mechanisms dealing with Hawala should be further explored.

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## 6.2 Defining Hawala

In Arabic, the root h-w-l signifies “change” or “transformation.” The word “Hawala” is derived from this root and is defined as a bill of exchange or promissory note that can be used as Hawala Safar or a traveler’s check (Jost and Sandhu 2000). The word permeated into Hindi (national language of India) and Urdu (national language of Pakistan) and retained its original meaning, but acquired the additional connotations of “trust” and “reference.” This reflects the basic principles on which the system operates. A Hawala dealer is described as a Hawaladar: this term will be used throughout the paper (Jost and Sandhu 2000).

The word Hundi is etymologically rooted in Sanskrit and means “to collect.” This meaning is synonymous with promissory note, bill of exchange, or Hawala. A Hundi operator is referred to as a Hundiwala. Padayachee and Morrell (1991) defines Hundi as “a kind of bill of exchange or written order for payment that its drawers used much in the same way that the Americans used checks to draw on their checking accounts. In order to draw a Hundi, a client had to open up an account and maintain a correspondence relationship with a [private] banker.” Essentially, Hundi and Hawala have the same meanings and are used interchangeably, especially now that the system has undergone international notoriety. However, Hawala is an Arabic term, while Hundi is its Indian and Pakistani variant. There are suggestions that Hundi and Hawala have amalgamated into one network and their distinctions have been dissolved (Jost and Sandhu 2000).

IVTS were established means of transferring valuables and money long before any of the formal methods were conceived. Ever since the growth of formal value transfer systems, informal systems have operated in the shadows, albeit maintaining a devoted following. Many of today’s IVTS originated among ethnic Asian peoples who based codes of conduct for value/money transfer on mutual trust within groups and individuals. The various systems derived their names from geographical locations and ethnicity of the group. Following are some of the more common names and groups that once used or still use IVTS:

- Hawala (Middle East)
- Hundi (Pakistan and India)
- Fei ch’ien—flying money (Chinese)
- Phoe kuan (Thailand)
- Hui k’uan—to remit sums of money (Mandarin Chinese)
- Ch’iao hui—overseas remittance (Mandarin Chinese)
- Nging sing kek—money letter shop (Tae Chew and Cantonese-speaking groups)
- Chop shop—non-Chinese use this term for one of the Chinese methods
- Chiti banking. Refers to the “chit” used as receipt or proof of claim in transactions introduced by the British in China (short for “chitty,” a word borrowed from the Hindi “chitthi,” signifying a letter, document, or mark)
- Hui or hui kuan—association (Vietnamese living in Australia)
- Stash house—for casa de cambio (South American systems) (Passas 1999)

### 6.3 Simulated Hawala Model

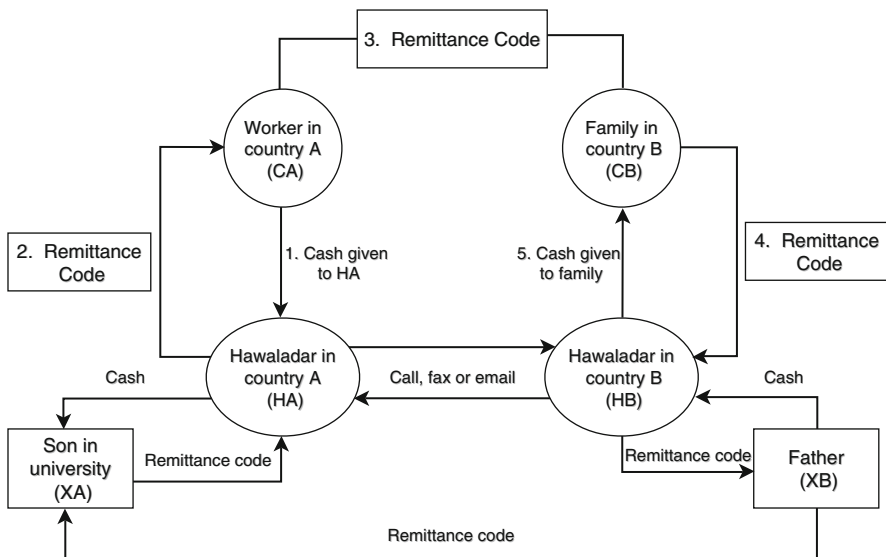
In theory, Hawala works in a simple framework: just two customers and two Hawala operators, called Hawaladars, are needed to make the transaction work in its entirety. However, in practice, there are more than two customers, and the number of Hawaladars reaches to thousands (Ballard 2003). Varying the components of the contract can lead to exponentially confusing networks of transfers and accounts. For this reason, the following example is based on the assumption that there are two Hawaladars, two customers, and two countries. This simplification is required to create a simple model.

El-Qorchi (2002) outlines a simple Hawala transaction and builds a model to represent both the initial transaction and the reverse Hawala transaction that ensues. The model is depicted in Fig. 6.1.

The model transaction consists of the following steps:

- Customer A (CA) wishes to send money to customer B (CB)
- CA visits Hawaladar A (HA) in country A
- HA receives money to be remitted (Q) to CB plus a service fee from CA
- CA receives code of authentication and passes it on to CB
- HA then instructs Hawaladar B (HB) in country B to remit Q to CB
- CB discloses the code to HB, who then presents CB with the funds

This simple Hawala transfer may constitute the remittance from an expatriate worker to his family in his native country. It is imaginable that an increase in even one variable, such as the number of Hawaladars in the market, would greatly enhance the complexity of the transaction. For instance, since each Hawaladar



**Fig. 6.1** Model of simple Hawala transfer

would have an account with all of the Hawaladars, the clearing of debts would become much more complex.

Contrary to popular belief, Hawaladars keep records of every transaction. This is because the network can get complicated quickly and all details of the transaction become difficult to retain in memory. These records are only for the eyes of the Hawaladar, are often written in a code to deter potential theft, and are promptly discarded after use. It is for this reason that authorities have had problems following Hawala transactions through to their end (Ballard 2003).

Following Fig. 6.1 illustration, El-Qorchi (2002) details the process of reverse Hawala. HA has a liability to HB which can be settled through a reverse Hawala transaction. Reverse Hawala transactions are often used for investment purposes, and to cover travel, medical, or education expenses. The reverse Hawala transaction will consist of the following steps:

- Customer B (XB) wishes to send money to customer A (XA)
- XB visits Hawaladar B (HB) in country B
- HB receives money to be remitted (Q) to XA plus a service fee from XB
- XB receives code of authentication and passes it on to XA
- HB then instructs Hawaladar A (HA) in country A to remit Q to XA
- XA discloses the code to HA, who then presents XA with the funds

This transaction flows in the opposite direction from a simple Hawala transfer, yet the balance of the accounts depends on the quantities transferred in each case. If the quantities are not the same, which is most likely, there remains some account imbalance. Thus, open accounts are kept and the aggregate sum of all transfers gets balanced over time.

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## 6.4 Formal Versus Informal Systems

Although IVTS is considered as an alternative to formal banking, the processes involved are quite similar. Formal value transfers can take several forms: cash carriers, exchange houses, and money remitters. Apart from cash carriers, formal value transfer systems do not physically move cash or valuables, but an agent forwards a sum to an individual on behalf of another agent representing a different individual. An illustration of this is a transfer of funds through the Western Union. Detailed records are kept which are then netted and settled through formal banking sectors, while impartial third parties monitor and enforce rules and regulations for the formal system. In contrast, even though Hawaladars do keep some records of transaction, these are not to monitor their activity but as reminders concerning the details of individual accounts, transactions, and balances. This record keeping is a matter of individual practice in contrast to the standardized procedures followed by the formal sector. The settlement process for Hawala works on the same basis as that for the formal system: open accounts are kept and there is occasional netting off between Hawaladars to settle accounts, although they may not necessarily use formal channels (Wilson 2002).

The largest discrepancy between the two systems involves the monitoring process. The formal system relies on an impartial third party to monitor all transactions and ensure adherence to the rules. Any party departing from fair transactions would become liable to penalties imposed by the legislation governing the system. On the contrary, the informal system does not rely on third party monitoring. Individual Hawaladars and other members of the network monitor all transactions. This is enabled by the customary trust that exists between the Hawaladars, a trust that stems from a homogeneous set of beliefs that govern code of conduct within ethnic groups and communities. Any individual engaging in acts contrary to the code of the network is punished accordingly (Schramm and Taube 2002). The detailed documentation required to monitor the formal system is missing from the informal mechanism. Record keeping exists but it is neither standardized nor available in the form that is accessible to monitoring agents in the formal system.

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## **6.5 Benefits and Risks of Hawala Transaction**

Hawala and other IVTS offer a number of benefits over the formal banking system. They do, however, have a few drawbacks. The following are a few of the benefits and potential risks of using an IVTS such as Hawala.

### **6.5.1 Benefits**

#### **6.5.1.1 Low Cost**

This results from less monitoring compared to the formal system, the ability to use unofficial exchange rates rather than official rates, less paper work, fewer channels of operation, and no legal contracts (Schramm and Taube 2002).

#### **6.5.1.2 Less Time**

The transactions are simple to execute and are not bound by any formal regulations. They follow basic and simple paper work (Schramm and Taube 2002).

#### **6.5.1.3 Increased Trust**

The network constitutes a homogeneous club, with shared social, religious, and ethnic values. There is less defection among players (Schramm and Taube 2002).

#### **6.5.1.4 Increased Efficiency**

Hawala by nature is efficient and cost effective, as opposed to many larger, formal systems. Thus, the network puts pressure on the formal sector to become more efficient and cost effective too (Ballard 2003).

#### **6.5.1.5 Increased Disposable Income**

Both receivers of remittances and Hawaladars realize additional income from the use of Hawala (Ballard 2003).

### **6.5.2 Risks**

#### **6.5.2.1 Erosion of Profits**

The profits of formal banking and money remittance channels are eroded by the use of Hawala (Passas 1999).

#### **6.5.2.2 Loss in Tax Revenues**

Money moved outside formal channels is not subject to taxation and results in a loss of government revenue (El-Qorchi 2002).

#### **6.5.2.3 Decreased Estimation Capability**

Uncertainty regarding the composition of monetary aggregates may result in inefficient monetary and fiscal policies (El-Qorchi 2002).

#### **6.5.2.4 Limited Paper Trail**

Because of limited and informal paperwork, government supervision is difficult and it becomes hard to get to the root of a problem (Schramm and Taube 2002).

#### **6.5.2.5 No Legal Leverage**

There are no governing bodies to enforce implicit contracts, thus there are no efficient legal safeguards (Schramm and Taube 2002).

#### **6.5.2.6 Potential Increase in Financial Crime**

Hawala facilitates not only legitimate but also illegal transfers. As a result, there is an ever-increasing need to monitor criminal activity (Passas 1999).

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## **6.6 Size of the Formal and IVTS Transactions**

It is difficult to estimate a figure for the funds flowing through the Hawala channel. Using a sample of 15 countries, a study by El-Qorchi et al. (2003) used a simulation model and estimated that over 300 billion US Dollars have been transferred informally into these countries during the last 20 years. According to the World Bank (2008), recorded remittances to developing countries exceeded \$251 billion in 2007. If all countries are included, the amount increases to \$337 billion. The World Bank estimates that unrecorded flows through the IVTS such as Hawala are 50% higher than these recorded flows.

Remittances are often a by-product of migration. They have been growing steadily over the past 30 years and are likely to continue to grow, given international migration patterns and steady emergence of diasporic communities. Over the



last thirty decades, the number of migrants all across the globe has risen from 76 million to over 150 million. It is estimated that these 150 million migrant workers sent home more than \$300 billion in 2006, surpassing the \$104 billion provided by donor countries in foreign aid (International Association of Money Transfer Networks 2009). The consistent increase in number of migrants will enhance the monetary value of remittances worldwide and ensure more fund inflows to developing countries (Martin 2001).

Government agencies and academia have begun to acknowledge the impact of remittances on global economic systems only since the past few years (Martin 2001). This impact, which may be much greater than originally believed, has both favorable and adverse consequences, like any other Pareto-efficient change. Generally, developing countries that receive remittances realize positive social and economic gains, primarily in the form of better living standards and a strengthened community infrastructure. On the contrary, remittances that trigger prosperity in the home country have costs for the host country. Lower income groups in host countries suffer reduced labor opportunities, and migration levels go up in the community (Martin).

Migration also takes place due to wars, civil unrest, economic crises, and a weak or nonexistent banking system. The IMF study (El-Qorchi et al. 2003) found that IVTS is highly adaptable to such events and provides an efficient mechanism for funds transfer.

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## 6.7 Impact of the Economy

Financial markets and transactions play an important role in maintaining stability in the world. The ability of financial markets and governments to ensure this stability is dependent upon accurate and complete information concerning the flow of funds. The IVTS, being non-documented transactions, do not register on the radars of the financial markets, leading to anomalies and distortions which in turn can cause instability in the global financial markets. This is all the more important because of the sheer size of these non-documented transactions, with estimates in the range of several billions of dollars.

Countries with substantial outflow of funds via Hawala are industrialized states with high degrees of immigration (Schramm and Taube 2002). Sudden unregulated flow of funds from a country can play havoc with governmental regulatory policies. First, estimation procedures for monetary and fiscal policy can suffer substantially when so much money moves in and out of the country, undetected by regulatory bodies. Funds moved via Hawala from one country to another are not recorded in either country's foreign assets or liabilities. This leaves governments with suboptimal estimates of the composition of money, money in circulation, savings rates, and investment rates. As a result, policies implemented may have unintended consequences on the economy (El-Qorchi 2002). For example, if a government is attempting to stabilize its economy by using injections or withdrawals (fiscal policy through government spending or tax cuts), Hawala may cause unexpected results

since no taxes are paid on Hawala transfers. Consequently, the government's revenues will not be maximized and fiscal policy will not have its full effects.

In addition to this, funds moving across borders undetected are not subject to taxation and cause losses in government revenue. Also, Hawaladars often use unofficial exchange rates that can induce problems by undermining official exchange rates. Using unofficial rates can threaten the stability of the country's exchange rate relative to the international rates (Ballard 2003).

Hawala can also have a positive impact on a country's economy. In Pakistan, which has had one of the highest levels of money remittances in the world since the 1950s, the effects of Hawala have been quite apparent (Puri and Ritzema 2000). In the 1990s, Pakistan complied with IMF demands and removed restriction on the free convertibility and outflow of rupees. At the same time, Pakistan's banking rules were amended to allow the registration of Hawaladars. Hawala was no longer an "underground" system but an "official" means to transfer funds. As a result, the gap between the official and unofficial exchange rates closed and banks were better able to compete with Hawaladars. This continued for a few years until 1998 when, at the height of the nuclear testing race between India and Pakistan, the international community imposed stringent financial sanctions on both countries. The Pakistani rupee plummeted and the Pakistani government responded by reinstating restrictions on the convertibility of the rupee, causing extensive flight of capital from the country. The official and unofficial gap widened again, and Hawala was extensively used for international transfers (Ballard 2003).

The sudden fall of the rupee caused devastation to Pakistan's economy. Yet, as Behar (2002) notes, "Hundi is both killing the economy and keeping it afloat" (p. 2). Many believed that the Pakistani economy would undergo hyperinflation after the 1998 nuclear tests and resulting sanctions. Similarly, plummeting of foreign exchange rates was predicted in the post-9/11 scenario, but none of this happened (Behar). Hawala saved the economy by maintaining international currency flows in and out of the country. This happened because clients chose the more attractive unofficial exchange rates of the Hawala system.

Hawala transactions have macroeconomic impact on individual economies, state sovereignty, international financial markets, financial regulation, and monetary policy (Reszat 2003). Hawala may not directly drain a country of foreign exchange, but it does work in conjunction with oppressive government regulations to keep needed dollars and other currencies from coming into the country. In fall 2008, a leading Hawala operator was arrested in Pakistan on charges of illegally remitting \$10 billion using the Hawala channel, depleting the country's foreign exchange reserves (The News 2008). According to a KPMG report published in 2008 (The Times of India 2008), over \$1 trillion is being laundered every year by drug dealers, arms traffickers, and other criminals in India. Under-invoicing exports and over-invoicing imports are chronic problems in countries which use Hawala transactions. As more businesses seek the Hawala alternative to traditional trade financing, local Hawala brokers raise the exchange rate and weaken the currency.

### 6.7.1 “Black Hawala” Syndrome

Increasing the ease of financial transactions through Hawala also increases the risk of illegal activity. The term “Black Hawala” is used to describe illegal activity through Hawala transfers. Criminals, just like other profit-oriented people, try to function more efficiently, and also seek to avoid detection while performing their transactions. Hawala offers more anonymity than the formal system since no personal questions are asked and business can be conducted with speed and ease (Passas 1999).

Hawala has been used in a number of illegal activities ranging from kidnapping to fraud, but the principal use of “Black Hawala” has been in international money laundering. Since 9/11, the international community has been awakened to the power of the Hawala system. An abundance of papers, articles, and studies have been published on the role of “Black Hawala” in international crime. “Black Hawala” has taken the IVTS spotlight and the media has generated a negative bias against the entire Hawala network (Passas 1999).

One must remember that criminals have also used formal channels to launder money and commit crimes and that Hawala is not solely used for illegal purposes. “Black Hawala” constitutes only a small fraction of the Hawala enterprise. Further research needs to be undertaken to estimate the size of “Black Hawala” and of Hawala as a whole to put the comparisons in perspective. Prudent measures should be taken to combat “Black Hawala,” for the situation can exacerbate if those who offer it decide to go further underground (Passas 1999).

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## 6.8 Regulation Dilemma

Much is unknown about Hawala, e.g., its size, exact methodology, and what should be done to control and monitor it in the wake of 9/11. The regulation of IVTS remains a difficult task due to the lack of paper trail. Although countries have tried to put in place regulations to check these flows, there are inconsistencies in legislation among the countries.

Impetus to regulations effecting IVTS was provided by anti-money laundering legislation. To foster international cooperation to combat money laundering, the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances was signed at the Vienna Convention in 1988. This was followed by the establishment of the Financial Action Task Force on Money Laundering (FATF) at the 1989 G-7 Summit. The purpose of the task force was to work with member countries to bring about national legislative and regulatory reforms to combat money laundering. Following the events of September 11, 2001, FATF expanded its mission to include the fight against terrorist financing as well.

Some of the agencies currently devoted to monitoring and ameliorating the international status of financial crimes include the following:

- FATF
- Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)

- Financial Crimes Enforcement Network of the US (FinCEN) enforces the USA PATRIOT ACT which requires individuals to comply with Bank Secrecy Act (BSA) requirements
- Asia/Pacific Group on Money Laundering (APG)
- Caribbean Financial Action Task Force (CFATF)
- Council of Europe Committee
- Interpol
- World Bank

One of the key issues in developing international standards for IVTS is the cooperation of the international community via the sharing of financial intelligence information. Governments in many countries have set up agencies to bring together information from the law enforcement agencies, regulators, and financial institutions with the objective of becoming more efficient in the capture and prosecution of criminals. Most of these agencies have used the FATF recommendations as the foundation of their organization.

In the recent past, the international community made strides toward proper regulation and monitoring. For example, in October of 2001, Dubai proposed its first anti-money laundering law that became effective on January 23, 2002. It also created a financial intelligence unit, the Anti-Money Laundering and Suspicious Cases Unit, in January of 2002. India, Pakistan, and Dubai are arguably three of the largest players in the Hawala system, while the USA is the leader in regulation and policy development. Evidently, the USA, Canada, and the UAE have taken the lead in active involvement, whereas Pakistan and India have fewer regulations in place. Pakistan has actually seesawed back and forth, legalizing and curbing Hawala intermittently. While regulations are in place, enforcement remains a questionable issue. There are concerns whether the existing regulations are seriously being enforced, or have they been put in place to fulfill commitments to the international community? (FATF 1999–2000).

The US Patriot ACT, the Money Laundering Control Act, and FinCEN are tools that the United States has used against money laundering. In addition the FATF provides “a forum for law enforcement and regulatory experts to identify and describe current money laundering methods and trends, emerging threats and potentially effective counter-measures” (FATF 1999–2000). The FATF is possibly the most effective tool the international community has against money laundering and financial crimes.

Canada has set up FINTRAC, and an Anti-Terrorism Act has been passed to deter, disable, identify, convict, and punish terrorist groups. The Canadian government in the recent past amended its Bill C-25 as part of its ongoing fight against money laundering and terrorist financing. In Canada, all money services businesses were required to register with FINTRAC by June 23, 2008. Real estate agents are also required to report on suspicious property transactions.

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## Conclusion

Misinformed activists are lobbying for the abolition or the regulation of Hawala operations. As a result, regulators have been forced to examine options at their disposal. A two-pronged choice is available to them: declaring the industry illegal, and/or mandatory registration of Hawaladars. Passas (1999) observes that the scale and frequency of serious criminal activity (aside from tax evasion and currency controls) under Hawala are minimal, and that no drastic measures should be taken without substantial evidence. He does recommend some action, a more indirect first approach to “test the waters.” This would be necessary because any substantial change in the system may force completely legitimate users of Hawala to rely on criminal means to transfer funds. He also notes claim of British banks that Hawala patterns in bank accounts can be detected. This could be useful to identify and monitor accounts of known Hawaladars to track any changes in pattern that may signal criminal activity.

The second International Conference on Hawala organized by the UAE Central Bank and the International Monetary Fund in 2004 stressed the need to design regulatory solutions that are proportionate to the risks and sensitive to possible unintended consequences. In addition, it suggested avoiding overregulation that may drive IVTS operations underground.

One of the largest concerns in the regulation debate is the idea that Hawala is an “economic phenomenon” and will exist regardless of controls and regulations. A stringent regulation may cause Hawaladars to submerge further “underground” and make monitoring even more difficult. Therefore, it is in the interest of the international community to monitor Hawala and not strangle it out of existence. Moreover, Passas (1999) suggests that since Hawala is not harmful in itself, regulators should exclude potential abusers from the network so that benefits of the system can accrue fully to the legitimate players. Therefore, the most effective means of protection against possible abuse is effective monitoring and identification of criminal networks that may potentially abuse the system. This is a difficult task because Hawala can become a conduit for any criminal activity. As noted, Hawala has its origins outside North America and Europe, and has a strong ethnic and religious basis. Therefore, regulators from different backgrounds need to understand the system fully before devising regulation and monitoring policies.

The best method to stamp out Hawala (to lure it to the surface?) is to reduce its economic advantages. This entails facilitating cheap, fast remittances and doing away with the system of parallel exchange markets.

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## **Part II**

# **Country Specific Cases from Emerging Economies**

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# Fraud as a Distinctive Part of Management Mistakes in Countries in Transition

# 7

Drago Dubrovski

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## 7.1 Introduction

From business practice and academic literature, it is well known that management mistakes can be a prevailing internal cause of corporate crisis. However, management mistakes are usually treated as a homogeneous group neglecting that they are actually deriving from different bases, circumstances, and periods. A classification of management mistakes is sometimes recommended, especially when dealing with crisis or making radical changes in a company in order to improve the chances for continued existence and faster development. In a highly complex business environment, characterized by today's financial crisis, recession, or slowdown in the world or national economies, when a much more fuzzy logic in management decision making is needed, management mistakes can derive also from incapacabilities to cope with such complex environment.

In this empirical and comparative article, we have tried to find and form a pattern of management mistakes characterized for a country in transition where business conditions could change dramatically in a short period of time. Based on several empirical research study and this author's own strategic management and restructuring consultancy practice in 57 companies from various branches in Slovenia from 1994 to 2008, working also in crisis management, some managerial implications are formed as a conclusion of the paper. Despite the fact that the hypothesis of existing a pattern of management mistakes which follows the changes in political and economic environment cannot be completely reliably confirmed, some outlines of such pattern are in spite of all seen. It was also found that frauds (and similar immoral behavior) could be a distinctive part of management mistakes.

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## **7.2 Roles and Tasks of Contemporary Management—Review of Key Findings**

A theoretical framework of today's business can be presented by at least five theories which on the basis of theoretical discourse influence the forming of various business approaches and models, and at the same time, they lower the reliability and applicability of corporate long-term planning. These theories are theory of chaos, theory of complexity, theory of contingency, "gestalt" theory (theory of shape), and theory of synergy. The aforementioned theories are not newly discovered and their roots already date back to the 1960s, although they are more easily utilized for interpreting the contemporary corporate developments today in comparison to the mechanistic or the basic statistical views.

In the past, managers have frequently relied on the general managerial approaches containing the key presumption that a defined level of predictability and order exists. Such presumption, based upon the Newtonian science as the base of the scientific management, stimulates the simplifications that are useful in regulated circumstances. Since the circumstances change, such simplifications are (no longer) not useful. If short and middle term plans are not sufficient or directly applicable for planning the strategic developmental orientations (the future of the company in question), since the latter had been prepared according to the corporate circumstances in a particular environment, and the circumstances have significantly changed up to the point of their implementation, the corporate vision, i.e., the visionary capability of the management, becomes much more significant as it defines the corporate "course of navigation" (development).

Therefore, since the development in the environment has become ever more intensified, while simultaneously being less linear and predictable, i.e., predicted, developments in the environment must be accordingly more attentively monitored and the company simultaneously adjusted (actively or reactively, evolutionally or revolutionally) to such changes. This, once again, places continuous attention and preparedness for changes in front of the management, as the passive approach cannot be successful. This does not only concern well-developed systems and development of processes in the environment, but also their introduction into the company and the adjustment of the company to the detected changes. One can determine that the previous managerial models and patterns represent a useful aid, although they may not be sufficient. Modern, quality strategic management becomes even more significant for efficient and successful operation of the company, while strategic decisions, containing a wide spectrum of possibilities of decision making, must be passed more rapidly and in ever more uncertain circumstances, which demand on continuous attention and activities of the management. There will ever be less opportunity for a slow, intrinsic, and noncreative operation, i.e., operation without a visionary brightness and knowledge of the various factors of the contemporary environment and the contemporary forms of business operations.

Research studies have shown that the managers who are successful in the circumstances of higher level of turbulence in the environment are much better in

comprehending how to design an organization (the management, culture, structures, and entrepreneurial behavior) that would be successful in such an environment. Internally orientated managers operating within the so-called closed-minded system are less successful on average (Snowden and Boone 2007; Underwood 2002, p 53). Managers leading a company in a particularly demanding and open competition environment are much more likely to successfully develop efficient strategic approaches in comparison to, e.g., managers in a monopoly or state-owned companies not facing competition, i.e., the global competition.

During the major part of the twentieth century, organizations led their businesses in a reasonably stable corporate environment and the managers were able to concentrate upon the design of structures and systems supporting smooth and efficient operations of organizations. Today's organizations must invest great efforts in successful pursue of changes, whereas their intensity significantly rises. Companies constantly change the extent and quality of engaged assets, routine labor, knowledge, and natural resources. Efficient managers must comprehend the alternative approaches to management and the use of such models in various contexts and requirements.

Although there is an abundance of data and analyses, experienced managers under pressure must rely upon the right instinct in regard to making difficult decisions (Matzler et al. 2007); this frequently exposes intuitive decisions in front of the analytical and routine ones, while there is ever less possibility and opportunity for the latter ones. Routine decision making is effective, on the one hand, but it possesses limited effectiveness; analytical decision making is rational, but it soon surrenders when faced with complexity. Therefore, particularly in complex circumstances, intuitive decision making prevails—based upon thoughts and ideas having their roots in deep memory (Tavcar 2008, p 144).

The increased complexity of the strategic management is influenced also by changed tasks, jurisdictions, and responsibilities of managers that, due to contemporary characteristics of business operations, do not only include responsibilities for the organizational unit (company, corporate system, sector, department) but for the entire planning, harmonization, leading, and monitoring of the operations that, with the use of strategic partnerships, capital mergers, outsourcing, etc., take place merely within “their” organizational unit but also in other companies. Consequently, responsibility for the successfulness of “one’s own company” (organizational unit) is replaced by the successfulness of operations superseding the company, while this is crucial for the successfulness of the company (corporation, legal entity) itself being managed. The management in this case also masters the relations with other participants, frequently operating in other countries, i.e., in different political, economic, and social environments, if they are to fulfill the aforementioned role that deviates from leading the company to leading operations. This, once again, requires new, additional competences that might not have been mandatory in the past. Such operation can only be mastered by a global manager (Ernst 2008, p 323) with global reasoning, cultural adjustability, multicultural values, cultural intelligence, and capability for learning and global managerial competences.

Development of the information communication technology can even lead to a misapprehension that the managerial decisions can be replaced by pre-prepared technological solutions. In reality, headway in the ICT domain can be an aid and support to the management, but it cannot substitute the subjective managerial assessment or decision making regardless of the sophistication of the technological solution. It is dangerous to rely upon (or make excuses of) the fact that the strategic decisions will be made “outside” the strategic managerial assessment.

If changes in the environment become ever more frequent, more rapid, and less predictable, what rules or formulas are to be followed by the management in order to avoid the emergence of a latent or acute crisis in a company and further assure existence and (rapid) development? Due to particularities of each individual case (company), there is actually no formula. Therefore, in regard to contemporary developments in the environment, the corporate practice permanently develops new approaches on how to survive and be successful in such a turbulent, complex, and chaotic environment, and they are all based on the inevitability and continuity of the so-called three-level action:

- Monitoring the developments and changes in the environment.
- Transfer of present and future characteristics of the environment into the company.
- Implementation of changes in the operations of the company, based on this.

Only in this way can a company respond to the turbulence in the environment that is beneficial from the point of view of its operations today and totally hostile tomorrow, while the three-level action must not be a temporary or occasional task but a means of the continuous operation of the management.

In our researches (Dubrovski 2004a, b, 2009a, b), some of the following characteristics of *roles and tasks of contemporary management* can be summarized:

- Operations of an individual company must not be opposed to the basic characteristics of the general macro-trend of the today’s environment (internationalization, flexibility, informatization, marketing, and innovativeness), while it is most beneficial if they are completely harmonized, meaning that the company, when setting up the vision and strategic orientations for ensuring further existence and development, must account for continuous development of new managerial approaches and methods besides new products and services, and new technological and manufacturing procedures.
- Contemporary company is simultaneously flexible, agile, dynamic, flat, virtual, network-organized, modular, adaptive, project-organized, intelligent, and continuously learning, as it contains all characteristics of the aforementioned connotations.
- Changes in the contemporary corporate environment in all domains are extremely dynamic, turbulent, and unpredictable, what demand permanent adjustment of the company by preparing and implementing, on the one hand, both active and reactive and, on the other hand, evolutionary and revolutionary methods of company renovation; “hyper-competition,” i.e., dynamic and unpredictable environment, requires flexible, innovative, and creative organizations that can rapidly adjust to the altered rules of the competition arena.

- Developments in the contemporary environment are neither predictable nor linear (linearly proportional) but are based upon the most various events and phenomena that frequently cannot be causally linked (cause–consequence relation), while this fact burdens managers when planning the long-term development.
- Dynamic changes in the environment and unpredictable changes face the contemporary management with continuous preparedness for implementing changes with the use of the three-level model (monitoring, transfer, and implementation) in order for the company to follow changes in the environment.
- Since the changes bring about new quality in a dialectical way (negation of negation), routine decisions, based on similar events in the past, become less useful, while analytical and moreover decisions having intuitive character become significant, when solutions are sought outside the well-established reasoning frameworks based on innovative and creative approaches.
- Numerous business models that might have represented the basic frame for decision making in particular previous situations are not (no longer) applicable, or their applicability is significantly reduced due to numerous limitations or invalidity of presumptions that they are based upon. In contemporary business circumstances, previous (archaic) managerial models, approaches, styles, and competences (skills, knowledge, and capabilities) are no longer sufficient; therefore, new ones, frequently innovative ones, have to be created.
- On the one hand, extreme intensity of changes in the macro- and micro-environment and, on the other hand, inapplicability or limited applicability of previous models, methods, procedures, and approaches place the management in an extremely demanding position, since in the circumstances of incomplete information, risks, and uncertainty, when the previous practice (routine) or pre-prepared plans cannot be relied upon, the most optimal decisions have to be made, frequently radical ones, while being time pressured.
- Therefore, due to the all aforementioned, the role and complexity of the management (in the so-called demanding or chaotic context) increase, while the headway in the information communication technology and models for predicting the future does not substitute the management but can only serve as an aid and support; and moreover, due to the very extreme headway in most various technologies and the extent of the available information, frequently non-processed and even contradictory, the subjective assessment of the management including the social, environmental, and ethical responsibility is of key significance.

Intensive and extensive, radical and dynamic changes in the environment require adjusted, creative, and innovative managerial developmental solutions, based also on fuzzy logic, needed for strategic decision making in today's business conditions; otherwise, the management cannot be able to successfully ensure further existence and development to the organizations.

### 7.3 Causes of Crises

A crisis is inseparably connected to contemporary companies (organizations). With the rise in complexity of companies that is interactively connected to various social spheres, the possibilities for the emergence of a crisis rise again, while the range of causes that can lead to a crisis also rises. If all other crises are added to this domain, we may consent that a crisis is as “inevitable as death and taxes” (Fink 1986, p 67) in today’s business. “Sooner or later, every business will be confronted with a crisis of some type. Its ability to manage the crisis successfully can mean the difference between survival and disaster” (Spillan 2003).

When talking about a company crisis, a crisis can be defined as a short-term, undesired, unfavorable, and critical state in the company which was derived from both internal and external causes and which directly endangers the further existence and growth of the company (Dubrovski 2004b; cf. e.g., Barnett and Pratt 2000; Barton 1993, p 2; Buchalik 2004, p 30; Fink 1986, p 15; Heath 1998, p 13; Kraus and Becker-Kolle 2004; Lerbinger 1997, p 4; Mitroff et al. 2006, p 51; Moore and Seymour 2005, p 31; Neubauer 1999, p 8; Roux-Dufort 2003, p 51; Slatter 1987, p 61; Smith 2006, p 7).

Hart et al. (2001) point out that the practice of crisis management has significantly changed during the recent period, which is indicated by the following characteristics (cf. also Boin and Lagadec 2000): the society has transitioned from the industrial into a more risky one, globalization enables a more rapid and simplified movement of products, services, technology, people, and information; therefore, in the environment of such complex network of links, the level of risk increases; if the level of safety in the society increases, the people and institutions become more vulnerable when something unpleasant and dangerous happens; instead of a heroic answer to a crisis, multi-domain and cross-border measures are required (a crisis affects both the local and the regional as well as the national level, occasionally the multinational as well); instead of episodic measures during a crisis, a continuous crisis management is to be developed (preventive and curative treatment and learning from the crisis).

In comparison with symptoms, on the contrary, which only point to the state of crisis, the causes are actually “responsible” for the present position. When talking about crisis solving, one must consequently analyze and do away with its causes without focusing on its symptoms. The analysis of proper causes of occurrence of certain state is of extreme importance since it identifies those areas (processes, appearances, and events) which of effects must be restrained and reduced. Addressing wrong causes means further useless waste of time, money, and effort which only intensifies the state of crisis.

In spite of the fact that the literature states various classifications of the causes of crises (some sources are, e.g., Bellinger (1962, p 58), Buth and Hermanns (2004), Kraus and Becker-Kolle (2004, pp 15–16), Mitroff et al. (2006, p 51), Müller (1986), Pate (1999, p 55), Richardson (1994), Slatter (1987, pp 25–55), Turner and Pidgeon (1997), Wildemann (2004, p 193), and <http://www.infoquelle.de>), it is nevertheless possible to say that the definitions of the causes are, more or less,

similar but differ in their terminology, time when they were drafted, the domain that they refer to, and the type of business which is predominant.

The causes of emergence of crises may be divided into external and internal. The external causes of crises are usually those that have emerged in the environment of a company, while the latter had no significant influence on their emergence. Therefore, they are frequently denominated as objective or exogenous. The internal causes, on the other hand, are those that have emerged within a company and, therefore, are denominated as subjective and endogenous.

An analysis of the true causes for the emergence of a certain state is of extreme significance, since those domains (processes, phenomena, and events), regarding which the effects are to be limited or done away with, are identified by utilizing the analysis. Dealing with erroneous causes represents a further useless loss of time, money, and efforts, which only makes the critical situation more acute.

Although the external causes play the key role for the emergence of a corporate crisis in many cases, those that emerge within a company itself nevertheless predominate. The external environment, in principle, represents the aggregate of uncontrollable variables that have to be adjusted to by the company, along with its internal processes, structures, strategies, and the marketing mix, which represent the aggregate of controllable variables. If a company does not adjust to the external variables, then it may be possible that the internal causes exist regarding this. Or, to put it differently: potential external causes of a crisis can be successfully eliminated by internal changes (adjustments) in the company.

It was already pointed out in defining a crisis that, in principle, both internal and external causes intertwined to bring about a critical situation [the so-called multi-causability of a crisis or also “polymorphous phenomenon” according to Hensen et al. (2003)]. Mellahi and Wilkinson (2004) state that “the organizational failure is connectively influenced by environmental factors (technological uncertainties, regulatory changes and economic changes), ecological factors (density, size, age and industry life-cycle), organizational factors (management tenure, homogeneity and successions, past performance) and psychological factors (managerial perceptions)”. According to Hamilton and Micklethwait (2006, p 1), the main causes of failure can be grouped into six categories: poor strategic decisions; overexpansion and ill-judged acquisitions; dominant CEOs; greed, hubris, and the desire for power; failure of internal controls at all levels from the top downward; and ineffectual or ineffective boards.

When the management merely analyzes the causes, it, almost without an exception, overestimates the external causes while underestimating the internal ones, which is reasonable since the latter is a direct criticism of the same management up to the point in time in question. Therefore, in the case of a detailed analysis of the causes, an objective and neutral, in regard to the implementer, overview of the causes must be prepared by all means, which may be most effectively carried out by skilled consultants, owners, debtors, industrial experts, and others and not be left to the existing management. Researches also show that people tend to overestimate their own influence on successes, while they blame failure on external uncontrollable factors (Mellahi and Wilkinson 2004).

The key cognition in this part of the debate is that the analysis of the causes of a crisis must not be left solely to the views of the (existing) management, since its selection of causes can lead to a wrongful resolution of the crisis, which only deepens the latter.

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## 7.4 Types of Management Mistakes

The emergence of a crisis is influenced jointly, i.e., parallel and in an intertwined manner, by both the internal and external causes (events, phenomena, and processes). Very few critical circumstances exist that are an exclusive consequence of the first or the second type of causes.

Although the state of crisis in the company can be affected by various interrelated external and internal causes, which as to intensity and appearance vary by company, the essence of the causes surely lies in the management of the company (Clarke et al. 2003; DiNapoli and Fuhr 1999, p 6; Hamilton and Micklethwait 2006, p 1; Kraus and Gless, 2004, p 116; Müller 1986, p 376; Platt 1998, pp 16–17).

*Management mistakes* can be divided into three groups:

- Different actions of the management which prove to be inadequate or less appropriate, regarding the perceived problem (wrong or bad business decisions and mismanagement)
- Omission of the correct and timely action when any decision is made despite the fact that actions are necessary (stoppage or redirection of negative flows, lost opportunities, etc.)
- Frauds and similar immoral behavior (unethical decisions, abuses, deceptions, accounting scandals, criminal offenses, etc.)

While the erroneous managerial decisions (e.g., unelaborated investments into new technologies, a takeover of a company), which can be influenced by the external causes, are visible, ascertainable, and provable, the omission to act, on the contrary, which was necessary in a particular moment, is less ascertainable, although this very group can be considered as the most dangerous cause of crises. Hartley (2005, p 2) divides management mistakes in two main groups: mistakes of omission (no action was taken) and mistakes of commission (bad decision, wrong actions taken, etc.). Evaluation of the successfulness of the management will often be possible in a longer period by a comparison with the competition or with the average of the industry, while actually one can never ascertain whether a hypothetically different management would have been more successful in the same circumstances. What does, e.g., an overlooked business opportunity taken by the competition mean? What does the developmental (technological and program) passiveness mean? What does unpreparedness for carrying out fundamental interventions into inefficient structures and processes mean? All these cases are not about erroneous business decisions, but about a lack of whatsoever decisions and practices that can trigger a severe crisis as a consequence of their adoption of an erroneous decision.

Sheppard and Chowdhury (2005) pointed out that there are four essential points one needs to know in order to understand organizational failure:

- Failure is not typically the fault of either the environment or the organization, but rather it must be attributed to both of these forces as failure is the misalignment of the organization to the environment's realities
- Because failure involves the alignment—or misalignment—of the organization and its environment, it is, by definition, about strategy
- Because failure deals with strategy, we can make choices to accelerate it or avoid falling into its clutches
- Because organizational failure can be avoided even after a decline—rapid or prolonged, the ultimate failure of the organization really stems from a failure to execute a turnaround successfully

In business literature regarding mistakes of the management, various theoretical debates can be found on the question of how such mistakes came about. On the one hand, classical industrial organization and organization ecology scholars have typically assumed a deterministic role of environment and argued that managers are constrained by exogenous industrial and environmental constraints, leaving them with little real strategic choice, and hence managers' role should be ignored. Sometimes a change is hard to predict and it heightens uncertainty for key organizational members. Criticism is related with the question of why it is that firms in the same industry facing the same industry-level constraints fail while others succeed. In addition, studies have demonstrated that performance is determined by the firm's strategy more than the industry. On the other hand, the organization studies and organizational psychology literature take a more voluntaristic perspective and argue that managers are the principal decision makers of the firm, and consequently, their actions and perceptions are the fundamental cause of organizational failure. Critical remarks of the latter are connected with overreliance on internal factors (Mellahi and Wilkinson 2004).

Mistakes are a constitutive element of the process of strategic management and, due to an unpredictable and turbulent environment, will always exist. There is no "right" or "wrong" approach in making business decisions—decision making is not like mathematics where you can prove that something is "right" (...). Business decision making is far more situational—the right decision today is really just the "best decision" based on the current situation, what is known, and what the options are (Kow 2004). Omissions of the correct and timely acting are of key importance for further development of a company, when measures, activities, developmental programs, and so on are not being carried out, which represents a loss of opportunities that would enable further existence, i.e., a more rapid growth, while simultaneously the competition is taking advantage of the same opportunities and increasing its power at the cost of the inactive company. "Even the most successful organizations make mistakes but survive as long as they maintain a good 'batting average' of satisfactory decisions" (Hartley 2005, p 333).

The historical perspective illustrates that the frauds of recent years are not a new phenomena. In last few years, "the world economic system has witnessed in monetary terms the largest dollar level of fraud, accounting manipulations and



unethical behavior in corporate history and certainly the most economic scandals and failures since 1920s” (Rockness and Rockness 2005). Many big scandals show that there is a strong impact of senior management on the corporate culture and resulting frauds, characterized by an ironic expression “Enron Ethics” (Sims and Brinkmann 2003).

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## **7.5 Empirical Findings—The Case of the Period of Transition in Slovenia**

The period of transition has caused similar macro-economic consequences in all transitional countries. At the beginning of the transitional period, the countries lost markets in Eastern Europe and in the Balkans, which initially led to a decline in GDP and a higher unemployment rate. Such circumstances led to a decreased aggregate demand and supply, i.e., to stagnating economies. The companies from transitional countries, sometimes facing deep crises, were forced to refocus their operations toward the markets of the EU, which required integral and drastic restructurings. A rapid and expansive privatization of companies, in state ownership, was the primary objective of all socialist countries, since it was expected that the privatization and autonomy of companies would trigger an increased interest both on the part of the labor force and on the part of the management for improvements in efficiency and successfulness of ventures.

Slovenia, according to numerous indicators, is completing the transitional period that begun in 1991 by the formal emancipation from the prior federal country of Yugoslavia and that was followed by the formal transition from the socialistic social order, by the transition from the one-party system to the pluralistic parliamentary system, and the transformation of the state (social, public) ownership into the private (the process of privatization).

The political changes had profound economic impacts, particularly for those industries and companies that were entirely or predominantly oriented to the relatively favorable Yugoslav market, which was practically completely closed in that period due to the events that followed the disintegration of Yugoslavia. Therefore, the management, which were not accustomed to highly competitive environments typical of global markets, were forced to seek substitutive markets actually “overnight,” whereas superior quality, attractive prices, and an appropriate marketing approach had to be provided. It can be concluded from the stated excursus that the position of an individual company within an industry must be monitored from the perspective of the circumstances in the industry, which can be identical to the economic conditions in the region or the country; it may also be better or even much worse.

Profound revolutionary changes both on the domestic and on the world scale (globalization) had brought tremendous pressures on the existing management. At that point in time when extensive manufacturing orientation dominated, typical of all socialistic economies, a spontaneous (ad hoc) approach prevailed in comparison to a planned and systematic one. There was a deficit in knowledge in other domains

(primary marketing) and a poor acquaintance of the international trade (varied among industries), since most of the transactions were carried out in the internal (ex-Yugoslav) market.

Consequently, the first stage of the transition (1991–1996) was not characterized so much by erroneous (bad) management decisions but predominantly by omissions to act, i.e., preparations for and carrying out measures for an integral strategic (program market, developmental-technological, manufacturing, financial, personnel, organizational, informational, etc.) restructuring. A lack of experience and knowledge in the field, sometimes also a lack of political will, prevented a more successful restructuring of numerous Slovene companies that either ceased operating or underwent a perspectiveless agony with the help of state aids.

According to the German model (Treuhandanstalt), Fund for Development was established in Slovenia that became the owner of 98 companies, employing 56,000 people, i.e., 10% of all employees. The aggregate loss of these companies, which was defined as irresolvable without state aids, amounted to approximately 1 billion EUR. Until the end of 1993, new management replaced the prior ones in 70% of the cases. Since the new temporary “state” managers were insufficiently skilled, a series of numerous *erroneous strategic managerial decisions* were taken in these companies, while somewhere even *frauds and other immoral deeds* were not a rarity. In the companies which had been in one way or another taken under state umbrella, thus, *omissions of acting* did not dominate, since the temporary managers were forced to carry out any measures available, but an abundance of wrong or bad decisions followed as a consequence of insufficient skillfulness and unorganized operation that could have been avoided in many cases. Mistakes of the management were “covered” by the additional state aid.

After a relatively short period of independence, many companies faced a new shock when Slovenia became a member of the European Union in 2004 (rules of the EU were actually effective even before, as of the Stabilization-Associational Agreement), once again differently among industries and individual companies. Likewise, the story from the beginning of the transition repeated once more when many companies did not adjust their operations to the new circumstances (omissions of management to act), although, due to the bitter experiences from the past, there were yet considerably fewer such failures (the reason can also be found in the private ownership of the companies). Those industries which had been in a more or less healthy state due to the protectionisms, again having various origins regarding both the Slovene and the former Yugoslav market space where these companies were dominant (e.g., food-processing industry), reacted worst. By the accession to the EU, Slovene companies lost their competitive advantages in those markets in comparison to other EU countries.

During the period of transition, all types of management mistakes could be found in Slovene corporate systems, which was not surprising or on the contrary to the other economic environments. Their influence (extent) differed during individual periods and with regard to the characteristics of the external and the internal environment, where individual companies operated, thus fundamental typical patterns evolved.

One can ascertain that the omissions of the correct and timely action played the key role during the period of transition, and erroneous decisions, on the contrary, to a lesser extent, while the latter predominated in cases when the company was receiving significant state aids. The mistakes, by all means, are a constitutive part of the management process. Where the environment is more turbulent, as was true for Slovenia, there are greater possibilities for mistakes that, in regard to the dramatic changes in the environment, were generally not “too extensive” at all. If a company operates in an industry which is characterized by a high, above average, growth rate, then the mistakes or troubles that would represent a severe critical situation in a poorly positioned industry will not have lethal impact. This means that the subjective decision (the internal cause) was directly connected to the events in the environment (the external cause). Simplified, it is still true that a company operating in a stagnating industry must make more key decisions in a short time period and often without an appropriate support, which, all together, only increases the possibilities for mistakes.

In the second period of the economic part of the transition, the objective for Slovene companies was to increase primarily their competitiveness, i.e., the value productivity and to catch-up the developed countries. According to the value-added per-employee indicator (31,000 EUR), Slovene processing industry is lagging behind the average of the EU-27 40% (2007), although this varies among industries. Regarding the fact that Slovenia was the most developed accession country, according to most indicators, at the point of accession, a comparison with the “older” members (the EU-15) would show a lag of 2–4 times.

Slovene companies, therefore, will have to boost the development of products incorporating a higher value added, which, once more, demands a complete commitment and skillfulness of the management. On the average, an insufficient part of the developmental, innovative component in products and services of producers is one of the key problems of Slovene economy. It was in some way also confirmed that corporate ethical failures appear more likely to occur in very successful companies lacking a solid ethical foundation when economic conditions change (Rockness and Rockness 2005).

International comparisons indicate that the intensity of restructuring in the processing industry in Slovenia in the second half of the 1990s was higher than in the 11 of 13 countries of the EU (for Ireland and Spain the data are missing) and slower comparing to the three transitional countries, for which the data (UMAR 2002, p 24) are available (Hungary, the Check Republic, and Slovakia). Although the value added per employee has increased in real terms, the contribution deriving from factual successful restructuring of companies is far lower, since quite a few large unsuccessful companies have disappeared in this period and their absence from statistics had a significant influence on calculation of the average. Since the value added in real terms also rises in the EU, Slovenia’s lagging according to this indicator is not decreasing, taking into account the aforementioned influence of the “failed” companies. This practically means that it cannot achieve the EU-27 average by an evolutionary change. The solution, therefore, can be sought in a revolutionary change of the economic structure that is ever more being

characterized by sophisticated services. Simultaneously, this solution is to be sought in abandoning and outsourcing the unprofitable mass non-sophisticated production in individual industries, as well as in individual companies, where transition into narrower market segments and market niches represents a real opportunity, likewise in a revolutionary manner. Exactly at this point, a danger lurks again that the restructurings are not sufficiently rapid, integral, and radical, i.e., *the danger of omission of the correct and timely acting* appropriate and timely reactions by management, which is, due to a required compensation of the lagging regarding the developed countries, actually necessary.

When considering crisis management less critically, there are often opinions to be heard that the latter is typical only of periods of the so-called transition of the economy, when the weak companies that are allegedly in the need of crisis management are presupposed to go bankrupt, while only the successful companies, not operating according to the principles of crisis management, are to survive; therefore, the significance of the latter will diminish. Unfortunately, the international and the domestic experience indicate differently. If, presumably, Slovenia completed its “period of transition” with the accession to the EU, then the period of severe crises in companies has not ended; on the contrary, for many the latter has just begun due to this very reason. A significant lagging of the Slovene processing industry behind the average of the EU-27 (even more of the EU-15) indicates that the Slovene management will be forced to draw rapid and often radical and environmentally appropriate moves in the future, where there will be increasingly less space for management mistakes that could have been kept secret during the period of transition (Table 7.1). Because the environment for conducting business is becoming ever more complex and turbulent, crises become ever more complex, interrelated, and interdependent as well (Boin and Lagadec 2000). Even small deviations from the initial guidelines may lead to a rapid escalation of the problems. Therefore, the measures for remedying the crises are becoming more demanding and extensive.

**Table 7.1** A pattern of management contribution in Slovene transition period

Period	1991–1996	1997–2003	2004–2008
Key features	Lost markets, stagnation, deep crises	Program market restructuring, state aid	EU integration, higher value added is needed
Prevailing management approach	Spontaneous, ad hoc approach, lack of strategic management	Introduction of planned approach with basic elements of strategic management	Planned, systematic approach, further development of strategic management
Prevailing management methods	Crisis management	Restructuring projects	“Classical” strategic management
Prevailing types of management mistakes	<ul style="list-style-type: none"> <li>• Omissions of the correct and timely acting</li> </ul>	<ul style="list-style-type: none"> <li>• Wrong or bad decisions</li> <li>• Frauds and similar immoral behavior</li> </ul>	<ul style="list-style-type: none"> <li>• Omissions of the correct and timely acting</li> </ul>

## 7.6 Managerial Implications—Discussion

In the economic perspective of transition, the management in Slovenia played one of the key roles, since they had to operate in circumstances characterized by the domestic and the foreign environment, both rapidly and drastically changing (globalization). Beside numerous successful restructurings of companies, all types of management mistakes occurred, which were characterized by certain peculiarities in the transitional period. While the extent of *frauds and other immoral behavior* can be suppressed on the longer run by a greater assertion of moral codes and promoting an ethical climate, on the one hand [“One natural way to facilitate moral outcomes is through organizational cultures where certain principles, norms, and values are internalized and fully motivating.” (Smith 2005)], and by a more efficient control, better accounting standards and even penal policy on the other, the *erroneous behaviors (wrong or bad decisions)* by the management can be reduced by their greater skillfulness regarding the complex processes of restructuring and the catching-up with the competitions. *The omissions of the correct and timely acting* of the management, on the other hand, can be prevented by a decreased influence of the state.

The omissions of the management, as one of the groups of mistakes, are otherwise problematic for identification (whether a different management would have been more successful during the same period); therefore, strategic alternatives ought to be pointed out where even the supervisory body (board) can have a significant consulting role. This body, however, needs to be adequately qualified. If management mistakes take place during a period of emergence of a crisis, then the mistakes are not to be given opportunity during the period of crisis healing. The greater the political influence, the visible management mistakes are less frequent, since a wider consensus of the participating sides is usually reached prior to making decisions, while the influence of omissions of the management is greater. The state aid, therefore, must not be an abetment to the management for the strategic decisions not to take place. Lesser the political influence, more activities will be required, whereas the mistakes can be more frequent but still less fatal than the potential passiveness (the failure to act).

Thus, the hypothesis that the omissions of the correct and timely actions on the part of the management during the transitional period might have been more damaging for a company, since they were vital for its existence and the development compared to the classical mistakes. This was confirmed in basic outlines, taking into consideration the related categories as they were explained and understood in this article. The omissions were only more visible after the event and often scientifically not possible to confirm. The companies or industries, lagging behind the competition or the previously set developmental objectives, cannot afford omissions to act even for the potential cost in the form of mistakes. If there is really a more or less valid pattern of management mistakes in corporate crises and these mistakes appear differently with regard to changes in political and economical environment in countries in transition, this could help decision makers with a more grounded choice in the process of appointing new crisis or restructuring managers,

every time according to their most appropriate competencies, including the capability for fuzzy logic in decision making.

By taking into consideration many limitations mentioned in this chapter confirms the hypothesis that there is plenty of room for further and deeper research studies in this area.

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## 8.1 Introduction

In an incident thought to be the first of its kind in India, partners of the auditing firm PricewaterhouseCoopers were arrested for their alleged role in Satyam Computers' scandal. A corporate fraud named as "India's Enron" was committed by promoters of the company which shocked India's corporate world. Promoters got involved in the manipulations of accounts and inflated revenues. The incidence stunned India's corporate world; the resulting consequence was that rattled investors and the government were left to pick up the debris in order to salvage what was left of Satyam Computer Services Ltd. after its founder and chairman admitted to committing the country's biggest financial fraud.

An organized crime was committed in which the magnitude of the forgery indicated that it was difficult to believe that employees at leadership level were not aware of the manipulations. Perhaps they did not know the actual amount involved, but they must have certainly been aware of the happenings.

Satyam Computer Services was incorporated as a Private Limited Company on 24<sup>th</sup> June 1987 for providing software development and consultancy services to large corporations. The company was promoted by B. Ramalinga Raju (Chairman and CEO) and B. Rama Raju. On 26th August 1991, the company was converted into a Public Limited Company.

Ramalinga Raju acquired large tracts of land through his family-owned property firm, Maytas Properties and the public-listed Maytas Infrastructure. To raise the cash to pay for the land, he used his stake in Satyam as collateral. Things began to fall apart at the beginning of the fall in the value of real estate properties and global stock markets problems of 2008. Creditors began to call in their loans as the Satyam stock they held as collateral was falling. Ramalinga Raju had to juggle his stocks

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and assets to meet the situation so he came up with the last ditch plan (Srinivas 2009).

On 16th December 2008, he announced that the 20 years old Satyam Computer Services would diversify into the real estate business by acquiring two business firms run by Mr. Ramalinga Raju's family, i.e., Maytas Infrastructure and Maytas Properties. Satyam had proposed to acquire a 51% stake in Maytas Infrastructure, a company listed on the BSE and 100% of privately held Maytas Properties. However, when institutional investors expressed their outrage, he was forced to withdraw the proposal. This was probably a way to siphon off cash from Satyam's books to meet the debt repayment and cash obligations that two Maytas Firms had to meet (Ganesh 2009). The deal involved total cash outgoings of Rs. 7,840 crore (\$1.6 billion US Dollars), of which about Rs. 7,400 crore would have accrued to the family members. After this withdrawal, the share prices of Satyam fell by 30% to Rs. 158 per share on the BSE from Rs. 544 per share, when the company was ruling the markets with their 52-week high. There are credible reports that Ramalinga Raju family now owns just about 5% of the stock. This is down from 8.61% after institutions from which he had borrowed money sold shares pledged with them (Ganesh 2009).

After this episode, the question arose as to whether Ramalinga Raju should continue as Chairman of the company when in India only in rare cases can promoters get pushed out of the management of their companies (Ghosh 2008). This, however, brought Satyam, Maytas Infra, and Maytas Properties under the regulatory scrutiny of the Securities and Exchange Board of India (SEBI). In the meantime, a lawsuit was filed against Satyam by a British firm, Upaid Services Ltd., an old client of Satyam in Collin County Texas District Court seeking depositions by Satyam Chairman, CFO, and its global head of corporate governance (Times Business 2008a, 2008b). World Bank also announced its ban on Satyam on December 23, 2008 for 8 years for any business with it over bribery and corruption charges. Class suits were filed in USA against the company.

The first sign of internal dissension among the members of Satyam's board of directors appeared when Dr. (Mrs.) Mangalam Srinivasan resigned on December 25, 2008 on the grounds of moral responsibility. She had been on the company's board since July, 1991 (Times Business 2008a, 2008b). As the board members of Satyam did not protest against Satyam's decision to acquire Maytas or its valuation, the independent directors on Satyam's board came under heavy criticisms, with the company's corporate governance being questioned. The company claimed that its decision to diversify into real estate and acquire 100% of Maytas Properties and 51% of Maytas Infrastructure was strongly debated with the full board signing the deal. It was observed that Satyam's board acted in contravention of all norms of corporate governance while deciding on Maytas takeover issue (Ramesh 2009). After the Maytas deal failed the company proposed to buy back its shares from its shareholders. In order to strengthen corporate governance in the company and improve investors' confidence, the company hired DSP Merrill Lynch to assist it in this step. On 7th January 2009, Ramalinga Raju faxed a confessional and

resignation letter to the board of directors of the company and SEBI in which he brought the following facts to the knowledge of board of directors that:

“1. The balance sheet carries as at 30th September 2008:

1. Inflated (nonexistent) cash and bank balances of Rs. 5,040 crore (as against Rs. 5,361 crore reflected in the books)
2. A nonexistent accrued interest of Rs. 376 crore
3. An understated liability of Rs. 1,230 crore on account of funds arranged by Raju
4. An overstated debtors position of Rs. 490 crore (as against Rs. 2,651 as reflected in the books)

For the September Quarter, the company reported a revenue of Rs. 2,700 crore and an operating margin of Rs. 649 crore (24% of revenues) as against the actual revenues of Rs. 2,112 crore and an actual operating margin of Rs. 61 crore (3% of revenues). This resulted in artificial cash and bank balances going up by Rs. 588 crore in Q2 alone. What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the number of years. It attained unmanageable proportions as the size of the company's operations grew significantly. The difference in the real profits and the one reflected in the books was further accentuated by the fact that the company had to carry additional resources and assets to justify higher levels of operations, thereby significantly increasing the cost. Every attempt made to eliminate the gap failed. As the promoters held a small percentage of equity, the concern was that poor performance would result in a takeover, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten! The aborted Maytas acquisition deal was the last attempt to fill the fictitious assets with the real ones.”

Ramalinga Raju wanted to bring it to the notice of the board that neither he nor the MD (including their spouses) sold any shares in the last 8 years—excepting for a small proportion declared and sold for philanthropic purposes, and that in the last 2 years a net amount of Rs. 1,230 crore was arranged to Satyam (not reflected in the books of Satyam) to keep the operations going by resorting to pledging all kinds of assurances. Significant dividend payments, acquisitions, and capital expenditure to provide for growth did not help matters. Every attempt was made to keep the wheel moving and to ensure prompt payments of salaries to the associates. The last straw was the selling of most of the pledged shares by the lenders on account of margin triggers, that neither he nor the MD took even one rupee/dollar from the company and have not benefited in financial terms on account of inflated results, and that none of the board members, past or present, had any knowledge of the situation in which the company was placed. Even business leaders and senior executives were unaware of the real situation as against the books of accounts. None of his or MD's immediate or extended family members had any idea about these issues.

Raju also proposed some steps to tackle the current situation like formation of a task force in the last few days to address the situation arising out of the failed Maytas acquisition attempt, Merrill Lynch can be entrusted with the task of quickly exploring some merger opportunities, and a “restatement of accounts” prepared by the auditors in the light of the facts that had been placed before the board.

This letter of guilt and resignation sledge hammered India Inc., dumbfounded regulators, pummeled Satyam's stock, knocked the bottom out of the market, and caused a long shadow over industry in general and the IT sector in particular. It also raised disconcerting questions about corporate governance, the role of auditors, and independent directors. Satyam is not some fly-by-night operator; it was listed on the NYSE, ranked 185 in the Fortune 500 companies and the US Government was among its clients, and employed about 53,000 employees. The hole that existed in Satyam's books was around Rs. 7,136 crore.

There was intense speculation as to what triggered Ramalinga Raju's confession. It seemed that the beginnings of the end came when investors forced Ramalinga Raju to reverse its Maytas moves. The question that arose was that could he be entrusted on all that he had disclosed or was there more to what he had admitted? His letter explained that revenues and profits for 7 years were overstated because there was fear that poor performance could result in a takeover thus exposing the gap. But despite the overstated balance sheets, Satyam's performance never matched any of its peers. In a bid to prevent a takeover, in early 2000, Satyam merged four companies owned by Srinivas Raju, younger brother of Mr. Ramalinga Raju. This helped in raising promoters' holdings, but after a fallout with S. Raju, the promoters' holdings fell again around 2003 (Rajawat 2009). According to the letter, the actual operating margin was Rs. 61 crore or 3% of revenue which was considered to be very low for any IT company and quite unbelievable by the experts. There was also a violation of Section 372-A of the Companies Act, 1956 which provides for an investment up to 60% of the paid-up share capital and free reserves or up to 100% of free reserves, whichever is more, with the resolution of board of directors only.

It is also reported that company's employees' payrolls were inflated. About 13,000 fictitious accounts of employees were reported to exist.

The present study has been conducted in order to analyze the background that led to corporate loot.

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## 8.2 Findings

The findings with respect to the role of directors, auditors, regulators, and stock exchanges are discussed below:

### 8.2.1 Exit Strategy

Ramalinga Raju had a well-organized scheme for moving out from Satyam gradually. The move began gradually in 2001 with 25.6% promoters holding only 8.6% of the company's equity in 2008.

### 8.2.2 Financial Logic

It was a very convenient financial logic to inflate false revenues and show false profits, but it was actually very difficult to carry this out in the company's books of account. It could only have been possible with the help of several people, besides the auditors of the firm. According to experts, besides the Hawala route, the only way to inflate revenues was by showing either false clients with false receivables or real clients with false receivables. If false receivables were to be shown from real clients, then it would have involved employees in sales and delivery from other circles. Most of Satyam employees, past and present, ruled out the possibility of the latter as nobody wanted to admit that they were part of the fraud. The CFO (Mr. Srinivas) confessed to the police that he just followed the orders of Ramalinga Raju and did not manage the bank accounts or monitor the cash. According to Ramalinga Raju, the receivables were false; the sundry debtors' figures were also false. Sundry debtors were reflected on the assets side of the balance sheet as soon as these funds were received by the company. In Satyam' case, the total sundry debtors at the end of the financial year 2007–2008 were Rs. 2,223.41 crore, compared to Rs. 1,650 crore in the same period in 2006–2007, indicating a jump of Rs. 573 crores. At the end of the financial year 2005–2006, this figure was only Rs. 1,122 crore. According to CFO, sundry debtors were only Rs. 490 crore as at 30th September 2008, while the books showed them to be Rs. 2,651 crore. This clearly indicates that Rs. 2,161 crore shown on the books was false. In the balance sheet for the year ending 2007–2008, debt worth Rs. 61.60 crore was shown as more than 6 months old debt, whereas other debtors less than 6 months old were shown as Rs. 2,161 crore. The normal accounting convention requires that the cash flow position of a company should be shown in the time period to which debts are incurred when recording the transaction in the ledger and this should be closely monitored by the analysts and auditors. Thus, there was lack of cash flow in Satyam.

### 8.2.3 Fictitious Accounting

To create false revenues, it might be necessary to create fictitious customers and fictitious services would invariably need to be rendered to them and in the end fictitious receivables would come through them. These fictitious receivables would eventually end up as sundry debtors. Debts which are not easy to recover have to be audited by internal and external auditors. This was not done by Satyam. In this case, fictitious receivables were created and transferred to sundry debtors. These fictitious entries accumulated over time as there were no payments to settle them. However, whether these debtors vanished from the books after a period of 6 months or whether they were shown as bad debts, it was neither noticed nor commented upon by the auditors of the company.

Forgery and manipulations were conducted under many heads which were not mentioned in the letter by Ramalinga Raju. The books had to be balanced as the reserves and surplus on the liability side were forged. According to Ramalinga

Raju, out of the total cash reserves of Rs. 5,312 crore on the book Rs. 5,040 crores did not exist. That means that either these reserves never existed or else they were siphoned off from Satyam. These dealings with respect to cash reserves could not have been done without active connivance of bank officials. Criminal investigation for financial misappropriation is now being carried out and the parliamentary standing committee on finance is also investigating the fraud.

#### **8.2.4 Negligence of the Market Regulator—SEBI**

Satyam had earlier won an award for best corporate governance practices. Its report on corporate governance and code of conduct as shown on company's Website were in accordance with clause 49 of the listing agreement. However, the magnitude of the fraud clearly indicated that nothing was actually complied with. Even then the company obtained a certificate from the auditors regarding compliance of conditions of corporate governance as stipulated in the clause with a rider that "In our opinion and to the best of our information and according to the explanations given to us, we certify that the company has complied with the conditions of Corporate Governance as stipulated in the above mentioned Listing Agreement. We state that such compliance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company." The auditors have not stated anywhere that they have verified the explanations given to them. This certificate has to be sent to shareholders and stock exchanges along with the annual returns.

Regarding the board structure, clause 49 of the listing agreement says that where the chairman of the board is a non-executive director, at least one third (33%) of the directors should be independent directors. SEBI came up with a modification that at least half of the board of directors of a listed company should consist of independent directors if the non-executive chairman of the company is related to the promoters or persons occupying management position. Another modification provided that the gap between resignation or removal of an independent director and appointment of another independent director in his place shall not exceed 180 days. Disclosures of relationships between directors should be made in the specified document to the stock exchanges. The regulator also directed the companies to ensure that requisite qualifications and experience for the independent director would enable him/her to contribute effectively to the company in his/her capacity as an independent director, though it was non-mandatory (The Hindu Business Line 2008).

SEBI ordered an investigation on the basis of Ramalinga Raju's letter revealing fabrication in the statement of accounts of the company. Its investigation will be into affairs relating to buying, selling, or dealing in Satyam's shares and ascertaining whether any provision of the SEBI Act or regulations have been violated. SEBI has not been successful so far in checking real compliance of clause 49. It is necessary to have more preventive measures rather than punitive measures.

Senior management of Satyam sold about 60L shares of the company in 2008 only. SEBI is probing whether the sale of a sizeable chunk of shares by FIs in lieu of debts a few days before the confession letter amounted to insider trading. If the suspicion is confirmed, the proceeds of the sale can be recovered from them and could very well be distributed among the thousands of small investors hit by the sharp drop in the value of Satyam shares.

Here it becomes necessary to examine the role played by the audit committee in corporate governance. According to clause 49, all members of the audit committee are required to be financially literate; at least one member shall have accounting and related financial management expertise. Two thirds (67%) of members are required to be independent members and the chairman should also be an independent director. The audit committee has the power to investigate any activity within its term of reference, can seek information from any employee, obtain outside legal or professional advice, and may also secure attendance of outsiders with relevant expertise. An audit committee meeting is usually briefed by the company's internal auditors and statutory auditors, besides the CEO and the CFO. There does not seem to be any reason normally for the audit committee to question the basic data, such as cash balances, the liability statement, inventory levels, and accounts receivable. These are presumed to be verified by the auditors by virtue of a process of reconciliation statements received from the contracting parties involved in the transaction. Even the audit committee does not have a chance to go behind or beyond the figures furnished it by statutory auditors, who are expected to follow all the relevant rules and precautions and accounting standards. The management, the chief executive officer, and the chief financial officer are expected to provide accurate data. The audit committee, by its very nature, does not have the competence or knowledge to question the basic premise of statutory auditors who believe that they are given accurate accounts by the management and staff (Venkitaramanan 2009). It is necessary for the audit committee to be competent, diligent, informed, probing, skeptical, and capable of making sound judgment independently of management (Deloitte Audit Group 2009).

Satyam had a policy for whistle-blowing which provided that "all directors, officers and associates of the company are responsible to report in good faith, questionable accounting/auditing matters, internal accounting controls, financial reporting (accounting complaints), any violations, fraudulent/unethical practices, misconduct or such other genuine concerns, which are against the interests of the company. It is the policy of the company to treat such complaints seriously and expeditiously. The reporting, which will be free of retaliation and discrimination, shall be in writing either by way of e-mail or letter. While the policy encourages directors, officers and associates to disclose their names, the reporting may also be made anonymously." Even then no one came forward for whistle-blowing. Under Clause 49 whistle-blower policy is a non-mandatory requirement. This requires reconsideration in order to make it functional; probably access to independent directors on the board should also be provided.

### 8.2.5 Negligence of Stock Exchanges

It is necessary for stock exchanges to carefully scrutinize the returns filed with them as part of the disclosure requirements. In regular quarterly disclosure of shareholding pattern of Maytas Infrastructure a distortion was found. An individual B. Rama Raju was listed as holding 2.5% stake in the promoter's category; the same name appeared as holding 8.7% in the public category (Srinivas 2009). It is to be noted that the SEBI has prescribed only the minimum limit for promoters' shareholding, and no maximum limit has been prescribed.

### 8.2.6 Negligence and Deliberate Omissions of Independent Directors

Directors owe fiduciary obligations, duty of care, diligence, skill, duty to attend board meetings, duty not to delegate, and duty to disclose interest in companies in which they are directors (Singh 2007). Duties are the same for both the executive as well as non-executive (independent) directors. In this case, independent directors have acted negligently in allowing the chairman of the company to take independent decisions. The role of independent directors has been to act as a watchdog to protect the interest of the shareholders who appointed them. As per clause 49 of the listing agreement, independent directors shall periodically review legal compliance reports prepared by the company as well as the steps taken by the company to cure any taint. In case of proceedings against independent directors no defense is permitted on the grounds that they were unaware of this duty. As independent directors do not have any vested interests in the company, they are supposed to examine, question, and take into consideration the protection of shareholders before agreeing for any decision. Problem arises only when directors develop vested interests in the company. Thus, it is necessary to have provisions in the Companies Act to restrict reappointments of directors. Section 256 of the Indian Companies Act, 1956 provides for deemed reappointment of directors. According to the Act, in a public company only one third (33%) of directors are given permanent appointments whereas the office of the rest of them is liable to determination by rotation. The vacancies created by retiring directors should be filled up at the same meeting. But the general meeting may resolve that the vacancies shall not be filled up. If it has done neither, the meeting shall be deemed to have been adjourned for a week. If at the reassembled meeting, neither a fresh appointment was made nor a resolution was passed against the appointment, then the retiring director is deemed to have been reappointed. According to the listing agreement, a person shall be eligible for the office of the non-executive director so long as the term of office did not exceed 9 years in three terms of 3 years each, running continuously. This provision requires some consideration. According to the preface of the code of conduct and ethics for board of directors and other associates of Satyam, "the Directors (both executive and non executive directors) and Associates are responsible to carry out their duties in an honest, fair, diligent and ethical manner..."

The board of directors of Satyam had two executive directors, one whole time director, and eight independent directors. But none of them seemed to have followed the code of conduct meant for them. As per the definition of NYSE, Krishna Palepu did not qualify as Satyam's independent directors (Nag 2008). His remuneration was Rs. 9,948,000 for the financial year ending 2006–2007, whereas remunerations of other non-executive directors were within the bracket of 13–14 lakhs. They had received excessive remunerations. One should not forget that duties of directors are intermittent in nature arising only at board meetings. Listing agreement has provided a mechanism for the performance evaluation of non-executive directors by a peer group comprising the entire board of directors, excluding the director being evaluated. This review could be the mechanism to determine whether to extend/continue the terms of appointment of non-executive directors. The independent directors must have witnessed numerous indications of questionable practices, but chose to ignore them to the detriment of Satyam shareholders, employees, and business associates. An examination of the extent of breach of trust and fiduciary responsibility of the directors and the board is necessary to be conducted. They are bound to be held liable for deliberate omissions and negligence. By claiming moral responsibility and resigning from the directorship, independent directors cannot save themselves from their liability.

Under section 193 of the Companies Act, 1956, companies are required to record minutes of all board meetings. In these minutes, the name of directors who dissented or abstained from the decision and the fact that an interested director did not participate in the discussion or vote are also recorded. Minutes of board meetings are *prima facie* evidence of proceedings of board meetings. One can have a fair idea about the role played by independent directors in Satyam's case through minutes if they are properly recorded and kept.

Nair (1966) observed in a case, "...The deliberate falsification of the books year after year could not have been the handiwork of the staff of the company; it could have been at the specific instructions of those at the helm of affairs, and although the rudder might have been in the hands of the managing director, it is their duty to keep an eye on him and see that he steers a proper course."

### 8.2.7 Negligence of Auditors

"An auditor's duty is not confined him/herself merely because the task of verifying the arithmetical accuracy of the balance sheet, but to inquire into substantial accuracy, and to ascertain that it was properly drawn up, so as to contain a true and correct representation of the state of the company's affairs." (Stirling 1887). In the words of Romer (1924), "...auditor must be honest, i.e., he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of the case." They owe their duty to the company and company only. Every auditor has the right of access to books,



accounts, and vouchers of the company. He may require from the officers of the company any information he thinks necessary for the performance of his duties.

Auditors for Satyam were Price Waterhouse. It was only at the beginning of the current financial year that the Reserve Bank of India finally gave Price Waterhouse the nod to audit banks again after a ban of 4 years after being banned for its role as auditor of the now defunct Global Trust Bank.

The firm's Chief Relationship Partner S. Gopalakrishnan and Engagement Leader Srinivas Talluri were suspended from taking on client-related work until the completion of the investigation. Both were taken into police custody.

After its investigation, the CID told the courts that S. Gopalakrishnan and Srinivas Talluri were not part of PW but Lovelock and Levis (L&L), one of the audit firms owned by PricewaterhouseCoopers International. The PW is said to have put evidence that the two partners are the members of PW and not L&L (Mohan 2009).

Price Waterhouse had admitted that its audit report, which overlooked one of India's largest corporate frauds, is wrong as it was based on wrong financial statements provided by the Satyam management. In a statement sent to BSE, to the three new board members, and to the company secretary of Satyam, Price Waterhouse tried to shift the blame of its inaccurate audit report on the false statements given by the erstwhile software giant (India Business World 2009). If this is true then the real value of such audit is very little for user of accounts (Somanathan 2009).

This confession does not absolve Price Waterhouse, the Indian audit arm of PricewaterhouseCoopers, from allegedly failing to detect the falsification of accounts as admitted by Satyam chairman.

The Institute of Chartered Accountants in India (ICAI) has begun disciplinary proceedings against the arrested partners of Price Waterhouse. If they are found guilty, they could lose their permit to practice and face a penalty up to Rs. 5 lakhs. As per a government directive, ICAI had also asked for the working papers or the audit methodology that PW followed in the last 5 years while auditing Satyam's accounts.

The questions that arise here are whether auditors were negligent in their duties, were unaware of the real facts, or it was a deliberate omission. It appears that the auditors simply believed the facts given to them by the directors and did not go into verification of bank guarantees and books of accounts. The case highlights that even the routine procedures and standards were not followed by the auditor. For example, the inflated cash balance on books could have been easily verified. Conventionally an auditor takes an independent, but neutral look at procedures, controls, and records, based on a sampling of various transactions. Their primary aim is not to uncover wrongdoings, but to satisfy lenders' and investors' interest on the overall financial condition of the audited company. An auditor is not an investigator, but he has to exercise diligence and skill in the discharge of his duties. The issue is that of extent and depth of auditors' effort in their exercise of due diligence. Auditors should be restricted from putting excessive reliance on the statements given by the management. Independence of auditors and their powerlessness in family-owned

businesses have become a very important issue that should be taken care of by ICAI. The need is felt that the ICAI should review the guidelines to audit firms. Some proposals have been put forward that include rotation of auditors once in 3 years to restrict the association of a particular audit firm with a company for a long period of time; a system of joint audit by two firms for listed companies should be evolved.

Internal audits of the companies are not mandatory. It is necessary for the statutory auditor to mention if it is missing. However, companies must have an internal audit department and hire chartered accountants for conducting internal audit. There is a need to make internal audit mandatory. Statutory auditor should undertake sample checking to know the effectiveness of the internal audit. In case of suspicion he should conduct an in-depth checking of transactions. Suits for compensation can be filed by both the company and shareholders against the auditors of the company.

### **8.2.8 Investigation by the Company Law Board/RoC**

Section 237(b) of the Companies Act, 1956 gives discretion to the Company Law Board (CLB) to appoint inspectors on its own motion. The CLB is empowered by the section to ask the government to act if there are circumstances suggesting fraud, misfeasance or misconduct. "Section 234 of the Companies Act, 1956 confers on the Registrar of companies the jurisdiction to call for information or explanation in relation to any document submitted to him. A further power is conferred on Registrar, who may after being authorized by a Presidency Magistrate or a First Class Magistrate, enter any place, search or seize any document relating to the company, or its managerial personnel, if he has reason to believe that it may be destroyed or tampered with" (Hidayatullah 1966). The Registrar at Hyderabad has reported that many of the required documents were missing from the office of Satyam. On his recommendation the matter is now being investigated by Serious Frauds Investigation Office (SFIO).

### **8.2.9 False and Inflated Pay Rolls**

Satyam's 53,000 headcount was inflated and millions of rupees were withdrawn every month in the name of nonexistent workers. The question is whether Ramalinga Raju was in a position to inflate Satyam's headcount by 13,000 and manage as many salary accounts, withdraw cash from them every month for several years, and appraise these fictitious employees every year all by himself without any support? Obviously it cannot be done single handedly. The role of finance and HR head cannot be ruled out here. According to Pendse (2009), "We are talking about 20% of the total employee strength that did not exist. You can hide 10 people, not 13,000. There is obviously a team to manage this number." There must have also

been collusion with some employees of the banks where fictitious accounts were maintained.

### **8.2.10 Loss of Shareholders**

It is often said that the law provides little remedy to investors even when they suffer due to corporate misfeasance. Shares are accepted as an inherently risk-prone investment. But tortuous suits for negligence are possible at the behest of the shareholders (similar to the class action suit already filed in the USA), who could equally explore the option of collectively approaching the CLB for mismanagement action. They can also file a case against the auditors as well as the company for their loss. The question as to whether shareholders have the right to sue for reflective loss in case of breach of fiduciary duty by directors and whether they could be debarred from recovering loss under the rule against recovery of reflective losses were an issue in a case. The court said that the rule against reflective loss was not concerned with barring causes of action as such but with debarring recovery of certain types of loss. The foundation of the rule against reflective loss was the need to avoid double recovery. There was a powerful case for saying that it should be applied in a case, where in its absence, both the beneficiary and the company would be able to recover effectively the same damages from the defaulting trustee or director. The filing of a claim for damages for breach of fiduciary duty had the effect of barring the claim for reflective losses (BCLC 2004). Resignation by all the independent directors has also left the minority shareholders of Satyam in the lurch. For protection of investments there was a need to get bail out for the company.

### **8.2.11 Serious Fraud Office Investigation**

On the recommendation of the Registrar of Companies in Hyderabad, who inspected the books of Satyam and eight promoter companies to ascertain the facts about the fraud, the Government of India asked the SFIO to probe the financial irregularities in Satyam Computer Services and report its findings in 3 months.

### **8.2.12 Investigation by Central Bureau of Investigation**

After investigation into Satyam “a unique accounting fraud,” CBI has enough reason to believe that the scam involves a much bigger amount, close to Rs. 10,000 crore, than what was disclosed. The Agency has retrieved over 7,000 fake invoices and forged documents showing fixed deposits and bank balances and their evaluation shows that the size of the scam is over 9,600 crore. These inflated figures were also reflected in the form of audit reports which helped the company to

cheat the public who were purchasing its shares. Ramalinga Raju also gave false and fabricated statements about high capital of the company. He forged documents and created fake FD receipts to the tune of Rs. 3,300 crore. The FDRs were shown as available deposits by the company. He also allegedly manipulated the bank guarantees to show the balance in bank accounts as Rs. 1,800 crore. CBI is also investigating the “digital evidence” about the share transactions at NSE and BSE and has not ruled out the possibility of questioning some officials of SEBI. CBI was probing the rotation of funds and role of front companies used in the rotation of funds and has found that the accused had floated more than 320 companies and nearly 60 companies had the same address.

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### 8.3 Conclusions and Suggestions

If business friendliness is to be protected domestically as well as internationally, corporate governance must top India Inc's list of priorities. The biggest question that has to be addressed immediately is that do we have the kind of business environment and business culture that actually promotes good corporate governance and demonstrates it? The institutions that are responsible for integrity of the system and the reliability of the financial information are required to go through a rigorous self-examination. The market analysts, who consider themselves to be more knowledgeable than the ordinary investors, failed to guess the pattern of what was going on. It seems inconceivable that the company's auditors did not know what was going on. According to accounting experts, assets can be overstated, but cash balances are difficult to manipulate without deliberate deception. The need of the day is to have an advocacy perspective rather than an independent or neutral one that auditors are required to take. It is said that auditors face a trade-off between speed and accuracy. It is not necessary to give quick results but to give correct results. There is a need to strengthen the internal audit process so that they can become whistle-blowers if need arises. According to KPMG India Fraud Survey Report, 2008, 42% of the respondents agreed that frauds are most likely to be committed by senior management and the company's board. The report has come up with the conclusion that so far the internal auditors have been more successful in the detection of frauds (Jain 2009a, 2009b). It is often argued that changes in the syllabi of the ICAI have to go through a long process of governmental approval, when most of these are technical matters that the ICAI should solely deal with. It is the ICAI which has the wherewithal to understand what the professional issues involved are and it is they who should be involved into it (Roy 2009). It seems to be an argument given for the sake of argument only because government's interference is limited to constitution of ICAI only; mechanism for audit profession is decided by ICAI only. There is a need to have strict penalty provisions for fraud committed by auditors. There is a need to ensure rigorous follow-up and take deterrent steps. ICAI has suggested certain changes in the regulation to get more powers. ICAI currently cannot take action against any chartered accountant who has indulged in professional misconduct or any other misdeed if he is not a

registered member of the institute. Although ICAI conducts peer review of large firms, conducts mandatory training programs for auditors, and monthly newsletters point out ways in which companies might resort to “creative accounting” practices, all these practices appear to be insufficient. It may come up with a guidance note for its members on how they should keep a vigil on documentation provided by clients for auditing (Agarwal 2009a, 2009b). ICAI should come up for constituting an independent oversight board, which is an EU-mandated requirement. ICAI should make a comparative analysis with the approach of American Accounting Association (AAA) and adopt their better practices (Srinivas 2009). ICAI has decided to equip professionals with state-of-the-art technology or forensic accounting, which it thinks will be a potential weapon to detect and fight corporate frauds. It is planning to set up a serious fraud detection cell to assist regulators like RBI and SEBI to prevent such scams. Although appointment/reappointment of auditors is in the hands of shareholders, it is actually the management which appoints convenient auditors. The time has come to check this practice now. If the stand of the profession is that a nonnegligent and proper corporate audit will not be able to detect frauds of the size of Satyam, then the very rationale for a statutory audit is lost (Somanathan 2009).

Government of India had constituted Quality Review Board (QRB) for review of audit processes in India. Head of QRB resigned during the period when questions were being raised over the quality of auditing process in India (Doval 2009a, 2009b). This raises concern about the functioning of such high-powered committees and their success in strengthening and improving the quality of the processes for which they have been constituted.

The SEBI was brought to fore as a market regulator in 1992 and was given wide powers to call for records and take action against erring listed companies. The lack of effective enforcement and foresight in corporate regulation is evident from frequent corporate frauds. For an effective investigation, it should be time-bound investigation. The regulator needs to show that it can act without delay and act tough. The performance of SEBI may face CAG audit for its failure to detect irregularities in corporate governance. SEBI has been maintaining its funds running into crores of rupees outside the government accounts (Thakur 2009).

SEBI and other regulatory bodies have been ignoring the warnings given to them about financial irregularities committed by Satyam for the last 6–7 years. According to Sarma (2009), financial irregularities were found in Satyam in 2001 and an inquiry was ordered in 2002, but there was no progress on the front. When World Bank was planning to ban Satyam, information was sent to Prime Minister, Nasscom, and IT minister to conduct an inquiry, but no action was taken (Shekhar 2009). In the aftermath of the Satyam case, SEBI has decided to introduce a peer review mechanism to review the accounts prepared by a company’s statutory auditor. In addition, SEBI has also decided to constitute a panel of auditors to review the financial statement of all BSE Sensex and NSE Nifty companies. These initiatives will add more layers to regulations, but the benefits of these may not be significant (Som 2009).

There is probably a need to relook existing corporate governance principles. For example, Canadian securities regulators have proposed an overhaul of the corporate governance regime for Canadian issuers. The proposals feature a new policy that articulates nine high-level corporate governance principles. Issuers will be required to disclose the practices they use to achieve the objectives of each principle. This is a significant change from the current requirement to “comply or explain” against specific governance guidelines. An issuer should establish the respective roles and responsibilities of the board and executive officers, the board should comprise directors who will contribute to its effectiveness, a board should have processes to examine its membership to ensure that directors, individually and collectively, have the necessary competencies and other attributes, a board should have processes to improve its performance and that of its committees, if any, and individual directors, an issuer should actively promote ethical and responsible behavior and decision making, an issuer should establish a sound system of oversight and management of actual and potential conflicts of interest, an issuer should establish a sound framework of risk oversight and management, an issuer should ensure that compensation policies align with the best interests of the issuer, and the board should endeavor to stay informed of shareholders’ views through the shareholder meeting process as well as through ongoing dialogue. SEBI should introduce some mechanism for examination of working of managing directors and for identifying financial glitches.

In 2008, Mumbai-based analysts at Clear Capital, a subsidiary of the Noble Group, a global securities research firm, came out with a report titled “Creative accounting threatens to rear its ugly head.” In their analysis of the financial aspects of all the companies listed on the Bombay Stock Exchange’s BSE-500 index, the analysts said that at least 60 companies were indulging in revenue manipulation, mostly by recording revenues ahead of time and booking fictitious sales. The report identified some 15 companies involved into cash manipulations through disbursement of bulk of their loans and advances to companies in which directors have an interest (Srinivas 2009). But it seems that no notice of this report was taken by the stock exchanges.

The role of the RBI has become crucial in bringing to book the bank officials involved in the scam.

High decibel shareholder activism has been found to be unprecedented in India. The institutional investors in Satyam decided to act jointly to oust the company’s management to protect their interests. This is probably the first time in India that institutional investors have displayed such activism. In such situations, the investors can either move to the CLB or call an extraordinary general meeting of shareholders to change the management, including the board. Transparency is a basic tenet of corporate governance, as with appropriate information shareholders can exercise their rights and it is also a remedy for fraud and manipulation. As one of the judges of the US Supreme Court Lewis Brandeis succinctly put it—sunlight is the best disinfectant and electricity the best policeman (Som 2009). An example can be taken from the UK regulatory system which focuses on shareholder empowerment. Under the new English Companies Act, 2006, shareholders are given a new

statutory right to bring a claim, on behalf of the company, for negligence, default, breach of duty, or breach of trust. This is wider than the current position in that claims can be brought for negligence and because there is no need to show that the person against whom the claim is made has benefited from his or her actions (Deloitte Audit Group 2009). Comparatively, in India shareholders cannot file such a claim against the directors; the company is required to be made pro forma defendant.

Pledging shares to raise funds is a common practice in India. Most institutional lenders want assurance that the promoter borrower will repay the debt. This assurance comes in the form of collateral such as shares and the lender and borrower enter into a security agreement. This ensures that the collateral is collectible if there is a default or is appropriately adjusted whenever the value of the shares falls. In a falling market, lenders are forced to liquidate positions in accounts which fall short of the minimum margin requirement (Roy 2008). The same circumstances were faced by the lenders of Ramalinga Raju. Some preventive measure should be brought to overcome such situation wherein promoters are restricted from pledging their shares during the lock-in period. It is noted that transfer of shares by promoters is not allowed during the lock-in period and pledge of shares is deemed transfer. This fact must also be considered as the government has decided to review and strengthen new Companies Bill, which is awaiting parliamentary approval to prevent such frauds.

SFIO is a multidisciplinary organization which has so far investigated the irregularities in about 40 group companies. The Department of Company Affairs carries out the prosecution for violations under the Companies Act, 1956; the SFIO forwards investigated reports on violations under other Acts to the respective agencies for prosecution and/or other appropriate action. The need is to look into how much successful SFIO has been till now? It seems that the SFIO is yet waiting for the government to arm it with ammunition in the form of personnel and resources to carry out its role at a point when a lot of water has already flown down the bridge (Law in Perspective 2009). The SFIO welcomes information on alleged serious financial frauds from the public. Anybody having any complaint or information in this regard may send the same to the SFIO in the prescribed proforma. How many persons are aware of such a provision? It should be brought to the knowledge of general public.

Is Satyam fiasco a blessing in disguise as felt by many experts? Experts are of the opinion that this episode might have exposed the underbelly of the Indian corporate sector, but it will help in defining the role of auditors and fixing responsibility for negligence or complicity. The scandal would help in plugging loopholes in auditing processes and help make the system more vigilant (Doval 2009a, 2009b). The question is should one wait for such a scam to happen and then strengthen its vigilance or one should be proactive to invoke preventive measures?

According to Ganguli (2009) (former Chairman of PricewaterhouseCoopers), "Auditing history has shown that there is lesson to be learnt from every fraud. Generally frauds come to light due to whistle blower or accidentally." But can

auditors be allowed to forget that they are bound to act with due diligence and care in the performance of their duties?

It is important to remind ourselves that the existence of a democratic society is based upon a fundamental principle of Rule of Law. This axiomatic principle has been incumbent upon the functioning of all the three wings, namely the legislature, executive, and judiciary. But it seems that all civil laws have become ineffective as lame ducks to suit the convenience of the manipulators for cheating and violating contractual terms. The episode clearly indicates that present laws and regulations can easily be evaded. An important facet is that "justice must not only be done but must also been seen to be done." One can only hope that the wrongdoers would have to face the demands of justice, and faith in the system is restored to a level where undesirable operators would be deterred of the consequences of committing such a fraud with the citizens of the country on the whole. Delivery of justice should be timely and actually compensatory to the persons who have been affected by this fraud and not just a battle won for the sake of academic discussion and statistical purposes.

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# The Effect of Corruption on Country-Level Investment: The Case of Pakistan

# 9

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## 9.1 Introduction

Globalization and technological innovations create investment opportunities for enterprises worldwide. Foreign direct investment (FDI) is one investment option which firms choose when expanding into international markets. Firms pursuing international business opportunities analyze a number of factors regarding the FDI location decision (Dunning 1999). At the same time, countries compete to attract foreign firm's FDI inflows. One competing factor receiving increased attention in international business is a country's level of corruption. Media attention, academic studies, and international agreements are increasingly focused on corruption. Transparency international, a not-for-profit agency established in 1993, annually compares country corruption and provides a corruption perceptions index (CPI) ranking to the public through its website. The level of corruption for countries competing for FDI inflows is readily available for potential foreign business investors to compare.

What is the link between corruption and FDI inflows? Prior research has pointed to both positive and negative influences of levels of corruption on levels of FDI inflows.

The basic idea behind much of the analyses is that corruption represents a cost: it increases the uncertainty associated with an investment opportunity, which in turn increases the cost of capital and hurdle rates of return for an investment. All other things remaining equal, this increase in the cost of investing will result in lower levels of investment. At the same time corruption has been thought of as an opportunity, where a firm's managers can exploit weaknesses in a nation's institutional environment to gain advantages in competition.

Before addressing the issue of the net effects of corruption, it is important to recognize that corruption is just one dimension associated with the level of

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transparency of a nation's institutions. National institutional environments comprise the formal rules of a nation as defined by its political and legal institutions as well as the informal rules, as they extend from the social and cultural dimensions of a country. Corruption is a key aspect of the transparency of a nation's political and legal institutions and therefore has an impact on the level of political uncertainty and risk and the burden of regulation as it is related to the extent of market liberalization. Each of these dimensions in turn can influence the levels of FDI inflows, yet each of these dimensions is not separate from one another.

Indeed, corruption is often thought of as extending from, or being a consequence of, other dimensions of a nation's institutional environment. The role played by the regulatory state in the economy has been generally acknowledged as one of the major sources of corruption (Shleifer and Vishny 1999; Rose-Ackerman 1999). The political and bureaucratic allocation of scarce resources through an elaborate system of permits and licenses provides fertile ground for rent-seeking activities that in turn favor the emergence and development of illicit behavior. If excessive regulation stimulates corruption, then policy measures such as deregulation and privatization might reduce levels of corruption, through reductions in opportunities for private rent seeking by public officials (Rose-Ackerman 1988; Bliss and Di Tella 1997).

Corruption, in this line of reasoning, emanates from the interaction of corporate decision-makers on the one hand and politicians or regulators on the other. To the extent that politicians/regulators are able to extract legal rents or illicit payoffs from firms, this interaction has a direct bearing on the cost of capital and cash-flow forecasts. Pursuing this chain of reasoning, the burden of the regulatory state (of which corruption is a part) leads to a higher of cost of capital, a lower incentive for firms to invest, and consequently a lower economic growth rate.

In this study, we focus on the effects of corruption on investment decisions by foreign firms that are on FDI. Although the intent of our study is not to investigate how corruption levels can be reduced by market liberalization reforms (when those reforms reduce the regulatory burden in an economy), these points do relate to the idea that corruption is not only just one dimension of a national environment, it is a dimension that could plausibly be a consequence of other dimensions. If this is the case, then it is possible that any observed relationship between corruption and FDI inflows might be spurious, or at least contingent on other dimensions of the environment. FDI inflows could possibly be influenced by a dimension that is correlated with corruption levels, or with a dimension that is thought to be a causal precursor to FDI inflows. We investigate this point in this study, both conceptually and empirically.

We construct this investigation by first reviewing the background literature on corruption, domestic and foreign investment, and economic growth. We next move to a discussion of corruption and its correlates in national institutional environments, which is followed by our arguments about our expected relationships between corruption and FDI. We next move to an examination of these ideas using the empirical context of FDI into Pakistan. From this, we conclude that the influence of corruption on economic outcomes, such as FDI inflows, needs to be considered in the broader context of a more full consideration of a nation's institutions; otherwise the strength of inferences one draws about the influence of corruption will be less conclusive.

## 9.2 Literature Review

Mauro (1995) determined that there is a negative association between corruption and investment as well as growth. A one-standard-deviation increase in the corruption index will generate an increase in the investment rate of 2.9% of GDP. Thus, the impact of corruption on investment is significant. Wei (2000) found that corruption acts like a tax and its impact of FDI inflows can be measured as such. Comparing corruption levels between Singapore and Mexico, Wei (2000) concludes that raising the index of corruption from the Singapore level to the Mexican level is equivalent to raising the marginal tax rate on enterprises by 50% points. Goldsmith (1999) indicates that the new consensus view of corruption is that it stunts economic growth. The Economist Intelligence Unit (2002) asserts that corruption's damaging impact cannot be underestimated and that there is clear evidence that it deters investment.

In a study on Swedish multinational firms by Katariina Hakkala, Pehr-Johan Norbäck, and Helena Svaleryd, these scholars using firm-level data on Swedish multinational firms identified investments abroad driven by different motives and found that the effects of corruption are not uniform. Given that a firm invests in a country, corruption decreases so-called horizontal FDI and increases so-called vertical FDI. However, corruption seems to have a negative effect on the probability that a firm will conduct any investment in a country. This effect is smaller for larger firms, indicating that the bargaining power of a firm may affect the cost of corruption.

Furthermore, in a research on Bureaucratic Corruption, MNEs and FDI by Andreas Johnson, they develop a simple model that includes bureaucrats and MNEs and describes how bureaucratic corruption in a host country gives rise to increased MNE costs of operating. The model provides insight into the incentives for engaging in corruption as well as suggestions of how to reduce the severity of corruption. The conclusions of the model are complemented by an empirical investigation that analyzes whether host-country corruption reduces the amount of FDI inflows that the country receives. Preliminary regression results indicate a negative relationship between host-country corruption and FDI inflows.

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## 9.3 Defining Corruption

Transparency International (TI) has chosen a clear and focused definition of the term: corruption is operationally defined as the misuse of entrusted power for private gain. TI further differentiates between “according to rule” corruption and “against the rule” corruption. Facilitation payments, where a bribe is paid to receive preferential treatment for something that the bribe receiver is required to do by law, constitute the former. The latter, on the other hand, is a bribe paid to obtain services the bribe receiver is prohibited from providing.

Understanding the multifaceted dimension of corruption is essential in order to identify workable ways of dealing with it. Corruption comes in many guises. Bribery,

extortion, fraud, trafficking, embezzlement—but also nepotism and cronyism—are all different manifestations of it. Even the most straightforward acts of bribery need not always involve the exchange of money. Other gifts or advantages, such as membership of an exclusive club or promises of scholarships for children, have been used as “sweeteners” to clinch deals. Whatever form it takes, corruption is always a two-way transaction; it requires a supply side (the briber) and a demand side (the one who receives the bribe). That is why measures must be designed to hit both sides of the corruption equation.

Another aspect of corruption is that it can occur in many different sectors of the economy. A commonly cited and morally reprehensible form is when government officials abuse public trust by accepting bribes from private businesses. However, the distinctions between the private and public sectors have been blurred by privatization, and corruption within the private sector is not without pernicious consequences as well. While not as common, bribes happen between public officials too. And a recent bribery scandal involving government representatives and officials of the International Olympic Committee in a bid to influence the choice of venue for the Olympic Games is a reminder that propriety is something to be maintained between public officials and respected nongovernmental organizations as well.

When corruption permeates a country’s political and economic institutions, it is no longer a matter of a few dishonest individuals, but rather institutional, systemic corruption. It is a phenomenon which thrives where institutions are weak or nonexistent. And it is strongly related to poor governance. Systemic corruption happens most where adequate legislative controls are lacking, where there is no independent judiciary or oversight, and where independent professional media and civil society agencies are absent. Reforms aimed at providing greater transparency and accountability of public institutions and government operations are urgently needed to redress such corruption.

There is much to be done. And let it not be forgotten that wherever corruption occurs and at whatever level, the ultimate victims of corruption are ordinary citizens and society at large. That is why fighting corruption is so important. Finding effective, credible, and enforceable measures to stamp out corruption and to hold those guilty accountable is more than a noble objective. Our economic, political, and legal institutions may depend on it.

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## **9.4 Costs of Corruption**

The cost of corruption is fourfold: political, economic, social, and environmental. On the political front, corruption constitutes a major obstacle to democracy and the rule of law. In a democratic system, offices and institutions lose their legitimacy when they are misused for private advantage. Though this is harmful in the established democracies, it is even more so in newly emerging ones. Accountable political leadership cannot develop in a corrupt climate. Economically, corruption leads to the depletion of national wealth. It is often responsible for the funneling of

scarce public resources to uneconomic high-profile projects, such as dams, power plants, pipelines, and refineries, at the expense of less spectacular but more necessary infrastructure projects such as schools, hospitals, and roads, or the supply of power and water to rural areas. Furthermore, it hinders the development of fair market structures and distorts competition, thereby deterring investment. The effect of corruption on the social fabric of society is the most damaging of all. It undermines people's trust in the political system, in its institutions, and its leadership. Frustration and general apathy among a disillusioned public result in a weak civil society. That in turn clears the way for despots as well as democratically elected yet unscrupulous leaders to turn national assets into personal wealth.

Demanding and paying bribes become the norm. Those unwilling to comply often emigrate, leaving the country drained of its most able and most honest citizens. Environmental degradation is yet another consequence of corrupt systems. The lack of, or nonenforcement of, environmental regulations and legislation has historically allowed the North to export its polluting industry to the South. At the same time, careless exploitation of natural resources, from timber and minerals to elephants, by both domestic and international agents has led to ravaged natural environments. Environmentally devastating projects are given preference in funding, because they are easy targets for siphoning off public money into private pockets.

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## 9.5 Quantifying Costs of Corruption

The short answer is “no.” Some experts use regression analyses and other empirical methods in order to try to put a dollar figure on the cost of corruption. It is virtually impossible, though, since payments of bribes are not publicly recorded. No one knows exactly how much money is being “invested” in corrupt officials annually. And bribes do not take only monetary form: favors, services, presents, and so on are just as common. At most, one can research the correlation between the level of corruption and, say, democratization, economic development, or environmental degradation. The social costs of corruption are even less quantifiable. No one knows how much the loss of an energetic entrepreneur or an acclaimed scientist costs a country. Moreover, any estimated social costs in dollars would be inadequate to the task of measuring the human tragedy behind resignation, illiteracy, or inadequate medical care. A general skepticism vis-à-vis any attempt at quantifying the costs of corruption is thus warranted. The following example illustrates the dilemma of pressing the issue into facts and figures.

A power plant is being built somewhere in the world, at a cost of US\$100 million. It could be argued that—were it not for corruption—the cost could have been as low as US\$80 million. The financial damage to the public would then be US\$20 million. In practice, quite often projects are planned simply so that those involved can make huge private profits. Assuming that the power plant was superfluous, the financial damage would have to be assessed at US\$100 million. Yet no major construction project leaves the environment untouched. The results may be increased pollution,

a lowering of land prices, resettlement of local residents, an increased debt burden for the country, etc. This calculation—probably closest to reality—is immensely complex. On a global scale, it seems almost impossible. But even if one were able to calculate the environmental damage, the increase of the debt burden, and other factors, how would one measure the erosion of public confidence and the deterioration of a government's legitimacy, which are the direct result of corruption?

### 9.5.1 Corruption Most Prevalent

At a first, indiscriminate glance, the CPI, published annually by transparency International (TI), seems to confirm the stereotypical notion that corruption is predominantly a problem of the South.<sup>1</sup> While the Scandinavian countries come out on top, most of sub-Saharan Africa ranks at the bottom. It would not only be wrong to conclude, however, that—according to the CPI 2001—Bangladesh is the most corrupt country in the world; it would also be counterproductive. The index is not intended to brand any one country, or to pit the North against the South. Rather, it is a tool to raise public awareness of the problem and promote better governance. Corruption is as much a problem of the North as it is of the South. Recent scandals in Germany, France, Japan, the USA, or the UK attest to that. It is well-established checks and controls that make the difference in proportion. People are as corrupt as the system allows them to be. It is where temptation meets permissiveness that corruption takes root on a wide scale. Such an environment is more likely in the emerging democracies of the South and East. There administration and political institutions are still weak and pay scales are generally very low, tempting officials to “supplement” their income. In dictatorial systems, meanwhile, administrative and political institutions are nothing but an extension of the usurper's corrupt practices. The North also carries part of the responsibility for the situation in the South due to its role as the bribe-payer. After all, it is largely Northern corporate interests that supply the bribe payments. Until recently, governments of the North not only tolerated these corrupt practices, but they even rewarded them with tax deductibility. Fortunately, the 1999 OECD Anti-Bribery Convention has made the bribing of foreign officials a criminal offence. TI has addressed this aspect with its Bribe Payers Index (BPI), the logical complement to the CPI. In addition to the question of the regional pervasiveness of corruption, the issue of corruption by sector is also often raised. The BPI provides some statistical evidence as to which business sectors are most prone to corruption. According to these results, the problem of corruption is particularly prevalent in public works and construction, followed by the arms and defense industry. The sector with the least detected corruption was agriculture.

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<sup>1</sup> [http://www.aman-palestine.org/english/Corruption\\_Faq.html](http://www.aman-palestine.org/english/Corruption_Faq.html)

## 9.5.2 Global Corruption Barometer<sup>2</sup>

The Global Corruption Barometer 2007 explores experiences of households with petty bribery. On average, more than one in ten of those interviewed had to pay a bribe in the past year to obtain a service. The reported experience of bribery is very different for people living in different places of the world; however, Fig. 9.1. provides information on Transparency International's Global Corruption Barometer.

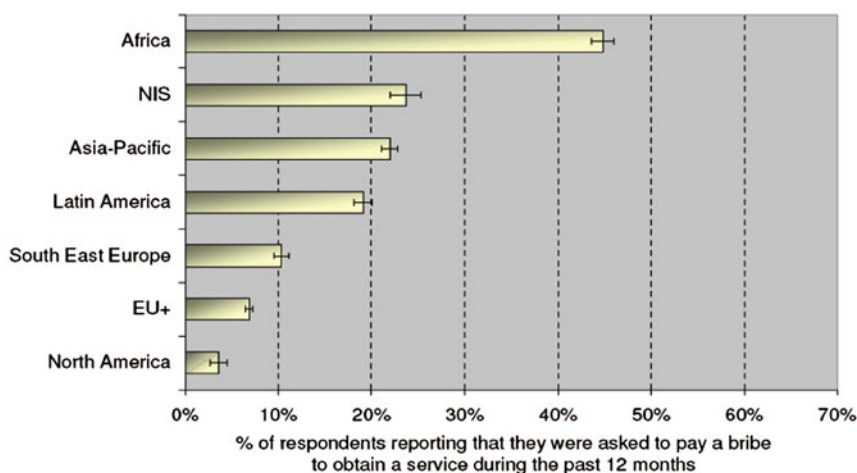
Countries most affected by petty bribery include Albania, Cameroon, FYR Macedonia, Kosovo, Nigeria, Pakistan, Philippines, Romania, and Senegal. Table 9.1 groups countries in quintiles based on reported bribery for services.

## 9.6 Methodology

### 9.6.1 Objectives of the Study

As mentioned in the previous section, corruption has a very strong negative relationship with FDI in different foreign markets.

This study was conducted to analyze effects of corruption on FDI in Pakistan. Various other economic and political factors were also considered and their correlation with FDI was studied. It is presumed that whereas corruption decreases FDI in developed countries, it is the norm in developing countries and hence does not



Source: Transparency International Global Corruption Barometer 2007. Percentages are weighted and calculated for those respondents who came in contact with the services listed. Thin lines indicate confidence intervals at 95%.

**Fig. 9.1** Demands for bribery, by region

<sup>2</sup> [http://www.transparency.org/policy\\_research/surveys\\_indices/gcb/2007](http://www.transparency.org/policy_research/surveys_indices/gcb/2007)



**Table 9.1** Countries most affected by bribery

	Quintile	Countries/territories
Percentage of respondents reporting they paid a bribe to obtain a service	Top quintile: more than 32%	Albania, Cambodia, Cameroon, FYR Macedonia, Kosovo, Nigeria, Pakistan, Philippines, Romania, Senegal
	Second quintile: 18–32%	Bolivia, Dominican Republic, Greece, India, Indonesia, Lithuania, Moldova, Peru, Serbia, Ukraine
	Third quintile: 6–18%	Bulgaria, Croatia, Czech Republic, Luxembourg, Malaysia, Panama, Russia, Turkey, Venezuela, Vietnam
	Fourth quintile: 2–6%	Argentina, Bosnia-Herzegovina, Finland, Hong Kong, Ireland, Portugal, South Africa, Spain, United Kingdom, United States
	Bottom quintile: Less than 2%	Austria, Canada, Denmark, France, Iceland, Japan, South Korea, Netherlands, Sweden, Switzerland

Source: Transparency International Global Corruption Barometer (2007)

have a significant impact on FDI in developing countries. It is written in manuals of MNCs that they are to follow different standards while conducting business in developing countries than what they follow in developed countries. For example, there are many MNCs whose manuals contain instruction as to not accept bribes or do bribing while conducting any of their business process, while the same MNCs allow their African or subcontinent subsidiaries to be involved in bribe as businesses are incomplete without it. This study was conducted to check corruption effects in Pakistan's FDI.

Others factors included in this studied are different economic factors like GDP, population, imports, exports, and inflation. Political factor was also included in this study and measured by "Political Risk."

## 9.6.2 Sample Size and Data

The sample size of the study is taken for 2 years, that is 2006 and 2007, making it a cross-sectional study covering 2 years for Pakistan.

Inflation remains the biggest threat to the economy, jumping to more than 9% in 2005 before easing to 7.9% in 2006. Furthermore, 2007 was a year marked by instability and uncertainty for Pakistan.<sup>3</sup> The FDI *inter alia* was constrained by a number of factors namely, political instability, law and order, economic

<sup>3</sup> <http://www.pu.edu.pk/economics/pesr/PDF-CurrentIssue/PESR%20Summer%202008/3%20YOUSAF%20Economic%20Evaluation.pdf>

environment and no proper infrastructure, the instability in stock markets, and regulatory regime. Nevertheless, FDI and foreign remittances provided a strong base to improve the economic situation of the country.

### 9.6.3 Variables of the Study

This section will cover the variables involved in our study. The set of variables that are relevant for the analysis are FDI, gross domestic product (GDP), exports, imports, population, inflation, political instability index, and CPI.

The FDI has been taken as the dependent variable and the rest of the variables are all taken as independent.

#### 9.6.3.1 Foreign Direct Investment

The FDI has been taken as the independent variable in our analysis. The values for FDI have been taken from the Federal Bureau of Investigation (FBI) for the years 2006 and 2007.

#### 9.6.3.2 Gross Domestic Product

The GDP or gross domestic income (GDI) is one of the measures of national income and output for a given country's economy. A significant change in GDP, whether up or down, usually has a significant effect on the FDI. We have taken the values of GDP from secondary sources for our analysis.

#### 9.6.3.3 Exports and Imports

Current theoretical studies have shown that international trade and investment are complementary rather than substitutes if trade between two economies is based on their comparative advantages. However, if the trade between the two countries is based on their absolute advantages, there may be substitution between trade and investment, as businesses decide to supply products and services through exports or FDI. The closer the relationship between trade and investment, the better chance the host country has of realizing the benefits from trade and investment liberalization in terms of welfare improvement. If trade and investment are complementary, FDI inflows are supposed to enhance the gains from trade.<sup>4</sup> Thus, high level of exports and imports in a country is likely to have a positive impact on FDI.

#### 9.6.3.4 Population

Gross inflows of FDI are generally strongly and positively influenced by population health in low- and middle-income countries.

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<sup>4</sup> <http://www.pu.edu.pk/economics/pesr/PDF-CurrentIssue/PESR%20Summer%202008/3%20YOUSAF%20Economic%20Evaluation.pdf>

### 9.6.3.5 Inflation

A high level of inflation, according to studies, drives away FDI. This relationship is tested in our study.

### 9.6.3.6 Political Instability Index

FDI flows to transition economies unaffected by conflict and political instability exceed those that would be expected for comparable countries that are affected by such instabilities. Success with stabilization and reform increased the volume of FDI inflows. The higher a country ranks on the political instability index, the lower the amount of expected FDI.

### 9.6.3.7 Corruption Perceptions Index

CPI ranks the countries of the world according to “the degree to which corruption is perceived to exist among public officials and politicians.” A higher scoring in the range of 0–10 means more corruption exists in the country.

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## 9.7 Methodology

Regression and correlation analysis were conducted in order to investigate the relationship between dependent variable and independent variables.

For this study, country size is measured as the log of population (logPOP) (Delios and Henisz 2000). A country's purchasing power is operationalized as GDP per capita (GDPPOP) (Grosse and Trevino 1996; Kobrin 1976). Market growth rate is measured as the annual growth in GDP (GDPGRW) (Wells and Wint 2000). The combined export and import value as a percentage of GDP (EXIM) is used for measuring a country's international orientation. Inflation is represented by the consumer price index (PRICEIND) of the country (Drabek and Payne 1999). The political risk (POLRISK) index found in the PRS Yearbook is an aggregate index of several dimensions deemed important for political instability. The POLRISK variable is used in this study.

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## 9.8 Results

The results of this study presented in Tables 9.2 and 9.3 show that FDI has a strong positive correlation with GDP per capita, which shows that the higher the values for GDP the more the inflow of FDI in the country. FDI is positively correlated to the population. This shows that in Pakistan as population is increasing, the FDI also increases as the market the MNC would cater to is large in this case and also more labor would be available. Thus the large population attracts the FDI. Moreover, we can say that health has a positive and significant effect on such inflows for low- and middle-income countries. The gross inflows of FDI are strongly and positively influenced by population health in low- and middle-income countries.

**Table 9.2** Intercorrelation among variables

Variables	1	2	3	4	5	6
Log FDI	1					
Log POP	0.32***	1				
GDPGRW	0.00	−0.02	1			
GDPPOP	0.41**	−0.04*	−0.05	1		
PRICEIND	−0.07*	0.02	−0.08	−0.07	1	
EXIM	0.17	−0.12*	0.07	0.04	−0.23	1
POLRISK	−0.19**	−0.18	−0.17	0.19*	−0.13	0.22**
CPI	−0.16**	−0.23	−0.00	0.21*	−0.03	0.12*

*FDI* foreign direct investment, *POP* population, *GDPGRW* GDP growth, *GDPPOP* GDP/capita, *PRICEIND* price index, *EXIM* export and import as % of GDP, *POLRISK* political risk, *CPI* corruption perceptions index (TI)

\* $p < 0.10$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$

**Table 9.3** Results of regression analysis for foreign direct investment (logFDI)

Independent variables	Model
Log POP	0.38*** (0.07)
GDPGRW	0.01 (0.01)
GDPPOP	0.21* (0.00)
PRICEIND	−0.02 (0.00)
EXIM	0.16 (0.03)
POLRISK	0.22 (0.01)
CPI	−0.28** (0.04)
$R^2$	0.33
$F$	34.66***

Values are standardized regression coefficients with standard errors in parentheses

\* $p < 0.10$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.01$

This study finds that FDI has a strong negative correlation with political risk, which obviously implies that the higher the ranking of political instability in the country, the lower the amount of FDI. Similarly a high inflation level makes investment in Pakistan extremely unattractive for foreigners, which is why the correlation is strongly negative. The balance of payments comprises the current account, the capital account, and the financial account. The financial account is a combination of FDI, portfolio investment, and other investments. The FDI can be obtained by subtracting the increase in the domestic ownership of foreign assets from the foreign ownership of domestic financial assets.

CPI the best known of TI's tools. It has been widely credited with putting TI and the issue of corruption on the international policy agenda. The CPI ranks 180 countries by their perceived levels of corruption, as determined by expert assessments and opinion surveys. The index scoring is from 0 to 10 with 10 being the most corrupt. Pakistan ranks 7.92 on this index and has a strongly negative relationship with FDI. This means that the more corrupt the country, the less the inflow of FDI in the country.

## Conclusion

This study was conducted to analyze effects of corruption on FDI in Pakistan. Various other economic and political factors were also considered and their correlation with FDI was studied. It is presumed that whereas corruption decreases FDI in developed countries, it is the norm in developing countries and hence does not have a significant impact on FDI in developing countries. It is written in manuals of multinational corporations (MNCs) that they are to follow different standards while conducting business in developing countries than what they follow in developed countries. For example, there are many MNCs whose manuals contain instruction as to not accept bribes or do bribing while conducting any of their business process, while the same MNCs allow their African or subcontinent subsidiaries to be involved in bribe as businesses are incomplete without it. This study was conducted to check corruption effects in Pakistan's FDI.

This paper has attempted to explore the effects of various factors like GDP, exports, imports, population, inflation, political instability index, and CPI on FDI. FDI has a strong positive correlation with GDP, and has a strong negative correlation with political risk. Similarly a high inflation level makes investment in Pakistan extremely unattractive for foreigners, which is why the correlation is strongly negative. The correlation analysis shows that FDI is positively correlated with exports and imports. Corruption does have a negative impact on FDI which has been proved through this study.

Our analysis of the effects of corruption on FDI confirmed the outcome of previous studies based on older data. Corruption remains a significant problem for investment today. Given that the study included almost the entire world's FDI inflow for a significant and recent period of time, the generalizability of the results is high. It is also suggested that public officials must realize that the macroeconomic environment and the institutional framework will continue to play a critical role in FDI decisions even with respect to (developing) countries being targeted for traditional market seeking motives. As part of their efforts to promote the economic space of a nation state (marketing a country), Pakistani government needs to know the relevance and importance of factors affecting its image. Corruption is one such factor. While it cannot be eradicated overnight, realistic targets need to be set. For policymakers, the impact of corruption on foreign and local investment can help determine the welfare loss and thus facilitate planning.

Similarly, companies involved in international business are developing a position on corruption from an ethical, competitive, and risk-taking perspective. The preliminary part of such endeavors is to have an accurate idea of the impact of corruption.

For future research, it is suggested that priority should be given to examine the effect of corruption at the company level. Are certain companies more amenable to corruption than others? And, if so, what specific characteristics differentiate them from the rest? Answering these questions will greatly benefit academics and practitioners alike. We hope that future research will further investigate the issues raised here.

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## **Part III**

# **Fraud from Two Professional Perspectives**

Asli Yüksel Mermod

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## 10.1 Introduction

This chapter is organized as follows: first, definitions, concept, and the motivations that lead fraudsters to execute fraudulent actions are clarified. Second, different types of fraud in the banking industry are observed with emphasis on online/internet banking fraud. In the third part, the detection and prevention of banking fraud especially the methods used to prevent online banking fraud are stated and the pros and cons of these methods are discussed.

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## 10.2 The Fraud Concept in the Banking Industry

The Financial Times defines fraud as “*a method of illegally getting money from a person or organization, often using clever and complicated methods*”. The Federal Bureau of Investigation (FBI) describes the word fraud as “*appropriation or illicit usage of funds or goods entrusted to, in the custody or under the control of a person*”.

*In general, Fraud is deception that includes the following elements:*

- *A representation*
- *About a material point*
- *Which is false*
- *And intentionally or recklessly so*
- *Which is believed*

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- *And acted upon by the victim*
- *To the victim's damage (Albrecht et al. 2011)*

According to the definitions above, the act of fraud has the intention to deceive, lie, or cheat in order to get some personal benefits. Fraud makes the fraudster to somehow act in favor of his or her own best interest. The critical point here lies in the self-interest mechanisms of human beings which enable the fraudster to rationalize the outcome of the cheats they conveyed (Singleton et al. 2006). Banking is a highly information based intermediary business that relies on information technology (IT) to access, process, and provide necessary up-to-date information to all their customers. Banks use the Internet technology as a strategic weapon to improve their market position in their operations in a competitive environment (Agarwal 2009). Bank fraud is a crime in many countries. The person attempting to intentionally deceive the financial institution would plan the act in order to obtain money or some valuables from the financial institution. The valuable or money could be in the form of banknotes, funds, credits, assets, securities, or other items of value owned by, or under the custody or control of the financial institution. In the widest sense, a fraud is a consciously performed action that is supposed to benefit the executer but harm the victim psychologically or in some other sense. The globalization of the world economy, modern information and communication technology, and other factors make this crime a lot easier to commit in the twenty-first century. Banking fraud occurs mostly because of the lack of knowledge on the part of some citizens in different countries of the world about the technicalities of the new banking activities, especially internet banking.

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### 10.3 Some Facts About Fraudulent Actions

According to the periodic research made by the Association of Certified Fraud Examiners (ACFE), the annual cost of fraud in the USA is nearly \$640 billion. Most of the fraudulent acts are carried by people in the accounting department (30% of total frauds) and also by those in senior management (20% of total frauds). 42.1% of fraud losses results with no chance of recovery while only 16.4% of the losses can be recovered fully (ACFE 2006). According to a report prepared by KPMG, regarding the profile of fraudsters and their activities, 85% of fraudulent people are males, and 70% of total population involved in the crime is between the ages of 36 and 55. 68% of the cases are carried out by a single individual and 89% of the perpetrators are company staff. Another dramatic fact is that senior management represents 60.2% of the total fraud cases which reveals that the system of internal control is weak, inefficient, and difficult to easily capture these fraudulent activities. In only 13% of the cases the perpetrators are workers who have only been with the organizations for a period of less than 2 years (Bozkurt 2002).

According to one of the fraud theories criminality cannot happen without the existence and support of other people. Learning criminal activities usually takes place in some small intimate groups like families and friends (Bozkurt 2009).

A dysfunctional parent is more likely to raise a dysfunctional child. The learning process of the crime consists of two parts: The methods to commit the crime and the attitudes, motives, drives, and rationalizations of the criminal mind (Bologna 1996). A dishonest employee can infect an honest employee in an organization and it can also be vice versa (Sutherland 1949).

According to some of the fraud auditing researches, it was found out that the most common red flags for professional fraud are related with high personal debts, belief that one's job is in jeopardy, no separation of asset custodial procedures, and no adequate background checking (Albrecht et al. 1984).

It was also pointed out that the main reason for employees' theft was workplace conditions and the workers tended to underestimate the social costs of fraudulent activities. It was concluded also that the real income of the employee was not related to fraud (Hollinger and Clark 1983).

The cruelty of financial markets comes from the reality that the participants who construct these markets recognize only one value: money. An old proverb says "money is the devil's eye," signifying the importance and power of money in people's lives. Money is power in the capitalist world and power means having rights. Money is also the best incentive to make people work harder and it has a magical power to have a control over them. When two people meet to discuss about how to spend third parties' money, the outcome is typically fraud and this kind of discussion takes place typically in financial institutions, mainly in banks. The temptation is ever growing between the market players. Investors seek for the highest return, banks try to reach the best return on equity, and analysts and traders try to gain the maximum premiums. In this very competitive environment, all these participants are ready to do everything possible to reach their targets, even if sometimes their ways might not sound very ethical. Financial markets rely on shared ethical standards. Although people and institutions voluntarily limit their actions, written rules and their enforcements are required in the system. People try to avoid an illicit action if there is little chance of being caught; they try to keep away from certain things if they think that it is unethical (Persaud and Plender 2007).

The banking system is known to be one of the strictest regulated sectors. Good quality auditing and internal observance of the norms make fraud difficult to perpetrate, but only bank professionals who know how the system works and have the knowledge to detect the potential weaknesses of the internal norms may find some approaches to misuse the system. Fortunately, these people are usually not involved in fraud issues as their education, background, and social and cultural level limits them to be that much brave and unethical. But still in the past, we can see some examples of some bank officials who used their specific knowledge of bank management and auditing in order to maximize their own wealth or hide their investment mistakes such as traders like Nick Leeson of the then Barings Brothers. Leeson's decisions had caused the collapse of the oldest English bank, reputable as

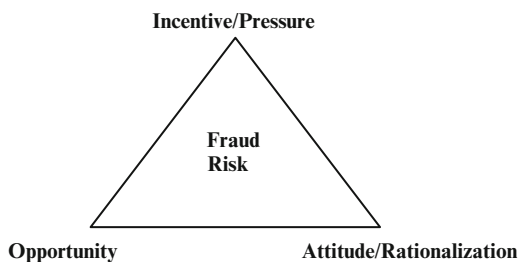
the Queen's bank which had financed the Napoleonic wars of centuries ago. In the Barings' case, the missing part and the gap were again the banking regulations; it was possible at that period that the front and the back office of the bank could be managed by the same executive person.

After the scandalous Barings collapse this rule has changed, but what we distinguish from the past experiences is: people are able to find some gaps in the regulations and try to adapt their management using their exceptional knowledge about the cracks in the system to use the system to work for their own good. The leading motivation tools to make people work can be defined as the two "P"s: Pain and Pleasure (Becker 1976). There is a reasonable equilibrium between pain and pleasure in all our decisions. Depending on our needs we have the intention to find a good reason to make ourselves right for our choices and we have the ability to reason this choice according to our needs, virtues, and values (Dumbravă et al. 2008).

In a capitalist economy some people are convinced that happiness and pleasure can only be bought by money and banks are the excellent places for those money-oriented groups to easily reach that kind of liquidity. Banks have been the target location for robberies for many centuries as their traditional mission is to keep safe other people's money in large amounts in their safety deposit boxes Tierney (2003). Now there are many forms of money such as credit cards, checks, security papers, guarantee papers, and internet money which make the potential thieves excited to set up new crime facilities.

Banks are excellent places for those who would like to reach money as soon as possible and with the minimum effort. The best way to be closer to the largest pool of money is to be a staff and a part of that sparkling pool for those educated, sneaky, and intelligent potential future burglars. We have to admit here that many bank employees who were accused of fraud had no intention to be a part of such a crime at the beginning. But after a while having the opportunity in the work environment, the pressure and the incentives, the absolute trust of the directors, and logical reasoning of that behavior could lead the innocent staff to listen to the devil instead of their own consciousness.

This phenomenon is called the fraud triangle (Fig. 10.1) (Cressey 1953).



**Fig. 10.1** The fraud triangle.  
Source: Cressey (1953)

Trusted persons become trust violators when they conceive of themselves as having a financial problem that is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions on themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property. (Cressey 1953, p 30)

According to Cressey's fraud triangle there are three motivators which are the triggers for the fraudulent action:

**Incentive/Pressure:** the source of pressure is either a financial need or a nonfinancial need. One common financial pressure is gambling or drug addiction problem; others can be the pressure of the expensive tastes and needs of a spouse or lover or to impress the family. Sometimes the need can be more humanly like high medical bills or high credit card debts. The motivation can also be nonfinancial. There may be high pressure for good results at work or a need to cover up someone's poor performance.

**Rationalization:** the person committing the fraud often rationalizes the crime he has committed. Rationalizations may include, "I'll pay that amount of money back", "They will never miss the funds," "They don't pay me enough, I deserve more salary." Or as rouge traders: "I will cover my loss soon and nobody will notice my failure."

**Opportunity:** the person committing the fraud sees an internal control weakness and, believing no one will notice if funds were taken, begins the fraud with a small amount of money. If no one notices, the amount will usually grow larger. In that case the cracks in the laws, regulations, and their restructuring are very important.

Banking regulations are strict and complicated but not always sufficient to regulate the whole financial system. No internal control system is infallible. No audit or auditor can detect all system flaws. The smarter the people, the better the regulations must be restructured and updated. Unfortunately to restructure these regulations, people or victims almost always need a trouble like a serious financial crisis or a financial fraud case. Unfortunately, dirty business and shocking bankruptcies in the financial sector are often discussed in public with delays, after their occurrence, when the huge losses shock all the performing "actors" at the fall of the curtains (Voicu et al. 1998). Banking fraud is a big business in today's world. With more educational qualifications on the part of bank staff, banking is becoming impersonal and increase in banking sector has given rise to white collar crime.

Using the term fraud with regard to the banking sector one could say that it mostly describes a process by which either a bank or its customers are defrauded of money. Concerning the types of fraudulent acts it is important to understand that there are different mediums through which the fraudulent action could be committed. The most important ones are mail, phone, and the internet—which covers computer crime and the resulting internet fraud which has developed into a serious problem within the past decade as the use of the internet and online banking has gained popularity in the global market. The most fashion crime in banks is online banking fraud nowadays, which is the reason why we will highlight this matter in this chapter.

## 10.4 Different Forms of Fraud in the Banking Sector

### 10.4.1 Internal Fraud

**Rogue Traders:** Rouge traders are bank insiders or managers who are usually in very top executive positions and have the authorization to invest very large funds in the name of the bank. The phenomenon that is described by the term rogue trader is the following: a trader who secretly makes increasingly risky investments following a very aggressive strategy by using the bank's assets. As the risk of those investments is high, the chances that the trader will suffer a loss from that investment decision are also very high. If that investment decision is not successful, rogue traders engage into another more risky position to cover up the losses incurred from the previous trade in order to generate a quick profit which would enable the trader to cover the loss. These rogue traders are a serious threat to banks and there have been some outstanding cases in the past in which some banks have had to close down due to losses of several hundred millions because of such activities. Some of the most well-known examples are John Rusnak, Nick Leeson, and Jerome Kerviel, who defrauded Societe Generale of 4.9 billion € while engaging in derivative operations (Jennings 2008).

Rogue traders can be classified as internal fraud cases. First of all they have a great deal of knowledge about their bank's internal processes. The age group of rogue traders can differ between 28 and 35. Concerning the first aspect we can state that even though the control systems in present-day banks are very sophisticated no system will ever be free from defects. Another critical point in the discussion of rogue traders can be seen in the fact that they in some cases accomplish skyrocketing performances. These seem to be too good to be true and most superiors of the traders prefer to turn a blind eye to the problem of having such a high risk after being strongly affected by their successful profit margins.

**Fraudulent loans and fraudulent documents:** One of the main activities of a bank is to grant loans, but this has to be made after a high-quality loan analysis and the loan has to be given to creditworthy and trustworthy customers. Some motivations and pressures on the bank staff for example having more bonuses or meeting expected minimum branch performance per month cause the branch staff to provide loans also to some people or companies who have bad credit ratings, or those in immediate need of money for emergencies. A fraudulent loan is one that is given by a dishonest bank officer or an accomplice. In some cases the "borrower" declares bankruptcy or vanishes soon after the granting of the loan and the money is gone. Some banks' subsidiary companies during 2001 Turkish financial crisis took some fraudulent bank loans from their own banks or their own special purposed entities and declared bankruptcy afterward; at that time deposits in Turkish Banks were all insured by the government, which meant that the victims were bailed out by the Turkish government and consequently the Turkish taxpayers.

Fraudulent documents, however, are mostly used in order to cover the theft of a major amount of money. In this particular kind of fraudulent activity the fraudster would fake some documents using wrong information in order to hide their credit

history or their income or making use of creative accounting techniques about his financial position or identity and takes the loan concealing the fact that the money has been stolen from this bank.

**Wire Fraud:** This criminal act is done by using electronic communications and wire transfer networks such as the SWIFT interbank fund transfer system. These kinds of networks are used by banks to settle accounts and actualize overnight wire transfers. There is generally the risk that insiders of the banks would use faked documents that claim a depositor's money to be wired to another bank usually to an offshore account in one of the offshore centers which is quiet far away to control instantly such as Cayman Islands or use the clients' money for their own good and pretend that the money is safe by replacing by another account through the wire system when the actual owner of the emptied account appears.

**Uninsured Deposits or Banks:** The risk of fraud is high when dealing with unknown or uninsured institutions such as offshore or Internet banks which trade without any license and have a professionally looking web page which is capable of misleading potential customers into believing that it was safe to transact business or disclose vital details, on the fake website. Depositors have to be alert about this issue when choosing their internet banks.

**Identity Theft—Impersonation:** Some fraudulent bank staff could steal personal details of the bank's customer in order to steal their credit card or order a fake credit card with the information of that customer for their own personal use or pass it on to a fraudulent group for their own use. The fraudster does not necessarily have to be a bank staff as personal information could be accessed very easily through the internet as many customers foolishly display their information online. Impersonation is the act of pretending to be someone else by using the data they could reach and deceive the banks and their customers, if the fraud is made by an outsider that can be recognized also as an external fraud.

## 10.4.2 External Fraud

**Forgery made by using “checks”:** Fraudsters can change the name and the amount written on the surface of the checks (instead of \$100, they can add one more “zero” and ask for \$1,000). They can also imitate the signature of another depositor or create and publish one bank's checkbooks and use the information of one of the depositors.

Stolen blank checkbooks are worth a lot to fraudsters who sign as if they were the depositor.

When someone illegally obtains credit from one of his bank accounts by paying in a check from another account, taking money out against this check, and using it for a few days before having to repay the original amount back is called **check kiting**, it is another form of check fraud. Say you have a deposit of 500 in a bank, and write a cheque on that amount and deposit it to your account in another bank; you now have 1,000 until the cheque clears.

**Booster checks** are bad checks used to raise the amount of available credit of a generally legal account or credit card. The amount stated on the faked check is credited to the account as soon as the transaction is made even though the check has not yet been cleared. This method is usually used to make a payment to a credit card to increase the credit limits of that credit card.

**Accounting Fraud:** Some companies use some fraudulent bookkeeping in order to hide serious financial problems such as boosting the worth of the company's assets or profits or income when the company is operating at a loss and in need of credits from a bank (Omurgonulsen and Omurgonulsen 2009). The losses are then hidden using special accounting techniques. This means that auditors have unique responsibilities to thoroughly control the connections and the payments made from corporations to banks (Ilter 2009).

**Payment card fraud:** This kind of fraud describes all forms of credit card fraud, which can be characterized as stealing customers' data and use their credit cards or debit cards in order to illegally access their accounts.

**Duplication or skimming of card information:** embraces copying the information which is stored in credit cards as well as stealing the PIN code of the client. The card will then be reproduced with special devices adding the information stored on the initial card. In combination with the PIN code, which has also been copied, the fraudsters withdraw money from the client's deposits. The information stored on the credit card as well as the PIN codes is copied as the thieves install certain devices to the ATMs or is copied when customers pay their bill at a restaurant or a shop. This action is the most common method used to carry out a payment card fraud.

**Money laundering:** Describes any scheme by which the true origin of the funds is hidden or concealed and is an extended topic referred to in other chapters of this book.

### 10.4.3 Online Banking Fraud

Convenience is the key reason of why millions of people are choosing to use internet banking instead of traditional banking (Wallack 2009), (Singhal and Padhamabhan 2008). Nearly 45% of the 141 million adults in USA pay their bills online (according to the Garter 2004 Survey). Banks try to influence their clients to use more online banking facilities as they can save money on operating costs. However, during the popularization of online banking, nearly 2 million Americans experienced fraudulent bank activity in 2004. Victims stated an average loss of \$1,200 per bank fraud. Most market researchers highlighted the increase in the number of bank frauds in online banking.

The term "online fraud" refers to any type of fraudulent method that makes use of e-mail, websites, chat rooms, or message boards to present fraudulent actions to prospective victims, to perform fraudulent transactions on financial institutions.

This crime's most common way is to steal a person's identity, and use it to his/her advantage (Kellermann 2005). Most of the internet fraud events derive from two steps: first, the victim's account information, password, and username are stolen. Second, the money of the victim is taken from the bank account by using the stolen information. The online fraud schemes include but are not limited to:

**Trojans:** A Trojan horse (or mostly used in a shortened form as Trojan) is a tricky medium that comes out to execute an attractive function for the user, but facilitates unauthorized access to the user's computer system. The term is derived from the Trojan horse story in Greek mythology. Trojan horses are designed to allow a hacker remote access to a target computer system. Once a Trojan horse has been installed on a target computer system, it is possible for a hacker to access it remotely and carry out a variety of functions.

**Keyloggers:** Keylogging is the practice of tracking the keys struck on a keyboard, typically in a covert manner so that the person using the keyboard is unaware that their actions are being monitored.

Keyloggers are small applications and mostly they are programmed by hackers to gather information about the users. Old keyloggers were designed for personal computers and laptops, but now there are many types of keyloggers for smart phones and mini devices. Latest keyloggers not only record the keys struck, but also capture the screen views and send them to a predetermined e-mail address. These applications are installed in a few seconds, and mostly, the computer or phone users would be unaware of the fact. Users can protect their systems with spyware and updated antivirus software. The files from the unknown users should not be opened.

**Phishing:** Phishing involves using a form of spam to fraudulently gain access to people's internet banking details. The term "phishing" indicates the use of spam e-mails which appear to come from a bank; in this way, criminals can "fish" for legitimate bank customer's login information in case the deposit owners get caught by their angles. The spam e-mails contain a website that is designed to match the actual homepage of a bank. If the user has no suspicion and enters his data thinking that it is his own original bank's website, he would disclose his password and all his personal details to the hackers' online system. The defrauders can withdraw money from the customer's accounts after inserting the information of the depositor on the webpage of the original bank.

**Social Engineering:** Social engineers use telephones or other media tools to get secret information like passwords or personal details from customers to use in order to steal their bank accounts or use their credit cards. They introduce themselves as an employee of a bank or another related company and sound like a credible source. Phishing can also be added in a type social engineering. Actually, people do not want to give their information except someone promises to reward or punish them. Social engineers try to attract people via gorgeous gifts or threaten them with the perceived risk to security of their account to get the private information with immediate effect.



**Wi-Fi Sniffing:** Today, many people connect internet via their wireless modems, but if the security level of the access point is weak, their neighbors could also access their information and misuse it. An attacker who accesses a wireless network and monitors all internet traffic through the router could make inquiries on every website that you visit, e-mail that you send, or user name and password that you use.

**Bank fraud detection in online banking:** In order to be able to verify satisfactory measures to detect fraudulent activities one has to consider the different forms of bank fraud (Whateley 2009).

Considering the different types of bank fraud most of the fraudulent activities in modern times could be observed using computer technology-related fields. Recognizing fraud in computer-based transactions is very vital for banking security as the major fraud operations are actualized in this area Fest (2009).

Detection of software is an important business for banks as they are more or less obliged to offer secure services. This means that banks which offer online facilities to their customers have to expand their IT-divisions.

In order to detect bank fraud on a technical level certain algorithms are designed which scan the customers' activities on each account. The early signals of fraud can be recognized by banks (i.e., sudden movements of frozen accounts, reduced line of credits, and bad history of written check payments).

**Fraud prevention:** In order to be able to prevent fraudulent activities in banks the bank staff play a critical role. Regarding this fact almost all banks offer special trainings for their employees in order to enable them to prevent potential fraud cases. By these particular trainings fraud can be prevented before it happens. Furthermore, potential financial risks can be eliminated. The bank staff will also be able to recognize particular types of fraud and identify potential executors and deny taking any further actions with them.

Besides the measures described above, regulatory compliance is another measure taken to fight against bank fraud. Regulatory compliance describes the goal that corporations or public agencies aspire to in their efforts to ensure that workers are aware of and take steps to meet the terms of relevant laws and regulations.

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## 10.5 Major Security Tools in Online Banking

### 10.5.1 Digital Signature

A digital signature is a mathematical format for representing the accuracy of a digital message or document. A valid digital signature confirms to the recipient that the message was sent from a recognized sender and has a trustable origin. Another form of digital signature is mobile signature. The mobile signature is equivalent to your own wet signature legally (Douglass 2009). Mobile signature is a new application and one of the safest ways of using mobile banking. It consists of creating your own PIN code by using your own mobile device and SIM card. Many banks have started to use mobile signature. After January 1 2010, using a mobile signature or

“One-Time PIN” generation devices will be an obligation to access online banking applications in Turkey.

### **10.5.2 One-Time Password**

A one-time password (OTP) is a password that is only valid for a single login session or transaction. One-Time Passwords can be generated by Electronical tokens or cards or mobile applications. However, One-Time Passwords are weak for phishing attacks. If the user types his/her username and one-time password in a fake website, hackers can use his/her password for a while.

### **10.5.3 Personal Messages or Images for Homepages**

One of the most efficient security tools against phishing attacks is personal messages or images that the account owners can recognize immediately at the homepage of their banks' websites. Firstly, banks ask their customers to choose an image or a message and then they publish this image or message in their homepage. In case of a phishing attack, if the customer does not recognize his predetermined image or message at the homepage, he/she will be able to find out the fake site and report it. These security messages or images have very common usage in online banking. But customers have to pay attention to remember their images and messages.

### **10.5.4 Voice Authentication**

Voice authentication is a capability to recognize a person by his or her spoken voice. This is used for security purposes. Voice Authentication services are based on “biometric voice authentication” by this way; the system has the ability to recognize the customer's voice, but unfortunately these systems are not used worldwide (Gilhooly 2003).

### **10.5.5 Virtual Keyboards**

Virtual keyboard is a software module that allows a user to enter characters via mouse or track point. Many banks use virtual keyboard during login period against keylogger applications. But latest keylogger applications also capture the screen shots.

All of these security tools are constructed to help the customer against the hacker attacks, but the golden rule is “only use computers that you trust.” Publicly accessible computers (such as those found in internet cafes) are not safe for online banking.

## Conclusion

Globalization and technological improvements have made many facilities easier in our lives. We do not need to spend so much time in banks' queues to pay our electricity bills anymore. By using online banking we can easily do all our daily payments, ask for credits, or transfer money from one account to another as internet banking saves our valuable time and money. But the most important topic about the mobile banking applications is the security. Customers know the development about mobile banking, but they still have fear about its security and privacy and this is rightly so.

The reason that banks and customers prefer online banking is because it is less costly and more convenient, but is it really safe? In this chapter after defining and explaining thoroughly bank fraud, highlighting the different types of bank fraud, we discussed the reasons and motivations behind fraud and fraudulent acts in the banking sector, security issues in banking, the potential banking fraud operations, and with particular emphasis on online banking fraud and made some recommendations on how to guide against this type of fraud.

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Ülkü Yüksel

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## 11.1 Introduction

This chapter is organized as follows: First, the author discusses the role of marketing in society by detailing some arguments about marketing's conviction of misconducts and the benefits the field offers consumers. Second, the author provides a definition of fraud, corporate frauds (in terms of cases like Enron 2001 and WorldCom 2002), and political frauds (such as the Nixon's Watergate Scandal of 1974). Third, the author delves into the issue of fraud in marketing, including multilevel marketing approach and its relevance to fraud and mass marketing fraud. Fourth, the chapter explains consumers' vulnerability to fraud and fraudulent practices and consumers' resistance and boycott in protest of the incidence of fraud in marketing. Finally, the chapter defines and acknowledges various consumer perpetrated frauds.

What is Fraud in Marketing and Consumption?

Sell them their dreams. Sell them what they longed for and almost despaired of having. Sell them hats by splashing sunlight across them. Sell them dreams—dreams of country clubs and proms and visions of what might happen if only. After all, people don't buy things to have things. They buy things to work for them. They buy hope—hope of what your merchandize will do for them. Sell them this hope and you won't have to worry about selling them goods.

(Helen Landon Cass in Twitchell 2000)

Those were the words of a radio announcer, Helen Landon Cass, to a convention of salesmen and published with no single clarification by The Philadelphia Retail Ledger of June 6, 1923. What she said then could be understood in two different fashions. First, as a “*melancholy Marxist*” you may read it as a hidden charge of marketing and actually selling processes. “*Does she think that consumers*

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*are—dopes to be duped? What is she selling? Snake oil?”* (Twitchell 2000, p 1). Second, as an “*unrepentant capitalist*” you may read it as a call for associating consumer products with their sold benefits and promises; that is, producers produce goods which the consumers’ demand (Twitchell 2000, p 1). Well, a perfect match with the definition of “marketing concept” in early marketing text books.

Hence, an important question comes to mind: is all marketing adversarial and fulfills a purpose in favor of the marketer? In fact, the relationship between stakeholders (e.g., supplier, producer, seller, consumer, and buyer) may be contradicting, in conflict, or cooperative and mutual, which leads to a win-win situation as in the case of Relationship Marketing (RM). Nevertheless, unfairly in many cases, the domain of marketing is mostly unjustly described as inherently evil in popular literature. This unwarranted attribution to marketing by a popularist anti-marketing standpoint is founded on arguments that marketing may convict one of the following misconducts:

1. Marketing may harm personal autonomy in which the victim (i.e., potential consumer) holds only restricted self-determination
2. Invasion of consumer privacy
3. Humiliating consumer identities via stereotyping
4. Damaging competitors’ positions especially in saturated markets
5. Manipulating social values and virtues via the promotion of consumerism
6. Harming the environment, in which marketing applauds consumerism and wastes resources

In particular, the effects of some of these misconducts have resulted in anti-consumerism movements and attempts by consumers, termed consumer resistance and boycotts, which we will discuss later in this chapter.

Despite all these negative points argued by the popularist anti-marketing stance, marketing offers many benefits for consumers. Hence, not all marketing activities involve unethical issues or any fraud.

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## 11.2 What Kind of Benefits Would Marketing Offer to Consumers?

Consumers are receiving more and more products that they really need or want to obtain due to enhanced and proper use of market research. Consequently, the number one benefit of marketing for consumers is that they are able to deliver their voice, needs, wants, and complaints to the marketer. Accordingly, they are able to shape what they want to get; that is, marketing gives consumers the power to speak out and order their desires while market research allows marketers to hear what their customers want. Marketing, especially the selling process and the promotion process, allows consumers to be informed on what is available in the market, what kind of needs the product satisfies, what the competition provides, what the advantage of using a specific brand is, and so forth. With a lot of new data on almost every communication channel, consumers are more able to know about the product or service they need; hence, this marketing process assists consumers to receive relevant and important information. Marketing gives them the opportunity

for better comparisons; this marketing is done mostly via promotional strategies. Hence, the number two function of marketing is informing consumers, providing first hand information. Consumers are increasingly subjected to marketing in a multichannel way.

Consumers search for, explore, and buy products online; get newsletters and offers from their preferred brands via mail or e-mail; and use SMS text messaging as they call and speak on the phone. So, in addition to receiving information by being passively exposed to marketing activities consumers also have the choice of being actively involved in receiving additional information via those channels. Hence, the third benefit is the improved technique or system of receiving needed assistance. Additionally, brand and marketing strategists provide consumers with a promise reflected by the brand name; accordingly, consumers are able to shape their expectations according to the brand they have chosen. Hence, managing brand and marketing activities is vital and significant for selling promises for the marketers and decoding brands allow consumers to shape or alter what to expect. Hence, brands work as guidelines for the consumers on the quality that should be expected. However, all these transactions or processes should be done in a fair manner by both the marketer and the consumer, and should not cross the borderlines of ethics or reasonable acceptance level of the public. Beyond some point of the acceptance level, it goes into the domain of unethical marketing or unethical consumer behavior, which also involves fraud in extreme cases.

Marketing is blamed to be looking merely after the firm's self-interest as does the discipline of economics (Jones and Monieson 1990). Marketing acknowledges the "ultimate power of consumer sovereignty" (Desmond and Crane 2004, p 1223). This results in the well-known marketing concept within the discipline which argues that the firm's self-interest is only achieved via satisfied consumer needs and wants. That is, marketing concept suggests that firms' main goal is merely monetary and firm's care on their profit, but this profit is only obtained as an outcome of being and acting favorably toward customers. In other words, customer satisfaction is an antecedent of profits (i.e., firms' self-interest). Hence, the outcome which the marketers long for depends on the process of being favorable to customers and considering the morality of marketing actions. Hence, unethical marketing or fraud in marketing cannot result in productive monetary gains for the corporation in the long run.

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## **11.3 What Is Fraud?**

### **11.3.1 Definition of Fraud**

In its broadest sense, a fraud is an intentional hoax, deceit, fiddle, trickery, and cheating, which is legally a crime and civil law violation, made intentionally for personal benefit and/or to give harm to someone else. Fraud as a noun has two meanings: one referring to the fraudulent act itself and another referring to the person who is conducting the false or misleading (i.e., fraudulent) act. Hence, the former one is a deliberate and mostly planned distortion of the truth for a gain and the latter is the person who provides this misleading and false information.

Fraudulent conducts or discoveries that are fake and deceptive information or data are found in different domains such as in personal life, in business life, in the financial systems, in the governmental systems, in marketing, in consumption practices, both by the marketer or by the consumer, in art, in science, and so forth.

*“Consumer fraud is an expansive term that includes a seemingly endless variety of unfair and deceptive acts. It usually involves some form of trickery used to achieve an unfair advantage in retail sale. In popular usage, many consider any bad buying experience to be a consumer fraud”* (Noorgard and Norrgard 1998, p 8). However, fraud in consumption practices should take not only marketer’s fraud into consideration but also consumer’s fraud. Because fraud is not exclusively committed against consumers, one should also consider fraud committed by consumers (Lee 2000).

#### **11.3.1.1 Fraud in the Corporate World, Fraud in Business: Corporate Frauds**

Fraud in business is the use of dishonesty and deception or untrue claims by hiding or omitting the real facts or some part of the real facts which is done for an unlawful, material benefit which results in harming the interests of others. Corporate fraud is conducted by large firms or organizations rather than individuals. Two of the most infamous corporate frauds, for instance, include the collapse of Enron 2001 and WorldCom 2002 which made auditing practice come under scrutiny. Arthur Anderson, the audit firm for both cases, has ignored the overstated profits and financial profile and statements of both firms and put its approval, committing one of the largest auditing frauds in the history corporate fraud.

#### **11.3.2 Enron 2001**

One of the largest frauds and audit failure in the business world history is the Enron Scandal in 2001 which caused two American giant firms go into liquidation and shut down: The Enron Corporation, which was an American energy giant based in Texas, and Arthur Anderson, one of the big five audit and accountancy firms in the world. The emergence of the fraud liquidated Enron and dissolved Arthur Anderson. When Enron was in billions of dollars debts as a result of failed businesses, its executives managed to hide this poor monetary condition of the firm from the public by abusing accounting loopholes and poor financial reporting systems. Enron’s executives including the Chief Executive Officer, Jeffrey Skilling, and Chief Financial Officer, Andrew Fastow, gave the wrong impression about Enron’s financial position and deceived Enron’s board of directors and audit committee of high-risk accounting issues, and forced Arthur Anderson to close its eyes to the issues. Hence, Arthur Anderson was also involved in this fraud by overlooking the real financial circumstances of Enron, misleading the folks. As an outcome of this misinformation (i.e., fraud), the shareholders lost almost US\$11 billion as the stock price of Enron shares fell from US\$90 per share to less than US \$1 in a year which led to federal investigations. When these investigations brought



the fraud to the surface, the outcomes of the deception were disastrous for the frauds. Most of Enron's executives were accused of various charges and sentenced to a long period in prison. Arthur Anderson, which was Enron's auditor, was also found guilty, lost its clients, and had to dissolve.

### 11.3.3 WorldCom 2002

WorldCom which was formerly named MCI was a main international telecommunications carrier. Similar to Enron, WorldCom also revealed inflated profits misleading the stakeholders. Consequently, WorldCom filed for bankruptcy with an amount of more than US\$10 billion debt, making it the largest accounting fraud in US corporate history. However, in 2004, WorldCom emerged from bankruptcy with a new name, MCI. It was paradoxical that WorldCom, shedding a US\$36 billion in debt, recovered from bankruptcy with an improved financial outcome: a clean balance sheet. A year later, the newly formed MCI was acquired by and became Verizon Telecom.

In order to improve the confidence in financial reporting of public firms, new rules, regulations, and legislations were passed in the USA, although this did not help those shareholders who only received limited returns on what they had lost due to that fraud (Premeaux 2009). The exposure of the Enron Scandal and other financial frauds (Asthana et al. 2009; Nelson et al. 2008; Verschoor 2008) in some American enterprises in 2001 resulted in corporate governance being the key focal point of related international organizations and institutions (Lee et al. 2009b). Another outcome of the Enron Scandal is the US energy markets' price manipulations in energy markets becoming an animated political and economic subject matter (Marthinsen and Gai 2010). Accordingly, more emphasis is given to financial transparency in corporate governance, or to factors influencing a firm's performance (Lee 2000; Noorgard and Norrgard 1998).

Fraud in businesses is mostly used to gain some unwarranted financial benefits from the governments in various ways. Sometimes firms hide information regarding their employment, that is, by the employment of illegal or undeclared labor by hiding the legal, and sometimes about their earnings to pay less tax (i.e., tax fiddles) or illegal export or import of supplies (Hjalager 2007).

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## 11.4 Fraud in Politics

The political scene of nations is not at all free from fraudulent scandals, for instance the **Watergate Scandal** in the USA in the 1970s which resulted in the resignation of the then President, Richard Nixon, and indictment and conviction of his several administration officials in 1974. Five men from the "Committee to Re-elect the President" broke and entered into the Democratic National Committee headquarters at the Watergate office complex in Washington, D.C. on June 17, 1972. Subsequently, FBI associated the men with a slush fund, a corrupted auxiliary monetary

account (i.e., a reserve fund to be used in favor of the elections). They were charged with conspiracy, burglary, and violation of federal wiretapping laws.

## 11.5 Fraud in Marketing

Fraud in marketing is found within the framework of marketing ethics which refers to the ethical practices and regulations in the area of marketing. As marketing holds in key areas of the markets made up of marketers, consumers, and the products and services available in the markets, the parties involved in a marketing fraud may be twofold which may also be conceptualized as a stakeholder-oriented discourse:

1. *Marketers.* Specifically, this is fraud conducted by the manufacturers, producers of the products or services, wholesalers, retailers, other intermediaries, distributors, or sales agents who are selling the products to publics.
2. Consumers who mislead the marketers.

From marketers' fraud framework, that is, process-oriented discourse, fraud conducts may occur in areas or procedures of

1. Production, provisions, supervision, research, or conduct of products and services
2. Pricing issues and strategies
3. From physical distribution to selection or conducts of distribution channel members
4. Promotions including personal selling, direct selling, infomercials, sales promotions, public relations, relations with media and governmental entities, publicities, advertising, and media

In view of that, fraud in marketing may be found in three different discourses.

1. Value-oriented discourse in which there are fraudulent issues that breach some values or virtues such as honesty, autonomy, respect to independence, privacy, confidentiality, and transparency. This discourse is with relation to the outcome of fraud.
2. Stakeholder-oriented discourse in which fraudulent conducts infringe stakeholders' interests (i.e., everyone who will be affected by the action of the firm, such as shareholders, employees, consumers, competitors, public, governments, and so forth).
3. Process-oriented discourse in which fraudulent conducts occur in marketing practices including production, pricing, distribution, placement, and promotion of products and services.

### 11.5.1 Multilevel Marketing Approach

Additionally, there are some corporations that use a very controversial marketing strategy, the Multilevel Marketing (MLM) approach. The MLM is very debatable among scholars and practitioners in terms of its legitimacy, that is, whether it is an ethical and legal marketing action or fraud. An example is Amway Corp. that built

its whole marketing system according to this pyramiding approach. MLM is a form of direct selling, and is also called network marketing, referral marketing, pyramid selling, or pyramiding. Firms that employ this marketing strategy pay the promoters for their own sales plus for the sales done by the promoters introduced to the firm by the original promoter. Accordingly, the sales distribution channel of the firm is made through the main (initial) distributors (i.e., sales force) as well as the new sales force introduced to the system by the initial sale force. Accordingly, the firm compensates the initial sales force for the sales made by them and for the sales made by the new sales force. Hence, MLM involves initial members getting commissions from recruiting new members which is outlawed in most states in the USA as “pyramiding” (Vander Nat and Keep 2002).

### 11.5.2 Mass Marketing Fraud

Mass marketing fraud is fraud committed via mass communication media such as telephone, mail, and the Internet. Mass marketing fraud is aimed at individuals, businesses, or staff (i.e., employees of businesses). A fraud attracts potential victims with fake assurances of cash prizes, products, and services, mostly for up-front fees, taxes, delivery expenses, duties, or donations. These false promises are typically “too good to be true” and are unsolicited offers; that is, they could claim that you have received or won something which you never ordered or participated in. Usually, this kind of fraud uses high pressure sales techniques such as that requires immediate action, payments in advance, or personal information on the phone or email. According to Federal Bureau of Investigation (FBI) report, some common fraud themes are foreign lottery and sweepstakes, Nigerian letter scams (in which you are required to provide your bank account details), credit and loan scams, overpayment scams, and charity scams (see, FBI Report [http://www.fbi.gov/page2/august09/massmarketing\\_081409.html](http://www.fbi.gov/page2/august09/massmarketing_081409.html)).

The phony sweepstakes or lottery scams are targeted not only at individuals but also at businesses. Some common frauds targeted at businesses include one in which they pretend that they are the usual office supplies provider and request for payments from the firm without delivering the products ordered. Or they could ask you to buy a nonexistent advertisement space in a nonexistent business directory. Or your firm receives invoices for unordered or undelivered products or websites.

Mass marketing fraud involves three general domains:

1. Materially false or misleading representations made knowingly or recklessly
2. Deceptive telemarketing
3. Deceptive prize notices
  - (a) False or misleading representations. This involves intentionally or carelessly making, or accepting the making of and disseminating, a false or misleading material matter to the public. Those false claims may be in relation to the standard, quality, value, grade, composition, style, model, or history of goods or services or make false claims about their characteristics or benefits.

- (b) Deceptive telemarketing. Telemarketing is the attempt of selling of products or services over the phone. Deceptive telemarketing is about the making, or the allowing of the making, of materially false or misleading representations so as to endorse the supply of a product or service during person-to-person telephone calls.
- (c) Deceptive notices of winning a prize. They give recipients (potential victims) the impression that they have won a prize or any other benefit. They usually require recipient to pay money in advance or incur a cost in order to obtain the prize or benefit. In fact, the recipient has not won a prize, in fact, he hasn't even entered a contest, and there was not a drawing of prizes in the first place.

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## 11.6 Consumer Vulnerability to Fraud

Scam literally means a trick used for a gain in slang language; that is, scam is a fraudulent business scheme. A person (i.e., a scam victim) is scammed (i.e., cheated) by a swindler by means of a stratagem. Swindle is to defraud one of money or property or obtaining something by fraudulent means and a swindler is the one who practices fraud as a means of obtaining money or property. Scam or swindle represents consumer frauds. Scams cause a massive negative charge on consumers and society. Scams' exact annual costs are over US\$100 billion and telephone scammers cost over US\$40 billion alone in the United States. The globalization efforts (Schachter 1996) and the rapid growth in the Internet practices have all added to these dishonest practices. Through the use of the Internet, con artists have entered an increasing market and are able to locate untapped consumer base which they could not identify easily before the advent of the worldwide web (www). Unfortunately, all the preventive steps taken to date have been mostly unsuccessful.

Consumers differ in their scamming vulnerability, such as elderly people, teenagers, young people, children, and disabled people would be more vulnerable to scamming conducts than others. There are various types of scams applying different baits and techniques; hence, it is not possible to define a typical scam, but the pattern is almost similar in all these diverse scamming activities. Hence, a typical pattern or procedure of scamming would be as follows: First, scamming practices commence with the identification of a potential victim. The identification of a victim may be twofold: by the swindler deciding on a particular target or placing an advertisement to which a potential victim may react (reply). Second, the swindler starts with the assessment process of the victim. Accordingly, the swindler evaluates the target and decides whether the potential victim is worth further conduct. Then, the deception commences in which the con artists would initially gain the victim's trust and focuses the victims' attention on particular basic rewards such as money, prizes, miracle cures, health or wealth promises, and so forth. Prize promotions scams, for instance, are the ones which claim that you have won a particular price from another country, say a firm in Canada (Kurt 1996). Next, the swindler convinces the victim that some money has to be paid beforehand so that

the promised product or service could be delivered with tricky justification by the swindler of this up-front payment to be made by the victim. For example, in the case of prizes, you are asked to pay up front for the delivery or custom duties. After that, the victim transfers the money in order to receive the product, service, or the prize s/he has won. Finally, the swindler disappears; needless to say, no prize or promised products arrive (Langenderfer and Shimp 2001).

### **11.6.1 A Potential Outcome of Corporate Frauds: Fraudulent Practices, Consumer Resistance, and Boycotts**

Fraudulent practices of firms in particular or consumerism in general have allowed people to engage in consumer resistance practices. They take the forms of anti-consumption movements or consumer boycotts (Yuksel and Mryteza 2009). A variety of recent and novel ideas surfaced with a significant attention offered by consumer researchers in the domain of consumer resistance and anti-consumption. Hence, resistance studies in social research as well as anti-consumption literature are enriched with an assortment of different perspectives (Sandikci et al. 2005) in conceptualizing the consumer resistance and anti-consumption phenomena. However, there is still much uncertainty about the conceptions of anti-consumption and consumer resistance with regard to whether they are indicating toward the same underlying principle of withholding consumption.

Consumer resistance is the confrontation of people toward some type of consumption, fraud in consumption, or consumerism in general. Consumer resistance has two facets. As such, the first facet of resistance may be an active (or proactive) behavior in which consumers may aggressively attack, confront, conflict, and battle a particular product. On the other hand, the second facet represents a passive behavior (i.e., reactive in the form of post-action) in which consumers defend their position, oppose, or refuse to accept a particular product. Consumer resistance resembles anti-consumption in particular, when resistance is considered in its second, passive facet. Anti-consumption emerges via inaction with regard to stopping consumption (i.e., not purchasing, not consuming, etc.), as does the second facet of resistance. However, consumer resistance may differ from anti-consumption with its first facet, because anti-consumption is a passive mode of action while resistance may be both active and passive. A protest or walk against an idea, a practice, a corporation, and so forth, for example, falls in the domain of active resistance. Although anti-consumption behavior may also be termed as proactive (internally driven) or reactive (externally driven); this mode is related to the origin or source of anti-consumption trigger or call which causes an individual to stop consuming rather than the type of an active behavior (i.e., attacking versus defending). More specifically, resistance embraces also anti-consumption phenomena for resistance (which may sometimes represent a mere attitude) is an antecedent of anti-consumption behavior.

Specifically, anti-consumption means the inaction of people toward consumption promotions, appeals, and practices by not purchasing. This phenomenon may

be associated with opposing consumption in general (as a life style) or in particular (e.g., a brand or product category; Gopaldas 2008). They are then called selectively practiced anti-consumption (e.g., politically motivated brand avoidance such as boycotting) and generally practiced anti-consumption (e.g., a lifestyle choice such as voluntary simplification; Lee et al. 2009a). People's rationale in not consuming or stopping consuming may vary. Consumerism is conceptualized as personal happiness with consumption and the purchase of material possessions while anti-consumerism is the outcome of a sociopolitical movement, a call for consumer resistance against consumerism.

The politically motivated brand rejection as an emergent form of resistance behavior is a form of boycotting in which people refuse to purchase and/or use a brand (i.e., anti-consumption) due to its perceived association to a particular political ideology that the consumer opposes (Sandikci and Ekici 2009). Boycotts, as a mode of consumer resistance, usually activated by an ethical or political motivation, serve as a method for consumers to communicate their displeasure of a company's product or corporate behavior (Yuksel and Mryteza 2009; Zack 1991). Hence, a boycott represents an active mode in its action or inaction by withholding consumption, and therefore, conceptualized as consumer resistance and movement.

Boycott literature conceals two key domains: (1) consumer boycotts as marketing-policy boycotts (Sen et al. 2001) and (2) corporate boycotts as corporate-practice-related boycotts (Yuksel and Mryteza 2009). Previous boycott literature covers areas such as types of boycott behavior (Kozinets and Handelman 1998), motivations that underlie participation (John and Klein 2003; Klein et al. 2004; Sen et al. 2001; Tyran and Engelmann 2005), and firm's effective managerial and strategic responses to boycott calls (Yuksel and Mryteza 2009). That is, *"the relative effectiveness of the various marketing strategies, in particular the public relations strategies, that firms use to combat the likelihood of boycotts as a politically motivated form of anti-consumption"* (p 248).

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## 11.7 Consumer Frauds

Fraud in consumption practices should take not only marketers' fraud into account but also consumers' fraud for the reason that fraud is not exclusively committed against consumers, but also by consumers (Lee 2000). In fact, there are consumers misbehaving themselves in exchange settings and are unavoidably influenced physically, financially, and/or psychologically. These misbehaviors infringe the commonly permitted norms of conduct during consumption practices. Accordingly, fraud conducted by consumers in order to gain personal benefits is termed consumer fraud representing the dark, negative side of the consumer. For example, fraudulent, illegitimate, or faked consumer complaints fall in this category. These are mostly intentionally, preplanned, feigned complaints of ("in fact") satisfied customers about calculatingly and purposely fabricated issues, such as untrue product or service failures in order to receive, for instance, reimbursements (Kowalski 1996; Piron and Young 2000; Reynolds and Harris 2005). Other forms of consumer

misbehavior include shoplifting, credit card and check fraud, vandalism (mostly among teenagers), “financial fraud and physical or verbal abuse of other consumers and of marketers’ employees” (Fullerton and Punj 2004, p 1239). Daspin (2000) reports other types of fraudulent misbehavior conducted by consumers from “sneaking into first class on an airplane and sitting there while traveling on a coach ticket”, to “playing on a golf course without paying green fees by starting at the third or fourth hole”, to “driving away without paying after filling-up with gasoline at a pump” to “buying items such as a party dress or a power tool, for a single use, and then returning them” (Fullerton and Punj 2004, p 1239) to abusiveness toward marketers’ employees, to tag-switching, and to bad check passing to name a few. These misconducts may possess various dimensions including the nature of the misbehavior, degree of disruption, and the reaction(s) by marketers, employees, and other consumers. The targets of the consumer misconduct may be:

1. Marketer’s employees
2. Other consumers in the exchange setting
3. Marketer’s merchandise and services
4. Marketer’s financial assets
5. Marketer’s physical or electronic premises

According to these targets, varieties of consumer misconducts include (Fullerton and Punj 2004, p 1240).

1. Directed against marketers’ employees (Curtis 1971; Richins 1983; Schultz 1978):
  - Verbal abuse of marketers’ employees
  - Physical abuse of marketers’ employees
  - Willful disobedience of rules
  - Bizarre behavior
2. Directed against marketer merchandise (Best and Luckenbill 1982; Cox et al. 1990; Schultz 1978)
  - Shoplifting
  - Fraudulent returns
  - Switching/altering price tags
  - Abusive exploitation of advisory services provided by marketers
  - Theft from service institutions
  - Coupon misredemptions
  - Use of forged or stolen tickets
  - Copyright theft
3. Directed against other consumers
  - Jumping queues
  - Illegitimate use of express or “cash only” checkout lines
  - Hostile physical acts
  - Annoying to ominous behavior towards other consumers
  - Criminal behavior in exchange settings
4. Directed against marketer’s financial assets (Albrecht et al. 1982)
  - Defrauding retail cashiers
  - Failure to report billing errors favorable to consumer

- False or questionable claims of injury on marketer premises
  - Bad check passing
  - Credit card fraud
  - Loan fraud
  - Fraudulent assertions to avoid payment
  - Warranty frauds
  - Insurance fraud
  - Computer-based consumer crime
  - Rumor generation
  - Sabotage of marketer's goods
5. Directed against marketer's physical or electronic premises (Schultz 1978).
- Destructive theft acts
  - Vandalism (i.e., damage, destruction)
  - Arson (i.e., fire-starting)
  - Database theft
  - Denial-of-service attacks on retail websites
  - Spreading computer viruses

### Conclusion

This chapter has explained the fraud phenomenon in the domain of marketing and the consumption world.

Marketers like their other professional colleagues have also been affected by this white-collar crime of over time. It should not be assumed that fraudulent acts are only perpetrated against marketers by consumers, but there are some not "fit for purpose" marketers who defame the profession by carrying out fraudulent acts against their consumers. They like individual fraudsters should similarly be made to pay the price of the socially irresponsible acts.

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## **Part IV**

### **Concluding Remarks**

Samuel O. Idowu

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## 12.1 Introduction

To say that the modern business environment is permeated with fraud and all its related socially unacceptable criminal acts, which are perpetrated by the so-called white-collar criminals, is neither an attempt to frighten anyone nor to overemphasize the seriousness of the problem.

Historically, the crime of fraud and deception is not new, but the incidence has been alarmingly high in recent years. In recent years, the forms the crime is perpetuated have changed drastically due to modern advancements. These crimes are costing the global economy dearly in both financial and nonfinancial terms. Several of the preceding chapters have quantified the financial costs to stakeholders of some of the resulting consequences of fraud, corruption, and financial reporting scandals in many countries. It appears that the nonfinancial consequences might be very difficult to quantify, simply because the social impacts of the crimes could affect an unquantifiable number of people and the environment. This, therefore, means that stakeholders need more decisive actions from governments, corporate entities, law enforcing agencies, and everyone regardless of where they live on planet Earth. The problem is everybody's business, and finding solutions to it must involve everyone!

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## 12.2 Modern Technology and White-Collar Crimes

The advent of the Internet has in fact exacerbated the problem. Fraudsters in some parts of the world are taking advantage of modern technology—the Internet, to impersonate financial institutions or other corporate entities in order to retrieve confidential personal details from unsuspecting innocent citizens either in their own

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country of abode or in some foreign countries in order to commit crimes—this is unsustainable. Some gullible individuals when told by these scammers through the email or text messages on the cell phone that they have won a large sum of money or some parcels are on the way to them but they need to provide some personal details or pay some money upfront before the prize could be released to them easily succumb to such unbelievable statements. They too are either fraudulent individuals or certainly gullible and living in a dream world! Such individuals need to be forewarned that anything too good to believe is definitely false.

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## 12.3 Some of the Perspectives Taken by the Book

All the chapters in this book have competently addressed several of the pertinent issues. In some cases, some of these chapters have either identified solutions to some of the problems arising from the criminal acts or noted some preventive measures which could be taken in order to avoid being taken for a ride by these fraudsters.

*Mermod* in a chapter on “*Fraud in modern Banking: Highlights on on-line internet Banking Fraud*” provides a comprehensive list of some of the possible scamming methods used by modern fraudsters to commit banking or financial services-specific crimes. *Mermod*, for example, notes in the chapter that banking fraud could be either internally or externally initiated and perpetrated by fraudsters. Internet banking, we are told, has many advantages to both the bank and its stakeholders. Should we allow criminals to deprive us of these advantages in modern advancement? The answer from this author and of course a large number of people worldwide is certainly a big no! This therefore makes *Mermod's* contribution a must read chapter by anyone still unfamiliar with all the online fraudulent techniques used by Internet fraudsters. These fraudsters, as anyone who has seen their scam would tell you, are indeed very skillful in making the information they send to their victims look real.

The issue of corporate governance has taken center stage in the twenty-first century business management as a result of a series of corporate financial scandals which have plagued both the developed and the developing parts of the world. This is most welcome. Several of the chapters have understandably mentioned Enron and of course the SOX Law of 2002 in the USA. Interestingly, *Kaur* brought to the fore the case of what he describes as *India's Enron*! The chapter provides a comprehensive assessment of what went wrong in Satyam Plc, a former Fortune 500 company, and the roles the external auditors and some senior executives of the company played in the total failure of corporate governance in the company. There are certainly many lessons to learn from all these corporate financial scandal cases highlighted in the book. The law should not be allowed to abandon innocent stakeholders to suffer due to the fraudulent acts of corporate executives and other third parties.

*Gohar et al.* focus on corruption in several parts of the world with particular reference to their own country of abode. Corruption is not a disease of any

particular economy; it is a general problem regardless of whether you are located in the East, West, North, or South, but the seriousness of corruption differs from one country to the next. The incidence of this unacceptable practice might be more pronounced in the less developed parts of the world because of the level of poverty in those countries which fall into this category. Corruption has many adverse effects on economic and political developments. These scholars were able to examine the effects of corruption on Foreign Direct Investments (FDIs) in Pakistan while looking at the correlation between economic and political factors and FDI. *Gohar et al.* in fact provide a league table of corrupt nations of the world.

*Çahyurt* who is very concerned about the incidence of fraud perpetrated against SMEs believes that not enough has been done to protect small- and medium-sized enterprises. This was perhaps her motivation in devising what she refers to as the *Fraud Free Company Model*. *Çahyurt* believes that any SME which uses this model should be able to prevent fraud being perpetrated against it. The jury is out on this!

Forensic accounting is a growing field over the last few decades. Similarly, the work of the Association of Fraud Examiners (ACFE) continues to increase in popularity. The problem and incidence of fraud over the last few decades are perhaps responsible for the growth in these two fields. Several of the chapters have focused attention on both forensic accounting and the activities of the ACFE. *Sadiq* in a chapter on forensic accounting argues that there is a correlation between corrupt practices and life expectancy, and some of the roles forensic accountants would play could extend lives. This perhaps connotes the impression that corruption is a health hazard, as a result of its social impacts. Without fully understanding *Sadiq's* argument, one might assume that the author was only making a mockery of the effect of the problem. This certainly is not the case. Whatever public funds corrupt politicians or others divert to the own private resources have social consequences on citizens of the nation. For example, it prevents the building of hospitals, buying the required drugs and medicines for hospital patients, the employment doctors and nurses, etc. The absence of all these, needless to say, shortens lives. The work of forensic accountants should hopefully provide the warning signs that things are not in order.

In conclusion, we believe that together we can all make a big difference in solving these social crimes by our small actions in all our different areas in life. If you asked a victim of fraud, he or she would tell you it is an unpleasant experience. That man through his search for a better way of communicating with his fellowman was able to discover and put to use the Internet should be celebrated, not abused by some criminals! Greed is perhaps the root of corruption which encourages underdevelopment and poverty in the less developed world. Politicians and those with easy access to public funds in all parts of the world should be aware of this.

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