

Review Article

A Solution to Corporate Fraud

Ipsita Ray

Author Affiliation

Assistant Professor, School of Law,
Christ University, Hosur Road,
Bangalore, Karnataka- 560029.

Reprint Request

Ipsita Ray

Assistant Professor, School of Law,
Christ University, Hosur Road,
Bangalore, Karnataka- 560029.
E-mail:
ipsiray@gmail.com

Abstract

Law is the procedure to maintain harmony and balance in the society. Humans were the only subject of law, but after industrial revolution, the world has witnessed corporate giants holding more wealth than small economies of the world. Thus, corporates have placed themselves as subject of law. Each corporate has a CEO who dictates corporate policies which revolves around a sole motive of earning profit. The capital is collected by deposits from general public to conduct business. But in real practise, a handful of wealthy families control the entire corporate world. Occurrence of corporate fraud has become a common problem throughout the world. Such frauds can be controlled by identifying the distinction between personal and corporate funds. It is essential for ethical conduct of business. Ethical dilemmas arise from conflicting interests of parties involved. The core ways of handling frauds in organisations can be classified into two broad headings: Corporate Governance and Corporate Social Responsibility. Corporate governance is a prescribed set of system, process and principles which ensures fair and transparent governance of a company. Corporate Social Responsibility (CSR) shows the path of ethical conduct. It provides a philosophical foundation for responsibilities of corporations. CSR works to makes business effective and at the same time it makes the business organization a good and just society. It ensures the following of principles of contributive justice. The author proposes to reflect a solution for corporate frauds by combining the concept of corporate governance and corporate social responsibility.

Introduction

The rapid growth of trade and commerce has brought a dynamic change in the course of business. Gone are the days when sole proprietorship or simple forms of partnership used to dominate the business world. The consumer preferences have increases many folds and thus, a new form of business mechanism came into existence which is

known as company or corporation.

The word company has been derived from two Latin terms: *com* and *panis*. 'Com' means with or together and 'panis' means bread. Thus, originally the world 'company' denotes an association of people who took their meals together. In other words, company is an association of person incorporated for common purpose and thus evolved as a new form of business mechanism.

According to Justice Lindley, "a company is an

association of many persons who contribute money or money's worth to a common stock and employed it in some trade or business and who share the profit or loss arising there from. The common stock so contributed is denoted in money and is the capital of company. The persons who contributed it or to whom it belongs are the members. The portion of capital to which each member is entitled is his share. The shares are always transferrable although the right to transfer them may be restricted" [1].

A company is an association of persons who conduct business with common stock as contributed by the members of association. Industrial Revolution in nineteenth century had given momentum to conduct business by joint stock companies. Companies like British East India Company were incorporated to satisfy trading interests. These companies started crossing international borders in search of raw materials and thus the concept of transnational corporations evolved. The post-Second World War has witnessed a trading regime controlled by transnational Corporations. For example, in US half of the imports can be regarded as transactions involving transnational corporations. (Krugman & Obstfeld 2000). According to World Investment Report, these corporations influence the nature and size of world economy with their international transactions [2]. With huge capital in hand, these giants have started manipulating the funds. The first part of the paper focuses on the conceptual aspect of corporate fraud. The second section of the article throws light on certain instances of corporate frauds whereas the third section looks for reasons of corporate fraud. The fourth part emphasises on solution for corporate fraud.

Corporate Fraud

Webster's New World Dictionary defined fraud as the intentional deception to cause a person to give up property or some lawful right. Publication of misstatement by a corporation to deceive the shareholders and other stakeholders, is known as corporate fraud.

Bologna (1995) classified corporate fraud on the basis of victims: *internal* fraud and *external* fraud. Fraud is internal if the victim is internal. The board of directors, managers may suffer a financial as well as reputational loss and thus may be termed as internal fraud. On the other hand, external fraud deals with loss of investors, creditors, suppliers, customers [3]. Davia had classified corporate fraud as transaction versus statement fraud. Transaction

fraud represents embezzlement or stealing of organizational assets whereas statement fraud denotes misstatement of financial values. The objective of statement fraud signifies intentional enhancement of profit index to defraud shareholders and creditors [4]. In Davie's terminology, these two classifications can be termed as *financial statement balance* fraud and *asset- theft* fraud.

The present world has seen scams and frauds which have damaged economy globally. Collapses of high profile companies have raised the question relating to effectiveness of financial reports and credibility of audit committees. The purpose of publishing financial report and audit reports is proving futile as increase in corporate frauds have dampen the confidence of investors.

Few Instances of Corporate Fraud in India

Though there are numbers of corporate frauds have taken place in India yet a few have been discussed here to understand the problem at hand.

Satyam Scam

From Satyam Scam, Ketan Parekh Securities scam and NSEL scam, it appears that corporate fraud is turning into a major problem in India. Generally there are three categories of people who commit corporate fraud. They may be top officials like CFO or CEO or middle-level or low-level management staff [5].

Research shows financial audit reports are not the reliable source to detect fraud. Satyam Scam is one such example. Satyam Computers Services Private Limited was incorporated in 1987 in Hyderabad by Mr. Ramalinga Raju. It was a 'rising star' IT-service industry. Since 2005 Satyam won several awards. But, unfortunately immediately after bagging 'Global Peacock Award' for global excellence in corporate accountability, it become the focus of accounting fraud. On 7th January 2009, Mr. Raju disclosed to the Board of Directors of the company that he was manipulating company's accounts for years. One and half billion dollars were not existent in company's accounts. The company has been overstating accounts for several years. Mr. Raju along with global head of internal audit had opened several fake accounts to satisfy his greed of money. According to CBI reports, fraud can be traced back to 1999 when the company started showing double digit growth rate. Mr. Raju had violated all his duty of care as was imposed upon him as a fiduciary.

The objective of the fraud was to divert company's money into real estate investment business, show inflated profits and to make huge profit by selling state at higher price. Initially the gap between the accounts book and reality was nominal but with passage of time, gap became unmanageable.

Role played by Auditing Firm

Satyam has claimed \$1.04 billion in non-interest bearing accounts. According to accounting professionals, any company with such huge amount will either invest in interest bearing account or hand over the excess fund to shareholders. This raises suspicion on Price water house Coopers (PwC), global firm which audited Satyam's accounts since 2000. Moreover, the auditors never verified the figures independently about the money from the bank.

Another interesting point regarding PwC is that Satyam paid twice the money to PwC for auditing. Does that mean the auditing firm is an integral part of the whole scam? Furthermore, Price water house Coopers had audited the accounts of Satyam for nearly a decade and they could not discovered the fraud whereas Merrill Lynch uncovered the fraud within ten days [6].

Outcome of Satyam Fraud

Satyam share prices fell to 11.50 rupees. Merrill Lynch severed all ties with Satyam. PwC faced serious scrutiny from the whole sector. In fact, all other clients of PwC were also under suspicion. But, immediately after the declaration of fraud, steps have been taken to rescue Satyam. New Board of Directors was appointed without wasting any time so that the firm can survive the situation. The new board started looking for solutions to save Satyam from meeting same fate as Enron. On the other hand, Indian Government started investigating the fraud. The government had set up a time line of hundred days to sell off the company. Securities and Exchange Board of India (SEBI) appointed a retired Supreme Court Justice, Mr. Barucha, to supervise the auction. Finally, Tech Mahindra brought Satyam after making the highest bid and Satyam could be saved from meeting the same fate as Enron.

In January 2014, the Economics Offences Court convicted Mr. Raju and others to imprisonment for Satyam Scam. The male directors involved in the scam were imprisoned for one year with ten thousand rupees fine whereas female directors were granted a sentence of six months with five thousand rupees penalty [7].

Ketan Parekh Securities Scam

Ketan Parekh fraud started in 1990s which resulted in bringing down several co-operative banks in India. There is a striking similarity between Satyam fraud and Ketan Parekh fraud. Both frauds were committed with the help of top managements.

Although Ketan Parekh (KP) was a successful broker, he did not have enough money to buy large stakes [8]. According to analysis, KP borrowed from various companies and banks for fulfilling its objective. KP used to buy shares from the market at low prices and when prices go high, he pledged the shares with banks for getting funds. A small Ahmadabad based bank, Madhavapura Mercantile Cooperative Bank (MMCB) was the main partner in the fraud. First method they used was pay order route. KP used to issue cheque drawn on Bank of India (BOI) to MNCB, against which MNCB used to release pay order. Second route is issuing of loans to KP without sufficient collateral security. At the same time, KP was also collecting money with the help of other brokers and agents from the Mandvi branch of the same bank [9].

The pay order route turned out to be fatal for public sector banks like State Bank of India, Bank of India, and Punjab National Bank. The Global Trust Bank also issued loans to KP.

NASDAQ crash in December 2000 led to payment problems in the markets. Payment crisis in Calcutta Stock Exchange (CSE) was the major blow on business activities of KP. Brokers from CSE used to buy shares for KP. Officially the scrips were in the name of brokers but in practice KP had control over them. These scrips were the safety valve for KP and paid 2.5 per cent weekly interest to the brokers. By the beginning of 2001, the value of these scrips reduced to half. CSE brokers started pressurizing for payments and thus KP turned to MNCB for loan which MNCB honoured without any security.

Small investors, who lost almost every penny of their savings in the scam, believe the scam is the result of broker-banker-promoter nexus proved fatal. On the other hand, SEBI was also blamed of poor market intelligence.

Parekh was arrested and was in custody for fifty-three days and then released on bail in May 2001. Though Parekh is currently bared from stock trading, he is still operating through various companies and other actors [10]. CBI Court has convicted Parekh for cheating to two years of rigorous imprisonment. Aftermath of the scam resulted in reduced trading cycle. Thus trading cycle is now one day instead of one week. Forward trading was formally introduced

in the form of exchange-traded derivatives to endure a well regulated future market [11].

NSEL Scam

NSEL is promoted by Financial Technologies India Ltd. and National Agricultural Cooperative Marketing Federation of India Ltd. (NAFED). The scam was identified when National Spot Exchange could not pay its investors in July 2013. NSEL was promoted as a spot exchange and mere 100 shares were assigned to NAFED so that the brand name can be used.

NSEL got exemption from Forward Contracts Regulation Act (FCRA) 1952. The exemption was granted by the then head of Consumer affairs Minister, Mr. Sharad Pawar. The exemption was allowed only for one day forward contract to eleven days contract. Later in 2010, the company applied for registration of contracts exceeding eleven days to FMC. FMC did neither approved nor reject the same. NSEL went ahead with selling long term contract with the help of brokers. The Ministry of Consumer affairs had full knowledge of these illegal contracts but nothing was done to stop them.

In the beginning of 2012, FMC was appointed to collect data from NSEL for protecting investors' interest. One show cause notice was issued to NSEL for violating registration norms under FCR Act. It was realized only in 2013 that most of the underlying commodities did not exist and all the transactions were only on papers. Many borrowers got funds without any underlying commodity deposited. One of such borrower is a company owned by the son-in-law of the former chairperson Mr. Shankarlal Guru of NSEL. Moreover, minutes of the meetings were showed warehouses which existed only on paper.

Mr. Jignesh Shah, promoter, had powerful political connections. Thus, the company managed to escape for a long period of time. To add to the benefit of the company, there is no particular body to regulate spot commodity trading. The formal authority, Forward Markets Commission, has powers only on paper. There is no sanction attached to the authority. Another aspect of the fraud includes ex-officials being part of MCX and vice versa [12]. But later, Mr. Jignesh Shah was arrested. Shah has been charged with criminal misappropriation, forgery, criminal conspiracy and the MPID Act for defrauding investors [13]. This scam was a pre-planned and pre-mediated.

All three corporate frauds discussed in the paper prove certain commonality in frauds. The next part of the paper shifts its focus to such issues.

Issues involved in Corporate Frauds

Financial statement fraud includes three characteristics namely, opportunity, attitude or rationalisation and motive or pressure. **Cressey** (1986) calls these three factors as fraud triangle. Opportunity provides the circumstance for the management to commit material manipulation on financial statement. Rationalization relates to morals and ethical values. Fraudsters look for a way to reason their action. Lastly, motive is greed for profit. It is in scripted in human nature to look for some extra easy money. The target group for these fraudulent companies always involve people who are in need of extra money.

The next issue is related to transparency. Company accounts involve complex financial statements which allow the wrong doers to manipulate the financial statements to prove creditability of their companies.

Next in line is poor management information. When a company is not producing result and other reports in timely manner, it can be presumed that some accounts and reports are being manipulated. Many companies make their audit committee to report to their own Financial Directors. When the internal audit committee, work in non-independent matter, the likelihood of fraud increases. Many a times, signals of fraud are ignored by such authorities.

Corruption is one of the leading causes of fraud. Starting from the top level to lower level, officials become corrupt. Each official safeguards the other and thereby the magnitude of fraud increases to a great extent until it gets exposed. Thus, it is clear that corporate fraud happens because of various reasons and therefore the next section of the paper deliberates on a proposed solution to corporate fraud.

A proposed solution to corporate fraud

Corporations around the world are struggling with corporate frauds and it is an established fact that imposing strict legal framework is not helping to stop such occurrence. Such frauds can be controlled by identifying the distinction between personal and corporate funds. It is essential for ethical conduct of business. Ethical dilemmas arise from conflicting interests of parties involved. The core ways of handling frauds in organizations can be achieved by sharing of responsibility from both sides: Corporate Governance and Corporate Social Responsibility.

Corporate governance is a prescribed set of system, process and principles which ensures fair and transparent governance of a company. The

purpose of corporate governance is to promote the enterprises in timely disclosures of financial and other reports to address the major concerns of investors and other stakeholders. The process also helps enterprises to attract investment.

One of the common methods of good governance involve disclosure of financial and operating results. All corporate governance codes around the world, including OECD and ICGN principles, expressly require the board of directors to furnish such reports.¹⁴ Mere availability of guidelines is not enough. The board could easily identify the loop holes of the financial situations and thus can be easily manipulated. The investors should also equip themselves against such instances. Frauds do not happen in one day. Every manipulation signals detection. Investors can keep an eye on incentives for CEO and CFO. If the incentives are higher than their base salary then the executives will be more motivated for manipulating company books. Another signal can be late or amended fillings. It is the responsibility of the investors to dig a little further to determine whether it was a mere clerical error or deliberate misstatement [15].

On the other side, Corporate Social Responsibility [16] can be defined as a responsibility of enterprises should take in a process to integrate social, environmental, ethical human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders [17].

UNIDO defines CSR as a management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders. CSR is also known as Triple Bottom Line Approach [18]. The three layers involve balance of economic, environmental and social imperatives.

In triple bottom line approach, the companies must take care of the economic interests of the shareholders. Corporations have to take responsibility of the actions taken by their agent. *Salomon versus Salomon & Co* [U.K 1897] had recognized separate identity of corporations from their agents but corporate veil should be lifted to punish the bad man [19] in cases of corporate fraud. The law has to focus on company's internal responsibility process along with external accountability. Therefore, it is always better to make the managers of corporations to distinguish between ethical and unethical conduct of business and not to let the bad man born in their minds.

References

1. Linsdley on Companies.
2. World investment report 1995
3. Tommie W. Singleton, Aaron J. Singleton, G. Jack Bologna, Robert J. Lindquist, FRAUD AUDITING AND FORENSIC, 3rd Edition, August 2006.
4. Howard Silverstone, Howard R. Davia, FRAUD 101: TECHNIQUES AND STRATEGIES FOR DETECTION, 2nd Edition, April 2005
5. D.L. Crumbley, L. E. Heigher and G. S. Smith, Forensic and Investigative Accounting Chicago: CCH Incorporated, 2003.
6. Madan LalBhasin, Corporate Accounting fraud: A Case Study of Satyam Computers Limited, Open Journal Accounting, 2013, 2, P.26-28.
7. Satyam Computers founder B Ramalinga Raju's wife, sons get jail terms, Times of India dated January 10th 2014.
8. The Ketan Parekh Scam, The Factors That Helped The Man, case studies and Management Resources, available at <http://www.icmrindia.org/free%20resources/casestudies/ketan-parekh-scam3.htm>.
9. *Ibid* 4.
10. SEBI alleged indirect participation of Ketan Parekh in 2009.
11. MaliniBhupta, 2001 –Ketan Parekh Scam: Stock and Bull Story, India Today, December 18, 2009.
12. Arindam Mukherjee, The Shah of Fraud, available at.
13. Swati Despande, Bombay HC grants bail to Jignesh Shah in NSEL case, Times of India, available at <http://timesofindia.indiatimes.com/Business/India-Business/Bombay-HC-grants-bail-to-Jignesh-Shah-in-NSEL-case/articleshow/40743733.cms>.
14. Guidance on Good Practices in Corporate Governance Disclosure, United Nations Conference on Trade and Development, New York and Geneva, 2006 available at unctad.org/en/docs/iteteb20063-en.pdf.
15. James A. Kaplan, The Impact of fraud on Shareholder Value: The Price you do not Have to pay, GMI Ratings, available at go.gmiratings.com/rs/gmiratings/images/GMIratings-ImpactofFraud_062013.pdf
16. Herein after referred as CSR.
17. Handbook on Corporate Social Responsibility, Confederation of Indian Industry.

18. The term Triple bottom line approach has been termed by John Elkington in 1994.
 19. Bad- man theory is a jurisprudential doctrine or belief, pronounced by Oliver Holmes J., according to which a bad person's view of the law represents the best test of what exactly the law is.
-

Instructions to Authors

Submission to the journal must comply with the Guidelines for Authors.
Non-compliant submission will be returned to the author for correction.

To access the online submission system and for the most up-to-date version of the Guide for Authors please visit:

<http://www.rfppl.co.in>

Technical problems or general questions on publishing with IJLHB are supported by Red Flower Publication Pvt. Ltd's Author Support team (<http://www.rfppl.co.in>)

Alternatively, please contact the Journal's Editorial Office for further assistance.

A Lal

Publication-in-Charge

Indian Journal of Law and Human Behavior

Red Flower Publication Pvt. Ltd.

48/41-42, DSIDC, Pocket-II

Mayur Vihar Phase-I

Delhi – 110 091

India

Phone: 91-11-22754205, 45796900, Fax: 91-11-22754205

E-mail: redflowerppl@gmail.com, redflowerppl@vsnl.net

Website: www.rfppl.co.in